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Auditing
Procedure
Study

Confirmation of Accounts Receivable

SECOND EDITION, REVISED



American Institute of Certified Public Accountants

Statement of Policy

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This auditing procedure study has not been approved, disapproved, or otherwise acted on by the Auditing Standards Board, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the contents of this study, including recommendations, are not authoritative.

Confirmation of Accounts Receivable

SECOND EDITION, REVISED

American Institute of Certified Public Accountants

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Foreword

This Auditing Procedure Study, *Confirmation of Accounts Receivable*, is designed to provide audit practice recommendations. The objective of the study is to survey and summarize the confirmation of accounts receivable literature in order to identify practical suggestions for improving the effectiveness and efficiency of the receivable confirmation process.

The first edition of this study was written by a group composed of Dan M. Guy (Vice President, Professional Standards and Technical Services, AICPA); Gerard L. Yarnall (Director, Audit and Accounting Guides, AICPA); Carl S. Warren (professor, University of Georgia); and the late Michael J. Barrett (professor, University of Illinois, Chicago). Professor Warren pioneered research in the confirmation area. Professor Barrett was actively involved with confirmation research and drafted a summary-of-literature paper for the study group. The study group was formed in cooperation with the Auditing Standards Committee of the American Accounting Association.

The second edition of *Confirmation of Accounts Receivable* has been revised to incorporate Statement on Auditing Standards (SAS) No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), and the receivable confirmation research that has been published since the first edition was published in 1984.

Although many of the recommendations herein are based on academic research, the study is written for practitioners. Thus, a reader interested in research methods should consult the original research studies. Some of these studies are annotated in appendix B, "Selected Annotated Bibliography."

J. Louis Matherne
Director, Auditing Standards

December 1995

Introduction

According to paragraph 34 of SAS No. 67, The Confirmation Process (AICPA, Professional Standards, vol. 1, AU sec. 330), confirmation of accounts receivable is a generally accepted auditing procedure. In engagements in which accounts receivable are material, independent auditors normally confirm receivables by direct communication with debtors. If it is impracticable or impossible to use confirmation procedures, alternative procedures may be performed.

BRIEF HISTORY

Prior to 1939, confirmation of accounts receivable was not normally performed. Instead, alternative procedures were used to substantiate accounts receivable balances. Although auditors recognized the value of direct communication, many did not use it because they believed their clients would object and would regard the confirmation process as too costly. Auditors also believed that debtors might misconstrue the confirmation as a request for payment.

As a result of the McKesson & Robbins investigation¹ by the Securities and Exchange Commission (SEC) in 1939, the American Institute of Certified Public Accountants (then the American Institute of Accountants), with the support of a membership vote, concluded the following:²

Confirmation of notes and accounts receivable by direct communication with debtors shall be regarded as a generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report.

The AICPA modified its position in 1942, when it recommended disclosure in the auditor's report of all cases in which communication with debtors concerning material accounts receivable was not carried out, even if the auditor was able to substantiate accounts receivable balances by

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1. United States of America before the Securities and Exchange Commission in the matter of McKesson & Robbins, Inc., *Report on Investigations* (Washington, D.C.: U.S. Government Printing Office, 1940).
 2. Statement on Auditing Procedure No. 1, *Extensions of Auditing Procedures* (New York: American Institute of Accountants, 1939).

alternative procedures.³ This requirement was rescinded in 1974 by SAS No. 2, *Reports on Audited Financial Statements*, but by then confirmation of receivables was an ingrained procedure in U.S. audit practice. Direct communication with independent sources has been considered a strong form of evidence by auditors. However, auditors may be overestimating the effectiveness of the receivable confirmation procedure and thus assuming higher levels of audit risk than they had planned.

SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330 and appendix D), issued in November 1991, is the current authoritative literature on confirmation of receivables and was issued in part to address the above concerns. It discusses the problem of non-response to positive-form confirmations and the need to employ alternative procedures to obtain the evidence necessary to reduce audit risk to an acceptably low level. Although this statement specifically addresses the confirmation of accounts receivable, it also defines the confirmation process, relates confirmation evidence to risk assessment and financial statement assertions, and discusses the positive and negative confirmation forms and the situations in which they can be most helpful.

PURPOSE OF THE STUDY

This study accomplishes three objectives. First, it discusses the relationship of financial statement assertions to accounts receivable audit objectives and how those objectives may be achieved by using confirmations. Second, it illustrates and discusses four different types of confirmation forms (positive, negative, blank, and expanded-field forms) and presents guidance on selecting an appropriate confirmation form for various client situations. Third, the study identifies practical suggestions for improving the quality and quantity of accounts receivable confirmation responses.

Since the mid 1960s there has been a continuing stream of articles and research studies that focus on the accounts receivable confirmation process. Approximately twenty-five empirical research studies were published during this period. The research studies of (1) Sauls, (2) Warren, (3) Hubbard and Burlington, (4) Sorkin, and (5) Krogstad and Romney varied the type of confirmation request in order to observe confirmation effectiveness in examinations of financial statements of banking, retailing, and manufacturing operations. Positive, negative, and other confirmation forms were used to confirm account balances as well as open invoices. Ashton and Hylas varied prenotification, postage, request wording, and other variables to determine their effect on response rates.

In response to the first edition of this publication, Bailey and Ballard, and File and Ward conducted a study of response improvement techniques as discussed in chapter 3, "Improving Confirmation Response Rates," to

3. Statement on Auditing Procedure No. 12, *Amendment to Extensions of Auditing Procedures* (New York: American Institute of Accountants, 1942).

measure their usefulness. The Caster's research assessed the reliability of the positive form accounts receivable confirmation as audit evidence, and Armitage conducted a survey of practicing auditor's perception of the competence and effectiveness of the accounts receivable confirmation auditing procedure as compared to the empirical research.

In conducting this study, research concerning confirmations and questionnaire surveys (which are used, for example, in marketing research) was also reviewed to gain insight into how practitioners might improve the effectiveness and efficiency of the confirmation process.

The suggestions presented in this study are based, in part, on existing research findings and the study group's review, deliberation, and interpretation of the research. Whether a particular suggestion will be beneficial to auditors depends on the context in which it is used. The study group's intent is to encourage auditors to experiment with the suggestions and communicate their findings to the profession so that the accounts receivable confirmation process may be improved. Evidence concerning a wide variety of practice settings may eventually allow the profession to establish more definitive guidelines on the use of accounts receivable confirmations.

Usefulness of the Confirmation Procedures in Auditing Accounts Receivable

This chapter describes illustrative audit objectives and accounts receivable, discusses the confirmation process, and discusses how accounts receivable audit objectives may be achieved by using confirmations. This chapter provides a foundation for discussions in later chapters on the effectiveness of various confirmation forms and the improvement of the efficiency and effectiveness of the confirmation process.

The auditor's objective in examining accounts receivable is to form an opinion regarding management's representation that the accounts receivable are presented fairly in conformity with generally accepted accounting principles (GAAP) applied on a basis consistent with the preceding year. In gathering sufficient, competent evidential matter to form a reasonable basis for an opinion, the auditor uses financial statement assertions to develop audit objectives and to design an audit program. Statement on Auditing Standards (SAS) No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), identifies the following five broad categories of assertions that are inherent in financial statement components:

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

From these assertions, audit objectives can be developed for accounts receivable and an audit program can be designed by selecting procedures to achieve the audit objectives. Audit procedures vary according to the engagement circumstances, and different procedures may be used to satisfy the same objective. The nature, timing, and extent of the procedures

selected on a particular engagement is a matter of professional judgment determined by the auditor in the specific circumstances.

AUDIT OBJECTIVES

In developing audit objectives for a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. No universal set of audit objectives exists. For illustrative purposes, the following audit objectives were developed for an audit of accounts receivable of a merchandising entity.

Existence or Occurrence

1. Accounts receivable included in the balance sheet exist.
2. Accounts receivable are the result of revenue transactions generated in the normal operation of the business.
3. Accounts receivable exclude all amounts owed to the entity from revenue transactions that occur in the subsequent accounting period.

Completeness

4. Accounts receivable include all amounts owed to the entity as of the balance sheet date.
5. Accounts receivable transactions for the period have been properly recorded.

Rights and Obligations

6. Accounts receivable are owned by the entity.
7. Accounts receivable that have been sold or factored as of the balance sheet date are excluded.

Valuation or Allocation

8. Accounts receivable are stated at their net realizable value as of the balance sheet date.
9. Accounts receivable are written off as uncollectible, where appropriate.

Presentation and Disclosure

10. Accounts receivable are properly classified in the balance sheet.
11. Pledged or assigned accounts receivable are properly disclosed in the financial statements.
12. Related party accounts receivable are properly disclosed in the financial statements.

In designing audit procedures to achieve these objectives, the auditor should recognize that some audit procedures may relate to more than one objective and that a combination of procedures may be required to achieve

an objective. The following section discusses how the written confirmation procedure relates to the audit objectives of accounts receivable.

WRITTEN CONFIRMATION PROCEDURES

Confirmation of receivables requires direct communication with debtors. The confirmation procedure typically involves a written request asking a recipient to consider the accuracy of the information presented.

In using the written confirmation procedure, the auditor should consider a variety of factors, including the nature, timing, and extent of the confirmation procedure. In addition, the auditor should consider the type of information to be requested, control over the confirmation procedure, follow-up of undelivered confirmations, follow-up of nonresponses, classification of returned confirmations, application of alternative audit procedures, and confirmation of a conclusion. (See appendix A, "Confirmation Flowcharts," flowchart A.1.)

Nature

Although a variety of confirmation forms exist, paragraph 17 of SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330) discusses two types of accounts receivable confirmations. Generally, a positive confirmation requests the debtor to respond whether or not the information presented is correct or, in the case of a blank request, to fill in the blank. The negative confirmation requests the debtor to respond only if they disagree with the information presented. (Examples of confirmation forms are described and illustrated in chapter 2, "Accounts Receivable Confirmation Forms.")

