

The Case for Electronic Audit Confirmations

How to Detect Audit Confirmation Fraud

*A white paper created for auditors
by CPA2Biz and Confirmation.com*

Table of Contents

Introduction	Page 3
Manual versus electronic audit confirmations	Page 3
The problem with manual confirmations	Page 4
The Solution : electronic audit confirmations	Page 5
Getting started with an electronic confirmation solution	Page 7
The 8 keys to a successful implementation	Page 7
Conclusion	Page 9
About Confirmation.com	Page 9
About CPA2Biz.com	Page 9
Recommended Reading List	Page 9

Undetected fraud: The problem with manual audit confirmations

If you currently process audit confirmations manually, you know it can be a highly inefficient and time-consuming task. But there's a much bigger problem: Manual paper-based confirmations can make it difficult for even the most experienced auditors to detect financial fraud.

As you will see in this white paper, if you're a criminal intent on concealing a fraud, you will find and capitalize on a weakness in the system. For example, over a period of 20 years, Russell Wasendorf, Sr., Chairman of Peregrine Financial Group (PFG) had managed to embezzle \$215 million from customer accounts through a scheme of using false bank statements. More recently, hedge fund owner and operator James A. Shepherd of Vass, North Carolina pled guilty to stealing millions of dollars from more than 100 investors over a seven-year period.

In both cases, the fraud was achieved by using readily available software tools, like Adobe Photoshop and Acrobat, to create fake bank statements. The fraudsters then directed the auditors to send bank confirmation letters to a PO Box they had rented, forged a fictitious bank employee's signature, and then sent the fraudulent audit confirmations back to the auditors. In both cases, the fraud was only uncovered after the auditors utilized an electronic audit confirmation service, Confirmation.com. Similar cases include the Parmalat and CF FOODs fraud cases. Again, the management at both companies concealed their fraud by compromising the auditor's paper confirmation processes. Clearly, a properly designed and implemented electronic confirmation system could have prevented virtually all of these cover-ups.

This white paper will show you how electronic audit confirmations will reduce the risk of fraud going undetected, while saving you and your audit staff time and effort.

Manual versus electronic audit confirmations

Manual confirmations are typically paper-, fax-, and/or email-based and, by its very nature, can expose you and affected parties to the liability issues and risks of fraud that goes undetected. For example, with manual confirmations, how do you know the person at the other end responding to your request is authorized to respond? And how can you verify and authenticate this person? Likewise, how does the party responding to your audit confirmation request know that you are the person you say you are and are authorized to receive this information?

Audit confirmations have been done manually for more than 130 years. Today, there is a far more efficient, secure, automated way to request audit confirmations without the risk of fraud going undetected. It's called electronic, or online, audit confirmations. Many auditors are already leveraging the benefits of electronic audit confirmations, from eliminating the risk of fraud going undetected to freeing up staff to devote more time to billable work, while reducing business operating costs as well.

In short, there are many benefits and advantages of using electronic confirmations, from the ease and simplicity of getting started, to how it can literally transform audit confirmations from being a weakness in the audit process to an efficient, reliable tool in your workflow. The PFGBest fraud showed how paper confirmations can open the door to fraud. Now, you can seamlessly integrate secure electronic audit confirmations into your workflow and dramatically reduce the risk of fraud going undetected.

The problem with manual confirmations

Manual audit confirmations have several weaknesses or problems. The manual process is:

Inefficient and time consuming

At some point in your engagement, you or someone on your staff will need to set aside precious time in your work day to stuff envelopes and mail out paper confirmation requests to banks or businesses. The problem is you may often have to wait several frustrating weeks (sometimes even months) without a response. You may find yourself having to make multiple telephone calls to follow up on the initial paper confirmations that you or your staff mailed out weeks or months ago that were never returned.

