CONFIRMATION RELIABILITY
AS
AUDIT EVIDENCE

Tan Ming Kuang
Dosen Jurusan Akuntansi, Univ. Kristen Maranatha

ABSTRACT. As we have already known together that one of the audit evidence is audit confirmation. In several audit firm, audit confirmation is used as the main audit evidence, in the contrary, there are many academicians said that it couldn’t fulfill any of audit goals. In our country situation, in the middle of huge crisis, there are not much investor want to investing their money unless we prepare a very reliable audit reporting. To achieve that, we must use reliable audit evidence, of course.

To knowing which argument is true, we are trying to study some literature related with audit evidence and audit confirmation. We compare those literatures, and make a conclusion through analyzing and logical thinking. And, as we concluded at the end of this paper, we stated that audit evidence couldn’t be used to fulfill the audit goals, completeness and valuation.

INTRODUCTION

In some literatures, we found that confirmation can be used to fulfill the audit goals, completeness and valuation. But, we found in several researches that both audit goals could not be fulfilled by confirmation. There is argument from Paul Caster, R. K. Mautz, E. H. Sauls, and a lot more that discussing audit evidence and audit confirmation. So, in this paper, we are trying to make an explanation about audit risk and audit evidence – in this case audit confirmation – and previous research denying the ability of confirmation to fulfill those audit goals.

AUDIT EVIDENCE

Evidence

The word ‘evidence’ describes the whole range of ‘things’, such as documents, reports, guesses, inferences, and calculations, upon which the auditor exercises his expert judgment in evaluating whether or not the accounts show a true and fair view. More formally, evidence is ‘the facts presented to the mind of a person for the purpose of enabling him to decide a disputed question’ (Mautz 1958).

The nature of audit evidence causing the auditor won’t be completely convinced that the opinion is correct. However, the auditor must be persuaded that his or her opinion is correct with a high level of assurance. The four determinants
of the persuasiveness of evidence are relevance, competence, sufficiency, and
timeliness. Notice that the second and third determinants are taken directly from
the third standard of field works.

Relevance. Evidence must pertain to or be relevant to the audit objective
that the auditor is testing before it can be persuasive. For example, assume that the
auditor is concerned that an client is failing to bill customers for shipment
(completeness objectives). If the auditor selected a sample of duplicate sales
invoices and traced each to related shipping documents, the evidence would not be
relevant for the completeness objective. A relevant procedure would be to trace a
sample of shipping documents to related duplicate sales invoices to determine if
each had been billed.

Relevance can be considered only in terms of specific audit objectives.
Evidence may be relevant to one audit objective but not to a different one. In the
previous example, when the auditor traced from the duplicate sales invoices to
related shipping documents, the evidence was relevant to the existence objective.
Most evidence is relevant to more than one, but not all, audit objectives.

Competence. Competence refers to the degree to which evidence can be
considered believable or worthy of trust. If evidence is considered highly
competent, it is a great help in persuading the auditor that financial statement are
fairly stated. For example, if an auditor counted the inventory, that evidence
would be more competent than if management gave the auditor its own figures.
Most auditors use the term reliability of evidence as being synonymous with
competence.

Competence of evidence deals only with the audit procedures selected.
Competence cannot be improved by selecting a larger sample size or different
population items. It can only be improved by selecting audit procedures that
contain a higher quality of one or more of the following five characteristic of
competent evidence.

1. Independence of provider.
   Evidence obtained from a source outside the entity is more reliable than that
   obtained within. For example, external evidence such as communications
   from banks, attorneys, or customers is generally regarded as more reliable
   than answers obtained from inquiries of the client. Similarly, documents that
   originate within the company and have never left the client’s organization. An
   example of the former is an insurance policy and the latter a purchase
   requisition.

2. Effectiveness of client’s internal control.
   When a client’s internal control are effective, evidence obtained is more
   reliable than when they are weak. For example, if internal controls over sales
   and billing are effective, the auditor could obtain more competent evidence
   from sales invoices and shipping documents than if the controls were
   inadequate.

3. Auditor’s direct knowledge.
Evidence obtained directly by the auditor through physical examination, observation, computation, and inspection is more competent than information obtained directly. For example, if the auditor calculates the gross margin as a percentage of sales and compares it with previous periods, the evidence would be more reliable than if the auditor relied on the calculations of the controller.

4. Qualifications of individuals providing the information.
Although the source of information is independent, the evidence will not be reliable unless the individual providing it is qualified to do so. For this reason, communication from attorneys and bank confirmations are typically more highly regarded than accounts receivable confirmations from persons not familiar with the business worlds. Also, evidence obtained directly by the auditor may not be reliable if he or she lacks the qualifications to evaluate the evidence. For example, examination of an inventory or diamonds by an auditor not trained to distinguish between diamonds and glass would not provide reliable evidence of the existence of diamonds.