Positive confirmations provide audit evidence only when responses are received from the debtor. Alternative procedures are performed to provide audit evidence as to the validity and accuracy of the significant non-responses. This is generally sufficient to reduce audit risk to an acceptably low level.

As to negative confirmations, many practitioners believe that the sample error resulting from negative confirmations should not be projected as population characteristics. Negative confirmations, according to these practitioners, have a low probability of detecting errors; that is, many recipients of negative confirmations do not inform the auditor of differences between their balances and the client's. For that reason some practitioners do not believe that the results of negative confirmations are measurable in any reasonably accurate manner. They believe that negative confirmations should be used only as a secondary source of assurance. Other practitioners believe that negative confirmation may be used and evaluated normally if the three criteria in paragraph 20 of SAS No. 67 are met. Those criteria are stated as follows:

Negative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk

is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.¹ For example, in the examination of demand deposit accounts in a financial institution, it may be appropriate for an auditor to include negative confirmation requests with the customer's regular statements when the combined assessed level of inherent and control risk is low and the auditor has no reason to believe that the recipients will not consider the requests. The auditor should consider performing other substantive procedures to supplement the use of negative confirmations.

Requirement (a) effectively eliminates negative confirmations as an option when the auditor is unable or chooses not to assess control risk below the maximum. Flowchart A.2 of appendix A illustrates this decision model. In some situations a combination of the positive and negative forms may be used, with the positive form used for large balances and the negative form used for small balances.

Timing

An auditor may confirm accounts receivable as of a date before, on, or after the balance sheet date. If the accounts are confirmed as of a date before or after the balance sheet date, roll-forward or roll-back procedures should be performed. These procedures often involve (1) an analysis of activity in the receivable control accounts, along with supporting details (for example, journal entries) from the confirmation date to the balance sheet date and (2) performance of tests of the intervening transactions. Any unusual changes in accounts should be investigated, and if the auditor has sent confirmations before year-end, accounts with unusual changes or major accounts for which responses were not received may be reconfirmed.

One of the primary considerations in determining whether to confirm accounts other than at the balance sheet date is the reliability of the client's internal controls for receivables. If the client's controls are not reliable, it may not be efficient or effective to perform roll-forward or roll-back confirmation procedures. However, if the client's controls are reliable, confirmation prior to the balance sheet date may be desirable since it enables the auditor to conduct his or her work more efficiently throughout the year and allows more time for clearing reported exceptions prior to reporting on the financial statements.

See the section entitled "Substantive Tests Prior to the Balance-Sheet Date," in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), for detailed guidance on the timing of substantive audit tests prior to the balance sheet date.

1. Use of negative confirmation in this way approximates what is known as *discovery sampling* in the statistical sampling literature. Discovery sampling is used when the auditor believes that the population's *occurrence rate* (errors in the accounts receivable population) is near zero. If the occurrence rate is not close to zero, discovery sampling applications are designed to yield a large enough sample size so that at least one occurrence will be produced if the occurrence rate exceeds a predefined tolerable rate.

Extent

Professional standards provide general guidelines on the extent of testing, but the number of confirmations that should be sent in a given situation—the extent of testing—is judgmentally determined by the auditor based on the auditor's assessed level of inherent and control risk. Paragraph 7 of SAS No. 67 states the following:

The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk increases, the auditor designs substantive tests to obtain more [extent] or different evidence [nature] about a financial statement assertion.

Furthermore, if the negative rather than positive form of confirmation is used, the number of requests sent or the extent of the other auditing procedures applied to the receivable balance should normally be greater to obtain the same degree of satisfaction with respect to the accounts receivable balance.

In determining the number of confirmations that should be sent, the auditor should consult SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and the AICPA Audit Guide *Audit Sampling*. In applying SAS No. 39, auditors might select all high-value accounts, past-due accounts, accounts with credit balances, or certain other accounts for 100 percent confirmation and a sample that is expected to be representative of the remaining accounts. The auditor's working papers usually document the accounts selected for confirmation.

Information Requested

The type of information confirmed by the auditor depends on the ability and willingness of the confirmation recipients to verify the data and the nature of the transactions represented in the account. Regardless of the data appearing on the confirmation, the confirmation procedure may not provide valid audit evidence if the recipient cannot verify the data. For example, a confirmation requesting members of the general public to verify amounts that are based on complex interest computations will not produce meaningful audit evidence regardless of the type or number of confirmations sent.

In considering what information to confirm, the auditor should be careful to accurately define the population to which inferences will be made. For example, if credit balances are excluded from consideration and not confirmed, the inferences drawn from the confirmation results apply only to the positive, or debit, balances in accounts receivable.

As to the nature of the transactions, paragraph 8 of SAS No. 67 states:

Unusual or complex transactions may be associated with high levels of inherent risk and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with

the other parties in addition to examining documentation held by the entity. For example, if the combined assessed level of inherent and control risk over the occurrence of revenue related to an unusual, year-end sale is high, the auditor should consider confirming the terms of that sale.

Control of Requests

The auditor should maintain control over client records and confirmations throughout the selection, preparation, mailing, and return of the confirmations. Loss of control at any point could negate the reliability of the procedure. The nature of the control procedures will vary, depending on the specific circumstances.

Confirmation control procedures are intended to ensure the validity of the confirmation procedure by establishing direct communication between the recipient (the debtor) and the auditor, thereby reducing the chance of the client intercepting and biasing the results. If the client has the opportunity to intercept the confirmations (for example, by mailing the confirmations), the reliability of the procedure is significantly reduced. Therefore, confirmation requests should be mailed by the auditor (in envelopes printed with the return address of the auditor, not the client) and the recipient of the confirmation request should be asked to reply directly to the auditor. Confusion concerning this latter point may be reduced by including a return envelope with the confirmation request.

Accounts Not Confirmed at the Client's Request

Occasionally a client may request that certain accounts receivable not be confirmed. If the client has a valid reason for making such a request, these accounts do not have to be confirmed. However, the auditor should apply alternative procedures to those accounts.

Undeliverable Confirmations

Sometimes confirmation requests are returned by the post office as undeliverable. Undeliverable requests returned by the post office should be investigated. If possible, correct addresses should be obtained from the client, verified by reference to external sources (such as credit reports or telephone directories), and then remailed. If a correct address cannot be determined, the validity of the account should be questioned.

Nonresponses

Nonresponses result when recipients apparently refuse or are unable to respond to the type of confirmation that asks for a response. When a positive confirmation is used and no response is received within a reasonable period, additional or follow-up requests are normally sent. If a recipient still does not respond, alternative procedures such as those discussed below can be applied. In some cases the auditor may find direct contact by telephone to be a useful alternative confirmation technique. Chapter 3,

“Improving Confirmation Response Rates,” suggests ways auditors may be able to improve confirmation response rates.

Returned Confirmations

Some auditors evaluate all information reported by the debtor on the confirmation. Respondents sometimes supply gratuitous comments that the receivable or a part of the receivable balance was paid on a certain date, perhaps in a subsequent period. Although professional standards do not require follow-up on such gratuitous comments, verification procedures could lead to the discovery of errors or conditions that otherwise might not be discovered (for example, a possible lapping of accounts receivable). Therefore, some practitioners follow a policy of always investigating gratuitous comments.

Returned confirmations should be reviewed and categorized as one of the following:

- *Confirmed correct*—confirmations that are properly signed and on which the respondent has not indicated any exceptions to the information presented.
- *Incomplete or invalid*—confirmations that are returned unsigned or that are returned directly to the client. In such cases the auditor should consider remailing the confirmation request along with an explanation of the problem.
- *Unable to confirm*—confirmations on which the customer indicates that he does not have the ability to confirm the information presented. In such cases the auditor may wish to have the client prepare information that the recipient will be able to confirm. For example, as discussed in chapter 3, the auditor might consider asking a company that uses an open-invoice system to confirm a monthly statement or selected individual invoices, or the auditor might consider simplifying the information the recipient is asked to confirm.
- *Exceptions*—confirmations on which the respondent disagrees with or questions the information presented.

Exceptions indicated on the confirmation should be thoroughly investigated. Exceptions typically reported by recipients can be due to in-transit items (for example, payments made but not received or goods shipped but not received), disputed sales prices, credits allowed but not posted to the accounts receivable records, and clerical errors. Procedures used to investigate exceptions depend on the nature and frequency of the exceptions reported. Exceptions may be investigated by client personnel if the auditor supervises the activity and subsequently inspects, at least on a test basis, the evidence supporting the client’s explanation of differences. If an exception cannot be resolved or the follow-up procedures indicate that the exception represents an error in the client’s records, the auditor should determine how the error occurred. If similar errors could exist, additional

audit procedures may be necessary to determine the extent of errors and their effect on the achievement of confirmation audit objectives.

Confirmation by Facsimile

Frequently, the only way to obtain timely confirmation of a balance is by facsimile. In these circumstances, to minimize the risk associated with facsimile responses, the auditor should consider verifying the source and content of a facsimile directly with the sender by telephone. The auditor should also request the sender to mail the original confirmation directly to the auditor. In many cases, all the auditor will receive is the facsimile² and this oral confirmation. The oral confirmation should be documented in the workpapers.

Alternative Audit Procedures

If confirmation requests are not sent or replies are not received, the auditor applies such alternative procedures as are necessary to obtain sufficient, competent evidence to achieve the audit objectives of accounts receivable. If the auditor concludes that alternative procedures are inadequate, the standard audit report may need to be modified.

Paragraph 31 of SAS No. 67 indicates that the auditor should apply alternative procedures to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, the omission of alternative procedures may be acceptable when—

- There is no indication of unusual qualitative factors or systematic characteristics related to the nonresponses.
- The aggregated nonresponses are projected to the population as a 100 percent misstatement and added to the sum of all other unadjusted differences; and this result does not affect the auditor's decision about whether the financial statements are materially misstated.

