

Industry Guidance

The role of audit confirmations



Table of Contents

| | |
|---|---|
| Introduction | 2 |
| Role of Audit Confirmations | 2 |
| The AICPA Practice Alert 2003-01 | 3 |
| The Confirm™ Service | 4 |
| Solution Furthers the Goals of Alert 03-01 | 6 |
| The World of Information Security | 6 |
| Endnotes | 8 |

Introduction

The following white paper discusses the audit confirmation process and the recent professional literature related to audit confirmations, and addresses the role and potential added value of the Confirm™ service (“Confirm”) of Capital Confirmation, Inc. (“Capital Confirmation”) in the audit confirmation process.

The Role of Audit Confirmations

The confirmation process during the course of a client audit is a means by which the auditor can receive evidence from a third-party regarding assertions that have been made by the client’s management with respect to its financial statements. Confirmations are widely used in the audit process, although they represent merely one means by which auditors can address financial statement assertions of a client, and typically serve to address only certain of the categories of assertions.¹ In other words, confirmations are one of many tools that auditors use to test assertions and are heavily dependent on the overall audit risk, as determined and measured by the auditor, with respect to the client and its financial statements.

Should an auditor determine that, given the assessed level of audit risk, it is appropriate and reasonable to rely on audit confirmations to test assertions, such third-party confirmations are a valuable tool with respect to certain accounts. It is important to note that there is no standard form of audit confirmation; the auditor designs the confirmation based on the information to be obtained, the assertion to be addressed and the risks associated with such assertion. In addition, and as the October 1992 article of The CPA Journal Online provides, “[a]n auditor should consider the respondent’s competence, knowledge, motivation, ability, willingness to respond, and overall objectivity.” Furthermore, “if independent outside parties can be expected to provide relevant, reliable evidence and it is reasonably efficient to obtain this evidence from these parties, confirmation would be appropriate.”²

To ensure the reliability and security of information, an auditor “should maintain control over sending the confirmations and the responses received.”³ In sending the confirmations, the auditor and respondent should be the communication link, without interference by the client.⁴ The accounting guidance provides that if a telephone or facsimile response is received, the response should be documented in the audit workpapers, and the auditor should call the facsimile respondent to verify the source.⁵ It appears, and should be noted, that since SAS 67 took effect in audits of periods ending after June 15, 1992, the accounting literature has not contemplated addressing the world of secure information transfer that is central to the confirmation service provided by Capital Confirmation.

The AICPA Practice Alert 2003-01

What the Alert provides

Practice Alert 2003-01 (the “Alert” or “Alert 03-01”) from the American Institute of Certified Public Accountants (“AICPA”) was released in January 2003 in an effort to “communicate additional guidance to practitioners with respect to the use of audit confirmations.”⁶ Alert 03-01 provides general confirmation guidance, confirmation guidance pertaining to specific assertions and areas and evolving alternatives to the confirmation process.

With respect to general confirmation guidance, Alert 03-01 addresses, among other things:

- i. the methods for improving response rates, including means of clarifying confirmations and using methods to decrease the complexity of certain confirmations;
- ii. the benefits of positive confirmations over negative confirmations;
- iii. the use of client personnel in the confirmation process so as to ensure the auditor maintains control over the confirmation process up until the receipt of responses; and
- iv. confirmations received via fax or electronically.

With respect to the last item, regarding fax and electronic confirmations, the Alert essentially recalls the discussion under original accounting guidance pertaining to SAS 67 (and as discussed in The CPA Journal Online, October 1992 where information received via fax or phone should be verified by phone and followed by direct mail), with the addition, however, of recognizing email as a new potential source of confirming information. Note that in the specific sentence of Alert 03-01 that addresses confirmations received “electronically” that the concept of “electronically” appears to be a synonym for “e-mail” rather than a reference to secure electronic transfers of information. The phrase “received via fax or electronically” is restated in the guidance as “received by fax or e-mail.”

“Confirmations received via fax or electronically

The auditor should communicate directly with the intended recipients. In order to validate confirmations *received via fax or electronically* [emphasis added], the auditor should consider (a) verifying by telephone with the purported sender the source and contents of a response *received by fax or e-mail* [emphasis added] and (b) asking the sender to mail the original confirmation directly to the auditor. All procedures performed and conclusions reached should be documented in the audit workpapers.”