5. Degree of Objectivity.
Objective evidence is more reliable than evidence that requires considerable judgment to determine whether it is correct. Examples of objective evidence include confirmation of account receivable and bank balances, the physical count of securities and cash, and adding (footing) a list of accounts payable to determine if it agrees with the balance in the general ledger. Examples of subjective evidence include a letter written by a client, observation of obsolescence of inventory during physical examination, and inquiries of the credit manager about the collectibility of non-current accounts receivable. In evaluating the reliability of subjective evidence, the qualifications of the people providing the evidence are important.

Sufficiency. The quantity of evidence obtained determines its sufficiency. Quantity is measured primarily by the sample size the auditor selects. For a given audit procedure, the evidence obtained from a sample of 200 would ordinarily be more sufficient than from a sample of 100. There are several factors that determine the appropriate sample size in audits. The two most important ones are the auditor's expectations of misstatement and the effectiveness of the client's internal control. To illustrate, assume in the audit of Jones Computer Parts Co. that the auditor concludes that there is a high likelihood of obsolete inventory due to the nature of the client's industry. The auditor would sample more inventory items for obsolescence in an audit such as this than one where the likelihood of obsolescence was low. Similarly, if the auditor concludes that a client has effective rather than ineffective internal controls over recording fixed assets, a smaller sample size in the audit of acquisitions of fixed assets is warranted.

In addition to sample size, the individual items tested affect the sufficiency of evidence. Sample containing population items with large dollar values, items with a high likelihood of misstatement, and items that are representative of the population are usually considered sufficient. In contrast, most auditors would
usually consider samples insufficient that contain only the largest dollar items from the population unless these items make up a large portion of the total amount.

**Timeliness.** The timeliness of audit evidence can refer either to when it is accumulated or to the period covered by the audit. Evidence is usually more persuasive for balance sheet accounts when it is obtained, as close to the balance sheet date would be more persuasive than a count two months earlier. For income statement accounts, evidence is more persuasive if there is a sample from the entire period under审计 rather than from only a part of the period. For example, a random sample of sales transactions for the entire year would be more persuasive than a sample from only the first six months.

Quality of evidence is determined by (a) the closeness of the evidence to the thing being evidenced, (b) the directness of the correspondence between the evidence and the thing being evidenced, and (c) the reliability of the source of the evidence. The first of these was considered by Mautz and Sharaf (1961). They identified three broad classes of evidence: natural evidence, created evidence, and rational argumentation. Keenan (1979) discussed the ‘directness’ of evidence. He considered the classes of evidence to be found in law and identified these as: primary evidence, secondary evidence (both are forms of ‘direct evidence’) and indirect or circumstantial evidence. The final element in the quality of the evidence relates to the reliability of the source of the evidence. This issue was addressed in some detail by Hatherley (1980). Hatherley identified three sources of evidence: processes largely under the control of the auditor, processes largely under the control of the directors and processes largely under the control of third parties.

Taken together the three classifications provide a fairly detailed description of the qualitative characteristic of any evidence that the auditor has collected. By preference, the auditor will always employ natural primary evidence from sources under his control. Such very best evidence is rarely to hand. The Committee on Basic Auditing Concepts (AAA 1973) emphasized this problem:

*The auditor can and does perceive the physical consequences of events. These physical consequences include the existence of cash, securities, inventory and plant. On the other hand, only a few operating events (e.g., payroll distribution and transactions in the cut off period) are directly observed. ... Operating events are far more significant in the accounting model than the physical consequences of such events. Thus the auditor must depend on the perception of others (particularly the client’s personnel) for most of the information on the financial statements.*
Thus much of the audit opinion will be based on created evidence, from sources under the control of the directors, and will frequently involve an important degree of inference. These qualitative characteristics are summarized in Figure 1.

<table>
<thead>
<tr>
<th>Closeness (Mautz and Sharaf)</th>
<th>Directness (Keenan)</th>
<th>Source (Hatherly)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural</td>
<td>Primary</td>
<td>Auditor control</td>
</tr>
<tr>
<td>Created</td>
<td>Secondary</td>
<td>Director control</td>
</tr>
<tr>
<td>Rational Argumentation</td>
<td>Circumstantial</td>
<td>Third party control</td>
</tr>
</tbody>
</table>

Figure 1. The Qualitative Elements of Evidence

THE TYPES OF AUDIT EVIDENCE

There are seven broad categories of evidence from which the auditor can choose. These categories, referred to as types of evidence, are listed below.

