

# Best Practices Guide to Online Audit Confirmations

The Institute of  
**Financial Operations**  
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 Confirmation.



# Best Practices Guide to Online Audit Confirmations

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## Introduction

Paper-based confirmations have been used by the audit profession for more than 90 years. Through numerous changes in technology, business practices, and auditing rules and regulations, the paper and mail system used for making direct contact with third parties has endured. And the process becomes increasingly outdated, less efficient, and less secure every year.

But there is a better way!

In 2009 and 2010, those who set auditing standards approved the use of electronic confirmations as a much-needed replacement to the traditional paper- and mail-based process. In order to preserve the integrity of the confirmation process, they carefully defined what is and is not an electronic confirmation as well as the steps auditors must take to ensure a confirmation from a third party is reliable audit evidence.

There's good reason why companies should adopt the use of electronic audit confirmations as the method for responding to these requests. In three major financial frauds, management at these companies concealed massive frauds by compromising the auditor's paper-based confirmation process. To do this, employees at these three companies persuaded employees at some of their vendors to respond falsely to the auditors' confirmation requests. As each vendor company discovered, there was a cost to defend itself in a court of law, and its reputation and brand in the court of public opinion. Had they used electronic confirmations to control their audit confirmation responses, these companies would not have been associated with the fraudulent activity and wouldn't have spent the time, money, and resources to defend their names.

Research shows that electronic confirmations produce a much lower error rate than the paper alternative. Similar research reveals that replacing paper-based confirmations with electronic confirmations leads to tremendous efficiencies. With new auditing standards expanding the requirements of audit confirmations, we expect the rate of adoption to continue to increase.

In this guide you'll learn why and how to make the switch.

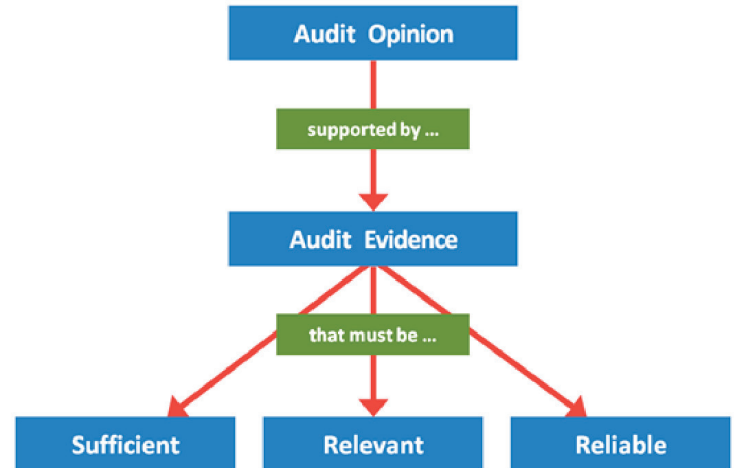
C. Brian Fox, CPA

## The Audit Confirmation Process

Investors, lenders, government agencies, and the public rely heavily on an external auditor's independent opinion from a financial audit on whether a company's financial statements are accurately presented. An easy way for a company to inflate its cash balances – to look more profitable to investors – is to create phony invoices that are used in its general ledger and financial statements. With so much at stake, auditors are required to obtain "sufficient appropriate audit evidence" to support their opinion on the financial statements.

"Sufficient" relates to the quantity of audit evidence obtained. Has the auditor gathered enough?

"Appropriate" relates to relevance and reliability.



### How Auditors Build a Reliable Confirmation Process

All three baseline elements – sufficient, relevant, and reliable – must be in place for the auditor to fulfill his/her responsibilities. To ensure audit quality, there are a variety of standards that auditors must follow including the four tenets of performing a proper audit confirmation:

1. Communicate directly with and receive an active response from the third party.
2. Exercise professional skepticism.
3. Identify and validate a respondent who is free from bias and authorized to respond.
4. Maintain control of the confirmation process.

## Why Companies Need to Control the Process

Under Rule 13b2-2, the SEC has the authority to pursue anyone doing business with a public company who knew or should have known that the information provided to the public auditors was misleading or false. To support these auditing standards and make sure that key stakeholders can rely on independent audit opinions, it's extremely important that companies control the process when responding to audit confirmation requests. To do this, companies need to make sure that responses are received from and sent to an authorized requester such as a CPA firm or an auditor and that only the properly designated personnel respond to these requests. Things to consider about your current confirmation response process:

- Who sent the confirmation?
- Where does the response go?
- Who performed the work within the company and was that person authorized to respond?