For example, a nonresponse for an accounts receivable balance may include many invoices for which alternative procedures may need to be performed. It is often only necessary to perform alternative procedures on the larger and other selected balances so long as there are no unusual characteristics to the untested invoices and the projection to the population will not alter the auditor's evaluation of the sample results.

Alternative procedures to the written confirmation procedures include the use of other means to communicate directly with the debtor. For example, telephone inquiry to verify account information is frequently used. In some cases the auditor may visit a debtor to verify the accuracy of the account information. Tests of credits may be performed by referring to

2. Faxes are often printed on thermographic paper. This paper fades in a relatively short period. Information on thermographic paper that is intended to be retained in audit files should be replaced with a photocopy of the document.

remittance advises, deposit slips, bank statements, cash receipt records, and authorization of write-offs. Debits may be audited by examining evidence of sales, such as contracts, customer purchase orders, shipping documents, bills of lading, and freight bills.

Evaluating Confirmation Results

The results of the confirmation procedure are typically summarized by type of confirmation (for example, positive and negative), and summary statistics are usually calculated, including the percentage of accounts in dollars tested and the percentage of accounts in dollars associated with non-respondents and errors. The objective of this summary is to enable the auditor to arrive at a conclusion about the sufficiency of the confirmation procedure.

In evaluating the confirmation summary, the auditor should consider (1) the reliability of the confirmations and alternative procedures; (2) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (3) the evidence provided by other procedures; and (4) whether additional evidence is needed. In some situations the confirmation findings, in combination with the results of other tests, may require the auditor to send additional confirmations or extend other audit procedures.

In sampling applications, a question frequently arises regarding whether it is proper to combine confirmation results with results generated by alternative procedures and then make an overall evaluation. For example, if 125 confirmation replies indicate two errors and alternative procedures applied to 75 nonresponding accounts indicate one error, should the evaluation be based on a sample of 200 accounts with three errors?

It is appropriate to combine confirmation results with alternative procedure results unless there is some type of error that could not be found by the alternative procedures applied. Therefore, before combining such results, the auditor should analyze the nature and cause of each misstatement.

USEFULNESS OF CONFIRMATIONS

The usefulness of an audit procedure should be assessed by its relative effectiveness and efficiency in achieving audit objectives. The following paragraphs consider the usefulness of confirmations from an effectiveness/efficiency perspective.

Effectiveness of Confirmations

The effectiveness of an audit procedure relates to its ability to achieve audit objectives. Professional standards recognize that the competency of evidence depends on its validity and relevancy. Confirmations are relevant because they request independent verification of information about accounts receivable balances or transactions, and such verification is impor-

tant for the completion of the audit. Validity is based on the following general presumptions:

1. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
2. There is more assurance about the reliability of accounting data and financial statements when they are developed under satisfactory conditions of internal control than when they are developed under unsatisfactory conditions.
3. The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

Confirmation can be relied on as both primary and secondary sources of evidence for the following illustrative audit objectives (which were presented at the beginning of this chapter).

Primary Source of Evidence

Existence. Accounts receivable included in the balance sheet exist.

Secondary Sources of Evidence

Completeness. Accounts receivable transactions for the period have been properly recorded.

Occurrence. Accounts receivable exclude all amounts owed to the entity from revenue transactions that occur in the subsequent accounting period.

Valuation or allocation. Accounts receivable are stated at their net realizable value as of the balance sheet date.

The term *primary source of evidence* does not imply that the procedure is the only source of evidence or that other primary sources of evidence do not exist. Rather, it means that the auditors normally place significant reliance on the result of such a procedure in forming a conclusion about a particular audit objective. A client-imposed restriction on a primary source of evidence would usually cause the auditor to issue a modified opinion due to a scope limitation unless he or she can achieve the audit objective by using another primary source of evidence. The term *secondary source of evidence* means that the procedure generally provides some evidence concerning the audit objective but that other procedures are relied on as sources of primary evidence.

As already indicated, confirmations are a primary source of evidence in determining whether the accounts receivable exist as of a certain date. By properly exercising control over the processing of confirmations, the auditor reduces the possibility that the client is able to manipulate or otherwise bias the findings. Confirmations that require and receive responses from the recipient (such as positive confirmations) provide highly reliable evidence

that the accounts receivable exist. Although fictitious responses could be received, auditors are normally careful to watch for unusual accounts or items, such as post office box addresses that might disguise a fictitious account. Another primary source of evidence for assessing the existence of an account receivable or transaction is the examination of subsequent cash receipts. Examination of other supporting documentation, such as credit files and shipping documents, is normally considered a secondary source of evidence of existence. In combination, however, these sources may provide evidence of existence equivalent to confirmation, especially if some external evidence related to existence, such as a credit report, is also generated.

Confirmations serve as a secondary source of evidence in assessing the completeness objective of proper recording. Although confirmations are not a primary source of evidence of the proper recording of transactions, they may reveal discrepancies in transaction recording. Since debtors are more likely to respond to overstatements rather than understatements in their accounts, confirmations also serve as a secondary source of evidence in detecting transactions occurring in the subsequent accounting period but recorded in the current accounting period. For the latter objective, cutoff procedures serve as a primary evidential source.

Confirmations also serve as a secondary source of evidence in assessing whether the accounts receivable are stated at their net realizable value as of the balance sheet date. The primary evidential sources for assessing net realizability are collectibility reviews, including the aging of accounts receivable, review of current credit files, and review of subsequent cash collections. However, the confirmation procedure may result in the reporting of disputed sales returns and credits. Thus, confirmations can be viewed as the secondary evidential source in the assessment of net realizability.

One Caveat

Recent studies of accounts receivable confirmations as audit evidence suggest that their error detection rate is less than the auditor might expect. For one empirical study, less than 50 percent of "seeded" errors in an accounts receivable circularization were reported by the confirnee. For those receiving confirmations with large, unfavorable errors (account balance overstatements), the rate was only slightly better. A separate survey of practicing auditors' perceptions of the efficacy of accounts receivable confirmations indicated that they perceived the detection rate for confirmations to be significantly higher than suggested by the empirical research. Therefore, auditors may be placing too much reliance on confirmation procedures to detect errors in account balances and may want to consider additional procedures particularly for the valuation assertion.

Efficiency of Confirmations

The efficiency of an audit procedure relates to the cost incurred to achieve audit objectives: the lower the cost, the more efficient the procedure. In auditing, a major factor influencing cost is the amount of time required to perform a procedure. The written confirmation procedure is efficient in

achieving its primary audit objective of existence. The principal costs associated with confirmations are attributable to processing and investigating nonresponses and exceptions. With proper control and supervision, many of the clerical confirmation tasks can be performed by client personnel. For a confirmation returned with no exceptions, the audit time spent in gathering evidence is minimal when compared to alternative procedures.

The use of alternative procedures to achieve the audit objective of existence involves the examination of supporting documentation, such as proof of subsequent cash payment, shipping documents, bills of lading, and other documentary support. The auditor can rely on client personnel if properly supervised to gather the data, but he or she usually spends a significant amount of time examining it. Although the auditor will incur additional costs in applying alternative procedures to nonreplies and exceptions, the majority of confirmations normally require only minimal follow-up. Consequently, even with some nonreplies and exceptions, confirmations tend to be highly efficient.

SUMMARY

This chapter described the audit objectives for accounts receivable and the usefulness of the written confirmation procedure in achieving these objectives. Although each audit engagement is unique, this chapter discussed the general factors to consider in using the written confirmation procedure. Alternative procedures and confirmation sampling were also discussed. The written confirmation procedure is highly effective and efficient in achieving the primary audit objective of existence and can be used as a secondary evidential source in examining the audit objective of existence and can be used as a secondary evidential source in examining the audit objectives of completeness and valuation or allocation.

Accounts Receivable Confirmation Forms

When confirming accounts receivable, practitioners may select from a number of available confirmation forms. This chapter discusses and illustrates several forms.

TYPES OF CONFIRMATION FORMS

There are four basic types of confirmation forms. Statement on Auditing Standards (SAS) No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), describes two types of forms and provides guidance about using the forms in various circumstances. The purpose of this section is to (1) describe two additional confirmation forms that could be useful in auditing accounts receivable and (2) present guidelines for selecting among the four basic confirmation forms. (See appendix A, “Confirmation Flowcharts,” flowchart A.2.) The four types of confirmation forms discussed are the positive, negative, blank, and expanded-field forms. A brief description of each follows.

Positive Form

The recipient of the positive confirmation is asked to respond directly to the auditor, whether or not he or she agrees with the information presented.

Positive confirmations may be directed toward either debtor account balances, as illustrated in exhibit 2.1, on page 18, or individual items included in account balances (for example, invoice confirmations), as illustrated in exhibit 2.2 on page 19. The positive invoice confirmation addresses the same audit objectives as the account balance confirmation. Invoice confirmations may be especially appropriate when—

- The customer’s accounts payable system is maintained on an invoice basis; that is, accounts payable transactions are associated with supporting purchase requisitions, purchase orders, invoices, and receiving reports.

- The client's receivable information processing system is maintained on an invoice basis; that is, the system matches cash receipts, credit memos, and other adjustments to specific invoices.

In these circumstances the invoice confirmation form may have audit advantages, such as increased response rates, more efficient alternative procedures, and more efficient reconciliation work relating to in-transit items and processing lags.

When an auditor chooses to confirm account balances rather than invoices, he or she may find it beneficial to include a client-prepared "statement of account," showing the details of the balance in the customer's account, along with each confirmation form. An example of such a confirmation form is illustrated in exhibit 2.3 on page 20. Including the client's statement along with each confirmation may increase efficiency. For example, the need to enter address information on each confirmation may be eliminated. However, the auditor should be sure to compare confirmation forms and statements prepared by the client to the accounting records.