- ✓ Physical examination
- ✓ Confirmation
- ✓ Documentation
- ✓ Observation
- ✓ Inquiries of the client
- ✓ Re-performance
- ✓ Analytical procedures

A the most question to be asking is “how reliable the audit evidence is?” To answer this question, we use a table as seen at figure 2.

<table>
<thead>
<tr>
<th>Criteria to determine reliability</th>
<th>Independence of provider</th>
<th>Effectiveness of Client’s Internal Control</th>
<th>Auditor’s Direct Knowledge</th>
<th>Qualification of Provider</th>
<th>Objectivity of Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical examination</td>
<td>High (auditor does)</td>
<td>Varies</td>
<td>High</td>
<td>Normally high (auditor does)</td>
<td>High</td>
</tr>
<tr>
<td>Confirmation</td>
<td>High</td>
<td>Not applicable</td>
<td>Low</td>
<td>Varies – usually high</td>
<td>High</td>
</tr>
<tr>
<td>Documentation</td>
<td>Varies – external more independent than internal</td>
<td>Varies</td>
<td>Low</td>
<td>Varies</td>
<td>High</td>
</tr>
<tr>
<td>Observation</td>
<td>High (auditor does)</td>
<td>Varies</td>
<td>High</td>
<td>Normally high (auditor does)</td>
<td>Medium</td>
</tr>
<tr>
<td>Inquiries of the</td>
<td>Low</td>
<td>Not</td>
<td>Low</td>
<td>Varies</td>
<td>Varies</td>
</tr>
</tbody>
</table>
CONFIRMATION AS AUDIT EVIDENCE

One of the most important audit procedures is the confirmation of account receivable. The primary purpose of accounts receivable confirmation is to satisfy the existence, accuracy, and cutoff objectives.

Confirmation describes the receipt of a written or oral response from an independent third party verifying the accuracy of information that was requested by the auditor. Because confirmations come from sources independent of the client, they are highly regarded and often used type of evidence. However, confirmations are relatively costly to obtain and may cause some inconvenience to those asked to supply them. Therefore, they are not used in every instance in which they are applicable. Because of the high reliability of confirmations, auditors typically obtain written responses rather than oral ones whenever it is practical. Written confirmation are easier for supervisors to review, and they provide better support if it is necessary to demonstrate that a confirmation was received.

Whether or not confirmation should be used depends on the reliability needs of the situation as well as the alternative evidence available. Traditionally, confirmations are seldom used in the audit of fixed assets additions because these can be verified adequately by documentation and physical examination. Similarly, confirmations are ordinarily not used to verify individual transactions between organizations, such as sales transactions, because the auditor can use documents for that purpose. Naturally, there are exceptions. Assume the auditor determines that there are two transactions recorded three days before year-end. Confirmation of these two transactions may be appropriate.

In performing confirmation procedures, the auditor must decide the type of confirmation to use. Two common types of confirmations are used to confirming accounts receivables: positive and negative. A positive confirmation is a communication addressed to the debtor requesting him or her to confirm directly whether the balance as stated on the confirmation request is correct or incorrect. A second type of positive confirmation, often called a blank confirmation form, does not state the amount on the confirmation but requests the recipients to fill in the balance or furnish other information. Because blank forms require the recipient to determine the information requested before signing and returning the

<table>
<thead>
<tr>
<th>client procedures</th>
<th>applicable</th>
<th>low to high</th>
</tr>
</thead>
<tbody>
<tr>
<td>Re-performance</td>
<td>High (auditor does)</td>
<td>Varies</td>
</tr>
<tr>
<td>Analytical</td>
<td>High/low (auditor does / client responds)</td>
<td>Varies</td>
</tr>
</tbody>
</table>
confirmation, they are considered more reliable than confirmations that include the information. Research show, however, that response rates usually lower for blank confirmation forms. A positive confirmation is more reliable evidence because the auditor can perform follow-up procedures if a response is not received from the debtor. With a negative confirmation, failure to reply must be regarded as a correct response, even though the debtor may have ignored the confirmation request.

A negative confirmation is also addressed to the debtor, but requests a response only when the debtor disagrees with the stated amount. Offsetting the reliability disadvantage, negative confirmations are less expensive to send than positive confirmations, and thus more can be distributed for the same total cost. Negative confirmations cost less because there are no second requests and no follow-up of nonresponses.