## How Reliable Are Paper-Based Confirmations?

To protect your company from being associated with financial fraud, it's important to understand how it takes place, how easy it is to circumvent an auditor's confirmation procedures, and what motivates an employee to respond falsely to auditors' confirmation requests. The following fraud scheme examples illustrate these components and serve as a reminder that by controlling the audit confirmation response process, companies can help prevent this type of fraudulent activity.

### Confirmation Fraud Schemes

#### Client provides false contact information

In a survey of more than 150 accounting firms, researchers discovered that almost all of the mailing addresses for confirmations are being provided to the auditor by the client or taken directly from client-provided bank statements.

To thwart the paper confirmation process, a dishonest client simply uses a scanning machine to manipulate or even create a false statement and provides incorrect contact information in an effort to defraud the auditor. This appears to be one of the techniques employed by Parmalat executives who committed that company's almost \$5 billion audit confirmation fraud.

With today's technology, a dishonest client can easily adjust the balance on a statement and change the contact information to be a friend's address, phone/fax number, and email. Fraudsters do not have to use a friend's address, as Mark Morze, the former CFO of ZZZZ Best Carpet Cleaning, did. Instead, they can use a UPS Store mail account, which is

presented as a real street address and not a P.O. Box address. Phone numbers can be prepaid cell phone numbers or a FedEx Office store fax number. Email addresses can have extensions that closely resemble a legitimate client's email extension.

In an attempt to fool an auditor, a fraudster with \$200 can easily establish three sources of legitimate contact information (address, fax, and phone lines) at any executive office suite that offers those services. In some cases the fraudster can establish an email account, and a receptionist will answer the phone using the name of whatever company the fraudster asks.

Continuous improvements in scanning and printing capabilities will continue to make these types of activities more difficult to detect even as today's regulatory scrutiny and public expectations demand that auditors catch such frauds.

#### Client provides the contact name

When auditors do spend the time and resources to independently validate the address, phone/fax number, or email for a company or financial institution, many times they do not independently know or validate an individual employee within the confirming entity.

To circumvent the paper confirmation process when auditors validate contact information, a fraudster simply provides the correct mailing address or phone/fax number of a co-conspirator within that organization. This dishonest associate can be a friend or relative who fraudulently fills out the paper confirmation and may even sign it with the name of another employee in order to hide the dishonest associate's involvement.

In one case, the director of apparel sales for Adidas America intentionally provided auditors false information because of his motivation for future sales to his client. Just for Feet's auditors sent an accounts receivable confirmation directly to Adidas' director of sales, who confirmed \$2.2 million in receivables due when in reality Adidas only owed Just for Feet approximately \$40,000.

This event exposed both companies, every individual involved in the audit, and the audit firm itself to a huge liability.

#### Client influences the confirmation process

With a little effort, a dishonest client can create third-party credentials that closely resemble legitimate credentials. For example, an inexpensive fake website, displayed as if it were for a legitimate financial institution, can be created to provide incorrect contact information.

In 2004, in two separate cases, thieves created a fake U.S. Bank website and a fake Union Planters Bank website to steal important online banking information from customers for their

own gain. These fraudsters were even able to hijack and use an email with the real bank email extension to direct customers to the fake websites. If the banks' own customers could not distinguish the real site from the fake one, how can those of us who might see it once a year determine whether it is real or fake?

## Signature verification is impracticable

Given all the possible loopholes that exist to circumvent the paper confirmation process, it is not practical to think that an auditor has the resources to validate the signature of the person who responded to a confirmation request.

In today's environment, unfortunately, a cursory review of a signature no longer provides a safeguard from liability when presented to a jury that does not understand why a signature was not validated and does not appreciate the challenges associated with checking the validity of a signature on a paper confirmation. Juries do not understand the tremendous resources that are required to accomplish such an ongoing task.

Fraudsters know that the type of effort required to validate the signature of the confirming entity is rarely used proactively to prevent fraud because of the enormous costs involved and is only used once a potential fraud is believed to have occurred, which could be too late to eliminate the liability associated with the fraud exposure.

Knowing this, fraudsters falsely responding to a confirmation request simply scribble the signature of anyone, to include the signature of a legitimate signatory, to effectively validate a paper confirmation response.

