

External confirmation – the means to obtain audit evidence in audit procedures

Marie Vejsadová Dryjová¹

Abstract: Few information systems can generate the documents necessary to reconcile the balances of the receivables and the liabilities. For these purposes, the external confirmation method is suitable, which can be used voluntarily by the accounting units within the framework of the inventorying of the receivables and the liabilities, and by the auditors when auditing the financial statements. The external confirmation, as one of the audit procedures, is the most effective way of verifying the account balances correctness, the contractual terms, the contracts, or the transactions, for the reason that audit evidence is obtained from independent sources outside the accounting unit. The paper presents the external confirmation and offers the solutions in the problematic areas, such as the "obligation" to send the external confirmation, unreceived response from the confirmation letters, the choice of the sample unit, the question of the prefilling the confirmed amount, the reliability of audit evidence obtained from the confirmation letters, or possible reasons of the unsent external confirmation, etc.

Keywords: external confirmation, audit procedures, receivables and liabilities, sampling unit, audit evidence

JEL Classification: M41, M42

1 Introduction

An external confirmation (or even a confirmation letter) as a method for obtaining audit evidence is not only used by auditors when auditing financial statements but the confirmation method is also used by accounting units, especially when inventorying receivables and liabilities. The accounting units send the confirmation letters to customers to confirm the account balance of the receivables and to suppliers to confirm the account balance of the liabilities because the Act No. 563/1991 Coll., On Accounting, as amended, in Part Five regulates the obligation of the inventorying the receivables and the liabilities. The accounting unit has the state of the liabilities agreed by each of its creditors and the state of the receivables by each of its debtors in the form of the external confirmation. The method of confirming the status of the receivables and the liabilities, as well as the given form, should be specified in an internal directive within the process of the inventorying the receivables and the liabilities, and may differ among accounting units in practice. Act No. 563/1991 Coll., On Accounting, as amended, does not impose the form of the inventorying the receivables and the liabilities through the external confirmation to the accounting units as mandatory but it is true that this form is still the most effective and demonstrable when it comes to documenting the actual state of the receivables and the liabilities, and the resulting recorded differences.

While on the side of the accounting unit, the method of the external confirmation of the receivables and the liabilities is considered as voluntary (Act No. 563/1991 Coll., On Accounting, as amended, not only does not require it for the inventorying, but also does not regulate it), on the side of the auditors, the external confirmation is considered one of the audit procedures necessary to obtain audit evidence regarding with account balances and other facts. Furthermore, the external confirmation is considered a highly valued audit method, it provides audit evidence in the sense of the confirmation of a given fact from an independent source outside the accounting unit.

2 Methods

The International Standard on Auditing 505 (ISA 505) regulates the audit procedures when using the external confirmation to obtain audit evidence. ISA 505 includes the design and performance of the external confirmation procedures to obtain relevant and reliable audit evidence (Kareš, 2014). ISA 505 defines the external confirmation as audit evidence relating to assertions in the financial statements or related disclosures as a direct response to the auditor from a confirming party in paper, electronic or other media. As ISA 505 states, the procedures related to the external confirmations are often performed to confirm or request the information regarding account balances and their components. However, these procedures can also be used to confirm the contractual terms, the contracts or the transactions between

¹ University of South Bohemia in České Budějovice, Department of Accounting and Finances, Faculty of Economics, Studentská 13, 370 05 České Budějovice, Czech Republic, vejsadova@ef.jcu.cz.

the accounting entity and other parties. The external confirmation can also be used to confirm the absence of certain conditions, such as the conclusion of an unofficial agreement.

