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ISCA Audit Bulletin 7

AB 7: Considerations over External Confirmation Procedures



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The terms of reference are executed through AASC with the support of three Sub-Committees, namely the Core Sub-Committee, the AGS 1 Sub-Committee and the Data Analytics Sub-Committee.

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1. Background

Obtaining external confirmations is one of the most fundamental processes which, when executed properly, provides the auditor with reliable audit evidence. External confirmations are valuable as they are obtained directly from independent external sources, providing a higher degree of reliability than internally generated records.

However, when procedures to obtain external confirmations are not carried out appropriately, the value of the external confirmations may be compromised and the auditor may be at risk of placing undue reliance on such confirmation received.

2. Scope of this Audit Bulletin

This Audit Bulletin (AB) highlights certain key considerations for the auditor when designing and performing external confirmation procedures. The AB illustrates how some of these considerations apply in several scenarios where external confirmation procedures are used.

3. Considerations over External Confirmation Procedures

The following are certain key considerations for the auditor in designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

- (a) **Maintaining control over external confirmation requests** – paragraph 7 of SSA 505¹ requires the auditor to maintain control over external confirmation requests. This includes:
- determining the information to be confirmed or requested;
 - selecting the appropriate confirming party;
 - designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
 - sending the requests, including follow-up requests when applicable.

To ensure that the bank provides complete information of all the banking relationships and accounts relating to the entity, and not only selected accounts, the auditor can refer to AGS 6² for a standard letter of request for bank report for audit purposes and verify that the bank has provided replies to all the fields listed in the confirmation request.

For examples of considerations and procedures which the auditor could consider in seeking to maintain control over external confirmation requests, please refer to ISCA's [Auditing Bulletin 2 Bank Confirmations Through Digital Platforms](#).

- (b) **Evaluating the reliability of the external confirmation received** – If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

For example, the auditor may consider the following:

- Whether there is a heightened risk of fraud or collusion, particularly in foreign jurisdictions where regulations may be less stringent or where there are differing business practices and norms.

¹ SSA 505, *External Confirmations*

² AGS 6, *Bank Report for Audit Purposes*

- Whether the confirmation was received through methods other than original hardcopy receipt or via independent external platform. If the confirmation was received through another method, such as via email, whether the auditor can verify its source.

Please refer to Illustrations 1 and 3 below for examples of matters the auditor can consider in relation to the reliability of confirmations received. Refer to ACRA's [Audit Practice Bulletin No. 1 of 2010 External Confirmations](#) for considerations which may be applicable where confirmations are not received via traditional modes.

- (c) **Dealing with non-responses** – when there is no reply from a bank, the auditor should determine if alternative procedures may be sufficient to address relevant financial statement assertions. In the case of the completeness assertion, this would include, for example, the identification of any unrecorded loans or liens over the entity's assets.

Please refer to Illustration 1 below for an example of how the auditor might deal with non-responses from a bank in a foreign jurisdiction.

- (d) **Understanding of the effects of laws and regulations** as well as the business rationale behind the balances being confirmed. Please refer to Illustration 2 below.
- (e) **Reliability of the counterparty** providing the confirmation, including independence and whether management could influence the respondent. Please refer to Illustrations 2 below on how this factor may affect the auditor's risk assessment as well as nature and extent of external confirmation procedures.
- (f) **Determining which assertions are being addressed** and whether external confirmation procedures are sufficient or appropriate to address these assertions. Please refer to Illustration 3 below.

The list of considerations above is non-exhaustive. Please also refer to SSA 505 as well as ACRA's [Audit Practice Bulletin No. 1 of 2010 External Confirmations](#).

4. Illustrative Scenarios

Illustration 1: Obtaining confirmation from a bank in a foreign jurisdiction

Illustration 2: Obtaining confirmation on escrow accounts

Illustration 3: Relying on a confirmation for the valuation of investments in unquoted funds

The examples provided in this Audit Bulletin are for illustrative purposes only. Auditors are reminded to exercise their professional judgement when evaluating the facts and circumstances of their engagements.

Illustration 1: Obtaining confirmation from a bank in a foreign jurisdiction

In designing and executing audit procedures in relation to a confirmation from a bank in a foreign jurisdiction, the auditor can consider the following in assessing the reliability of the confirmation response received:

- (a) Is the auditor satisfied that the confirmation received has not been tampered with and originated from the authorized personnel of the bank?

