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Proposed statement on auditing standards : the confirmation process;Confirmation process

American Institute of Certified Public Accountants. Auditing Standards Board

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EXPOSURE DRAFT

**PROPOSED STATEMENT ON
AUDITING STANDARDS**

THE CONFIRMATION PROCESS

NOVEMBER 13, 1990

**Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting**

**Comments should be received by February 1, 1991, and addressed to
Douglas P. Sauter, Technical Manager, AICPA Auditing Standards Division, File 2371
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775**

SUMMARY

Why Issued

The Auditing Standards Board is considering the issuance of this proposed Statement to provide practitioners with additional guidance about the use of confirmations. The Board determined that additional guidance was necessary after reviewing problems identified in the peer review process, in the SEC Enforcement Releases, and in research. The Board's review indicated that practitioners do not always appropriately consider—

- The financial statement assertions addressed by confirmations.
- The design of the confirmation request.
- The third party to whom the request was addressed.
- The evaluation of confirmation results.

What It Does

This proposed Statement provides guidance about all types of confirmations, including accounts receivable confirmations, and establishes certain performance responsibilities for auditors using confirmations in engagements performed in accordance with generally accepted auditing standards. This proposed Statement—

- Discusses the relationship of confirmation procedures to the auditor's assessment of audit risk and discusses financial statement assertions addressed by confirmations.
- Describes certain factors that affect the reliability of confirmations and emphasizes that proper design of the confirmation request is key to achieving specific audit objectives.
- Provides guidance on performing alternative procedures when responses to confirmation requests are not received.
- Provides guidance on evaluating the results of confirmation procedures.

This proposed Statement retains the notion set forth in existing standards that the confirmation of accounts receivable is a generally accepted auditing procedure. It also states that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit, unless certain conditions exist. If an auditor does not request confirmations in the examination of accounts receivable, this proposed Statement requires an auditor to document how he or she overcame this presumption.

How It Affects Existing Standards

This proposed Statement would supersede paragraphs 3–8 of Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures*, section 331 (AICPA, *Professional Standards*, vol. 1, AU sec. 331.03-.08), and the portion of paragraph 1 of section 331 that addresses the confirmation of receivables. The proposed Statement would not supersede the portion of paragraph 1 of section 331 that addresses the observation of inventories.

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
 - *Members of AICPA Council and technical committees.*
 - *State society and chapter presidents, directors, and committee chairpersons.*
 - *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
 - *Persons who have requested copies.*
-

November 13, 1990

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board, of a proposed statement on auditing standards titled The Confirmation Process. This proposed Statement provides guidance to the auditor on using confirmations in engagements performed in accordance with generally accepted auditing standards. A summary of the proposed Statement also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate consideration of responses by the Auditing Standards Board, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

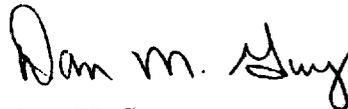
In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the Board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the AICPA after March 1, 1991, for one year. Responses should be sent to the Auditing Standards Division, File 2371, in time to be received by February 1, 1991. For convenience in responding, a postpaid response form is attached.

Sincerely,



Donald L. Neebes
Chairman
Auditing Standards Board



Dan M. Guy
Vice President
Auditing Standards Division

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PROPOSED STATEMENT ON AUDITING STANDARDS

THE CONFIRMATION PROCESS

INTRODUCTION AND APPLICABILITY

1. This Statement provides guidance concerning the confirmation process in engagements performed in accordance with generally accepted auditing standards. This statement—

- Defines the confirmation process.
- Discusses the relationship of confirmation procedures to the auditor's assessment of audit risk.
- Describes certain factors that affect the reliability of confirmations.
- Provides guidance on performing alternative procedures when responses to confirmation requests are not received.
- Provides guidance on evaluating the results of confirmation procedures.
- Specifically addresses the confirmation of accounts receivable and supersedes paragraphs 3–8 of Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures*, section 331 (AICPA, *Professional Standards*, vol. 1, AU sec. 331.03–.08), and the portion of paragraph 1 of section 331 that addresses the confirmation of receivables. This Statement does not supersede the portion of paragraph 1 of 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* (AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312). Guidance on the timing of audit procedures is included in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU sec. 313).

3. In addition, this Statement does not address matters described in

SAS No. 11, *Using the Work of a Specialist* (AU sec. 336), or in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (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 relative to 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* (AU sec. 312), discusses the audit risk model. It describes the concept of assessing inherent and control risks, determining the appropriate 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. SAS No. 31, *Evidential Matter* (AU sec. 326), states: "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 higher the assessed levels of inherent risk and control risk, the higher the level of assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the assessed levels of inherent risk and control risk increase, 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 tests directed toward documents or parties within the entity. Furthermore, if the entity has entered into an unusual or complex transaction, 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 inherent and control risks over the occurrence of revenues related to an unusual, year-end sale of software are assessed as high, the auditor should consider using confirmation requests to confirm the terms of recorded transactions related to those revenues.

8. In some cases, the evidence provided by confirmations will not be sufficient and additional substantive procedures will be necessary. For example, if inventories are held at public warehouses, the auditor ordinarily would obtain direct confirmation from the custodian. However, depending on the materiality of such inventories and the auditor's inherent and control risk assessments concerning the existence of such inventories, the auditor may apply other substantive procedures in addition to confirmation, such as observing physical counts of the inventory.