The external confirmation is one of the audit procedures leading to obtain **audit evidence**. Audit evidence, the methods of obtaining it, as well as the auditor's responsibility in obtain audit evidence are regulated by the International Standard on Auditing 500 (ISA 500). ISA 500 states that audit evidence is primarily the result of the audit procedures performed during the audit. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based:

- *Relevance of information* – deals with the logical connection with, or bearing upon, the purpose of the audit procedure and may be affected by the direction of the testing.
- *Reliability of information* – is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation. ISA 500 uses the following generalization of the reliability of audit evidence relating to the external confirmation audit procedure:
 - the reliability of audit evidence is increased when it is obtained from independent sources outside the entity;
 - audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally;
 - audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

ISA 500 states that even when information to be used as audit evidence is obtained from the external sources outside the accounting unit, there may be circumstances that affect the reliability of that information. This is because all responses carry some risk of withholding, alteration, or fraud. Such risk exists regardless of the form in which the response is received from the confirming party. When the auditor has doubts about the reliability of information, the auditor must use his professional judgment to decide whether to modify or add the additional audit procedures to resolve the doubts about the reliability of information that he intends to use as audit evidence. However, if the auditor concludes, based on his professional judgment, that the response to the confirmation letter is not reliable and therefore cannot be used as audit evidence, the auditor must reassess the assessed risks of the material misstatement at the assertion level, including the risk of the fraud, and adjust the planned audit procedures, in particular their extent and timing.

In the case of the unreceived response, the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence. The nature and extent of the alternative procedures is influenced by the relevant account and assertion and is entirely dependent on the professional judgment of the auditor. ISA 505 provides examples of the alternative audit procedures only for receivable a liabilities accounts balance:

- *receivable accounts balances* – testing of selected subsequent cash payments, delivery documentation and sales revenues near the end of the accounting period;
- *liabilities accounts balances* – testing subsequent cash payments or correspondence from third parties and other records such as receipts.

ISA 505 does not prescribe the alternative audit procedures for other accounts balances. The auditor should proceed according to his professional judgment in this case.

ISA 505 also addresses the situation where the **auditor does not receive the response from the confirmation letter due to management's refusal** to send the confirmation letter. In this case, according to ISA 505, the auditor is obliged to inquire as to management's reasons for the refusal and seek audit evidence as to their validity and reasonableness and perform alternative audit procedures designed to obtain relevant and reliable audit evidence. If the auditor is unable to obtain relevant and reliable audit evidence from the alternative audit procedures, the auditor shall communicate with those charged with governance and determine the implications for the audit and the auditor's opinion.

In relation to external confirmation, ISA 505 requires to auditors to **maintain control over the external confirmation requests** – i.e., determining the information to be confirmed or requested, selecting the appropriate confirming party, designing, and sending the confirmation request.

The auditor selects the sample from the entire set of the receivables and the liabilities. The selection of the samples for performing audit procedures is governed by ISA 530 which deals with the auditor's use of the statistical and the non-

statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. As ISA 530 states, with the statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With the non-statistical sampling, judgment is used to select sample items. Because the purpose of the sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population. As Ricchiute (1994) adds, each method has its advantages and disadvantages. The choice of the method should always be based on the expert knowledge, the professional judgment, and the fact whether the auditor has already performed the audit procedures in the company in previous years. Therefore, each auditor can choose a different way of the sample size quantification. However, the number of the tested samples depends on the determined level of significance, the amount of the tested population of the receivables and the liabilities, and the amount of the sampling risk that the auditor is willing to accept. If the auditor has quantified the number of samples that must be tested, the selection of the sample itself follows, where one sample can correspond to one subscriber, supplier (i.e., one sample is equal to one customer balance account), or one sample can correspond to one accounting document.

The external confirmation, which is one of the tests of detail, is a source of information on the completeness, existence, correctness, including the valuation of the item, and is used to collect audit evidence to substantiate the amount stated in the financial statements. They provide audit evidence about whether the amount was accounted correctly and to the period with which it is temporally and materially related (Müllerová & Králíček, 2014). As Štěpán (2012) adds, the International Standards on Auditing basically only inform what the auditor should deal with. And it is no different in case of ISA 505. The auditor has to collect enough quality information then analyze this information thoroughly and only then draw the conclusion. However, the resulting method of the performance is left to the professional judgment, subjective opinion, and experience interspersed with the intuition of each auditor. For that reason, the whole process of the external confirmation as one of the audit procedures can be considered completely variable.