The auditor is reminded to verify the bank's contact details on the confirmation reply against official sources to confirm that the reply is legitimate. Agreeing the information in the reply to other supporting documents and records, such as bank statements, reconciliations, loan agreements, director's resolutions and meeting minutes can also help to assess reliability.

- (b) The credibility of the bank – is the bank a branch of an international bank or is it a local bank in a small province in a country where the banking regulatory landscape is less developed?

In the case of the latter, the auditor should consider the need to assess the bank's financial health and reputation by researching publicly available information, such as news reports, financial statements and any available regulatory filings. If possible, the auditor may also request for the bank's most recent audit report or inquire with third parties, such as local regulatory authorities, on the bank's credibility.

- (c) Banking infrastructure and regulations
- (i) Are the banking infrastructure and regulatory and licensing regime well-developed in that jurisdiction?
 - (ii) Is the banking system centralised or decentralised?
 - (iii) Is the bank subject to the jurisdiction's regulatory and licensing regime?

If the bank is operating in less regulated environment, the auditor should consider the need to obtain an understanding of the local banking landscape, including any relevant bank associations, networks or industry groups. The auditor can also consider engaging local expertise, such as component auditors of the foreign jurisdiction who have the knowledge, experience and understanding of local laws and regulations to assist in verifying the bank confirmations. If the banking system is decentralised, taking into account the banking infrastructure, the auditor may consider if it is necessary to confirm the origin of the confirmation reply with the bank's head office or make the request for bank confirmation directly with the head office instead of the local branch.

- (d) Risk of fraud – does the business environment and culture in that foreign jurisdiction increase the risk of fraudulent activities due to factors such as weak governance or poor enforcement of laws, thereby affecting the reliability of bank confirmations?

If there is risk of fraud, the auditor should consider the requirements under SSA 240 (Revised)³.

³ SSA 240 (Revised), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

(e) Is there business rationale for the entity to hold cash balances in that foreign jurisdiction?

Some factors to consider include presence of business operations or investments in the jurisdiction, strategic considerations such as market expansion, compliance with local regulations that mandate the maintenance of a specific level of cash reserves and tax advantages.

Frequently asked question – Would the auditor need to visit the bank branch physically?

There may be certain circumstances in which the auditor may find it necessary to conduct a physical visit to the bank branch. This may include situations where:

- there is no confirmation response from the bank and the auditor has determined that other alternative procedures (such as review of bank statements) are not sufficient, as those alternative procedures may not address the completeness assertion, given the risk that the entity may have other banking relationships or accounts with that bank;
- the auditor has doubts over the authenticity or reliability of the confirmation response received, such as where the auditor is unable to establish if the confirmation originated directly from the bank or the authority of the respondent;
- there is suspected fraud or collusion; or
- there is higher fraud risk assessed, for instance where the entity holds significant amount of cash in a small local bank in a small province with no clear business rationale.

Additional factor for consideration

When arrangements are made for the auditor to obtain confirmation through a physical visit to the bank branch, it is not uncommon for the auditor to be accompanied by client personnel in the foreign jurisdiction.

In such situations, it is important for the auditor to apply an appropriate level of professional scepticism in conducting such visits. This may include considerations such as verification of the address of the branch, whether the confirmation reply was provided by the bank personnel with the right level of authority and whether the confirmation is system-generated or hand-written. Where possible, the auditor should conduct separate interviews with the bank personnel without the client's presence, to independently verify specific aspects of the confirmation reply.

It is also important to note that where there is a risk of collusion, a physical visit to the bank by itself may not sufficiently address this risk, especially where this involves collusion between the client personnel and that particular bank branch's personnel. Some red flags that may indicate the risk of collusion include:

- (a) deviation from the standard confirmation process of the bank
- (b) client personnel attempting to arrange the visit exclusively with specific staff at the bank branch, rather than with any available staff
- (c) format of the bank confirmation differs from the auditor's expectations, for example:
 - the confirmation is typically stamped with an official company stamp as a standard practice in the jurisdiction, but such stamp is absent.

- the quality of the letterhead and alignment are not consistent with other correspondence from the bank.
- the format of the confirmation differs from prior year or other confirmations received from the same bank.

