The Audit Confirmation Importance and Necessity

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ABSTRACT

The aim of this article is describing the importance and necessity of external requiring confirmation as an audit evidence obtaining method. On this basis and according to the performed studies in this field, using qualitative research, firstly we describe the importance of this method and then mention the audit confirmation related subjects namely its reliability and effectiveness. The results of this research have shown that this method is being used extensively in the financial statement auditing and has been accepted as one of the convincing evidence of auditing.

INTRODUCTION

With ever-increasing and complicating companies operations, volume and complexity increase of their financial data, extension of financial and non-financial relationships between real persons and companies, the necessity of presenting relevant, correct, complete and timely information (including financial statements) to the users of them to make decision making easier is ever-increasing. Considering the need of external users comprising of shareholders, creditors, creditors and potential investors on one hand and need of government and legal authorities like supreme audit court and tax authorities to them on the other hand it is necessary to ensure the correctness of financial and non-financial information of companies. Since these information are presented in a complete set of financial statement, the most important tool for ensuring correct, precise and complete information is a “Financial statement auditing”.

The aim of financial statement auditing is commenting on whether the financial statements have been prepared considering all the material aspects and are in compliance with accounting standards [1]. To realize this and commenting properly on the conformance of presented information with accounting standards, they have to obtain convincing evidence from both quantitative and qualitative aspects.

Auditors considering special conditions use different methods to get proper and sufficient evidence. One of these methods is inquiry appeal and the other one is investigation. Inquiry includes looking for information among aware people in or out of the client. Auditing confirmation is a special type of Inquiry which is used extensively among auditors and is considered by them as one of the most convincing auditing evidence. It normally consists of getting written confirmation from the third party with regard to account balance, the detailed components and conditions and details of transactions. SAS defines the accounting confirmation as follows:

“The process of obtaining and assessment of audit evidence which is gained via direct answer of third party to the request of auditor regarding the issues which can affect the claims of financial statements”.

Regarding the afore mentioned, the aim of writing this article is to emphasize on the importance and need of usage of audit confirmation as one of the methods of obtaining audit evidence and giving guidance for raising effectiveness of confirmation and improving the response rate of third parties to the requiring confirmation.

Relevant to audit confirmations, efficiency and effectiveness of audit confirmations, different types of confirmations and the response rate of confirmation inquiries have been done which a summary of them is presented in the following.
Research Background:

So far many researches on issues relevant to audit confirmation, efficiency and effectiveness of audit confirmation. Different types of confirmation and the response rate of confirmation inquiries have been done which a summary of them is presented in the following.

Huvanesianfar(2009) pointing to the importance of audit confirmation in his research, has surveyed the factors diminishing effectiveness of audit confirmation results. The results of the research showed that negligence of the auditor in selection of proper account or people to whom the requiring confirmation is sent and also sending the requiring by the client itself instead of the auditor, decrease the effectiveness of auditing confirmation [2].

Hubbard&Bulungton (1972) in their research gathered some information regarding reliability of audit evidence obtained from positive and negative audit confirmation. Studying 835 receivable accounts confirmation, they found out that evidenced derived from positive auditing confirmation are more reliable than negative ones [3].

Carmichael (1975) studied reliability of audit evidence obtained from audit confirmation in his research. Based on the results of his research, the reliability of these kind of evidences depends on factors such as a) Type and nature of the account which requiring confirmation has been issued for b) Account balance c) Usage of positive or negative confirmation and d) The intrinsic risk of the account for which requiring confirmation has been sent [4].

Caster (1992) in a research titled as “The role of confirmation as evidence of auditing” has described the aspects of audit confirmation as one of the reliable evidences. In this research, he has concluded the following through focusing on the audit confirmation related to receivables accounts and studying the reliability of evidences obtained from them:

a) The audit evidence obtained from receivable accounts confirmation relevant to valuation assertion are reliable; b) The audit evidences obtained from receivable accounts confirmation are weak if they are related to correctness; c) The audit evidence obtained from receivable accounts are suitable and acceptable if existence is in question and d) The audit evidence obtained from receivable accounts are weak if completeness is under investigation [5].