Risk of fraud going undetected

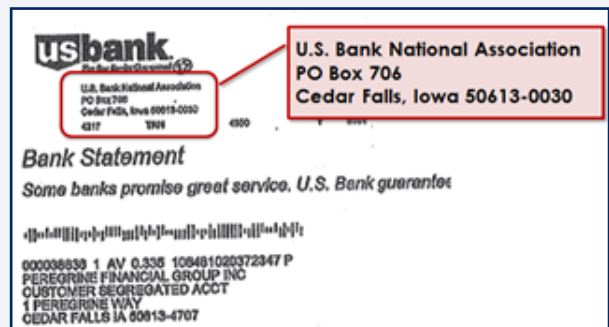
The manual confirmation process also makes it possible for fraud to go undetected. With the manual process, you simply can't guarantee the reliability of the information you receive from responders. The information provided in the confirmation may not be from an authentic source. The person responding to the confirmation may not be knowledgeable about the information being confirmed. And, finally, the integrity of the information may have been compromised. A perfect example is the PFGBest fraud. Let's take a closer look.

The PFGBest Fraud

On July 9, 2012, auditors discovered nearly \$215 million missing in customer funds from PFGBest accounts even though its clearing firm Peregrine Financial Group (PFG) reported to regulators more than \$220 million in customer segregated funds.

Russell Wasendorf, Sr., Chairman of PFG managed to conceal this fraud for 20 years by using simple software tools, like Photoshop, Excel, and a scanner, to create fake bank statements. When auditors wanted to verify PFGBest's customer account information, they would mail an audit confirmation request to the US Bank address provided by Wasendorf, which also happened to match the address on the forged bank statements. For years, PFG looked financially sound because the confirmation responses showed that the bank statements matched the firm's financial statements. This manual process worked so well that the auditors never suspected that Wasendorf had been skimming customer accounts for years.

Bogus US Bank mailing address:

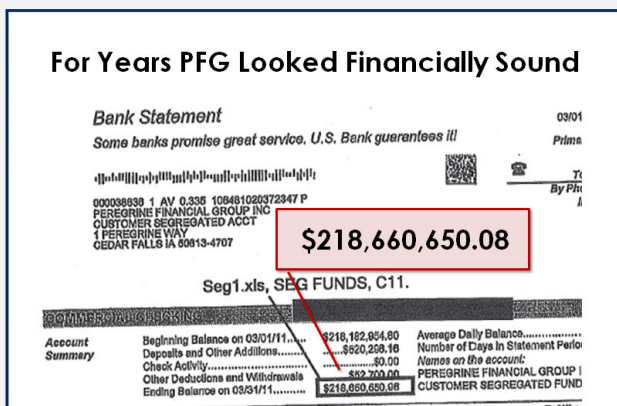


How the fraud was finally uncovered:

The auditors were in the process of implementing an electronic confirmation system (Confirmation.com) and began requesting that Wasendorf give their auditors permission to confirm PFGBest customer account information using the new electronic system. For months, Wasendorf stalled them, refusing to grant them permission. But after continued pressure from the regulator's auditors, Wasendorf finally relented.

By the next morning, the auditors began receiving confirmations through Confirmation.com that the US Bank account had a balance of approximately \$6 million as of 12/31/2011, instead of the \$220 million that was reported on their US Bank statement as of 12/31/2011. In less than 24 hours of giving auditors authorization to use Confirmation.com, Wasendorf's 20-year fraud was finally exposed.

For Years PFG Looked Financially Sound



The solution: electronic audit confirmations

For every audit, the auditor should always ensure the reliability of the information obtained through the confirmation process. Unfortunately, it's impossible to ensure with 100% certainty the reliability of confirmation responses using manual methods. On the other hand, a properly designed electronic audit confirmation system can ensure reliability.

To be effective, a properly designed electronic confirmation system:

- Must be secure, properly controlled and maintained, and should undergo regular performance testing and audits to ensure all information passing through the system is safe and secure.
- All in-network auditors (requesters) and responders, and their entities, must be fully vetted, validated, and verified through a proven authentication and authorization process.
- The system must be able to ensure requests, and the source of requests, are legitimate.

In short, an electronic confirmation system will answer these questions for you:

- Is the responding entity a legitimate organization?
- Is the correct person receiving the request?
- Is the responder authorized to respond?
- Who has access to the data being exchanged?
- Did the vendor really sign the confirmation?