With respect to its discussion regarding evolving alternatives to the audit confirmation process, Alert 03-01 stresses that “confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for a particular item affecting financial statement assertions” and goes on to provide that “an on-line inquiry of the third-party’s database does not constitute a response.” The critical component of this discussion in

the Alert is that, with such an on-line inquiry, there is no communication *at all* with the third-party respondent and the information is obtained in an unsecure and unauthenticated framework.

It would appear that one of the risks that the Alert attempts to address is that of verifying that the sender of an electronic message is, in fact, the sender the recipient expects. With fax communications and both insecure and secure email, it may be easy for a party to impersonate someone else for example by forging the email header (commonly referred to as “spoofing”) or a fax letterhead. Thus, the Alert imposes additional obligations on the part of the auditor to obtain some additional assurance as to the authenticity of the message.

What the Alert fails to provide

What Alert 03-01 does not contemplate or consider is the concept of secure confirmation information transfer and the use of a secure platform to facilitate such transfer between the auditor and the third-party confirmer. The Alert addresses confirmations received via fax and email and the process of securing confidence in such a non-secure means of delivery to the auditor, but fails to address the more recent and prevalent phenomenon of secure electronic transfer of information. The Alert also contemplates the use of the world wide web in accessing, without the direct involvement of the third-party confirmer, information regarding such third-party, but does not address the situation where the third-party confirmer is involved in electronic inquiries using a secure platform of information transfer between such third-party and the auditor.

The Confirm™ Service

The patent-pending Confirm service provided by Capital Confirmation is a secure platform of information transfer between the third-party confirmer and the auditor. Confirm allows an accountant, or auditor, to request confirmations related to a particular client and permits a financial institution, as third-party confirmer, to respond to such requests. The process is principally electronic and ultimately requires authentication of each of (i) the accounting firm, (ii) the accountant/auditor and (iii) the client who is the subject of the audit. The process also requires two “signatures”: an electronic authorization (in the form of the AUD number process and user agreement acceptance) and a physical authorization (typically in the form of an audit firm engagement letter with the audit client). The authentications and signatures are important in maintaining the security of the information transfer. The following is a description of some of the features of the Confirm system that are designed to ensure authentication, authorization and secure transfer of information.

Capital Confirmation has established a thorough, multi-step authentication process to authenticate each accounting firm, accountant/auditor and audit client involved in the Confirm process.⁷ A validated and authenticated audit client user will receive directly from the Confirm system an “AUD” number through the validated email process. The AUD number is a randomly generated PIN. The AUD number generation process can only be initiated by the authenticated accountant through the use of a login to the Confirm service using their unique ID and password. If a client user’s email becomes invalid, the AUD will not reach such client and the Confirm confirmation service would be halted. The Confirm system is designed such that the audit firm cannot initiate a confirmation request through the Confirm system without the AUD number. The audit firm can only obtain the AUD number from the audit client thus ensuring the audit client’s authorization to request confirmation. The electronic authorization is such AUD number. The use of the AUD number by the authenticated audit client creates the authorization for the authenticated audit client’s financial institution to release information regarding the audit client to the specified authenticated accountant/auditor via the Confirm service. In addition, the audit firm and audit client each agrees and acknowledges that among other matters that they each have authorization to request the confirmation information.

In addition to the electronic authorization, the highlights of which are discussed above, there is a physical authorization to the Confirm process. An authenticated accountant/auditor user’s authenticated accounting firm must receive proper written authorization from an authenticated client user in order to use the Confirm service. This authorization is usually in the form of an engagement letter between the audit firm and the audit client. The written authorization is to be kept on file by the authenticated accounting firm for at least five years. The Confirm process ultimately provides a means by which only a licensed accounting firm’s accountant/auditor user can set up a client and only an authorized representative of the financial institution’s client can authorize an audit confirmation, creating a traceable path of accountability governed by applicable laws and regulations.

Critical to this process is the authentication of the financial institution. Capital Confirmation sets up secure links between the accountant/auditor and a validated financial institution, assuring that when a confirmation request is sent, it goes directly to the financial institution without interference. Further, because the process is fully automated, the requested information is transmitted to the auditor/accountant in a secure fashion. The use of encryption and digital signatures allows the auditor/accountant to have an extremely high degree of confidence in the integrity and authenticity of the confirmation information. Indeed, the confidence level is much higher than is present in the paper-based confirmation process because there are far fewer opportunities for errors or corruption of the process.

