

How Inefficiencies Increase the Risk of Confirmation Fraud



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Introduction

Two major accounting firms have just been sued for \$10 billion by Parmalat for the fraudulent \$5 billion bank confirmation that sent the Parmalat company into bankruptcy and lost investors and lenders billions of dollars in the U.S. and abroad. The investment banks and underwriters have also just been sued by Parmalat:

- Citigroup – \$10 billion
- Morgan Stanley & Banka Intesa – \$1.96 billion
- Deutsche Bank – \$21 million
- UBS – \$355 million
- Bank of America – amount not yet disclosed

Along with the class-action lawsuits from the retail investors in Parmalat's stocks and bonds, the next round of lawsuits likely will be against the accounting firms by all those who relied on the financial statements: the investment banks, the institutional lenders, the investors, etc.

Impact of the Problem

Due to the ease of circumventing the paper confirmation process for fraudulent purposes and the inefficiency inherent in the paper confirmation process, auditors are (1) not identifying the confirmation fraud schemes employed and are (2) deficient in the resources necessary to authenticate the confirmation responses and therefore are (3) instead “papering-over” the objective of obtaining “sufficient audit evidence.”

Cash is the targeted asset in 93.4 percent of the fraud.

– 2004 ACFE Report to the Nation

Users of Financial Statements

The users of financial statements want usable financial statements that are free of material misstatement whether caused by error or fraud. The fact that 20 percent of the original \$1.5 billion HealthSouth fraud was false cash and that Parmalat posted a cash account that grew to \$5 billion over a ten year period creates doubt in the minds of financial statement users that today's audits are being performed with due professional care and an appropriate level of professional skepticism. The report released in July of 2004 from the Association of Certified Fraud Examiner's found misappropriation of assets represents 92.7 percent of the occupational frauds from their 2004 survey, and that cash was the targeted asset in those frauds 93.4 percent of the time.¹ Users of financial statements endorse the statement from Floyd Norris on the cover of *The New York Times* business section that states:

“Is it too much to ask that the auditing firms come up with a foolproof way to assure that bank accounts are real?”

- *New York Times* coverage of Parmalat Fraud²

Today, a secure clearing house for confirmations, like the one provided by Capital Confirmation, provides the industry a state-of-the-art, most “foolproof way” to assure that confirmation responses, including bank accounts, are real.

Marketplace Trends and Attractiveness

Fraud Detection

Fraud is the number one driving force steering the audit profession today. Auditors are being forced to incorporate procedures into their audit programs that will aid them in their ability to detect fraud.

The volume and magnitude of the recent corporate scandals involving financial statement fraud have created an atmosphere of public contempt and resentment for the external auditors who are viewed by most investors as the public's "corporate watch-dog."

The most recent confirmation fraud, the Parmalat fraud, proves that no firm, no matter how sophisticated, is immune to the simple confirmation schemes that so many fraudsters employ.³

Efficiency and Increased Realization

Rightly or wrongly, until recently many people viewed audits as a commodity service. With the recent changes to the independence rules, CPA firms can no longer use the audit as their internal "loss-leader" to open the door to more lucrative consulting type engagements with the same client. The paper confirmation takes an inordinate amount of time and energy and the sheer effort involved has driven some CPA firms to consider eliminating confirmations from their audit process, even though Practice Alert 2003-01 released by the AICPA in January of 2003 specifically reemphasized the importance of performing confirmations.

It is estimated that paper confirmations cost as much as \$70 per confirmation and that that figure can go up depending on staff rates and the amount of follow up work that is required on lost or inaccurate confirmations. A secure confirmation clearing house service streamlines the confirmation process, making it easier to manage, send and store confirmations, and the process takes 24 hours. In a Microsoft Case Study released at the 2004 Technology Conference, Capital Confirmation's clients say they have cut their time spent performing confirmations in half,⁴ which leads to an overall increase in realization rates.

Electronic Workpapers

There is a continued trend to transition from paper workpapers to electronic workpapers. A secure confirmation clearing house service allows CPA firms to download the audit confirmation results directly into any set of electronic workpapers, thereby supporting the profession's move to a completely paperless audit. The AICPA/Microsoft/Capital Confirmation Case study on the Use of Electronic Confirmations that was presented at the AICPA's Technology 2004 Conference, advances the cause that electronic confirmations are a natural extension of an auditor's electronic workpapers, and the added capabilities of the service make electronic confirmations the standard for all audit confirmations and audit workpapers.

Substantive Tests

A shift is taking place in the audit profession from a focus on risk-based auditing to performing more substantive tests, and doing so as often as quarterly. As reported by the *Wall Street Journal* in March of 2004, Timothy Flynn, vice chairman of audit and risk-advisory services at KPMG LLP, said that:

“there has been a shift back to more detailed testing and more substantive (procedures).”

Due to the enormous amount of paper-chasing that is required, a sampling of accounts is often performed, and many in the profession now question if auditors used large enough sample sizes to give the auditor enough measurements to appropriately predict a material misstatement. Secure electronic confirmations allow CPA firms to easily send and track large numbers of confirmations for larger sample sizes and potentially send confirmations on all of a client’s accounts.