Shields (1996) in his research have described different types of auditing confirmation, the details needed to be mentioned in a confirmation and the method of preparing a requiring confirmation.

Engle&Hunton (2001) in their research studied the effects of monetary incentives on quantity and quality of responses to the positive confirmation of receivable accounts found out that existence of even a little bit of monetary incentives for the people receiving requiring confirmation, can increase both the quantity and quality of the responses [7].

Afterman (2007) in his research titled as ‘Audit confirmation‘ has put forward some guidelines for using auditing confirmation [8].

Caster et al (2008) in their case study have surveyed the evidences obtained from audit confirmation, its effectiveness, restrictions and the factors negating the effectiveness of auditing confirmation, These researchers Found approving evidences on effectiveness of audit confirmation through studying the relevant academic researches [9].

The importance and necessity of external confirmation in auditing:

Auditors are always seeking reliable and proper audit evidence. The more reliable and convincible the auditing evidence obtained from the applied methods are, the auditor’s opinion will be more suitable. According to the section 50 (auditing evidence), the reliability of audit evidence is affected by their resource and nature and is also dependent to the conditions of obtaining evidence. As a general rule we can say that the evidence obtained from external independent resources is more reliable. Though the reliability of audit evidence are affected by the existing conditions, but the following general rules can be useful regarding auditing evidence reliability:

- The evidence obtained from independent external resources are more reliable;
- The audit evidence produced in the audited department is more reliable provided that the internal controls are effective.
- The audit evidence obtained directly by the auditor (like observing the application of a control) are more reliable compared to those evidences obtained indirectly or an impression (like inquiry on a control application);
- The audit evidence in form of a document (paper, electronic or any other kind) are more reliable and
- The evidence from the original documents is more reliable than those provided from a picture of them or fax.

Among the five general rules mentioned above, three of them including independent external resources, obtaining direct evidences by the auditor and documented evidence are valid for audit confirmation. Therefore,
we can say that since the audit confirmation is obtained from independent external resources and directly by the auditor, it can be considered as reliable. However, we should note that these rules are not necessarily always conforming. For instance, the auditing evidence obtained from external resources may not always be reliable because they have been collected from persons who lack enough knowledge and awareness about the subject or their involvement may be biased or even incorrect. Although the audit evidence obtained from independent external resources is normally more reliable, sometimes we can or even have to seek confirmation from people who lack the independence conditions.

For example, regarding transactions with dependent persons, the auditor may decide that it is necessary to obtain some information from dependent persons through a requiring confirmation.

Confirmation can be an effective tool for obtaining auditing evidence for some claims related to financial statements like existence claims if it is prepared and used properly. Receivable and payable accounts, bank and other deposit accounts, investments, inventories, and agreements like existence, claims for contingent liabilities, and transactions are included among the accounts for which confirmation may be required. For instance, the evidences related to receivable accounts, balances can provide us with convincing evidence about existence claims. Moreover, the confirmation provides us with strong evidences regarding ownership claims on the properties kept by third parties. But, regarding claims like information correctness and assessment, we usually cannot obtain convincing evidence through confirmation.

However, in some cases receiving confirmation can be a very effective method for obtaining proper and sufficient evidence. For example, some of the conditions and situations are as follows:

- Considerable sales in terms of volume or amount of money at the end of a fiscal period;
- A non-standard or unconventional contract or contract terms;
- Information change in contracts or shipment documents;
- Interlocked contracts or transactions;
- Large payments or unusual installment plans for receivables;
- Lack of participation of accounting department in sales deals and increasing of receivables for a certain customer, which can be a sign of inability of the customer in paying its liabilities.

In case of conditions like those mentioned above, using audit confirmation will be more essential for finding proper evidences.

