

STATEMENT 3.232
AUDITING GUIDELINE
VERIFICATION OF DEBTOR BALANCES:
CONFIRMATION BY DIRECT COMMUNICATION

Introduction

1. Paragraph 7 of Auditing Standard No. 3.101 "Audit Approach" states that:

"The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom."

This Auditing Guideline gives guidance on how that statement may be applied to the audit of debtor balances by means of confirmation by direct communication. It is supplementary to, and should be read in conjunction with, auditing standards and related guidelines.

2. This Guideline relates primarily to company audits but the considerations outlined apply equally to other audits which involve auditors in expressing an opinion on the truth and fairness of the view given by the financial statements.
3. This Guideline is mainly directed towards the verification of trade debtors and is not intended to deal with particular circumstances which may arise in the verification of balances with subsidiary or associated companies, or other special debts.
4. The Council emphasises that the adoption of procedures for confirming debtor balances by direct communication is not to be regarded as implying any weakness or irregularity in the internal control or accounting system of the entity concerned. Such procedures should be recognised as one of the normal means by which auditors may seek to satisfy themselves as to the accuracy of debtor balances.

Background

5. The nature and extent of the detailed checking which auditors should undertake are matters for individual judgement in the light of their knowledge and experience of the client's affairs. In the

absence of any similar properly controlled procedure carried out by the entity itself, the auditors should consider direct communication with debtors as one of the means by which they can form an opinion as to the adequacy of the system of internal control over sales and its operation in practice. It may also be useful as a check on the accuracy of the cut-off procedures for balance sheet purposes and may help to draw attention to irregularities. Where the auditors are not satisfied that the system is sound or properly carried out, the test will be useful in ascertaining whether the balances are genuine, accurately stated and not in dispute.

6. The decision to request the client's approval to carry out a test circularisation of debtors should not be construed as an assumption by the auditors of the directors' duties. Nevertheless, circularisation is essentially an act of the auditor, who should seek the client's approval before communicating directly with the debtors themselves. If a suitable approach is made, the client's agreement to circularisation will generally be forthcoming. Should the client refuse this will inevitably lead the auditors to consider whether they should qualify their report, as they may not be able to satisfy themselves, by means of other audit checks, as to the validity and accuracy of the debtor balances. Example 11 in Auditing Guideline 3.330 illustrates appropriate wording for a qualification arising from such a specific scope restriction. In general, the weaker the internal control, the more important it is to obtain external confirmation of debtor balances. The circularising of debtors on a test basis should not be regarded as replacing other normal audit checks, such as the substantive testing of sales transactions, but the results may influence the scope of such tests.
7. When circularisation is undertaken the most effective method of requesting information from the debtor is the positive one although the negative method may also be appropriate in certain circumstances. Under the positive method the debtor is requested to confirm the accuracy of the balance shown or state in what respect he is in disagreement. Under the negative method the debtor is requested to reply if the amount stated is disputed. In either case the debtor is asked to reply direct to the auditor. Both methods may be used in conjunction.
8. Weak internal control, the suspicion of irregularities or that amounts may be in dispute, or the existence of numerous book-keeping errors are circumstances which indicate that the positive method should be adopted as it is designed to encourage definite replies from those circularised. However, it may be found in prac-

tice that certain classes of debtors, e.g. overseas customers and government departments, may find it difficult to respond, due to differences in accounting treatment. Nevertheless it is desirable, where the auditors judge it appropriate, to attempt verification, preferably by the positive method, but this should always be carried out in conjunction with such other audit tests as may be appropriate.

9. Good internal control, with a large number of small accounts, would suggest that the negative method may be appropriate. However, in some circumstances, e.g. where there is a small number of large accounts and a large number of small accounts, a combination of both methods may be more effective.

Procedures

10. The timing of the circularisation must be considered carefully in order to ensure that sufficient time is left for replies to be received and followed up before the completion of the audit. Where the client has satisfactory internal control systems it may be appropriate to perform the circularisation before the year end in order to help ensure that there are no delays in completing the final audit. In such circumstances, consideration should be given to audit testing in the period between the date of the circularisation and the year end and the date chosen should be related to other audit work, such as cut-off between sales and stock.
11. It is seldom desirable to circularise all debtors and it is therefore necessary to establish an adequate sample, but if this sample is to yield a meaningful result it must be based upon a complete list of all debtor accounts. In addition, when constructing the sample, the following classes of account should receive special attention:
 - (a) old unpaid accounts,
 - (b) accounts written off during the period under review, and
 - (c) accounts with credit balances.

Similarly, the following should not be overlooked:

- (d) accounts with nil balances, and
- (e) accounts which have been paid by the date of the examination.

12. Before selecting the sample to be circularised, client approval should be obtained for circularising any individual account. If the client specifically requests that a customer be excluded, the reasons for the request should be noted and discussed and the balance should be verified using alternative auditing procedures (see paragraphs 16 and 17).
13. The request (with Chinese translation if appropriate) sent to debtors may be either a specially prepared form of letter or an attachment to the client's normal statement giving a copy of the debtor's ledger account for an appropriate period and, in the case of a 'positive' request, being accompanied by a pre-paid reply form addressed to the auditor.
14. Whilst entities may be expected to favour circularising debtors for audit purposes on the form of statement normally in use, it is to be preferred that the debtor should be sent a copy of his ledger account for an appropriate period as shown in the client's books, as by this means it is more likely that errors and fraud, if any, will be detected. This can be particularly useful where running accounts are maintained, possibly involving large amounts and many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the client's terms of trade.
15. The statements will normally be prepared by the client's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, must maintain strict control over the checking and despatch of the statements. This will include test checks of addresses to telephone or trade directories. The auditor should ensure that he is responsible for the mailing and that all replies are sent directly to him so that there can be no interference with the confirmations by the client. Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the auditors' own office for follow-up by them. Strict control must also be maintained over replies to ensure that they are authentic, by checking for example that the postmark on an overseas reply envelope is consistent with the customer's address.
16. When the positive request method is used the auditors must follow up by all practicable means those debtors who fail to respond. After two, or even three, attempts to obtain confirmation, a list of the outstanding items will normally be passed to a responsible company official, preferably independent of the sales accounting

department, who will arrange for them to be investigated; this does not of course absolve the auditors from satisfying themselves that the clearance procedure is properly carried out and from examining the results. Where there is any limitation in the follow-up procedure it is all the more important to apply other auditing tests to establish that there existed a valid debt from a genuine customer at the date of the verification.

17. Whether there is a satisfactory rate of response or not, any inaccuracies revealed by the circularisation or by the additional tests mentioned in paragraph 16 may have a bearing on other accounts not included in the original sample. In these circumstances the auditors will have to consider what further tests they should make in order to satisfy themselves as to the correctness of the customers' balances taken as a whole. A tabulation of the results of the test by number and by value may help the auditors to form a view as to the adequacy of the work already carried out.