The determination of which type of confirmation to use is an auditor’s decision, and it should be based on the facts in the audit. SAS 67 states that it is acceptable to use negative confirmations only when all of the following circumstances are present:

- Accounts receivable is made up of a large number of small accounts.
- Combined assessed control risk and inherent risk is low. The combined risk is unlikely to be low if either internal control are ineffective or there is a high expectation of misstatement. For example, if prior years’ audits indicate that there are often disputed or inaccurate accounts receivable, negative confirmations would be inappropriate.
- There is no reason to believe that the recipients of the confirmations are unlikely to give them consideration. For example, if the response rate to positive confirmations in prior years was extremely high or if there are high response rates on audits of similar clients, it is likely that recipients will give confirmations reasonable consideration.

Typically, when negative confirmations are used, the auditors puts considerable emphasis on the effectiveness of internal controls, substantive tests of transactions, and analytical procedures as evidence of the fairness of accounts receivable, and assume that the large majority of the recipients will provide a conscientious reading and response to the confirmation request. Negative confirmations are often used for audits of hospitals, retail stores, banks and other industries in which the receivables are due from the general public.

It is also common to use a combination of negative and positive confirmations by sending the latter to accounts with large balances and the former to those with small balances.

The discussion of confirmation to this point shows that there is a continuum for the type of confirmation decision, starting with using no confirmation in some circumstances, to using only negatives, to using both negatives and positives, to using only positives. The primary factors affecting the decision are the materiality of total accounts receivable, the number and size of individual accounts, control
risk, inherent risk, the effectiveness of confirmations as audit evidence, and the availability of other audit evidence.

**AICPA REQUIREMENT**

Two major audit procedures are formally required by the AICPA: *the confirmation of accounts receivable* and *the physical examination of inventory*. These requirements are a direct result of the 1938 landmark legal case, *McKesson and Robbins*, in which a massive fraud involving fictitious accounts receivable and inventory was not uncovered in the audit. There was ample support to demonstrate that the confirmation of receivables and the physical observation of inventory would have brought the fraud to light, but at that time neither of these procedures was normally performed. Because of a strong reaction in the financial statement, the membership of the AICPA voted in 1939 to require these two procedures whenever an unqualified report is issued.

Later, the standard for confirmations was modified by SAS 67 (AU 330) to the present requirement that permits an unqualified report even when accounts receivable are not confirmed in any of three circumstances: (1) accounts receivable are immaterial, (2) the auditor considers confirmations ineffective because response rates will likely be inadequate or unreliable, or (3) the combined level of inherent risk and control risk is low and other substantive evidence can be accumulated to provide sufficient evidence. If the auditor decides not to confirm accounts receivable, the justification for doing so must be documented in the working papers. This change in requirements, especially the third consideration, is likely to reduce the use of confirmations in practice. If a client has effective internal controls and low inherent risk for the sales and collection cycle, the auditor should often be able to satisfy the evidence requirements by tests of controls, substantive tests of transactions, and analytical procedures.

**ANALYSIS**

As noted earlier, auditors have considered that accounts receivable confirmation evidence a strong form of evidence because it involves direct communication with independent source outside of the entity being audited (AICPA, 1989). Nevertheless, defects in the reliability of confirmation evidence, however, have been reported in research, which is conducted, by Sauls (1969), Warren (1973), Sorkin (1977), and AICPA (1989). Unfortunately, these studies of confirmation evidence were limited in scope due to the population sampled (primarily customers of banks and credit unions).

Although the evidence from these studies has been applied to the entire realm of accounts receivable (AICPA, 1984), it is not clear that the result apply to the broader and more interesting area of trade accounts receivable. Furthermore, since in previous studies involved interest-bearing accounts, it is possible that
overstatement errors introduced by the experiments may have been confused with interest earned in the accounts.

Another common limitation in previous study was the failure to examine the confirmation process from the perspective of the confirmation recipient, which resulted in omission of variables. Only Sauls (1969) gave some consideration to the recipients in terms of the types of actions that could be taken in response to a confirmation request.

The last research focused on the defect in the reliability of confirmation evidence was the research by Paul Caster (1990). He developed a simplified model of positive confirmation processing, which is presented in figure 3.

The model represents the sequential decision process from the perspective of the recipient (confirmee) of a positive confirmation request. The positive form of confirmation was chosen because it is the strongest and most widely used form, and it is familiar to confirmees. The confirmee decides whether to process the request further in phase 1. In phase 2, the confirmee decides whether to investigate the confirmation request balance.
Mail from Supplier's Auditor

Phase 1

Confirmation Request → Process? → Investigate?

F(a,f,p,t)

No Return? Yes Investigate?