9. The lower the assessed levels of inherent risk and control risk, the less assurance the auditor needs from substantive tests to form a conclusion

about a financial statement assertion. Consequently, as the assessed levels of inherent risk and control risk decrease for a particular assertion, the auditor may be justified in modifying substantive tests by changing their nature from more effective (but costly) tests to less effective (and less costly) tests. For example, if inherent and control risks are assessed as low over the occurrence of revenue related to the sale of software, the auditor might use substantive procedures other than confirmation (such as inspecting relevant client-provided documentation and applying relevant analytical procedures), as long as audit risk is reduced to a sufficiently low level for the financial statement assertion.

Assertions Addressed by Confirmations

10. For the evidence obtained to be competent, it must be reliable and relevant. Factors affecting the reliability of confirmations are discussed subsequently in paragraphs 15 through 25. The relevance of evidence depends on whether it relates to the financial statement assertion being addressed. SAS No. 31 classifies financial statement assertions according to five categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

11. 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, for example, 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-of-receivables assertion than for the completeness and valuation assertions. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit proce-

dures (a) to complement confirmation procedures or (b) to be used in lieu of confirmation procedures.

12. Confirmation requests can be designed to elicit evidence that addresses the completeness assertion; that is, if properly designed, confirmations can be of some use 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, receiving documents, or disbursements rather than the amounts recorded in the accounts payable subsidiary ledger.

13. 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 seek information about accounts that are not listed on the form.

THE CONFIRMATION PROCESS

14. 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* [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

15. Confirmation requests should be tailored to the specific audit objec-

tives. 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, 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.

16. *Form of Confirmation Request.* There are two types of confirmation request: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she is in agreement 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.

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

18. Although there is a risk that recipients of any positive form of confirmation request may sign and return the confirmation without considering it, the use of blank forms mitigates 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 alternative procedures for more items than if the information to be confirmed had been stated on the confirmation request.

19. The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. The auditor should evaluate relevant information provided on negative confirmations

that have been returned to the auditor to determine the effect such information may have on the audit.

20. Negative confirmation requests may be used for certain types of entities when (a) the assessed level of 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 adequate consideration. Auditors of financial statements of entities in certain specialized industries (such as financial institutions, utilities, and retail organizations) may meet these conditions. The auditor should give consideration to performing other substantive procedures to supplement the use of negative confirmations. In such cases, when the auditor sends a large number of negative confirmation requests, the auditor normally expects to receive some responses indicating misstatements if such misstatements are widespread. 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 control risk is assessed to be low and the auditor's past experience indicates that the recipients consider the requests.

21. 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 party received the confirmation request and verified that the information contained on it is correct.

22. *Prior Experience.* 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 consider obtaining audit evidence from other sources.

23. *Nature of Information Being Confirmed.* 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 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.

24. 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 transactions being confirmed to determine the appropriate information to include on the confirmation request. The auditor should consider requesting confirmation of the terms of agreements or transactions in addition to the amounts. The auditor should also 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 oral modifications, he or she should inquire concerning 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.

25. *Respondent.* 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. The respondent's competence, knowledge, motivation, ability, and willingness to respond, as well as the respondent's objectivity and freedom from bias with respect to the audited entity, all affect the effectiveness of the confirmation process. Normally, the auditor is not obligated to search for information relative to these factors. However, in designing the confirmation requests and evaluating the results, the auditor should consider any such information that comes to his or her attention. In addition, there may be circumstances (such as for significant, unusual year-end transactions that have a material effect on the financial statements) in which the auditor should exercise a heightened degree of professional skepticism relative to these factors about the respondent.

Performing Confirmation Procedures

26. During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control¹ means establishing direct communication between the recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses.

¹ The need to maintain control does not preclude the use of internal auditors in the confirmation process. Paragraph 10 of SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 322.10), notes that internal auditors may provide direct assistance to the auditor in performing substantive tests.

27. There may be situations in which the respondent, due to timeliness or other considerations, chooses to use nontraditional media to respond to a confirmation request. The auditor should consider any special risks that may be associated with such media as electronic inquiries, facsimile responses, or oral confirmations when they are used in the confirmation process. When such media are used, additional evidence may be required to support the validity of the responses. For example, facsimile responses involve special 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 confirmation is significant, the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor.

28. When using positive confirmation requests, 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

29. 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 auditor may consider not performing alternative procedures to the nonresponses if (a) the nonresponses in the aggregate, when projected as 100 percent misstatements to the population, would not affect the auditor's decision about whether the financial statements are materially misstated

and (b) 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.

30. 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, shipping documents, or other client documentation, to provide evidence for the existence and valuation assertions and examination of correspondence from third parties and other records to provide evidence for the rights-and-obligations assertion.

EVALUATING THE RESULTS OF CONFIRMATION PROCEDURES

31. 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 relative to 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 differences, including the implications—both quantitative and qualitative—of those differences; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests of details or analytical procedures.

CONFIRMATION OF ACCOUNTS RECEIVABLE

32. For the purpose of this statement, accounts receivable are the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business. Confirmation of accounts receiv-

able is a generally accepted auditing procedure. As discussed in paragraph 6, it is 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—

- Accounts receivable are immaterial to the financial statements,
- The use of confirmations would be ineffective as an audit procedure,² or
- The auditor's combined assessment of inherent risk and control risk is low, and that assessment, 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.

33. An auditor who has not requested confirmation of accounts receivable should document how he or she overcame this presumption.

EFFECTIVE DATE

34. This statement is effective for audits of financial statement for periods beginning on or after January 1, 1991. Early application of this statement is permissible.

² For example, if, based on prior years' audit experience or 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.