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Inter-bank confirmation procedures

This International Auditing Statement was prepared and approved jointly by the International Auditing Practices Committee of the International Federation of Accountants and the Committee on Banking Regulations and Supervisory Practices of the Group of Ten major industrialised countries and Switzerland in November 1983 for publication in February 1984.

This Statement is published to provide practical assistance to external independent auditors and also internal auditors and inspectors on inter-bank confirmation procedures. This statement is not intended to have the authority of an International Auditing Guideline.

Introduction

1. The purpose of this Statement is to provide assistance on inter-bank confirmation procedures to the external independent auditor and also to bank management, such as internal auditors or inspectors. The guidance contained in this Statement should contribute to the effectiveness of inter-bank confirmation procedures and to the efficiency of processing replies.

2. An important audit step in the examination of bank financial statements and related information is to request direct confirmation from other banks of both balances and other amounts which appear in the balance sheet and other information which may not be shown on the face of the balance sheet but which may be disclosed in the notes to the accounts. Off balance sheet items requiring confirmation include, such items as guarantees, forward purchase and sale commitments, repurchase options, and offset arrangements. This type of audit evidence is valuable because it comes directly from an independent source and, therefore, provides greater assurance of reliability than that obtained solely from the bank's own records.

3. The auditor in seeking to obtain inter-bank confirmations may encounter difficulties in relation to language, terminology, consistent interpretation and scope of matters covered by the reply. Frequently, these difficulties result from the use of different kinds of confirmation requests or misunderstandings about what they are intended to cover.

4. Audit procedures may differ from country to country, and consequently local practices will have relevance to the way in which inter-bank confirmation procedures are applied. While this Statement does not purport to describe a comprehensive set of audit procedures, nevertheless, it does emphasise some important steps which should be followed in the use of a confirmation request.

The need for Confirmation

5. An essential feature of management control over business relations, with individuals or groups of financial institutions, is the ability to obtain confirmation of transactions with those institutions and of the resulting positions. The requirement for bank confirmation arises from the need of the bank's management and its auditors to confirm the financial and business relationships between the following:

- the bank and other banks within the same country;
- the bank and other banks in different countries; and
- the bank and its non-bank customers.

While inter-bank relationships are similar in nature to those between the bank and a non-bank customer there may be special significance in some inter-bank relationships, for example, in connection with certain types of "off balance sheet" transactions such as contingencies, forward transactions, commitments and offset agreements.

Use of Confirmation Requests

6. The guidance set out in the following paragraphs is designed to assist banks and their auditors to obtain independent confirmation of financial and business relationships within other banks. However, there may be occasions on which the approach described within this Statement may also be appropriate to confirmation procedures between the bank and its non-bank customers. The procedures described are not relevant to the routine inter-bank confirmation procedures which are carried out in respect to the day to day commercial transactions conducted between banks.

7. The auditor should decide from which bank or banks to request confirmation, have regard to such matters as size of balances, volume of activity, degree of reliance on internal controls, and materiality within the context of the financial statements. Tests of particular activities of the bank may be structured in different ways and confirmation requests may, therefore, be limited solely to inquiries about those activities. Requests for confirmation of individual transactions may either form part of the test of a bank's system of internal control or be a means of verifying balances appearing in a bank's financial statements at a particular date. Therefore, confirmation requests should be designed to meet the particular purpose for which they are required.

8. The auditor should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from another bank:

- listing balances and other information, and requesting confirmation of their accuracy and completeness, or
- requesting details of balances and other information, which can then be compared with the requesting bank's records.

In determining which of the above approaches is the most appropriate, the auditor should weigh the quality of audit evidence he requires in the particular circumstances against the practicality of obtaining a reply from the confirming bank.

9. Difficulty may be encountered in obtaining a satisfactory response even where the requesting bank; submits information for confirmation to the confirming bank. It is important that a response be sought for all confirmation requests. It is not usual practice to request a response only if the information submitted is incorrect or incomplete.

Preparation and Dispatch of Requests and Receipt of Replies

10. The auditor should determine the appropriate location to which the confirmation request should be sent, for example a department, such as internal audit, inspection and other specialist departments which may be designated by the confirming bank as responsible for replying to confirmation requests. It may be appropriate, therefore, to direct confirmation requests to the head office of the bank (in which such departments are often located) rather than to the location where balances and other relevant information are held. In other situations, the appropriate location may be the local branch of the confirming bank.