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Illustration 2: Obtaining confirmation on escrow accounts

There may be instances where the entity has cash placed in an escrow account while awaiting the completion of a deal or transaction. In general, entities might use the escrow services of banks, law firms or commercial escrow agents.

In relying on the confirmation on escrow accounts, what should the auditor consider in assessing the risks in relation to the existence and accuracy, as well as rights and obligations assertions over such escrow accounts?

- (a) Is there a clear business rationale for the funds placed in the escrow account? Are the terms and conditions of the escrow agreement aligned with this rationale?

In assessing the business rationale, some red flags include:

- (i) unclear purpose that fails to specify the needs or contingencies that the funds are intended to address,
- (ii) lack of clear, measurable milestones or performance conditions for the release of funds,
- (iii) an excessive duration for which funds are held without clear justification, and
- (iv) unclear roles of the parties involved.

When such red flags are present, the auditor should assess the implications for the risk assessment over such accounts and consider appropriate responses, such as enquiring further with management to obtain a clearer understanding of the business rationale.

- (b) Are there unusual movements in the escrow account during the period? Are the amounts and movements in the escrow account aligned with the timeline and objectives stipulated in the agreement relating to the underlying deal or transaction?

Example:

Consider a scenario where Company A has placed \$1 million in an escrow account as part of an agreement to acquire a property. The funds are held in escrow with the understanding that they will be released to the seller once certain conditions (such as satisfactory completion of property inspections and the transfer of legal title) are met. No interest is earned for funds held in the escrow account.

However, if the transaction does not proceed (for instance, if the conditions are not satisfied), the \$1 million should be refunded to Company A.

Considerations for the auditor

The use of an escrow account is typically justified to ensure security and control over the funds until certain conditions are met. In relying on the confirmation received, it is important for the auditor to evaluate whether the business rationale for holding the funds in escrow remains valid. If the transaction is delayed or unlikely to proceed, the auditor should consider whether it is reasonable for Company A to maintain the funds in escrow.

- (c) Are escrow services regulated⁴ in the jurisdiction where the escrow account is held?

If escrow services are not regulated, the auditor should consider whether the client has performed appropriate due diligence procedures on the escrow holder to assess their legitimacy and reliability, including assessing their reputation and financial stability.

- (d) As the amount is held by an escrow agent, it is critical to consider the counterparty risk involved. What are the rights and obligations of the entity and the escrow agent in the event of default or bankruptcy?

The auditor may need to assess the credibility and reputation of the escrow holder. This may include evaluating the track record, including any prior engagement(s) between the entity and the escrow agent, and financials of the escrow holder or understanding the controls in place to avoid unauthorised payments or co-mingling of funds by the escrow holder.

This could include obtaining and reviewing type 1 or type 2 reports, if available, in accordance with SSA 402⁵.

- (e) Are there other corroborating audit evidence obtained by the auditor?

For instance, the auditor may obtain confirmations from the other counterparties to the amounts held in escrow, such as the intended recipient or seller, to corroborate the amounts confirmed.

- (f) Are the amounts held in escrow co-mingled with other funds held by the escrow agent, or are they kept separate?

If the amount held in escrow is material, the auditor may request for the escrow agent to confirm whether amounts are co-mingled, as this might prevent proper segregation and tracking of the funds.

Co-mingling of funds can lead to several audit risks. For example, an entity's ability to assert its rights over co-mingled funds could directly affect the rights and obligations assertion. Similarly, the valuation assertion may be affected as the credit risk associated with the escrow amount could increase, depending on how the co-mingled funds are managed. Additionally, if the escrow agent has breached its contract by failing to avoid co-mingling of funds in accordance with the terms and conditions, it would also affect the rights and obligations and valuation assertions.

In cases where the auditor is aware that the funds are co-mingled and is unable to assess whether co-mingling will compromise the ability to segregate and track the escrow amounts, the auditor should assess the risks involved, taking into account the abovementioned considerations under (a) to (e) holistically.

⁴ In its 2011 [FAQ](#), the Ministry of Law highlighted that parties should be mindful that escrow accounts are not regulated under the Legal Profession (Solicitors' Accounts) Rules. It also noted that the Law Society has not drawn up any rules or guidelines governing the operation of escrow accounts.

⁵ SSA 402, *Audit Considerations Relating to an Entity Using a Service Organisation*.

