
**AUDIT GUIDANCE
STATEMENT**

AGS 2

Verification of Debtor Balances – Confirmation by Direct Communication

This Statement of Auditing Practice was approved by the Council of the Institute of Singapore Chartered Accountants (formerly known as Institute of Certified Public Accountants of Singapore) in January 1985.

It superseded the SAP of the same title issued in August 1977.

SAP 1 superseded the SAP of the same title in June 2004. No substantive changes were made to the original approved text and all cross references were updated, as appropriate.

Audit Guidance Statement (AGS) 2 supersedes SAP 1 in May 2006. No substantive changes have been made to the original approved text and all cross references have been updated, as appropriate.

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AGS 2

Verification of Debtor Balances - Confirmation by Direct Communication

Introduction

1. The verification of balances by direct communication with debtors is an established practice in most countries including Singapore. This Statement provides guidance on the principles underlying the verification of debtor balances by direct communication.
2. The Statement does not deal at length with other important auditing procedures which the auditor may need to carry out in conjunction with the direct confirmation of balances, for example, when replies to such confirmations are not received, although this is briefly referred to in paragraph 16. Also, it is not intended to deal with particular circumstances which may arise in the verification of balances with subsidiary or associated companies, loans or other special debts.

General

3. 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 the auditor may seek to satisfy himself as to the accuracy of debtor balances.
4. The practice of verifying debtor balances by direct communication should be seen in the light of the principles set out in Singapore Standard on Auditing (SSA) 200 *Objective and General Principles Governing an Audit of Financial Statements* and other related guidelines.
5. The nature, extent and timing of the detailed checking which an auditor should undertake are matters for individual judgement in the light of the auditor's knowledge and experience of his client's affairs. In the absence of any similar properly controlled procedure carried out by the entity itself, the auditor should consider direct communication with debtors as one of the means by which he 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 cuff-off procedures for balance sheet purposes and may help to draw attention to irregularities. Where the auditor is 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.

Client's agreement

6. The decision to request the client to carry out a test circularisation of debtors should not be construed as an assumption by the auditor of the directors' duties. Circularisation is essentially an act of the client, who alone can authorise third parties to divulge information to the auditor. If a suitable approach is made the client's agreement will generally be forthcoming. Should the client refuse, this will inevitably lead the auditor to consider whether he should qualify his report, as he may not be able to satisfy himself, by means of other audit procedures, as to the validity and accuracy of the debtor balances. 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 procedures, such as the substantive testing of sales transactions, but the results may influence the scope of such tests.

Positive and negative confirmation

7. When circularisation is undertaken the method of requesting information from the debtor may be either positive or negative. 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 only if the amount stated is disputed. In either case the debtor is requested to reply direct to the auditor. Both methods may be used in conjunction with the positive form used for large balances and the negative form for small balances.
8. Weak internal control, the suspicion of irregularities or that amounts may be in dispute, or the existence of numerous bookkeeping errors are circumstances which indicate that the positive method is preferably as it is designed to encourage definite replies from those circularised. However, it will almost certainly be found in practice that certain classes of debtors, for example, overseas customers and government departments, either cannot or will not respond. Nevertheless it is desirable, where the auditor judges 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, and when the auditor has no reason to believe the debtors receiving the requests are unlikely to give them consideration, would suggest the negative method as likely to be appropriate. However, in some circumstances, for example, where there is a small number of large accounts and a large number of small accounts, a combination of both methods, as noted above, may be appropriate. If the negative rather than the positive method of confirmation is used, the number of requests sent or the extent of the other auditing procedures applied to the debtor accounts should normally be greater in order for the auditor to obtain the same degree of satisfaction with respect to the debtor accounts.

Sample for circularisation

10. 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 accounts should receive special attention:
 - (a) old unpaid accounts,
 - (b) accounts written off during the period under review, and
 - (c) accounts with credit balances.
 - (d) Similarly, the following should not be overlooked:
 - (e) accounts with nil balances, and
 - (f) accounts which have been paid by the date of the examination.

Circularisation procedures

11. The request 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, accompanied by a pre-paid reply form.
12. 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 will be detected. This can be particularly useful where running accounts are maintained, possibly involving large amounts and many entries, for example,

contracting work, or where there is evidence that accounts are in dispute or are not being settled in accordance with the client's terms of trade.

13. Confirmation procedures may be directed towards account balances with debtors or towards individual items included in such balances. The latter procedures may be particularly useful when the nature of the accounts or the debtors' records are not likely to permit successful confirmation of account balances.
14. 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. Precautions must also be taken to ensure that undelivered items are returned not to the client, but to the auditor's own office for follow up by him.
15. Confirmation of debtors should be carried out either at the balance sheet date or, if internal control is adequate, prior to the year end with an analytical review of transactions in the intervening period. Where the confirmation is carried out at of a date other than the balance sheet date, an analysis of the general ledger control account should be obtained and the entries for the intervening period should be test checked to supporting records.
16. When the positive request method is used the auditors must:
 - (a) follow up by all practicable means those significant debtors who fail to respond, and
 - (b) reconcile any difference between the balance confirmed by the debtor and the client's records.

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 auditor from satisfying himself 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 procedures to establish that there existed a valid debt from a genuine customer at the date of the verification. These procedures may include:

- (a) examination of payments subsequent to the date of the confirmation where there is evidence that the payments are received from or on behalf of the debtor and that they are in satisfaction of specific items;
 - (b) examination of evidence such as customers' orders in correspondence files, shipping documents and billing records, and stock control procedures.
17. Whether there is a satisfactory rate of response or not, any inaccuracies revealed by the circularisation or by the additional tests mentioned above may have a bearing on other accounts not included in the original sample. In these circumstances the auditor will have to consider what further tests he can make in order to satisfy himself 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 auditor to form a view as to the adequacy of the work already carried out.

Effect on audit opinion

18. When the auditor is unable to satisfy himself by the application of other auditing procedures, depending on the degree of materiality of the amounts involved, he should indicate clearly in his report the limitations on his work and either qualify his opinion on the financial statements taken as a whole or disclaim an opinion on them.