The following are a few of the key benefits of an electronic audit confirmation system:

Highly efficient and fast turnaround

An electronic audit confirmation system can dramatically streamline and automate the entire confirmation process from the auditor generating the initial audit confirmation request to receiving the electronic response. With an electronic confirmation service, you can expect to initiate and receive confirmations in as little as 24 to 48 hours, not 4 to 6 weeks, which is typical for inefficient manual paper confirmations. In addition, you should expect 100% guaranteed response rates when requests are sent to In-Network Responders. No more worrying about whether or not the respondent will reply. And, no more having to make multiple phone calls to remind a responder to fill out the information and return it to you.

Saves time and money

Another benefit: No need to spend hours validating or authenticating the responding entity and responder, plus no more lost paperwork or mail to worry about. Conservatively, users of electronic systems should expect to save 50% of their staff's auditing time after implementing an electronic system. In the white paper "Automation is Key to Improving Efficiency and Effectiveness of Audits," Donny C. Shimamoto, CPA.CITP, quoted a Confirmation.com study that estimated manual confirmations can cost as much as \$70 per confirmation, "a figure that can vary depending on staff bill rates and the amount of follow-up work needed to address lost or inaccurate confirmations." Multiply those figures by the number of confirmations your firm processes per year and you can quickly see how much automated electronic confirmations can save your firm.



And because you and your staff will save time not having to prepare paper confirmation requests, you'll have more time to focus on billable work. One result: Your realization rates will improve as well. See how much your firm can save with our online calculator. Try it now. Go to cpa.com/audit-confirmations#calculator.

Centralizes the confirmation process

With an electronic confirmation system, everything is centralized in one place. All client audit and bank data is stored online in a secure system making it easy for even new auditors to reprise clients' confirmation requests from year to year. With a secure online system, you can also centralize and standardize the audit confirmation process across your entire firm — even with multiple locations. And with a centralized online system, one or two employees can be designated as the administrators handling virtually all confirmation requests within your organization. For example, many CPA firms have improved the workflow within their organizations by centralizing their confirmation efforts. They assign one or two people in the firm to coordinate the sending and receiving of confirmations for all audit engagements.

Secure — undergoes SOC 1, SOC 2, and SOC 3 audits

Confirmation requests contain highly sensitive client information. A properly designed system should undergo SOC 1, SOC 2 and SOC 3 audits at least every six months to ensure the highest level of security standards for privacy and data integrity. This will ensure absolute data integrity, platform security, privacy, and confidentiality. A secure system should also receive ISO 27001 certification.

SOC reports examine controls over the services provided by service organizations. There are 3 types of reports:

- Type 2 SOC 1 prepared in accordance with SSAE 16 reports on the design and operating effectiveness of controls relevant to user entities' internal control over financial reporting.
- Type 2 SOC 2 reports on the design and operating effectiveness of controls that affect the security, availability and processing integrity of the system used to process users' data and the confidentiality and privacy of the information processed by the system.
- SOC 3 reports on whether a system complies with specified Trust Services Principles and criteria.
- ISO 27001 Certification is the globally recognized standard for the establishment and certification of an information security management system (ISMS). The standard specifies the requirements for establishing, implementing, operating, monitoring, maintaining and improving a documented ISMS within the context of the organization's overall business risks. A system's ISMS should cover the online audit confirmation service and infrastructure, including data and data environments, servers, source code, and internal networks.



The importance of validated responders

In-Network versus Out-of-Network Confirmations

Not all electronic confirmation processes are created equal. In order to select an appropriate solution, as the auditor you must understand the differences in functionality, your requirements as the auditor, and the response rates for the in-network versus the out-of-network services. Both in-network and out-of-network processes should include security measures to ensure data integrity. Where they differ is in the authentication and verification of responders to the confirmation request.

- **In-Network:** Some electronic confirmation providers, such as Confirmation.com, have established an extensive network of participating banks and other responding entities. Establishing such networks requires the provider to take steps to authenticate and authorize both the entity and the individual responders to the confirmation request. As the auditor, accessing these validated responders eliminates the burden of having to verify the identity of the respondent and whether or not they are authorized to respond.
- **Out-of-Network:** An out-of-network confirmation service does not include authentication and authorization of the respondent. The provider of an out-of-network service has performed no procedures to validate either the entity or the individual responding to the confirmation. That responsibility falls to you the auditor, who is required to determine that the confirmation was sent to the proper source and that the respondent was authorized to respond.