A fake signature was used to perpetrate the Parmalat fraud. Believing that the auditors might attempt to validate the employment of the person who signed the confirmation, the fake signature of a legitimate employee from the bank was used by Parmalat executives to "verify" almost \$5 billion.

## Requirements of an Electronic Confirmation

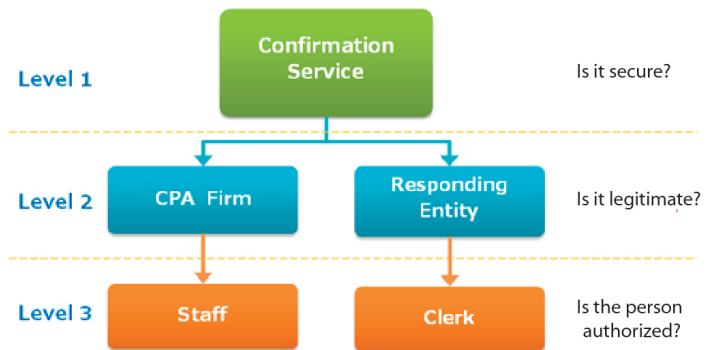
Because of the continued deficiencies seen within the confirmation process, in 2009 the Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) updated their confirmation standards to reflect advances in technology, acknowledging that electronic confirmations can improve efficiency for all parties involved. In 2010, the Public Company Accounting Oversight Board (PCAOB) also proposed new standards, which are awaiting final approval from the U.S. Securities and Exchange Commission.

To ensure the reliability of electronic confirmations, the ASB has stated that electronic confirmations can be considered reliable audit evidence if the auditor is satisfied that:

- The electronic confirmation process is secure and properly controlled.
- The information obtained is a direct communication in response to a request.
- The information is obtained from a third party who is the intended respondent.

## Ensuring Reliability

This diagram illustrates the relationship between the auditor and the responder to an electronic confirmation request. It indicates that authentication, validation, and security are required at three different levels.



- **Individual audit staff and responders.** Authentication and validation is required to establish the identity of the auditor making the request and the person responding to it. Both parties will want to ask:
  - Is the person I'm communicating with who he or she claims to be?
  - Is that person authorized to communicate with me?
  - Is the person responding to the confirmation qualified and authorized to respond?
- **Audit firm and responding entity.** Both parties will want assurance that the entity they are dealing with is a legitimate entity.
- **Communication channel.** Both parties need to know that they are communicating information over a secure channel.



## Authentication and Validation

A reliable electronic confirmation process means the auditor has assurance that he or she is sending the confirmation request to the intended recipient. At the entity level, the auditor should determine that the confirming entity is a legitimate enterprise by validating information such as its:

- Primary mailing address
- Physical address
- Website
- Telephone number

At the individual level, the auditor should verify the identity of the respondent and obtain some assurance that he or she is qualified and authorized to respond and has access to the necessary data to respond.

By the same token, the responding organization needs assurance that the auditor is who he or she claims to be and has the client's permission to request the confirmation. For example, the responder would want to verify the audit firm's:

- Mailing address
- Website
- CPA license
- Telephone number

## Data Security

*An electronic confirmation process that creates a secure confirmation environment may mitigate the risks of human intervention and misdirection. The key lies in the process or mechanism used by the auditor and the respondent to minimize the possibility that the results will be compromised because of interception, alteration, or fraud with respect to the confirmation.*

— AICPA Updated Practice Alert 03-1, Audit Confirmations

To ensure the data hasn't been altered, an electronic confirmation process must have controls that create a secure communication between the confirmation responder and the auditor. Such controls typically include elements such as:

- Passwords for individual participants
- Data encryption
- Intrusion detection and prevention systems

## Ensuring the Security of the Electronic Confirmation Platform

Both responders and auditors demand a high level of security from any electronic confirmation platform. Responders such as company AP departments rightly view the platform as an extension of their own IT system, and they want to make sure that the overall security of the system retains its integrity. It is common for companies that use an electronic confirmation

process to request SAS 70 Type II, SysTrust, and WebTrust reviews or the new SOC reports of the electronic confirmation provider and even perform periodic in-depth security reviews of the provider's IT system.