Reliability of confirmation and its effectiveness:

Just like other methods of auditing, confirmation can suffer from certain restrictions and barriers affecting adversely on its effectiveness. Some of such restrictions and barriers affecting the reliability of the obtained evidence are as follows:

- Low response rate to the confirmation.
- Wrong responses of third parties to the confirmation.
- Low attention in responding the confirmation and organized deviations in responding to the confirmation.

To obtain more reliable evidence from audit confirmation, an auditor has to control all the steps of third party selection, preparing, sending, and receiving the confirmation. The essential obligations which must be paid attention by the auditor are as follows:

a) To determine the requested information or data:

Before the receiving confirmation, the auditor has to consider all kinds of data the receivers of requiring confirmation are able and willing to respond. In other words, the auditor must consider whether the responding persons are able to confirm the requested data balance or also the comprising details of receivable account balance.

b) Selection of proper third parties for confirmation:

The obtained evidence of auditing are relevant and reliable only if the requiring confirmation are sent for the persons who are supposed by the auditor to have enough knowledge about the requested data. Otherwise, the obtained evidences will not be reliable.

c) Designing the requiring confirmation:

This includes correct sending of the requests for the third parties and then sending them back directly to the auditor.
d) Sending the requiring confirmation to the third party (including follow-up of the responses)

The requiring confirmation has to be sent directly by the auditor. Also, he may send the confirmation again if he does not receive the responses of the former confirmation.

Two essential deviations which are observed in the sending process of requiring confirmation by some auditors resulting in tarnishing of confirmations sending process and finally decreasing of reliability are as follows:

a) Selection of account or the persons who the confirmations are sent to them:

Some auditors entrust the selection of accounts or the receivers of requiring confirmation to the financial authorities of the client and ask them for example to select some creditors or debtors whom their account balance for the audited period is considerable or ask for data for the cases which there is no account balance in the client accounting records, subjectively [2]. It has to be mentioned that selection of accounts or persons for whom the requiring confirmation are sent should be done only by the auditor himself. If this is entrusted to the financial authorities of the client, there is a risk that it may be some interests between the receivers of the inquiries and some accounts or persons under audit (regarding account balance and etc.) and therefore those accounts or people are not selected.

b) Sending requiring confirmation:

If we suppose that the requiring confirmation are sent via post, some auditors entrust the personnel of client to send them via certified mail and give the receipts to the auditor This is not at all in compliance to the auditing standards, because the audited or some personnel of it may not be willing that some of the persons selected by the auditor receive the confirmation or response to some items. Therefore, the client or some personnel of it may open the confirmation and change or omit some parts or whole the confirmation. Sending of these envelopes has to be done by the auditor himself or his personnel [2].

Positive or negative requiring confirmation:

In designing the confirmation, auditor considers a claim which is relevant to the aim of the audit and the factors affecting the reliability of the evidences. One of the factors to be considered is the form of request (In positive or negative forms). Positive requiring confirmation it is important that the is the one in which we ask the receiver to directly mention wither he/she is in agreement with the received information [11]. The evidences obtained from positive confirmations are more reliable than those obtained from negative ones. However, the positive confirmation can only provide us with audit evidences when the responses are directly received from the request receiver. Negative confirmation is when the receiver is asked to respond in case He/she is in disagreement with the presented information [12]. But if the auditor does not receive the response, he knows that there are no clear evidences that the aimed person has received and verified the information in question. A negative confirmation is only valuable if it is replied [11]. Otherwise if it is not responded, no reliable evidences are obtained. One of the reasons of importance and necessity of sending audit requiring confirmation specially the positive one knows the exceptions. Exception happens for a positive confirmation when the replier disagrees the question or the prepared information is different from the information presented in the requiring confirmation [12]. Identification and assessment of these exception cases can affect the opinion of auditor.