Another variation of the account balance confirmation occasionally used in practice is to present the confirmation request on the CPA firm's letterhead instead of the client's letterhead. Appropriate wording for this type of request is illustrated in exhibit 2.4 on page 21. Practitioners generally prefer to mail the confirmation on the client's letterhead because they believe that the debtor is more likely to respond to a company dealt with regularly than to the auditor. A recent study, however, demonstrated that sending second requests on the CPA firm's letterhead may be beneficial. This is discussed further in chapter 3, "Improving Confirmation Response Rates."

If the confirmation is presented on the CPA firm's letterhead, it should contain a request, signed by the confirming company, to "please supply the information requested." Other confirmation forms discussed in this chapter may also be sent out on the CPA firm's letterhead, if appropriately tailored.

Negative Form

The recipient of the negative confirmation is asked to respond only if he disagrees with the information presented. Typically, negative confirmations are sent along with the client's statements that are regularly mailed to the customer (see exhibit 2.5 on page 22). They may also be stamped on the client's statements or include affixed portions (see exhibits 2.6 and 2.7 on pages 23 and 24). A sentence such as "If you do not report any differences within X days, it will be assumed that this statement is correct" is sometimes added to negative confirmations. Such a sentence encourages timely consideration of the negative confirmation by the recipient.

Blank Form

The recipient of the blank confirmation is not provided with a balance to verify, but rather is requested to supply information directly to the auditor. The auditor then compares the information provided by the recipient on the confirmation form to the client's records. The blank form is often used

in the audit of accounts payable to test for the existence of unrecorded liabilities. The form can be, but is not often, adapted for use in the audit of accounts receivable. The blank form is illustrated in exhibit 2.8 on page 25.

Expanded-Field Form

The recipient of the expanded-field confirmation is asked to verify, by selecting from a list of items, the item that corresponds to the information in the entity records or to explain any differences. For example, the recipient may be asked to mark the correct account balance (as shown in the entity records) from a list of two or more balances. The expanded-field form is illustrated in exhibit 2.9 on page 26.

SELECTION OF A CONFIRMATION FORM

In deciding which form to use for a particular client circumstance, the auditor should be guided by his or her attempt to maximize the effectiveness of evidential matter while minimizing audit costs. The usefulness of each of the four basic confirmation forms is discussed in the following paragraphs.

Using the Negative Confirmation Form

The negative confirmation is most effective in minimizing the direct cost of the confirmation procedures but least effective for determining existence or misstatements. This is because negative confirmations do not require follow-up procedures for nonrespondents. Since only exceptions are reported by the recipients, the auditor cannot identify nonrespondents, and nonresponses cannot be distinguished from responses with no exceptions. Therefore, if the auditor suspects that a significant number of recipients lack the willingness or ability to respond objectively, he or she should not use negative confirmations. However, if the auditor has no reason to believe the recipient will not consider the request, there are a large number of balances involved, and the combined assessed level of inherent and control risk is low, then negative confirmations may be used.

Using the Positive Confirmation Form

Although more costly to use than the negative form, the positive form is more effective because nonrespondents can be identified and alternative follow-up procedures can be used. Hence, the positive form is usually more appropriate than the negative form when the willingness of recipients to respond is questionable. However, if the auditor suspects that many of the recipients of confirmation requests may not give the requests proper attention, the positive form may also not be effective. This is because recipients may simply sign and return the forms without determining whether the information presented agrees with their records. The auditor will interpret such responses as evidence that the information is correct when, in fact, the accounts may be in dispute (see the reaction matrix on page 16).

In these situations the blank or expanded-field confirmation form may be preferable to the positive form.

Positive Confirmation Reaction Matrix

<u>Recipient Reaction</u>	<u>Account (or Information) Is</u>	
	<u>Correct</u>	<u>Incorrect</u>
1. Returns confirmation		
(a) Confirms as correct	Audit is efficient	Decreases audit effectiveness
(b) Confirms as incorrect	Increases audit costs: Requires additional audit evidence	Audit is effective
2. Does not return confirmation	Decreases audit efficiency. Increases audit costs: Consider alternative procedures	

Using the Blank Confirmation Form

The blank confirmation is as effective as the positive form in identifying nonrespondents. However, the blank confirmation may be less efficient because more nonresponses are likely to occur with the blank form than with the positive form. Consequently, the blank form may require more extensive follow-up procedures for nonrespondents. However, if the recipients are not likely to devote proper attention to their responses, blank confirmations may be preferable to positive confirmations since the recipients cannot simply sign and return the forms without checking appropriate records and supplying the information requested. Nonetheless, some recipients may report incorrect balances; the increased costs that result from the auditor's attempt to reconcile these incorrect balances may decrease the efficiency of blank confirmations.

Using the Expanded-Field Confirmation Form

Like positive and blank confirmations, the expanded-field confirmation can also be effective in identifying nonrespondents. The expanded-field confirmation is, however, not as effective as the blank form in deterring recipients from verifying incorrect information (for example, by randomly selecting an account balance from the set of account balances presented on the confirmation form) and signing the confirmation. Depending on the number of items presented in the list from which the recipient selects, the expanded-field confirmation may be more effective than the positive form in identifying misstated information. That increase in effectiveness occurs because respondents are more likely to consult their records.

The expanded-field form has received very limited use in practice. Its primary disadvantages are (1) lack of client acceptance of the form (for

example, because some information on the form is always incorrect) and (2) the cost of applying follow-up audit procedures for amounts that have been identified by respondents as exceptions. In the latter case, a recipient who does not know the correct account balance may mark a balance at random, and the auditor will interpret it as an exception if the marked item differs from the client's records. That will require the auditor to apply costly follow-up procedures. With the blank confirmation form, the recipient is less likely to indicate an incorrect balance and is more likely to supply a balance after consulting appropriate records. However, recipients are not as likely to respond to the blank form as to the expanded-field form.

RECOMMENDATIONS

Based upon the effectiveness and efficiency of the four basic confirmation forms just described, the following recommendations are presented:

1. Negative confirmations, because of their inability to identify non-respondents, generally should be considered as a secondary evidential source in achieving accounts receivable audit objectives¹ unless the three criteria described in sec. 331 of SAS No. 67 are met. These criteria are—
 - (a) The combined assessed level of inherent and control risk is low
 - (b) A large number of small balances is involved, and
 - (c) The auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.
2. Positive and blank confirmations may be used as primary sources of evidence in achieving certain accounts receivable audit objectives.
3. Positive confirmations should be considered when it is desirable to identify nonrespondents and when the auditor believes that recipients are willing and able to verify the information requested after examining their records.
4. Blank confirmations should be considered when it is desirable to identify nonrespondents and when the auditor believes a significant number of recipients might sign the confirmations without conducting careful investigations.
5. Expanded-field confirmations may be useful as a primary source of evidence and could be used when it is desirable to identify nonrespondents. However, the auditor should recognize that the expanded-field confirmation is experimental (that is, it has not been widely used in practice).

1. Chapter 1 contains a discussion of the confirmation procedures as they relate to the achievement of audit objectives.

Exhibit 2.1
Positive Form: Account Balance Confirmation

[Client's Letterhead]

[Date]

[Debtor's Name and Address]

Dear [Debtor's Name]:

Our auditors, [Name of CPA Firm], are currently auditing our financial statements. To facilitate this audit, please confirm the balance due us as of [Date], which is shown on our records as \$_____. Indicate in the space below if this amount is in agreement with your records. If there are exceptions, please provide any information that will assist the auditors in reconciling the difference.

Please mail your reply directly to [Name of CPA Firm]. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

 [Signer's Name and Title]
 [Company Name]

Exhibit 2.2
Positive Form: Invoice Details

[Client's Letterhead]

[Date]

[Debtor's Name and Address]

Dear [Debtor's Name]:

Our auditors, [Name of CPA Firm], are currently auditing our financial statements. To facilitate this audit, please confirm that the amounts on the invoice(s) listed below, as shown on our records, were due us as of [Date]. The following invoice(s) have been selected for confirmation and may represent only a portion of the balance due from you.

Invoice #	Invoice Date	Purchase Order #	Amount
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

Indicate in the space provided below whether this information agrees with your records. If there are exceptions, please provide any information that will assist the auditor in reconciling the difference.

Please mail your reply directly to [Name of CPA Firm]. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

[Signer's Name and Title]
[Company Name]

To [Name of CPA Firm]:

The amount shown above is correct as of [Date] except as follows:

Name	Position	Date
_____	_____	_____

Practice Notes

1. If the nature of the client's or customer's business is such that the customer may be unable to reply to requests for confirmation of account balances, the auditor may confirm specific transactions and related details (for example, customer's purchase order numbers) to facilitate the customer's response.
2. Optional sentence for paragraph 3: "This is not a request for payment."

Exhibit 2.3
Positive Form: Account Balance Confirmation
With Itemized Statement Enclosed

[Client's Letterhead]

[Date]

[Debtor's Name and Address]

Dear [Debtor's Name]:

Our auditors, [Name of CPA Firm], are currently auditing our financial statements. To facilitate this audit, please confirm the balance due us as of [Date], which is shown on our records and the enclosed statement as \$ _____. Indicate in the space below whether this is in agreement with your records. If there are exceptions, please provide any information that will assist the auditor in reconciling the difference.

Please mail your reply directly to [Name of CPA Firm]. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

 [Signer's Name and Title]
 [Company Name]

To [Name of CPA Firm]:

The amount shown above is correct as of [Date] except as follows:

Name	Position	Date

Practice Notes

1. A monthly statement accompanying a positive request usually shows, where practicable, all open items in detail and thus avoids an unexplained balance forwarded from previous statements.
 2. Optional sentence for paragraph 2: "This is not a request for payment."
-

Exhibit 2.4
Positive Form: Account Balance Confirmation
on CPA Firm's Letterhead

[Client's Letterhead]

[Date]

[Debtor's Name and Address]

Dear [Debtor's Name]:

In connection with our audit of [Name of Company], we are confirming the amounts owed by its customers. The company's records show that you owe a balance of \$ _____ as of [Date]. Please indicate whether this amount agrees with your records by signing this letter and returning it to us in the enclosed envelope.