Illustration 3: Relying on a confirmation for the valuation of investments in unquoted funds

There may be situations where the auditor seeks to obtain confirmation from certain third parties such as a custodian, fund manager/administrator, broker or bank (in its capacity as a broker) on the investment products owned by an entity, such as investments in unquoted funds.

The auditor should first determine the objective of seeking confirmation and the assertions being addressed. Is the auditor seeking to obtain evidence on

- the existence and/or completeness of those investments (i.e. number of units held in those unquoted funds);
- the fair value of those investments; or
- both?

If the auditor intends to rely on the valuation provided by the third party in its confirmation response for the purpose of evaluating the fair value of those investments, the auditor needs to apply the requirements under SSA 540 (Revised)⁶. The following are some relevant considerations in this regard:

- (a) As with the valuation of other assets, management needs to take ownership of the valuation process, including the valuation approach. There should be clear understanding between management and the third party that the amount stated in the confirmation reflects the fair value of those investments in accordance with FRS 113 / SFRS (I) 13⁷.
- (b) Is the auditor satisfied with the appropriateness of the valuation approach used to value the investment in the funds, key assumptions and inputs used by the third party?
- (c) Are there disclaimers and/or caveats in the confirmation which may render it inappropriate for the auditor to rely on the valuation provided?
- (d) Where the auditor is not able to obtain sufficient evidence in relation to (b) and (c) above, for example, where net asset value is used, the auditor may need to consider what further procedures are necessary. The nature and extent of these procedures are subject to professional judgement and may vary depending on the facts and circumstances. Some of these further procedures (which are not exhaustive) could include:
 - Understanding the fund's investment portfolio and structure⁸
 - Understanding the fund's valuation policy and processes⁸
 - Performing analytical procedures, such as benchmarking the underlying fund's portfolio performance against an observable market indicator
 - Checking against independent valuation platforms, such as Bloomberg.
 - Reviewing the audited financial statements / financial information of those unquoted funds, considering whether the entity and the fund have coterminous period-ends, if there are differences in accounting and auditing standards applied by the fund and whether such financial statements / financial information are relevant and reliable.
 - Considering the reliability and competency of the counterparty providing the confirmation based on factors such as reputation and past experience.

⁶ SSA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

⁷ FRS 113 / SFRS (I) 13, *Fair Value Measurement*

⁸ These procedures, by themselves, would not be sufficient as they are only meant to provide the auditor with further understanding, and are unlikely to be considered substantive procedures.

- Considering whether any contrary evidence exists in relation to the valuation of the underlying investment.
- Engaging the auditor's expert.
- Obtaining and reviewing type 1 or type 2 reports, if available, in accordance with SSA 402.

Additional factor for consideration

While a bank typically possesses valuation expertise and may have strong controls over its valuation process, an inherent conflict of interest arises if the bank is the counterparty in that arrangement, for instance where the bank is the broker, market maker or counterparty to the instrument.

The auditor should take this factor into consideration (where applicable) when determining the nature of and extent of procedures to be performed in relation to (a) to (d) above.

Further guidance on auditing the valuation of unquoted equity investments will be issued in a subsequent audit bulletin.

For reference: ISCA Auditing and Assurance Pronouncements and Publications

The table below summarises the formal categorisation, degrees of authority and due process for issuance of ISCA’s auditing and assurance standards and guidances. This provides credence to ISCA’s technical content, promulgates ISCA’s views on the application of auditing and assurance standards as well as promotes best practices and consistency in auditing and assurance.

Category	Nature	Degree of authority	Due Process	Highest level of approval
1. a) Singapore Standard on Auditing (SSA) b) Singapore Standard on Assurance Engagements (SSAE) c) Singapore Standard on Review Engagements (SSRE) d) Singapore Standard on Related Services (SSRS) e) Singapore Standard on Quality Control (SSQC) f) Statement of Auditing Practice (SAP)	Authoritative pronouncements	Required to comply	Public consultation required	ACRA’s Public Accountants Oversight Committee
2. a) Audit Guidance Statement (AGS) b) Singapore Auditing Practice Note (SAPN)	Provide interpretive and practical guidance to auditors Non-authoritative	Expected to apply or explain departures	Public consultation required	ISCA Council
3. Audit Bulletin (AB)	Informative / educational publications to highlight pertinent topical issues to auditors Non-authoritative	For information and educational purposes	Public consultation not required	ISCA AASC

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