11. Whenever possible, the confirmation request should be prepared **in the** language of the confirming bank or in the language normally used for business purposes.

12. Control over the content and dispatch of confirmation requests is the responsibility of the auditor. However, it will be necessary for the request to be authorised by

the requesting bank. Replies should be returned directly to the auditor and to facilitate such a reply a preaddressed envelope should be enclosed with the request.

Content of Confirmation Requests

13. The form and content of a confirmation request letter will depend on the purpose for which it is required, on local practices and on the requesting bank's account procedures. for example, whether or not it makes extensive use of electronic data processing.

14. The confirmation request should be prepared in a clear and concise manner to ensure ready comprehension by the confirming bank.

15. Not all information for which confirmation is usually sought will be required at the same time. Accordingly, request letters may be sent at various times during the year dealing with particular aspects of the interbank relationship.

16. The most commonly requested information is in respect of balances due to or from the requesting bank on current, deposit, loan and other accounts. The request letter should provide the account description, number and the type of currency for the account. It may also be advisable to request information about nil balances on correspondent accounts, and correspondent accounts which were closed in the twelve months prior to the chosen confirmation date. The requesting bank may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

17. An important part of banking business relates to the control of those transactions commonly designated as "off balance sheet." Accordingly, the requesting bank and its auditors are likely to request confirmation of contingent liabilities, such as those arising on guarantees, comfort letters and letters of undertaking, bills, own acceptances, and endorsements. Confirmation may be sought both of the contingent liabilities of the requesting bank to the confirming bank and of the confirming bank to the requesting bank. The details supplied or requested should describe the nature of the contingent liabilities together with their currency and amount.

18. Confirmation of asset repurchase and resale agreements and options outstanding at the relevant date should also be sought. Such confirmation should describe the asset covered by the agreement, the date the transaction was contracted, its maturity date, and the terms on which it was completed.

19. Another category of information, for which independent confirmation is often requested at a date other than the transaction date, concerns **forward currency**, bullion; securities and other outstanding contracts. It is well established practice for banks to confirm transactions with other banks as they are made. However, it is the practice for audit purposes to confirm independently a sample of transactions selected from a period of time or to confirm all the unmatured transactions with a counterparty. The request should give details of each contract including its number, the deal date, the maturity or value date, the price at which the deal was transacted and the currency and amount of the contract bought and sold, to and from, the requesting bank.

20. Banks often hold securities and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the confirming bank, at a specific date. The confirmation should include a description of the items and the nature of any encumbrances or other rights over them.

Appendix

Glossary

This appendix defines certain terms used in this Statement. The list is not intended to include all terms used in an inter-bank confirmation request. Definitions have been given within a banking context, although usage and legal application may differ.

Collateral

Security given by a borrower to a lender as a pledge for repayment of a loan, rarely given in the case of inter-bank business. Such lenders thus become secured creditors; in the event of default, such creditors are entitled to proceed against collateral in settlement of their claim. Any kind of property may be employed as collateral. Examples of collateral are: real estate, bonds, stocks, notes, acceptances, chattels, bills of lading, warehouse receipts and assigned debts.

Contingent Liabilities

Potential liabilities, which only crystallise upon the fulfilment of or the failure to fulfil certain conditions. They may arise from the sale, transfer, endorsement, or guarantee of negotiable instruments or from other financial transactions. For example, they may result from:

- re-discount of notes receivable, trade and bank acceptances arising under commercial letters of credit;
- guarantees given; or
- letters of support or comfort.

Encumbrance

A claim or lien, such as a mortgage upon real property, which diminishes the owner's equity in the property.

Offset

The right of a bank, normally evidenced in writing, to take possession of any account balances that a guarantor or debtor may have with it to cover the obligations to the bank of the guarantor, debtor or third party.

Options

The right to buy or sell or to both buy and sell securities or commodities at agreed prices, within a fixed duration of time.

Repurchase (or Resale) Agreement

An agreement between seller and buyer that the seller (or buyer) will buy (or sell) back notes, securities, or both property at the expiration of a period of time or the completion of certain conditions, or both.

Safe Custody

A facility offered by banks to their customers to store valuable property for safe keeping.

Line of Credit/Standby Facility

An agreed maximum amount of funds which a bank has made or undertakes to make available over a specified period of time.