If the amount shown above does not agree with your records, please list and explain any differences in the space provided below or, if necessary, in a separate letter.

Sincerely,

[CPA Firm Name]

Please supply the information requested above to our auditors.

[Name of Confirming Company]

By _____
[Signer's Name and Title]

The amount shown above is correct except as noted below:

Name	Position	Date
<hr/>		

Practice Notes

1. Since the debtor may be more likely to respond to a company that he or she deals with regularly than an unknown auditor, the confirmation should usually be sent out on the client's letterhead.
 2. Optional sentence for paragraph 2: "This is not a request for payment."
-

Exhibit 2.5
Standard Negative Form

[Auditor's Confirmation]

Our auditors, *[Name of CPA Firm]*, are currently auditing our financial statements. Our records (and the enclosed statement) show an amount of \$ _____ due from you as of *[Date]* . If the amount is *not* correct, please report any differences directly to *[Name of CPA Firm]*. Use the space below and the enclosed reply envelope. No reply is necessary if this amount agrees with your records.

[Debtor's Name and Address]

[Client] _____

By _____

Differences

Name	Position	Date
------	----------	------

Practice Notes

1. The request may be prepared on the client's letterhead.
2. It is usually preferable to send negative confirmations only when accompanied by the client's statements that are regularly sent to customers.
3. Optional sentence: "Remittances should not be sent to auditors" or "This is not a request for payment."
4. Optional sentence: "If you do not report any differences within X days, it will be assumed that this statement is correct."
5. It may be easier to use a rubber stamp or sticker along with client-prepared statements rather than the above form. (See exhibit 2.6.)

Exhibit 2.6

Negative Form Affixed to Client's Statements: Stamp or Sticker

PLEASE EXAMINE THIS STATEMENT CAREFULLY.
If it is *not* correct, please report any differences directly to our auditors:
[Name of CPA Firm]
[Address of CPA Firm]

Practice Notes

1. This request for confirmation should be mailed by the auditor in an envelope bearing the auditor's return address and with the auditor's business reply envelope enclosed.
 2. Optional sentence: "Remittances should not be sent to the auditors" or "This is not a request for payment."
 3. Optional sentence: "If you do not report any differences within X days, it will be assumed that this statement is correct."
-

Exhibit 2.7

Negative Form: Insert Accompanying Client's Statements

<i>Auditor's Verification Request</i>	
<p>Our auditors, [<i>Name of CPA Firm</i>], are currently auditing our financial statements. Please examine this statement carefully. If it is NOT CORRECT, please report any differences directly to our auditors.</p> <p>For your convenience please use the Reply Label attached below. Simply tear it off and affix it to any envelope. No postage is necessary.</p> <p>This is only for the purpose of confirming the accuracy of your statement. NO REPLY IS NECESSARY IF THE AMOUNT IS CORRECT.</p>	
PLEASE DO NOT SEND PAYMENTS TO THE AUDITORS.	
Tear off on dotted line.	
AUDIT I.D.	NO POSTAGE NECESSARY IF MAILED IN THE UNITED STATES
BUSINESS REPLY LABEL First Class Permit No. XXX Anywhere, USA	XXXXXXXXXX
	XXXXXXXXXX
	XXXXXXXXXX
Postage Will Be Paid by Addressee (CPA Firm Name) (Address of CPA Firm)	XXXXXXXXXX
	XXXXXXXXXX
	XXXXXXXXXX
	XXXXXXXXXX

Practice Notes

1. Optional sentence for paragraph 3: "This is not a request for payment."
2. Optional sentence for paragraph 3: "If you do not report any differences within X days, it will be assumed that this statement is correct."

Exhibit 2.8
Blank Balance Confirmation

[Client's Letterhead]

[Date]

[Debtor's Name and Address]

Dear [Debtor's Name]:

Our auditors, [Name of CPA Firm], are currently auditing our financial statements. To facilitate this audit, please indicate the balance due us as of [Date]. The balance shown by your records should be inserted in the space provided below.

Please mail your reply directly to [Name of CPA Firm]. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

[Signer's Name and Title]
[Company Name]

To [Name of CPA Firm]:

The balance due [Name of Company] as of [Date] is \$_____ according to my records.

Name	Position	Date
<hr/>		

Practice Notes

- Optional sentence for paragraph 2: "This is not a request for payment."
-

Exhibit 2.9
Expanded-Field Confirmation

[Client's Letterhead]

_____ [Date]

_____ [Debtor's Name and Address]

Dear [Debtor's Name]:

Our auditors, [Name of CPA Firm], are currently auditing our financial statements. To facilitate this audit, please indicate the balance due us as of [Date] . Circle the balance below that agrees with your records. If none of the amounts agrees with your records, please provide the balance shown on your records.

Please mail your reply directly to [Name of CPA Firm]. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

[Signer's Name and Title]
[Company Name]

To [Name of CPA Firm]:

My balance as of [Date] is (circle the correct amount):

\$3,763.82

\$3,961.92

\$4,160.02

None of the above amounts agrees with my current balance. My current balance is \$ _____ . (Please provide details.)

Name _____

Position _____

Date _____

Practice Notes

1. Optional sentence for paragraph 2: "This is not a request for payment."
-

Improving Confirmation Response Rates

This chapter presents some practical suggestions that could improve accounts receivable confirmation response rates. These suggestions are derived from a review of research studies that have examined response rates and the accuracy of responses and from study group discussions.

The efficiency of the confirmation procedure is influenced by both the willingness and the ability of recipients to respond accurately to the information presented on the confirmation. Improving confirmation response rates may reduce the extent of follow-up procedures for nonresponses, thus increasing the efficiency of the confirmation procedure and reducing audit cost.

SUGGESTIONS FOR IMPROVING RESPONSE RATES

The suggestions for improving confirmation response rates described in the following paragraphs are directed primarily at confirmation recipients who are individuals rather than commercial enterprises. However, many of our recommendations may also be beneficial when confirming commercial accounts.

Use Premailing Notification

The use of a brief letter, postcard, or telephone call immediately before mailing the confirmation generally tends to increase responses. The recipient, knowing the confirmation is coming, is less likely to treat it as junk mail. The premailing notification, either by mail or telephone, should be received by customers four or five business days before the confirmations are mailed. A premailing notification should identify the purpose of the request, the company, and the auditor, and it should request the timely cooperation of the recipient. (See exhibit 3.1 on page 31.)

Request Information the Recipient Is Able to Confirm

The confirmation request should include all the relevant detailed information required for a response by the recipient. In some cases the confirmation should include a list of items that constitute an account balance, a list of transaction activities for periods surrounding the confirmation date, or copies of transaction invoices. When verification of an account balance is difficult or complex, the auditor may ask the recipient to confirm supporting information from which the auditor can later compute the ending account balance. For example, instead of asking an individual to confirm a mortgage balance that includes a complex interest calculation, the auditor could confirm the original balance, interest rate, number of installments, and the date the last installment was paid. In other words, the auditor should request information that the debtor knows or can easily obtain.

Use Clear Wording

Auditors should be particularly careful to avoid technical or trade jargon in confirmations sent to individuals; the more complicated the language in the confirmation, the less likely the recipient is to respond promptly or adequately. The confirmation exhibits in chapter 2, "Accounts Receivable Confirmation Forms," use nontechnical language.

Use Multilingual Forms

If some of the confirmation recipients use a language other than English, the auditor should consider using multilingual forms. Recipients are more likely to respond to an easily understandable confirmation than to one that requires translation. Multilingual forms may be particularly appropriate in areas that have large numbers of ethnic groups.

Identify the Organization Being Audited

In developing correspondence to be sent to the recipient of a confirmation (for example, a prenotification letter, the confirmation, or a follow-up letter), it is important that both the client and the individual requesting the confirmation be identified.

There is some evidence that prominently identifying the client organization and the position or title of the requestor increases the response rate. For confirmations of receivables, both the client and the auditor should be identified, and the client employee asking for the customer's assistance should hold a high organizational position, such as controller or credit manager. This strategy adds an additional sense of importance to the confirmation, thereby increasing customer attention.

Use a Soft Color for Confirmations

Although the evidence in the studies surveyed did not indicate that color has a significant effect on questionnaire (confirmation) response rates,

questionnaire construction experts usually recommend that dark colors be avoided. Light-toned paper, such as pale yellow, is recommended.

Hand Sign Confirmations

Hand signing a confirmation may increase the response rate. This may be particularly true when the individual signature on the confirmation is familiar to the recipients. A hand-signed confirmation received from a known or important person is likely to be viewed by the recipient as an important communication.

Laser Print Confirmations

Several studies suggest that whether confirmations are customized and use a high-quality print versus the lower-quality standardized multiformed confirmation has no significant effect on response rate. However, in our opinion, laser printed confirmations that appear to be personalized are preferable because we believe the recipients view such forms as more important. Additionally, with the existing computer technology, cost should not be a significant factor.

Use High-Grade Postage

The type of postage used on outgoing confirmations may significantly affect response rates. Generally, higher response rates are associated with higher postage grades or classes. For example, express mail or special delivery postage tends to be more effective than first-class postage in generating a higher response rate, and first-class postage is more effective than third-class postage. Apparently, recipients view the type of postage applied to the envelopes as an indicator of importance and will sort and open mail accordingly. Hence, auditors should consider using higher postage grades for confirmation of key accounts or transactions. A cheaper method of attracting the recipient's attention is to print IMPORTANT AUDIT INFORMATION ENCLOSED on the envelopes used to send the confirmations.

Set Deadlines

Confirmations that have reply deadlines may increase response rates. Most studies that have examined deadlines suggest that they accelerate daily response rates, but they do not affect the overall response rate. Deadlines, if used, are usually in boldfaced type and say URGENT or REPLY REQUESTED WITHIN 5 DAYS.