3 Research results

Research results chapter analyzes the process of the external confirmation as one of the possible audit procedures to obtain relevant and reliable audit evidence, and furthermore it presents the most common problem areas associated with the external confirmation and it proposes possible procedures in practice.

3.1 The obligation of the external confirmation

Although ISA 505 regulates proposals and procedures for the external confirmation, no International Standard on Auditing determines the auditor's obligation to perform these external confirmations. The only comment on the obligation of the external confirmation is given by ISA 330 which determines the auditor's obligation to assess whether he should also perform the external confirmation. It is therefore only up to the auditor's professional judgment whether to continue with the external confirmations or not. However, we must not neglect the fact that the external confirmations are considered the most reliable source of audit evidence because they are obtained from an independent source (confirming party) outside the accounting unit.

The auditor also has the right to decide not to send the external confirmation too. At the same time, the auditor should properly justify the given fact in the auditor's file where he should also state by which other audit procedures, he obtains necessary audit evidence. In cases where the auditor identifies a significant risk in each area, it is not desirable to back off from sending the external confirmations because the obtaining of audit evidence by other (alternative) methods is impossible in this case.

Otherwise, when the auditor decides to send the confirmation letters, he should always keep in mind that the entire process with the external confirmation should be under his control, as described in ISA 505. Only in this way the auditor maintains a high level of the reliability of obtained audit evidence. However, the sending the confirmation letter may not yet provide necessary audit evidence to the auditor, as there is no legal way to compel the response to the confirmation letter from the confirming party.

3.2 Unreceived external confirmation

The auditor may not receive the confirmation response if the confirming party refuses to send the response to the confirmation letter – i.e., an obstacle on the part of the confirming party (customer). This phenomenon is a frequent reality in practice for any number of reasons and, as already stated, there is no legally enforceable obligation to respond from the confirming party. The auditor may still try to urge the confirming party to send the reply to the confirmation letter. In the second case, there may arise the situation when the manager of the audited company refuses to send the confirmation letter, for example, to the bank institution due to a low balance of the funds in the bank account. Now the obstacle is on the side of the audited company. In any case, the auditor has the obligation according to ISA 505 to perform the alternative

audit procedures leading to obtaining relevant and reliable audit evidence. ISA 505 provides the alternative audit procedures for the receivable and the liabilities balances, but not for the bank account balances. There are suggested the alternative audit procedures for the receivable, the liabilities, and the bank accounts balances below:

- **Area of the receivables** – the auditor performs the alternative procedures in accordance with ISA 505 in case of the unreceived replies to the confirmation letters (i.e., unconfirmed receivables). The auditor collects the supporting documents that confirm the origination of the receivables, such as delivery notes or other documentation (e.g., contracts, handover protocols, correspondence with the customer, etc.). The auditor must assent the amount of the accounted receivables through the tests of details on the invoice, the delivery notes or other documentation. Since the audit is carried out only after the end of the accounting period, it is likely that some of the receivables will have already been paid at the time of the audit. This is therefore a situation of the unconfirmed receivable that has already been paid. In this case, it is advisable for the auditor to request the documentation of the subsequent payments – i.e., the bank statement where he must assess its originality and whether the data could have been altered or otherwise manipulated. The amount of the paid receivables at the time of the audit depends both on the payment conditions of the audited company and on the time gap between the end of the year and the date of the audit. This method of the receivables testing is in most cases quickly feasible, and it has a high informative value despite the fact of the unreceived reply to the confirmation letter. Furthermore, there is no need to request information about the paid receivables from outside the audited company, as it is the case with the confirmations, and above all, all documents are easy to find for the auditor. During the audit of the receivables, however, there may arise the fact when the amount of the receivable is also unconfirmed and at the same time is unpaid too (i.e., unconfirmed, and unpaid receivables). The auditor proceeds similarly to the previous case, with the difference that he does not assent the subsequent payment. Testing of the unconfirmed receivables, whether paid or not, is influenced by how the auditor chose the sample for the sent external confirmations. It should be noted that it depends on the structure of the customers and, of course, on the auditor's professional judgment and knowledge of the audited company in the case of choosing the sample of the receivables for testing. It is not always a rule to focus exclusively on the highest items of the receivables. This option would only be possible when the rest of the tested set of the receivables would be insignificant, i.e., the sum of the untested unconfirmed receivables would not exceed the implementation materiality. Otherwise, the sample of the tested unconfirmed receivables should consist of the entire portfolio of the receivables so that the selected sample is representative. In general, the extent of the testing is also influenced by what the auditor considers as a sample unit (see below). The way in which the auditor selects the sample for the receivables testing is always influenced by his professional judgement.
- **Area of the liabilities** – the alternative procedures for the unconfirmed liabilities are like those in the case of the receivables. However, in the case of the liabilities, there may be a higher risk that the audited company will not have the liability listed at all in the accounting, for that reason it is advisable to consider the total turnover of the individual suppliers when selecting a sample of the liabilities for testing.
- **Area of the bank accounts** – the bank confirmation is not only about the confirming balances on the bank accounts, but also provides the auditor information about other facts, such as other contractual relationships concluded with the bank, i.e., derivatives, bank guarantees, pledges, etc., which are often significant for the presentation in the financial statements. For that reason, the bank statement is not enough to obtain audit evidence. Similarly, legal confirmations can also serve the auditor if the audited company cooperates with lawyers. If the auditor did not receive the response from the confirmation letter or the executive of the audited company refused to send the letter, the auditor performs the alternative procedures which would consist of the cost testing whether the audited company cooperates with any lawyers. Finding the alternative procedures for the bank and the legal confirmation is, however, difficult in practice.

