External Confirmations

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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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## AUDITING STANDARD

**AUS 504 “EXTERNAL CONFIRMATIONS”**

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MAIN FEATURES OF THE STANDARD

The Standard:

(a) establishes standards and provides guidance on the use of external confirmations as a means of obtaining audit evidence;

(b) provides guidance on the matters to be considered in determining whether and to what extent to use external confirmations under the audit risk model;

(c) identifies issues to be addressed in implementing external confirmations as an effective audit procedure.
Introduction

.01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on the auditor’s use of external confirmations as a means of obtaining audit evidence.

.02 The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial report assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial report assertions.

.03 AUS 502 “Audit Evidence” states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related assertions to an acceptably low level.

.04 External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial report. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

.05 External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. Other examples of situations where external confirmations may be used include the following:

(a) bank balances and other information from bankers;

(b) accounts receivable balances;
(c) inventory held by third parties at bonded warehouses for processing or on consignment;

(d) property title deeds held by lawyers or financiers for safe custody or as security;

(e) investments purchased from stockbrokers but not delivered at balance date;

(f) loans from lenders; and

(g) accounts payable balances.

.06 The reliability of the evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate procedures in designing the external confirmation requests, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor’s Assessments of Inherent Risk and Control Risk

.07 AUS 402 “Risk Assessments and Internal Controls” discusses audit risk and the relationship between its components: inherent risk, control risk, and detection risk. It outlines the process of assessing inherent and control risk to determine the nature, timing, and extent of substantive procedures to reduce detection risk, and therefore audit risk, to an acceptable level.

.08 AUS 402 also indicates that the nature and extent of evidence to be obtained from the performance of substantive procedures varies depending on the assessment of inherent and control risks, and that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform any substantive procedures. These substantive procedures may include the use of external confirmations for specific financial report assertions.

.09 AUS 402.63 indicates that the higher the assessment of inherent and control risk, the more audit evidence the auditor needs to obtain from the performance of substantive procedures. Consequently as the assessed level of inherent and control risk increases, the auditor designs substantive procedures to obtain more evidence, or more persuasive evidence, about a financial report assertion. In these
situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

.10 The lower the assessed level of inherent and control risk, the less assurance the auditor needs from substantive procedures to form a conclusion about a financial report assertion. For example, an entity may have a loan that it is repaying according to an agreed schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has led to the level of inherent and control risk over the balance of the loan outstanding being assessed as low, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

.11 Unusual or complex transactions may be associated with higher levels of inherent or control risk than simple transactions. If the entity has entered into an unusual or complex transaction and the level of inherent and control risk is assessed as high, the auditor considers confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

.12 AUS 502 categorises the management assertions embodied in financial reports as existence, rights and obligations, occurrence, completeness, valuation, measurement, and disclosure. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide evidence relevant to a particular financial report assertion varies.

.13 External confirmation of an account receivable provides strong evidence regarding the existence of the account as at a certain date. Confirmation also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

.14 Similarly, in the case of goods held on consignment, external confirmation is likely to provide strong evidence to support the existence and the rights and obligations assertions, but might not provide evidence that supports the valuation assertion.

.15 The relevance of external confirmations to auditing a particular financial report assertion is also affected by the objective of the
auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity’s principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Design of the External Confirmation Request

The auditor should tailor external confirmation requests to the specific audit objective. When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures.

Also, in designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the evidence obtained. For example, certain respondents’ accounting systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

Confirmation requests ordinarily include management’s authorisation to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management’s authorisation, and in some cases may be unable to respond unless the request contains management’s authorisation.
Use of Positive and Negative Confirmations

.20 The auditor may use positive or negative external confirmation requests or a combination of both.

.21 A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent’s agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of “blank” confirmation request may result in lower response rates because additional effort is required of the respondents.

.22 A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

.23 Negative confirmation requests may be used to reduce audit risk to an acceptable level when:

(a) the assessed level of inherent and control risk is low;
(b) a large number of small balances is involved;
(c) a substantial number of errors is not expected; and
(d) the auditor has no reason to believe that respondents will disregard these requests.

.24 A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance
comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

.25 When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management’s request. If the auditor agrees to management’s request not to seek external confirmation regarding a particular matter, the auditor should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.

.26 If the auditor does not accept the validity of management’s request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor’s work and the auditor should consider the possible impact on the auditor’s report.

.27 When considering the reasons provided by management, the auditor applies an attitude of professional scepticism and considers whether the request has any implications regarding management’s integrity. The auditor considers whether management’s request may indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor applies the guidance in AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report” and AUS 218 “Consideration of Laws and Regulations in an Audit of a Financial Report”. The auditor also considers whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

Characteristics of Respondents

.28 The reliability of evidence provided by a confirmation is affected by the respondent’s competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity’s long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.
The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent’s competence, knowledge, motivation, ability or willingness to respond may come to the auditor’s attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary. The auditor also considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial report, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests. Control is maintained over communication between the intended recipient and the auditor to minimise the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor ensures that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor considers whether replies have come from the purported sender.

No Response to a Positive Confirmation Request

The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial report assertions that the confirmation request was intended to provide.

Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor uses alternative audit procedures. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative procedures may include examination of subsequent cash receipts, examination of shipping
documentation or other client documentation to provide evidence for the existence assertion, and sales cut off tests to provide evidence for the completeness assertion. In the examination of accounts payable, alternative procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide evidence of the existence assertion and examination of other records, such as goods received notes, to provide evidence of the completeness assertion.

Reliability of Responses Received

33. The auditor considers whether there is any indication that external confirmations received may not be reliable. The auditor considers the response’s authenticity and performs procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor considers validating the source of replies received in electronic format (for example, fax or electronic mail). Oral confirmations are documented in the work papers. If the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

34. When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence.

In forming the conclusion, the auditor considers the:

(a) reliability of the confirmations and alternative procedures;
(b) nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
(c) evidence provided by other procedures.

Based on this evaluation, the auditor determines whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.
The auditor also considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity’s records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial report. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the evidence required.

Evaluating the Results of the Confirmation Process

The auditor should evaluate whether the results of the external confirmations process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial report assertion being audited. In conducting this evaluation the auditor considers the guidance provided by AUS 514 “Audit Sampling and Other Selective Testing Procedures.”

External Confirmations Prior to the Year-End

When the auditor uses confirmation as at a date prior to the balance date to obtain evidence to support a financial report assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. For practical reasons when the level of inherent and control risk is assessed at less than high, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period.

Operative Date

This AUS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AUS 504 supersedes AUS 504 “External Confirmations”, as revised in February 2000.

Compatibility with International Standards on Auditing

The basic principles and essential procedures of AUS 504 “External Confirmations” and of International Standard on Auditing ISA 505, External Confirmations, are consistent in all material respects.