Use Inducements

The use of inducements, such as small amounts of money, calendars, and other tokens, has been effective in increasing response rates in questionnaire surveys. The best incentive is cash that accompanies the confirmation. Other incentives, in order of their declining effectiveness, include promises

to send cash, merchandise (for example, pen, letter opener, calendar), and premiums or coupons.

Why should an accompanying cash inducement of a nominal amount (such as a dollar) significantly increase response rates? Apparently, it is not necessarily the value of the inducement that increase the response rate, but rather the psychology of offering a reward to the respondent. If the recipient of a confirmation request receives a monetary reward, he or she is more likely to feel obligated to comply with the confirmation request.

Since the cost of performing follow-up audit procedures for nonresponses is generally considered to be expensive, additional ways to reduce the extent of applying follow-up procedures are always sought. Although some auditors would consider the inclusion of a cash token with a confirmation to be unprofessional, limited use of small incentives (for example, pocket calendars) should be considered.

Provide Return Envelopes

Return envelopes that have the CPA firm's address printed in large, dark letters are likely to draw attention to confirmations and are likely to encourage recipients to respond. In addition, return envelopes may also have IMPORTANT INFORMATION printed on the front to encourage recipients to respond.

Provide Return Postage

To facilitate responses, auditors normally include a stamped, self-addressed return envelope along with each confirmation. Stamps tend to generate higher response rates than business postage permits. Apparently, recipients feel worse if they throw away unused stamped envelopes than if they discard unused business permit envelopes. Use of commemorative stamps and multiple stamps may also increase response rates.

Send Follow-Up Reminders

Providing confirmation recipients with reminders or follow-up notices via postcards or letters appears to increase response rates. Follow-up reminders are probably most effective if mailed three to four days after the initial confirmations are mailed. Most recipients apparently decide whether to comply with the confirmations during the three- or four-day period immediately after receipt of the requests. Moreover, it seems about as effective to send postcard reminders to nonresponders as it is to send second confirmations, letters, or both. Sometimes it may be more economical to send postcard reminders than copies of confirmations.

Send Second Requests on the CPA Firm's Letterhead

Usually, first and second requests are sent out on the client's, rather than the auditor's letterhead. It may, however, be beneficial to send second requests on the CPA firm's letterhead. While this technique has not been shown to significantly impact response rates, it does appear to be beneficial

in other respects; confirms are returned more quickly and the quality of the responses appears to improve. It is possible that debtors are responding with greater care and attention to balances associated with a CPA firm. Of course, the client's authorization is always required before the auditor can request confirming information from a debtor. Exhibit 2.4 illustrates a confirmation form on the CPA firm's letterhead.

SUMMARY

The fifteen suggestions discussed in this chapter are designed to enhance the effectiveness and efficiency of the confirmation of accounts receivable by increasing response quality and quantity. The suggestions are designed to overcome debtors' apathy toward confirmations and to decrease the cost of performing expensive alternative procedures.

It should be noted, however, that many of these suggestions do not appear to have a cumulative effect. For example, the use of an inducement with a premailing notification and a follow-up reminder may be no more effective than using only the inducement. In our opinion, a well-designed confirmation approach will use some of these techniques with consideration for the client's industry, the customer type—consumer versus commercial—the size of the accounts, and other factors as discussed in the previous chapters.

Many of the suggestions for improving confirmations are supported by existing auditing or survey research studies. Some recommendations have intuitive appeal but have not been subjected to practice validation. We encourage practitioners to experiment with the recommendations and to implement those that are cost beneficial.

Exhibit 3.1 **Prenotification Postcard or Letter**

[Date]

Dear Customer:

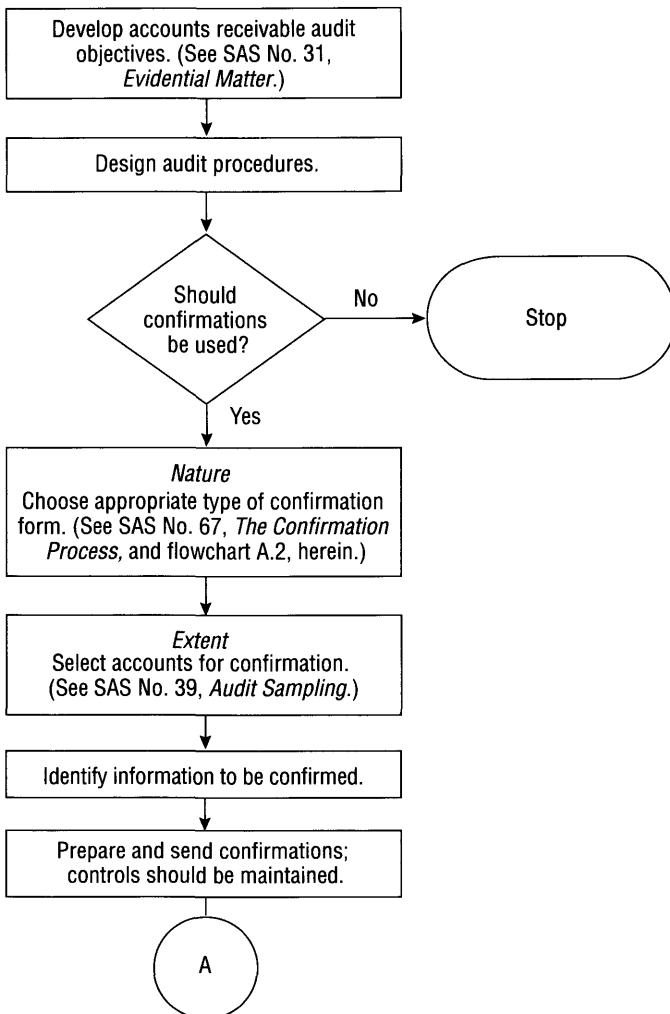
Our auditors, [Name of CPA Firm], are auditing our financial statements. Within the next few days, you will receive a request from [Name of CPA Firm] asking you to verify the balance due us as of [Date] . Please provide the information requested and mail your reply at your earliest convenience.

Sincerely,

[Signer's Name and Title]
[Company Name]