The choice of the sample unit in the case of the receivables and the liabilities can also have an influence on the unreceived confirmation. The sample unit can be equal to one tested unpaid invoice (i.e., one accounting document), or the sample unit can be the entire balance account of one customer which can contain hundreds of the invoices that the auditor must test individually then. The method of the sample unit selecting depends on the auditor's knowledge of the audited company, the industry in which the company operates and the relationship between the audited company and the confirming party. The basic requirement is efficiency. Many companies mutually confirm the amount of their receivables and liabilities in the inventorying without regard to the need for the audit, so it is natural to take advantage of this situation. However, if the sample unit corresponds to the account balance of one customer, there may be a risk that the customer (the confirming party) will not be willing to trace, prepare, and confirm the total amount of the account balance on a certain date. On the other hand, the indisputable advantage of this method, when the receivable is confirmed, is the smaller

number of tested samples, in contrast to the second method of the sample selection where the sample unit is equal to one accounting document.

Another disputed area is the fact whether the confirmation letter should contain the pre-filled required confirmed amount. It is undisputed that if the confirming party fills in the confirmed amount, the auditor has greater confidence in the reliability of audit evidence. The question is whether the confirming amount is the amount of the single accounting document or the amount of the customer's entire balance account. In the case of the confirmed single document, there is a higher probability of the completion than in the case of the confirmed amount of the customer's entire balance account. Here, it is likely that the customer does not need to fill in the amount, because he will not want to deal with the area at all and will not be willing to verify all the necessary data.

3.3 Unsent external confirmation

As there was already stated in chapter 3.1 The obligation of the external confirmation, the auditor has the obligation to assess whether he will use the confirmation procedure to obtain audit evidence. Therefore, the auditor can also decide not to use the external confirmation procedure for the receivables or the liabilities. His decision may, for example, be based on the fact that the confirmation letters sent during the previous audits were not returned, or that the confirming party does not provide credible confirmation, as it repeatedly confirms other account balances, and the audited company has the correct balances of the documents in the subsequent verification. In this case, the sending of the confirmation letters is completely inefficient to the auditor and time-consuming. The auditor does not use the external confirmations in case when the auditor is able to obtain relevant and reliable information from the alternative procedures, possibly less time consuming.

3.4 Reliability of information from the external confirmations

All responses from the external confirmations carry some risk of withholding, alteration or fraud. This risk exists regardless of the form in which the response is obtained (i.e., paper or electronic form).