Continuous Audit

Deloitte & Touche LLP told the *Wall Street Journal* that its auditors are performing more substantive tests of transactions on a quarterly basis, rather than waiting until year’s end. With the paper confirmation process having a turnaround time of four – eight weeks, it is impractical to perform confirmations on a quarterly basis. The Capital Confirmation service that is in the market today averages 24 hour response time that allows CPA firms to send confirmations on a quarterly basis for the first time ever.

Timeliness

With the average response time of 24 hours, CPAs have the ability to sort out any discrepancies early in the audit versus waiting until the last day to find out that an issue exists. Auditors report that receiving confirmations late in the audit is a constant problem with the paper confirmation process and it is at least possible that this may lead to a rushed and potentially inappropriate action on the part of the CPA when pressed for time at the end of an engagement.

Regulations

Panel on Audit Effectiveness

The Panel on Audit Effectiveness researched the effectiveness in auditor procedures and on August 31, 2000 issued their final report. As it related to their review of confirmations, the Panel recommended:

- To the Auditing Standards Board (ASB)
 - “Undertake research to develop more effective methods of confirmation or other means of obtaining evidence from third parties, such as through the use of technology”⁵

 Confirmation.

- To Audit Firms
 - Develop case studies or other communications to audit personnel that illustrate the dangers of losing control over the confirmation process⁶
 - “Emphasize to their personnel the importance of obtaining evidence from third parties whenever possible and that the presumption that receivables are to be confirmed when they are material is not easily overcome”⁷
 - “Provide more guidance to their personnel on other types of information, in addition to or in lieu of receivables balances, that might be confirmed”⁸
- To the SECPS Peer Review Committee
 - “Request that peer reviewers evaluate whether engagement teams are... (c) maintaining control over the confirmation process, (d) taking appropriate precautions when facsimile responses to confirmation are received

Auditing Standards Board (ASB)

As it relates to confirmations, the ASB’s SAS No. 31 Evidential Matter (AU sec. 326) states that:

“When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.”

In November 1991 the ASB issued SAS No. 67 *The Confirmation Process* to specifically focus on confirmations. The standard set up the guidelines under which a confirmation should be performed. The Four Tenants of SAS No. 67 are:

- Direct Communication (p. 2 sect. 4);
- Professional Skepticism (p. 5 sect. 15);
- Respondent is free from bias (p. 8 sect. 26-27); and
- Maintain Control (p. 9 sect. 28)

It should be noted that SAS No. 67 was written before the dawn of the internet and electronic workpapers. Congress has now made electronic documents as legally binding as paper documents when it passed the Electronic Signatures in Global and National Commerce Act, which was signed by President Clinton in 2000 (15, U.S.C. 7001 et. seq.). SAS No. 67 was even written before the plain paper fax was used or caller ID was available. In 1990 and 1991, fax machines used thermal paper and the ink disappeared after 2 years which is one of the reasons the standard recommends asking the responder to send back an original, so that the audit evidence would not “disappear.”

The other reason the standard recommends that the auditor call back the responder really has little to do with the detection of fraud, and had more to do with the standard writers’ belief that this new faxing process might inadvertently change or corrupt the information the responder sent. Remember, at that time, auditors believed that they only had a responsibility



to detect errors, and did not believe that they had a responsibility to find and detect fraud. Even when we assume the authors of the standard were recommending a phone call to the purported sender of the fax as a procedure that was fraud related, are we to assume that they didn't think through the entire fraud process? Wouldn't someone who provided a CPA with a false fax and fax number when trying to commit fraud simply also provide the CPA with a false phone number when the CPA called the responder back to verify the source and content of the information in the response? Are we to assume that a fraudster would fax a fraudulent confirmation to a CPA to commit a fraud but then when called on the phone by the CPA would tell the truth as to who they are and that the fax was fraudulent?

The only scenario that the recommended actions in SAS No. 67 make sense is if a fraudster faxes a false response to the CPA and hopes that the legitimate responder does not send back the CPA's legitimate confirmation with a response. With the risk that the CPA firm might receive two confirmation responses, one fraudulent and one legitimate, it is doubtful that any fraudster would attempt to commit the fraud in this manner. In fact, in all of the documented confirmation frauds in the last 20 years, this scenario never took place. Instead, the fraudster either provided the CPA with a false mailing address or had a confederate within the legitimate responding company send back false information.