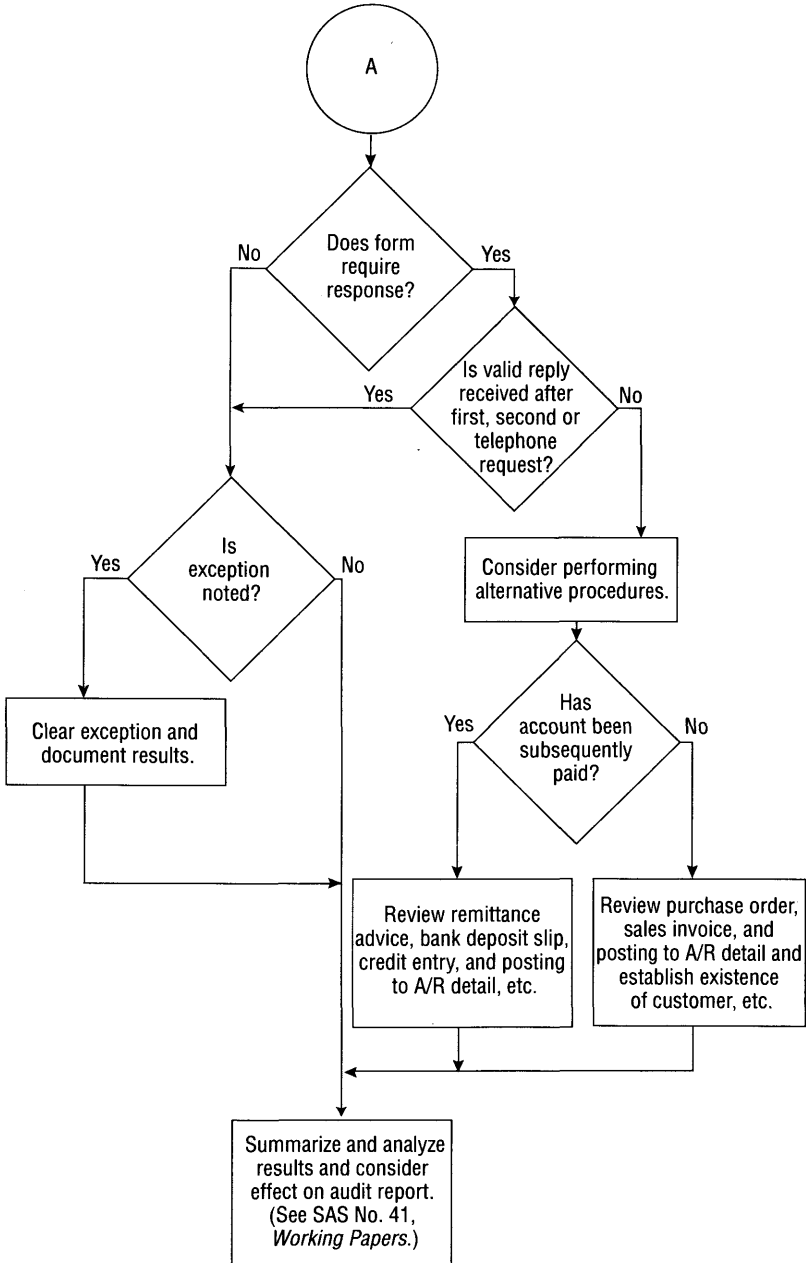
Confirmation Flowcharts

Flowchart A.1
The Accounts Receivable Confirmation Process

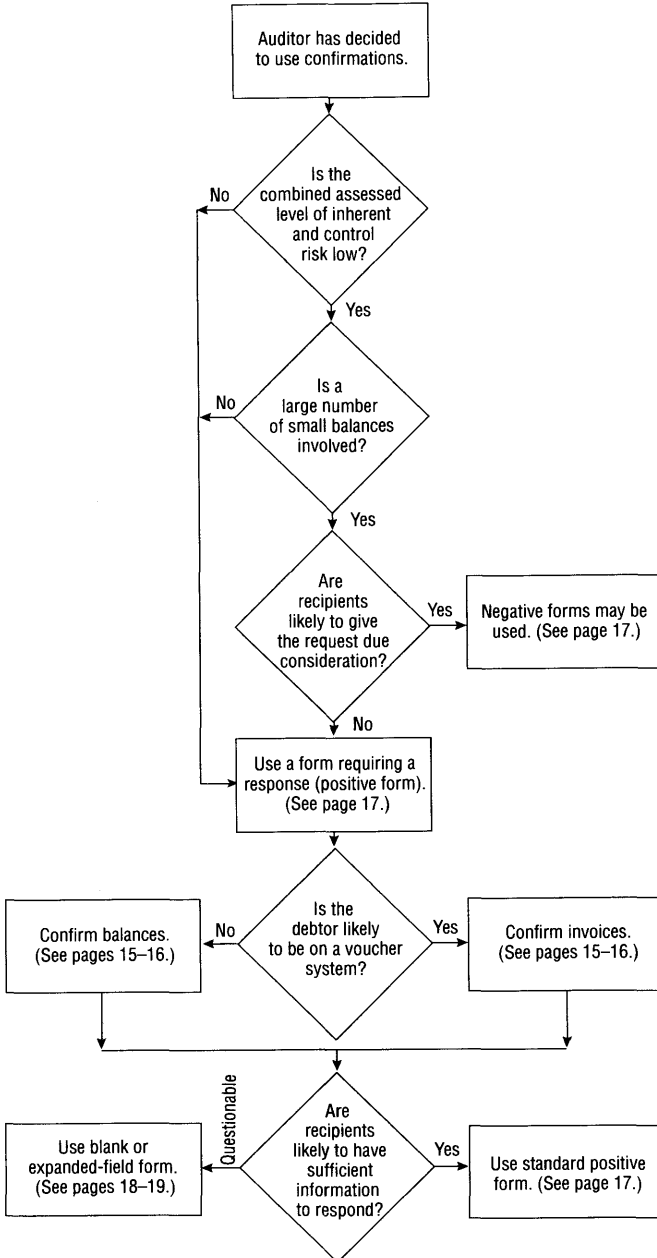


(Continued)

Flowchart A.1
The Accounts Receivable Confirmation Process (Continued)



Flowchart A.2 Selecting Confirmation Forms



Selected Annotated Bibliography

ARMITAGE, JACK L. "Accounts Receivable Confirmation Usage and Effectiveness: Perceptions of Practicing CPAs." *Journal of Applied Business Research* 6 (Spring 1993): 97–103.

This paper reports the results of a questionnaire survey of practicing auditors regarding their assessment of the competence and effectiveness of the accounts receivable confirmation auditing procedure. The respondents indicated they regularly use positive and negative confirmations in practice, and they rated the evidence provided by negative confirmations significantly lower than for positives. Also, the respondents perceived the detection rate for positive and negative confirmations to be 20 to 40 percentage points higher than rates reported from empirical research. Thus, auditors may be overestimating the effectiveness of this auditing procedure and facing higher levels of audit risk than they anticipate.

ASHTON, ROBERT H., and ROBERT E. HYLAS. "Increasing Confirmation Response Rates." *Auditing: A Journal of Practice and Theory* (Summer 1981): 12–22.

This article reports on a study of several techniques potentially useful for increasing the response rate on accounts receivable confirmations mailed to individuals. The techniques, adapted from those previously found effective for increasing response rates on mail-survey questionnaires, included alternative types of postage, provision of detail, a handwritten signature, alternative confirmation wording, and prior notification by postcard. The results suggest that the postage and postcard variables are very effective for increasing response rates, that the signature and detail variables are somewhat effective, and that certain combinations of techniques are particularly useful.

CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS. *Confirmation of Accounts Receivable*. 2nd ed. Audit Technique Study. Toronto: Canadian Institute of Chartered Accountants, 1992.

This study identifies problems and criticisms associated with accounts receivable confirmations and it recommends solutions. The study concludes that

direct communication with debtors remains the most useful technique for forming an opinion on the existence of accounts receivable. It recommends that the auditor use only positive rather than negative confirmations.

The study group's criticisms of confirmation techniques fall into two categories: (1) an inability to reply and (2) debtor apathy toward confirmation forms. By designing forms with the recipient in mind and by providing more information that the recipient can use in determining whether the balance is or is not correct, both criticisms may be addressed.

KROGSTAD, JACK L., and MARSHALL B. ROMNEY. "Accounts Receivable Confirmation—An Alternative Auditing Approach." *Journal of Accountancy* (February 1980): 68–74.

This article reports the results of one firm's experience in using open-invoice confirmations. According to the authors, open-invoice confirmations increase response rates, increase the efficiency of alternative procedures, reduce reconciliation work associated with exceptions, and increase the reliability of confirmation responses.

SAULS, EUGENE H. "Nonsampling Errors in Accounts Receivable Confirmations." *The Accounting Revue* (January 1972): 109–115.

This article reviews an experiment conducted between 1967 and 1969. In the experiment, positive and blank confirmations were sent to personal loan customers and automobile loan customers of a commercial bank. The objective was to determine the extent of nonsampling errors in accounts receivable confirmation procedures. Nonsampling errors consisted of incorrect-response errors and nonresponse errors. An incorrect-response error occurred whenever the respondent confirmed the balance as correct when it was incorrect or noted an exception when the balance was correct.

Sauls found the proportion of correct responses to incorrect confirmations to be much lower than satisfactory; therefore, he concluded that the assumption about recipients' normal responses to incorrect confirmations was invalid. However, his experiment also found no incorrect responses and generated no reason to believe that response is a function of account propriety.

SORKIN, H.L. "Third Party Confirmation Requests: A New Approach Utilizing an Expanded Field." Auditing Symposium IV, 61–72. Touche Ross/University of Kansas, May 25–26, 1978.

This research study is based on 2,280 confirmations—600 positive, 480 negative, and 1,200 of the expanded-field format. In all three categories, accounts were correctly stated as well as deliberately misstated. According to the study, the expanded-field format is more reliable than either the positive or the negative format. For example, the ability of the expanded-field format to detect discrepancies in the entity's books was superior to both the negative and the positive format, regardless of the amount or direction of error.

SORKIN, H.L., and K.H. MEUWISSEN. "A New Technique in Confirmations: The Expanded Field." *The Internal Auditor* (October 1978): 88–92.

This article deals with the purpose of the expanded-field confirmation, which is to improve the reliability of the information returned by recipients. A recipient of a confirmation with an incorrect balance may do one of three things: ignore the request, verify the misstated amount, or note an exception and return a restated balance. The advantage of the expanded-field format is its ability to discourage what Sorkin calls *say yes* behavior, which occurs when the recipient agrees with the information in the request even though it is incorrect. The expanded-field format motivates the recipient to compare the balances presented with information in his or her records.

This article discusses how several studies contrasting the positive and negative approaches with the expanded-field technique have indicated the superiority of the latter for detecting misstatements. In one survey involving installment loan customers, the overall detection rate for the expanded-field form was 89 percent, while the detection rate for the positive form was only 45 percent.

WARREN, CARL S. "Confirmation Reliability—The Evidence." *Journal of Accountancy* (February 1975): 85–89.

This article compares the results of five field studies that investigated the reliability of mail payable and receivable confirmations. All five studies examined reliability by sending both correctly stated and deliberately misstated confirmations. Two studies experimented with positive confirmations, while the remaining three used both positive and negative confirmations.

After comparing the results of the various studies, Warren concluded the following:

- The response rates for correctly stated positive confirmations varied only slightly from the response rates of the deliberately misstated positive confirmations.
- Positive confirmations are more reliable than negative confirmations.
- Confirmations are less likely to detect misstatements favorable to confirmation recipients than those that are unfavorable.
- The larger the account being confirmed, the more accurate the confirmation response will be.
- There was not enough evidence to determine whether detection rates differ for large versus small misstatements.

Technical References

The following AICPA technical pronouncements provide guidance on confirming accounts receivable.

AICPA Audit and Accounting Manual, June 1, 1994, sec. 5000, 6000, and 7000, presents materials on the following:

- Internal Accounting Control: Revenue, Receivables, and Receipts (5400.040)
- Illustrative Audit Objectives and Program (5400.070)
- Accounts Receivable Confirmation Statistics (6500.280–.281)
- Illustrative Confirmation Control Sheet (6500.310)
- Control of Confirmation and Correspondence (7100.01–.09)
- Accounts Receivable—Positive Form (7200.09)
- Accounts Receivable—Negative Form (7200.10)

Statement on Auditing Standards (SAS) No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330)

Technical Practice Aids, sec. 8340, “Evidential Matter: Confirmation Procedures,” contains practice aids that pertain to accounts receivable, including the following:

- Confirmation to Factored Receivables (8340.01)
- Confirmation of Receivables From Governments and Large Corporations (8340.02)
- Confirmation of Balances Due on Loans (8340.03)
- Wording of Confirmation Request Forms (8340.06)
- Use of Postage-Paid Return Envelopes (8340.08)
- Receivables in Cash Basis Financial Statements (8340.11)

Statement on Auditing Standards No. 67, *The Confirmation Process*

INTRODUCTION AND APPLICABILITY

1. This Statement provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. This Statement—

- Defines the confirmation process (see paragraph 4).
- Discusses the relationship of confirmation procedures to the auditor's assessment of audit risk (see paragraphs 5 through 10).
- Describes certain factors that affect the reliability of confirmations (see paragraphs 16 through 27).
- Provides guidance on performing alternative procedures when responses to confirmation requests are not received (see paragraphs 31 and 32).
- Provides guidance on evaluating the results of confirmation procedures (see paragraph 33).
- Specifically addresses the confirmation of accounts receivable and supersedes paragraphs 3 through 8 of Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.03–.08), and the portion of paragraph 1 of AU section 331 that addresses the confirmation of receivables (see paragraphs 34 and 35). This Statement does not supersede the portion of paragraph 1 of AU section 331 that addresses the observation of inventories.