No Trash Yes U Mailed to Supplier's Auditor

See Phase 2

Phase 2

From Phase 1 Investigate?

F(b,v)

Yes Low Level No

Sign and Return "Say Yes" Behavior

Mailed to Supplier's Auditor

Yes High Level

"Eyeball" Balance → Process Further?

Yes F(e,s) No

Sign and Return

C

Take exception?

Yes F(d) No

Sign, note exception and return

E Mailed to Supplier's Auditor

Function Variable Key

a = account balance age

U = Unable to confirm

f = confirmation format
Figure 3. Model of Positive Confirmation Processing

As shown in phase 2, three levels of investigation are assumed: no inspection, low inspection, and high inspection. No inspection results in what Sorkin (1977) referred to as “say yes” behavior. The request is signed confirming the balance as correct without checking the accounts payable files to verify the balance. Low inspection involves “eyeballing” the confirmation request amount to see if the balance seems reasonable. High inspection involves checking the accounts payable files to compare the accounts payable balance to the confirmation request amount.

Once returned, confirmations are classified in one of three ways: (1) the balance may be confirmed as correct (C), (2) the confirmee may take exception to the balance (E), or (3) the confirmee may indicate an inability to confirm a balance (U). A fourth classification is used if the confirmee fails to respond (N).

From the research done by Paul Caster, he found that only 47 percent of the errors (and only 53 percent of the large, unfavorable errors) were detected and reported to the auditors. Using confirmation evidence to assess the error rate in the population would have resulted in severe underestimation of the actual number of errors. These confirmations are not very reliable as a secondary source of evidence regarding the valuation assertion.

Furthermore, confirmation reliability was found to be related to the direction and size of errors in the accounts. Errors unfavorable (i.e., overstatements) to the confirmee had a greater likelihood of being detected and reported to the auditors than favorable (i.e., understatements) errors. Therefore, an estimate of the overall amount of error in the total population of account receivable would have been biased. Similarly, 20 percent errors were more likely to be detected and reported than 3 percent errors. The implication of these results is that confirmation evidence has a low degree of reliability with respect to detection and reporting of errors, and therefore, the valuation assertion. Furthermore, confirmations do not
provide very strong evidence regarding the completeness assertion – less than 42 percent of the large understatement errors were detected and reported by confirmer.

A number of questions arise, because in that study less than one-half of the seeded errors were detected and reported to the auditor, making the reliability of confirmation evidence questionable. What is the appropriate standard to use to evaluate confirmation reliability? Does the confirmation procedure need to be 100 percent reliable to be useful to the auditors? How reliable is it compared to alternative forms of evidence regarding valuation and completeness assertions?

CONCLUSION
From the literature reviews and several researches and our analysis, we conclude that, in fact the confirmation can’t be used to fulfill the audit goals, completeness and valuation. This conclusion is consistent with Paul Caster (1990) findings that in using confirmation evidence to assess the error rate in the population would have resulted in severe underestimation of the actual number of errors. These confirmations are not very reliable as a secondary source of evidence regarding the valuation assertion. Besides Paul Caster, there are several researchers who agree with our analysis. They are Sauls (1969), Warren (1973), and Sorkin (1977). But, these studies of confirmation evidence were limited in scope due to the population sampled (primarily customers of banks and credit unions).

We found that confirmation as an audit evidence must be consider the most effective confirmation form which is useful to obtain accurate information from debtor and the standard that regulate the use of confirmation as audit evidence.

We suggest for further research to consider several variables, like how large the auditors’ trust in using confirmation as audit evidence and so on.

SUGGESTIONS
After all our explanations and conclusions above, we are suggesting for the auditing process using confirmation as audit evidence, that:

1. To ensure the reliability of the confirmation process, the auditors should carefully design the confirmation requests to seek the appropriate information and make it easy for the recipient to respond. The auditors also should consider whether it is necessary to specifically address the confirmation request to an individual in the outside organization that has easy access to the information being confirmed. As an example, information about the terms of a debt agreement at a financial institution might best be sent to the client’s loan officer.

2. To be considered reliable evidence, the auditor from the time they are prepared until they are returned must control confirmations. If the clients controls the preparation of the confirmation, does the mailing, or receives the
responses, the auditor has lost control and with it independence; thus the reliability of the evidence is reduced.

In fact, the weakness of today's confirmation is there's no control and it seems to be done as a routines procedures, so it losses it's 'evidence power'. Thus, we have no means to change or replace the confirmation, because although it is one of the most expensive audit evidence, it was very best audit evidence. The key is control from the auditors. If we really control the process and carefully design the procedures, we're sure that it will help much for making an audit opinion.

REFERENCES