The answer in paper form obtained by the auditor directly is one of the most reliable answers when the confirming party fills in the required confirmed amount. The unfilled amount will "force" the confirming party to verify the necessary documents. Confirming the prefilled amount can be tempting to facilitate the work and to the risk that the confirming party will just sign the document without much checking and send it back. The auditor incurs a higher risk if the answer in paper form is received indirectly, i.e., the answer is addressed to the audited company, which forwards the confirmation to the auditor then. In this case, the auditor may request the confirming party to resend the confirmation directly to him.

The electronic form of the external confirmations (e.g., e-mail, fax) brings a multifold higher risk because the auditor cannot always to obtain audit evidence of the source and the authority (competence) of the individual who performed the external confirmation. The telephone verification is one possibility where the auditor can contact the confirming party by phone and make sure that the confirming party has access to the relevant documents by asking the confirming party questions. The auditor provides a minimum of information about the required document. The auditor chooses the telephone verification when it is necessary to find out information in a short period of time. Currently, the electronic form of the external confirmation includes techniques such as encryption or the very frequently used electronic digital signature which can reduce this risk.

4 Conclusions

The external confirmation method is used voluntarily by the accounting units within the framework of the inventorying of the receivables and the liabilities and, of course, by the auditors, as one of the auditing methods to obtain relevant and reliable audit evidence during the audit of the financial statements.

The auditors use the external confirmations not only to confirm the balances of the receivables, the liabilities, and the bank accounts, but also to confirm the contractual terms and the contracts. The receivables represent an important area of the financial statements because they are always tested for the risk of overvaluation due to artificially increasing of the economic result of the audited company, which is why the confirmation procedure is often used here. The testing of the confirmed liabilities is also specific because some liabilities may not be entered in the audited company's accounting, as well as the testing of the bank account balances where the bank confirms other important facts together with bank account balances.

A significant problem with the confirmation letters is not their preparation and sending, this area is regulated by ISA 505 but the receipt of the responses from the confirming party to the auditors. Furthermore, also the fact of the sample unit which the auditor requests to confirm. The fact that the amount to be confirmed by the confirming party is pre-filled can also have the certain influence. Since the auditor cannot demand that the confirming party fill out and send back the answer, for that reason this external confirmation process is based on a good relationship between the audited company

and the business partner (confirming party). In certain cases, the auditor may completely waive the procedure for the receivables and the liabilities confirming, the given fact must be properly documented in the auditor's file. The reliability of information from the external confirmations also plays its role here.

The auditor performs the alternative procedures based on his professional and expert judgement in the case of the unconfirmed receivables, the liabilities, and the bank accounts. The auditor is always fully dependent on the documents presented to him by the audited accounting unit, regardless of what the confirmation refers when obtaining audit evidence from alternative procedures.

The verifying process of the receivables, the liabilities and the bank accounts are not an automatic process that are repeated in the same way for all companies. The individual procedures, including the external confirmations, must be adapted to the given audited company based on the auditor's professional judgment and knowledge of the audited company. For that reason, the entire process of the external confirmation can be considered variable, as well as the flexible use of the audit procedures so that they are meaningful considering the size and the nature of the audited company. Despite all the problems that the external confirmation could bring, this way of audit evidence obtaining is still considered an effective method of the testing, regarding the total time spent by the company and the auditor verifying the given account.

References

- International Standard on Auditing ISA 330 The Auditor's Procedures in Response to Assessed Risk
- International Standard on Auditing ISA 500 Audit Evidence
- International Standard on Auditing ISA 505 External Confirmation
- International Standard on Auditing ISA 530 Audit Sampling
- Kareš, L. (2014). *Auditorské postupy*. Bratislava: Wolters Kluwer.
- Müllerová, L. & Králíček, V. a kol. (2017). *Auditing*. 2. vyd. Praha: Oeconomica
- Ricchiute, D. N. (2014). *Audit*. Praha: Victoria Publishing.
- Štěpán, M. (2012). Auditorské standardy – policajt, nebo rádce? *Auditor*. 8, 8-9.