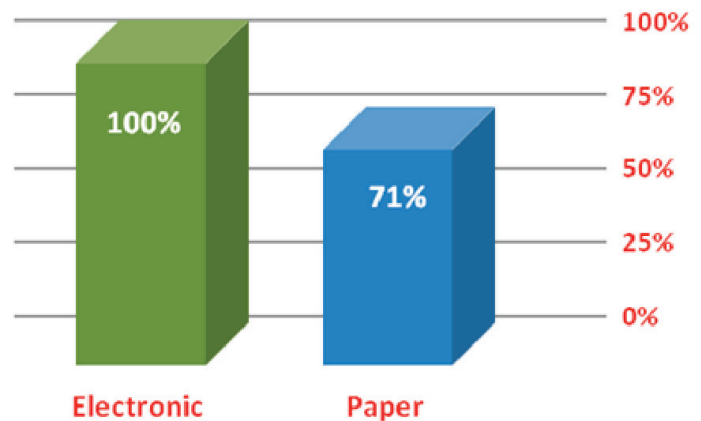
## Driving Confirmation Response Efficiency

The use of electronic confirmations leads to a more efficient audit confirmation response process. Research indicates that, when compared with paper-based confirmations, electronic confirmations result in dramatic improvements in three key confirmation response efficiency metrics.

## Confirmation Response Rates

When an audit confirmation response doesn't come back to the auditor in a reasonable amount of time, the auditor will send out second and third requests to that company. And when those requests go unanswered, the auditor will likely ask the client to help track down lost confirmations.

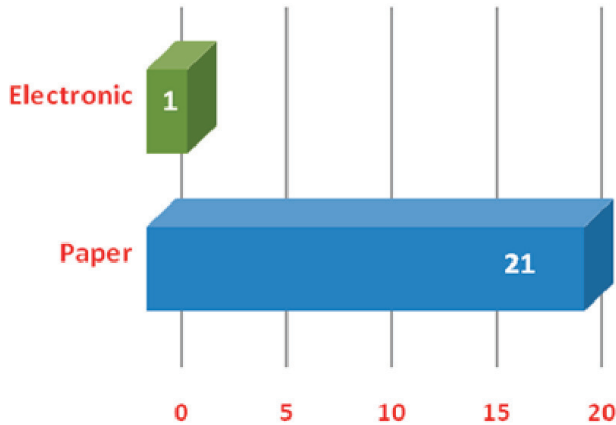
## Response Rates



## Turnaround Times

Slow turnaround times require the client and the audit team to spend more time following up with third parties to get them to respond. Quicker turnaround helps the client meet audit deadlines.

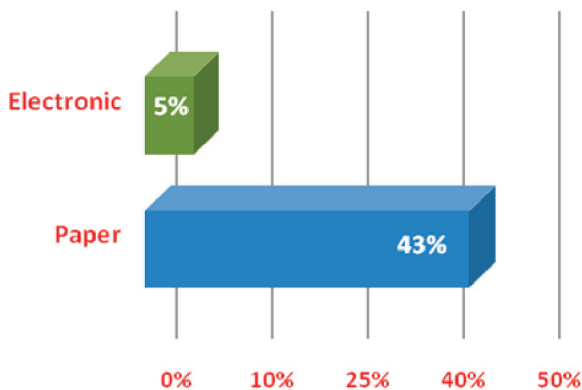
Average Turnaround Times (in Days)



## Error Rates

It is not uncommon for responders to confirm incorrect information or otherwise make errors in the confirmations they return to the auditors. When the responder makes an error, the auditor must either reconfirm with the responder or perform additional procedures to gather the audit evidence originally sought through confirmation.

Reconfirmation Rates



## Centralize the Confirmation Process

Many companies have recognized efficiencies by centralizing their confirmation response effort. They assign a department within the company such as the AP department to coordinate the receiving and sending of the audit confirmation requests. An electronic confirmation process is ideal for companies that use or are looking to implement a centralized confirmation response process.

## About Confirmation.com

Exclusively endorsed by the **American Bankers Association** and a Preferred Provider of Electronic Confirmations for the American Institute of CPAs Trusted Business Advisor™ Solutions Program, Confirmation.com simplifies the audit confirmation process and helps AP departments comply with regulatory standards, increase productivity, and reduce costs.

As the world's leading provider of online audit confirmation services, our solution allows auditors and responders to send and receive audit confirmation requests in a fraction of the time it would normally take. Although making audit confirmations efficient and paperless is a huge benefit of the system, maintaining control over the process is critical.