Based on the above, you can see that in-network confirmations are more secure and efficient and preferred over out-of-network confirmations. However, for confirmations going to responders outside the network, the out-of-network service is another alternative.

Getting started with an electronic confirmation solution

You will find that transitioning your firm or organization over to an electronic audit confirmation service can be quick, easy, and painless. Plus your audit staff can start realizing significant productivity and efficiency gains almost immediately. But managing the change within your firm is critical to ensuring a smooth, successful transition. In the white paper “Automation is Key to Improving Efficiency and Effectiveness of Audits” that we referenced earlier, Donny identified 8 keys to successfully transitioning your firm to an automated electronic confirmation solution.

By following these 8 keys, you will help ensure the success of your implementation, including realizing the full potential value of deploying audit automation tools.

The 8 keys to a successful implementation

Key 1: Appoint a “champion” or audit excellence officer as your firm’s confirmation expert

Don’t just purchase tools and leave it up to the staff to use it. To ensure success of your new electronic service, assign one person to be your “champion” or audit excellence officer to manage the implementation, training and support of your new electronic confirmation service. This person will ensure the solution is implemented properly, timelines are followed, and staff are properly trained to use it. Finally, this person should have the full support of your firm’s management. This will ensure that your staff perceives this as a firm initiative, not just someone’s pet project.

Key 2: Understand the audit confirmation process

As Donny states in his white paper, “If you take a broken process and automate it, you’ll just have a more efficient broken process.” Therefore, before starting the transition to your new automated service, make sure you have a solid grasp of the process you are automating. Start by creating a workflow chart or map of your current audit processes that identify the key tasks, phases, and critical paths in the process. Also identify the person responsible for performing each task. With electronic confirmations, you’ll find you are able to shift responsibility for processing confirmations from a member of the audit team to lower-cost admin staff. This will reduce the cost of performing the confirmations, as well as freeing up your audit staff to focus on more profitable, billable work.

Key 3: Consider a phased approach to implementation to ensure long-term success

For some firms, using a phased or incremental approach to implementation can help reduce the impact of the change to your staff. Remember, some people in your firm may be resistant to change, especially technological change.



With a phased approach, you can smooth over any bumps during the roll-out of your new electronic confirmation service. A phased approach should consider the type, complexity and phases of your audit engagements. Also consider rolling out the service to your tech-savvy staff first, so they can help train your less tech-savvy staff. Finally, consider a phased approach to implementing the various features and functions of your new service. The full functionality of your new service does not need to be rolled out all at once. Start training in one functional area at a time, adding more advanced functions later. . . only after your staff has grown comfortable using the previous one.

Key 4: Start slowly with a small “test drive” to identify usage procedures and process changes

When possible, start with a small controlled “test drive” as a proof of concept to demonstrate the effectiveness of transitioning to the new service. The lessons learned from this small test drive or “beta test” will help you identify the best way to roll out the new service to your entire firm. With a small beta test, usage procedures and process changes can be identified to help reduce any impact to your staff that a new tool may cause. A small test drive lets you become familiar with the new service before a full firm-wide implementation. This will help to identify the training that will be needed before you commence a full roll out. During this “beta” period, you’ll also be able to estimate the total cost of automating the process by identifying the changes and training that will be needed. You will also be able to determine the ROI or payback period.

Key 5: Manage expectations

Don’t oversell the benefits of your new service to your staff. One benefit of the test drive as proof of concept is to ensure expectations of your new service are realistic and achievable. As with client engagements, the key to a successful implementation is to communicate actively and manage expectations.

Key 6: Allow firm-wide usage to grow organically, but make it required

After the test drive as proof-of-concept phase has completed, you can allow staff usage of your new service to grow organically, or do a formal mandatory firm-wide rollout. In either case, you may find that early users, after using the new service on one engagement, will want to use it on other upcoming engagements as well, and will want to share the use of the new service with less tech-savvy staff, who may be less open to change. To this end, consider setting a timeframe for firm-wide adoption of the new service. This will help motivate those who are change resistant to start using the new service.