2. This Statement does not address the extent or timing of confirmation procedures. Guidance on the extent of audit procedures (that is, considerations involved in determining the number of items to confirm) is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). Guidance on the

timing of audit procedures is included in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313).

3. In addition, this Statement does not address matters described in SAS No. 11, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), or in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).

DEFINITION OF THE CONFIRMATION PROCESS

4. Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The process includes—

- Selecting items for which confirmations are to be requested.
- Designing the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining the response from the third party.
- Evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information.

RELATIONSHIP OF CONFIRMATION PROCEDURES TO THE AUDITOR'S ASSESSMENT OF AUDIT RISK

5. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), discusses the audit risk model. It describes the concept of assessing inherent and control risks, determining the acceptable level of detection risk, and designing an audit program to achieve an appropriately low level of audit risk. The auditor uses the audit risk assessment in determining the audit procedures to be applied, including whether they should include confirmation.

6. Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. Paragraph 19 of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), states that, in general, it is presumed that

When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.

7. The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk increases, the auditor designs substantive tests to obtain more or different evidence about a financial statement assertion. In these situations, the auditor might use confirmation procedures rather than or in conjunction with tests directed toward documents or parties within the entity.

8. Unusual or complex transactions may be associated with high levels of inherent risk and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity. For example, if the combined assessed level of inherent and control risk over the occurrence of revenue related to an unusual, year-end sale is high, the auditor should consider confirming the terms of that sale.

9. The auditor should assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures should be performed. For example, to achieve an appropriately low level of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable.

10. The lower the combined assessed level of inherent and control risk, the less assurance the auditor needs from substantive tests to form a conclusion about a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk decreases for a particular assertion, the auditor may modify substantive tests by changing their nature from more effective (but costly) tests to less effective (and less costly) tests. For example, if the combined assessed level of inherent and control risk over the existence of cash is low, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

Assertions Addressed by Confirmations

11. For the evidence obtained to be competent, it must be reliable and relevant. Factors affecting the reliability of confirmations are discussed in paragraphs 16 through 27. The relevance of evidence depends on its relationship to the financial statement assertion being addressed. SAS No. 31 classifies financial statement assertions into five categories:

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure.

12. Confirmation requests, if properly designed by the auditor, may address any one or more of those assertions. However, confirmations do not address all assertions equally well. Confirmation of goods held on consignment with the consignee would likely be more effective for the existence and the rights-and-obligations assertions than for the valuation assertion. Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

13. Confirmation requests can be designed to elicit evidence that addresses the completeness assertion: that is, if properly designed, confirmations may provide evidence to aid in assessing whether all transactions and accounts that should be included in the financial statements are included. Their effectiveness in addressing the completeness assertion depends, in part, on whether the auditor selects from an appropriate population for testing. For example, when using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population might be a list of vendors rather than the amounts recorded in the accounts payable subsidiary ledger.

14. Some confirmation requests are not designed to elicit evidence regarding the completeness assertion. For example, the AICPA Standard Form to Confirm Account Balance Information With Financial Institutions is designed to substantiate information that is stated on the confirmation request; the form is not designed to provide assurance that information about accounts not listed on the form will be reported.

THE CONFIRMATION PROCESS

15. The auditor should exercise an appropriate level of professional skepticism throughout the confirmation process; see SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Professional skepticism is important in designing the confirmation request, performing the confirmation procedures, and evaluating the results of the confirmation procedures.

Designing the Confirmation Request

16. Confirmation requests should be tailored to the specific audit objectives. Thus, when designing the confirmation requests, the auditor should consider the assertion(s) being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent should affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through confirmation procedures.

Form of Confirmation Request

17. There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

18. Positive forms provide audit evidence only when responses are received from the recipients; nonresponses do not provide audit evidence about the financial statement assertions being addressed.

19. Since there is a risk that recipients of a positive form of confirmation request with the information to be confirmed contained on it may sign and return the confirmation without verifying that the information is correct, blank forms may be used as one way to mitigate this risk. Thus, the use of blank confirmation requests may provide a greater degree of assurance about the information confirmed. However, blank forms might result in lower response rates because additional effort may be required of the recipients; consequently, the auditor may have to perform more alternative procedures.

20. The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. For example, in the examination of demand deposit accounts in a financial institution, it may be appropriate for an auditor to include negative confirmation requests with the customers' regular statements when the combined assessed level of inherent and control risk is low and the auditor has no reason to believe that the recipients will not consider the requests. The auditor should consider performing other substantive procedures to supplement the use of negative confirmations.

21. Negative confirmation requests may generate responses indicating misstatements, and are more likely to do so if the auditor sends a large number of negative confirmation requests and such misstatements are widespread. The auditor should investigate relevant information provided on negative confirmations that have been returned to the auditor to determine the effect such information may have on the audit. If the auditor's investigation of responses to negative confirmation requests indicates a pattern of misstatements, the auditor should reconsider his or her combined assessed level of inherent and control risk and consider the effect on planned audit procedures.

22. Although returned negative confirmations may provide evidence about the financial statement assertions, unreturned negative confirmation requests rarely provide significant evidence concerning financial statement assertions other than certain aspects of the existence assertion. For example, negative confirmations may provide some evidence of the existence of third parties if they are not returned with an indication that the addressees are unknown. However, unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct.

Prior Experience

23. In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. For example, if the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider obtaining audit evidence from other sources.

Nature of Information Being Confirmed

24. When designing confirmation requests, the auditor should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, certain respondents' accounting systems may facilitate the confirmation of single transactions rather than of entire account balances. In addition, respondents may not be able to confirm the balances of their installment loans, but they may be able to confirm whether their payments are up-to-date, the amount of the payment, and the key terms of their loans.

25. The auditor's understanding of the client's arrangements and transactions with third parties is key to determining the information to be confirmed. The auditor should obtain an understanding of the substance of such arrangements and transactions to determine the appropriate information to include on the confirmation request. The auditor should consider requesting confirmation of the terms of unusual agreements or transactions,

such as bill and hold sales,¹ in addition to the amounts. The auditor also should consider whether there may be oral modifications to agreements, such as unusual payment terms or liberal rights of return. When the auditor believes there is a moderate or high degree of risk that there may be significant oral modifications, he or she should inquire about the existence and details of any such modifications to written agreements. One method of doing so is to confirm both the terms of the agreements and whether any oral modifications exist.

Respondent

26. The auditor should direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed. For example, to confirm a client's oral and written guarantees with a financial institution, the auditor should direct the request to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements.

27. If information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity² comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary. In addition, there may be circumstances (such as for significant, unusual year-end transactions that have a material effect on the financial statements or where the respondent is the custodian of a material amount of the audited entity's assets) in which the auditor should exercise a heightened degree of professional skepticism relative to these factors about the respondent. In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence.

Performing Confirmation Procedures

28. During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control³ means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the

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1. Bill and hold sales are sales of merchandise that are billed to customers before delivery and are held by the entity for the customers.
 2. Paragraphs 9 and 10 of AU sec. 334, *Related Parties*, provide guidance on examining related-party transactions that have been identified by the auditor.
 3. The need to maintain control does not preclude the use of the internal auditors in the confirmation process. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.

results will be biased because of interception and alteration of the confirmation requests or responses.

29. There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. For example, facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the original confirmation directly to the auditor. Oral confirmations should be documented in the workpapers. If the information in the oral confirmations is significant, the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor.

30. When using confirmation requests other than the negative form, the auditor should generally follow up with a second and sometimes a third request to those parties from whom replies have not been received.

ALTERNATIVE PROCEDURES

31. When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, the omission of alternative procedures may be acceptable (a) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (b) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated.

32. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, for example, alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid), shipping documents, or other client documentation to provide evidence for the existence assertion. In the examination of accounts payable, for example, alternative procedures may include examination of subsequent cash disbursements, correspondence from third parties, or other records to provide evidence for the completeness assertion.

EVALUATING THE RESULTS OF CONFIRMATION PROCEDURES

33. After performing any alternative procedures, the auditor should evaluate the combined evidence provided by the confirmations and the alternative procedures to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions. In performing that evaluation, the auditor should consider (a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures.

CONFIRMATION OF ACCOUNTS RECEIVABLE

- 34.** For the purpose of this Statement, *accounts receivable* means —
- a. The entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and
 - b. A financial institution's loans.

Confirmation of accounts receivable is a generally accepted auditing procedure. As discussed in paragraph 6, it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective.⁴
- The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

4. For example, if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.

35. An auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption.

EFFECTIVE DATE

36. This Statement is effective for audits of fiscal periods ending after June 15, 1992. Early application of this Statement is permissible.

This Statement entitled The Confirmation Process was adopted by the assenting votes of seventeen members of the board, of whom two, Messrs. Harden and Pallais, assented with qualification.

Messrs. Harden and Pallais qualify their assents to this Statement because they believe that paragraphs 34 and 35, which discuss the confirmation of accounts receivable, inappropriately usurp auditor judgment. They believe that auditors should not be required under circumstances described in the Statement to confirm accounts receivable but, instead, auditors should be allowed to choose audit procedures that are the most effective in the circumstances.

Paragraph 12 notes that confirmations do not address all assertions equally well. Messrs. Harden and Pallais believe that paragraphs 34 and 35 may lead auditors to place undue reliance on confirmation of accounts receivable for assertions where application of the guidance in paragraphs 1 through 33 might otherwise lead the auditor to select a more effective test.

In addition, Mr. Harden believes that paragraph 35 is unnecessary and inappropriately places greater emphasis on the confirmation of accounts receivable than previously existing auditing standards.

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