Solution Furthers the Goals of Alert 03-01

Confirm provides a secure platform but maintains that it is only a venue and is not, itself, an authorized bank representative. Confirm facilitates the audit confirmation process by providing such a venue between the third-party confirmer and auditor user within a secure framework. Recognizing that audit confirmations are merely one tool of the auditor and are of value in certain audit risk contexts, Confirm confirmations may serve to further enhance the confirmation process by creating a clear and efficient confirmation process as encouraged by Alert 03-01. Confirm is also a means of positive confirmation. The auditor also maintains control over the confirmation process up to the receipt of the third-party response through the security measures under the Confirm service. Due to the automated, secure Confirm confirmation request and response environment, the Confirm system may lead to a higher confirmation response rate from financial institutions or other organizations.

Although information is transferred electronically with Confirm, the process is secure, authorized and validated, unlike the email, facsimile transfers and the independent on-line inquiries contemplated and discussed in Alert 03-01. Capital Confirmation through its Confirm service represents a movement into electronic information security technologies that can enhance the audit process by providing a secure information link between auditor and respondent and creating a means by which outside parties can provide “relevant, reliable evidence”⁸ that is reasonably efficient to obtain.

The World of Information Security

Electronic transfer of information is no longer a novel concept and is involved in virtually every aspect and area of business and commerce. With the broad use of electronic transfer comes certain risks and concerns over security. Thus, the need for secure networks and platforms for information transfer has arisen. Information security in the electronic context has four main objectives:

- i. Confidentiality, or ensuring that unauthorized persons are not privy to the information;
- ii. Integrity, or ensuring that there is no unauthorized alteration or destruction of transferred information;
- iii. Availability, or ensuring that authorized users are able to access information and other resources; and
- iv. Authorized use, or ensuring that resources are, in fact, used by only authorized persons in the authorized manner.⁹

There is also an important fifth objective: that of authenticity. The use of encryption and digital signatures allows parties to have assurance that the sender of a message is, in fact the party purporting to do so. This concept is embodied in the federal E-Sign Act as well as numerous state statutes, and is discussed extensively in various secondary sources, including the Digital Signature Guidelines set forth by the American Bar Association.¹⁰

Services like Confirm, have grown out of the need for information security in the electronic context. Although Confirm, like many authentication services and secure venues, does not authenticate the information transferred, it serves to authenticate and verify the parties involved in that transfer unlike the paper-based process. Confirm provides an efficient confirmation service that seeks to promote the above objectives of information security, furthering the audit confirmation process.

For more information about secure electronic confirmations, contact us at:
1-888-716-3577 or visit www.confirmation.com.

Capital Confirmation, Inc.
214 Centerview Drive, Suite 265
Brentwood, TN 37027
Phone: 888-716-3577

Endnotes

¹ Confirmations can be structured to address each of the five categories of financial statement assertions: (i) existence and occurrence; (ii) completeness; (iii) rights and obligations; (iv) valuation or allocation; and (v) presentation and disclosure. As noted in the CPA Journal Online in the article “SAS No. 67 fine tunes the confirmation process,” October 1992, “it is generally known, (SAS 67) that confirmations are most effective in testing existence and less effective for the completeness and valuation assertions.” The article suggests that with respect to certain assertions, “other audit procedures should be used in lieu of confirmations.”

² The CPA Journal Online, October 1992.

³ The CPA Journal Online in the article “SAS No. 67: guidance on confirmations,” March 1993.

⁴ The CPA Journal Online, March 1993.

⁵ The CPA Journal Online, October 1992.

⁶ Alert 03-01.

⁷ Authentication by Capital Confirmation includes such steps as independent third-party validations, periodic reviews, identity certifications and valid email verifications. This memorandum does not delve into the specifics of the authentication process, which is quite extensive and involved. Where an accounting firm, auditor/accountant or client cannot be verified and authenticated, such party will not and cannot be involved in the Confirm process.

⁸ See above, under the section entitled “The Role of Audit Confirmations,” quoting from The CPA Journal Online, October 1992.

⁹ “Information Security Technologies,” Secure Electronic Commerce, Warwick Ford and Michael Baum, 2001.

¹⁰ “Digital Signature Guidelines, Legal Infrastructure for Certification Authorities and Secure Electronic Commerce,” August 1996.