Key 7: Provide training to reduce resistance to change and increase adoption

According to the AICPA’s Top Technology Initiatives survey, staff training in the use of new technology has been one of the top firm priorities for several years. Proper training reduces wasted time trying to figure out how to use a new tool.

Most vendors now provide excellent web-based training, documentation, and even on-site training. Take advantage of these resources to address the training needs of your staff. Also consider having someone on your staff compile a cheat sheet of best practices for new users. Remember: if your staff does not use the new service, or if they don’t use it correctly, you can’t realize the full benefits that an automated electronic audit confirmation service can provide.

Key 8: Leverage time and labor savings to generate more revenue

While you should expect to see significant time savings from moving to an automated electronic audit confirmation system, the real return on time savings will come when you take the time you saved and use it to generate more revenue. Since most of your staff are likely on paid salaries, which are fixed costs, adding new technology services may initially increase your engagement costs, especially when a per-transaction cost is directly charged back to engagements.

By freeing your audit staff’s time to focus more on billable work, such as taking on additional engagements with the same number of staff, you’ll soon see increased revenue. In addition, you may also find your admin staff can now perform billable functions as well. It’s a win-win for your firm.



Conclusion

As an auditor, you want smooth, successful audit engagements. You don't want to deal with the problems and liability issues of audit confirmation fraud. As we have explained earlier in this white paper, manual paper-, mail-based audit confirmations can leave the door open to fraud. Now you can turn the inherent weakness of manual confirmations into a strength by implementing a secure, automated electronic audit confirmation process. In addition to helping you to detect, deter, and prevent fraud, an automated cloud-based confirmation service will help your audit staff to save valuable time and effort, freeing them up to focus more of their time on revenue-generating billable work.

About Confirmation.com

As the exclusive Preferred Provider of Electronic Confirmations for AICPA Trusted Business AdvisorSM Solutions and for the American Bankers Association, Confirmation.com provides secure online confirmation services for auditors, banks and their shared clients. Confirmation.com's patented service minimizes fraud and brings efficiency to the audit confirmation process. This easy to use, web-based service guarantees responses and has an average turnaround time of less than 2 business days. Using Confirmation.com, auditors will spend less time tracking down confirmations and have more time to spend on other critical engagement activities.

Confirmation.com provides both In-Network and Out-of-Network delivery options, allowing you to send confirmation requests to 100% of banks and other responding companies worldwide. For the greatest level of efficiency and security, Confirmation.com's In-Network application uses a unique Authentication and Authorization process to validate the authenticity and authorization of each user. To illustrate their commitment to effective operational controls, and to ensure privacy and data integrity, Confirmation.com undergoes all three types of Service Organization Control (SOC) examinations every six months, and has received an ISO 27001 certification of their Confirmation.com service.

In addition to its bank confirmation solution, the company provides more than 30 different types of audit confirmations, including accounts receivable confirmations. Several hundred In-Network responding companies, including all of the Top 10 banks in the U.S. and over 11,000 accounting firms in more than 100 countries, trust Confirmation.com for their audit confirmation needs. For more information, please visit cpa.com/audit-confirmations for more information.

About CPA2Biz.com

CPA2Biz is the technology subsidiary of the American Institute of Certified Public Accountants (AICPA), the world's largest member organization representing the accounting and auditing profession. The company, through its website CPA.com, as well as online webinars, conferences and training programs, helps firms position for success within the digital transformation that is revolutionizing the competitive landscape. CPA2Biz has emerged as a leading voice for firms on harnessing the power of cloud-based technologies, such as electronic audit confirmations, accounting, firm-wide workflow, bill management and more.

Recommended Reading List

- *Automation is Key to Improving Efficiency and Effectiveness of Audits* by Donny C. Shimamoto, CPA, CITP, CGMA
- *Guide To Electronic Confirmations* by L. Gary Boomer, CEO of Boomer Consulting, Inc. and Brian Fox, CPA, Founder & Chief Marketing Officer, Confirmation.com
- *Confirmation.com's Role Uncovering the Peregrine Financial Group (PFGBest) Fraud*

Download these and other related documents at cpa.com/whitepapers/confirmation.com.