The methods of responsiveness of confirmation:

Effectiveness of audit confirmation is affected by willingness and ability of the repliers to respond precisely to the presented information (Auditing standards AICPA). If the auditor asks for any information which the replier is probably willing and able to confirm, according to past experience, the confirmations will improve. Requiring confirmation may include the relevant necessary information for responding by the receiver (third party). For instance, in the receivable accounts confirmation, if the confirmation is sent together with monthly bill, the receiver will reply with higher probability. Moreover, the auditor may attach a list of important invoices which form the account balance. Also, if investigation on account balance is complicated and or difficult, the auditor can ask the replier to give him the complementary information which are needed for calculating account balance at the end of financial period.

For example, the auditor can send requiring confirmation for housing loan initial balance, interest rate, number of installments and the final due installment instead of asking questions about housing loan balance, which necessitates complicated calculations on interest rate. Of course in some cases, effectiveness of confirmation increases not with attaching related information but with asking the replier to describe his/her understanding of the information (open question). This is especially true when the confirmation inquiry is about transaction details. The auditors can improve the responsiveness of the confirmations applying some techniques in the process of confirmation inquiry [12]. Some of these techniques are as follows:

- Using clear and unambiguous language;
- Sending confirmation to special persons;
Audit confirmations have been extensively applied in financial statement auditing and are often accepted among auditors as one of the most Audit confirmation can be used as an effective tool for obtaining relevant and reliable convincing evidences, provided that it is used properly. However, there are limitations and barriers that restrict the effectiveness of confirmations for certain management claims. Some of these restrictions are low responsiveness to the requiring confirmation, wrong responding and organized biases. There may be conditions that responding to requiring confirmation or other requested information is difficult, but these difficulties must not stop the auditor from sending requiring confirmation in other favorable conditions. Auditor may discover that some third parties do not respond the requiring confirmation or all the requested information is not provided. So, planning alternative or additional methods may become necessary. According to some studies, the findings show that auditing confirmations are very effective methods for obtaining audit evidence for existence claims and assessments but it may not provide us with suitable audit evidences for other claims. Since the responses to the audit confirmations are always risky, it is necessary for the auditor to keep his/her control on the confirmation inquiry process. Moreover, maintaining professional doubt in all the stages of asking for confirmation especially in confirmation responses is of great importance. The barriers and restrictions which are there in audit confirmations do not necessarily mean that Reliability of audit evidences obtained from confirmation responses are ruled out. However, in assessment of responses given to the confirmations and for determining the properness of obtained evidences the auditor may need to study the nature and conditions of restrictions. Noting the afore mentioned and for clarifying the importance and necessity of auditing confirmation as a resource for obtaining auditing evidence, the following guides are presented regarding usage of auditing confirmations.

- Asking the client to sign the requiring confirmation manually; Seeing the manual signature of the client on the confirmation by the receiver, the probability of responding to the confirmation increases;
- To determine a rational and special period of time for receiving the response;
- Sending second confirmation (and if needed a third one)
- Calling the replier to ask for confirmation response. In addition to the mentioned items, auditors can apply other techniques depending on the existing conditions.

In a research done by Engel and Hunton on 2001 regarding Effect of monetary incentives and the quality of responses to the requiring confirmation, they concluded that applying a little amount of monetary incentive is an effective method for improving amount and quality of responses to the requiring confirmation. The findings of this research show that existence of a little amount of monetary incentives can extensively increase the responsiveness of confirmation inquiries [7].

Conclusion:

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The auditor has to consider the risk of cheating. In cases that there are unusual transactions and contracts, requiring confirmation should be done; when a) when controlling payable accounts and cash payments are weak or not reliable; b) when the risk of unregistered liabilities is high due to the nature of the industry in the department under auditor c) when complicated transactions make an environment that may lead to unregistered accounts, in these conditions one should consider payable accounts confirmation specially from raw material suppliers and the auditor has to receive confirmation for accounts balances and conditions of transaction with dependent persons (if possible, through a facilitator who prepares more reliable evidences)

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