## Control of the Audit Confirmation Process

Confirmation.com gives companies process control so that only authorized personnel respond to audit confirmation requests. It also ensures that responses are received from and sent to an authorized requestor (i.e., CPA firm). To do this, Confirmation.com uses a unique Authentication and Authorization process to verify the authenticity of the users.

## Fraudulent Activity Deterred

An automatic signature of the employee who responds to the confirmation eliminates the ability of a rogue employee to sign the name of someone else on the confirmation response.

The Review Storage feature allows managers and supervisors to review all the responses sent out by your company. This feature, along with the Automatic Signature feature, serves as a deterrent to an employee who considers falsely responding because he or she knows the false response will be tracked back to the employee.

## Secure

Designed to comply with your company's security requirements, Confirmation.com undergoes a SOC3 audit every six months. This ensures integrity of the data and protects your clients' account information when responding to confirmation requests.



## Easy to Use and Implement

Because the service is delivered over the Internet, there is no hardware to buy or software to install. The only thing you need is an Internet connection. Best of all, as this is a service for accounting firms, there is no cost for responding companies to use Confirmation.com, and setup, training, and customer support are all provided for free as well.

Confirmation.com is simple to use and easier to manage than paper. Users say that compared with handling paper inquiries, Confirmation.com is "more efficient and less complicated." To begin using Confirmation.com, simply go to Confirmation.com and complete the New User registration form. It takes only five minutes to sign up!



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Preferred Provider of Online Audit Confirmations for  
AICPA Trusted Business Advisor™ Solutions



2 Years on Inc. 500 List  
Ranked #169 for 2011  
Ranked #96 for 2010



## About the Author



**Brian Fox, CPA, MBA**, is recognized as the creator of electronic confirmations, and he received the first two patents granted on electronic audit confirmations. Fox founded Capital Confirmation Inc., which created Confirmation.com – a service now used by all of the Top 10 Banks, and more than 35,000 accountants in 100-plus countries. He is a four-time winner of the accounting profession’s “Top 40 Under 40 CPAs in America,” was named an Entrepreneur of the Year in Nashville, and was recognized as one of Nashville’s “40 Under 40” and one of Nashville’s Emerging Leaders in its inaugural class. Prior to Capital Confirmation, Fox was in Dallas, where he worked in audit for Ernst & Young LLP and in mergers and acquisitions for PriceWaterhouseCoopers.

Capital Confirmation, which ranked No. 96 on the Inc. 500 list, has won the overall “Best in Business Award” in middle Tennessee, has been named as a Future 50 company for four years, Fast 50 twice, and a Tennessee Hot 100. Its service, Confirmation.com, won the highest award in accounting software – the Tax & Accounting Innovation Award, as well as the Reader’s Choice Award, and the Quality Award for Tax & Accounting Software, among many other honors.

Professionally, Fox is a member of the AICPA and The Tennessee Society of CPAs. He is a nationally recognized speaker on financial fraud with articles and quotes in *The CPA Journal*, *The New York Times*, *The CPA Technology Advisor*, *AP Matters*, *The Auditor’s Report*, and *International Herald Tribune*.

Fox completed his MBA at Vanderbilt University’s Owen Graduate School of Management with a dual concentration in finance and electronic commerce and received a BBA in accounting from Southern Methodist University’s Cox School of Business.

## About



The Institute of Financial Operations is the umbrella association comprising four membership affiliates for finance professionals: International Accounts Payable Professionals (IAPP), International Accounts Receivable Professionals (IARP), the National Association of Purchasing & Payables (NAPP), and The Association for Work Process Improvement (TAWPI).

Based in Orlando, Fla., with offices in Boston and London, The Institute serves as a global voice, chief advocate, recognized authority, acknowledged leader, and principal educator for people in financial operations, with a particular focus on accounts payable, accounts receivable, procure-to-pay, automation, document management, and data capture. Combined, the affiliates have more than 6,000 members.

Under The Institute, the affiliates share one board of directors, one staff, and a single portfolio of member benefits available to all, including *Financial Operations Matters* magazine and a new website launched in late 2011. Each affiliate maintains its own customized brand, events, career resources, volunteer opportunities, online tools and other leading-edge resources, and educational offerings including e-learning and certification.