In January of 2003, Practice Alert 2003-01 was issued to reiterate (1) the importance of performing third party confirmations and (2) the importance of performing them correctly, but did very little to update the requirements under SAS No. 67. The Practice Alert continued to require the four primary considerations as the auditor performs confirmations, but did not address fraud and the fraud schemes used to circumvent SAS No. 67:

- Communicate Directly with the Intended Recipient (assumes work has been done to identify an "Intended Recipient") (p. J3);
- Maintain Control over the Confirmations (p. J4);
- Direct Communication from a Third Party (p. J5); and
- Active Response from Third Party (p. J5)

In 2003, the ASB created a Confirmation Task Force chaired by Stephen Schenbeck. The charge for the task was to update the language in SAS. No. 67. At the September 18, 2003 ASB meeting, before the December 2003 Parmalat fraud hit the headlines, the following came forth:

- "Initial research indicates that electronically transmitted confirmations may be more reliable than those transmitted via traditional methods if the confirming entity's system is equipped with certain software that can improve the security of the confirmation process. The ASB believes that SAS No. 67 would be improved by including a recommendation that the auditor consider the effect of specialized technology on the confirmation process, and a section that addresses manual and electronic security measures related to confirmations."⁹
- "The auditor should maintain control over the confirmation process"¹⁰

Two months after this September 2003 meeting, the \$5 billion Parmalat fraud was revealed. Realizing that the PCAOB, with fraud detection as its cornerstone, will probably look at the confirmation process, the reconstituted membership of the ASB has decided to forgo further efforts in the area of confirmations until more has been released by the PCAOB.

PCAOB

During the PCAOB's June 2004 Standing Advisory Group meeting in Washington D.C.,¹¹ Associate Auditor Greg Scates chaired the discussion on confirmations and whether or not to make them a priority in the PCAOB's agenda. The respondents during the discussion indicated that the PCAOB should make fraud the priority from a strategic level, and confirmations a priority at the tactical level. The entire meeting can be replayed on the PCAOB's website.

During the meeting Professor Zabi Rezaee, Thompson Hill Chair of Excellence and Professor of Accountancy The University of Memphis, recommended

"more emphasis on electronic confirmation rather than traditional confirmation which prove to be more effective based on research."

Jeff Steinhoff, the Managing Director of Financial Management & Assurance for the U.S. General Accounting Office answered the self posed question of "what do you want to achieve here?" as it relates to the confirmation process. He answered:

"I think you want sufficient audit evidence, that whether it be cash, receivables or whatever it is, that the entity you are auditing has those numbers. It is not solely to get the piece of paper that's got the number on it. It's to provide some information that when put together with other information, such as side letter agreements or whatever it is, someone would make a determination that they had sufficient audit evidence to accept that balance."

He continued by saying that in the review of an auditors work if:

"you found that there was no process and no attempt by the auditor (to meet the objective of the confirmation process), or it was merely just getting a piece of paper that confirmed a number and sticking it in the working papers then you might make a determination that that audit did not meet the objective of what you are looking at. (And that) when the General Accounting Office has looked at failed audits, (audits) failed because they (the auditors) have done very little or they've found a way to 'paper over' the process by sticking a management representation or a couple of confirmation type documents in an audit file."

Wayne Kolins, the National Director of Assurance for BDO Seidman stated:

"I think the biggest problem that I see with confirmations is 'who' on the other side is actually signing the confirmations? Are they sufficiently knowledgeable? And is the auditor even thinking about that when he or she receives the confirmation? This is one of the most significant pieces of evidentiary matter that the auditors have (an audit

confirmation) and to the extent that that is diluted is a significant detriment to the audit process.”

Global Public Policy Commission (GPPC)

Made up of the Big 4 firms, BDO Seidman and Grant Thornton, the GPPC also created a Confirmation Task Force to look at the confirmation process. The GPPC presented a report to the PCAOB that also recommended that the PCAOB look at the confirmation process. Part of the report was support for the use of secure electronic confirmation to aid the auditors in the confirmation process. This section of the report was indirectly influenced by Capital Confirmation’s participation in providing a draft of what the secure electronic confirmation process should look like.

ABA

The ABA, with help from Capital Confirmation, has begun to poll the ABA’s members to gather information on the banking communities’ confirmation issues. With the announcement on July 30, 2004 that Citibank is being sued for \$10 billion for its involvement in the Parmalat fraud¹² in addition to the other banks being sued, the ABA will be looking to define a more secure, electronic confirmation process to benefit its members.

International Federation of Accountants (IFAC)

In early 2003, before the Parmalat fraud, IFAC’s Transnational Auditors Committee (TAC) formed a Confirmation Task Force but very little resulted due to other issues and priorities. After the \$5 billion Parmalat fraud became Europe’s largest financial fraud ever, John Kellas told the PCAOB’s June 2004 Standing Advisory Group meeting in Washington D.C.¹³ that:

“Our Transnational Account Auditors Committee, which is a part of IFAC, is looking at the question of whether some supplementary guidance could be given in the area (of confirmations).”

The current ISA guidance that covers confirmations is ISA 505 *External Confirmations* which provides similar guidance to the ASB’s SAS No. 67:

- Direct Communication from a Third Party (sect. 4); and
- Maintain Control over the confirmation process (sect. 6 & sect. 30).

ISA 505 also requires the auditor to proactively authenticate the responder to the confirmation requests:

- Ensure that the confirmation request is directed to an appropriate individual (sect. 28 & sect. 30);
- Assess whether the responder is unbiased (sect. 29 & sect. 30);
- Evaluate the response’s authenticity (sect. 33); and
- Perform procedures to validate the response’s authenticity (sect. 33)

Solution

Secure electronic confirmation solutions, like the one offered by Capital Confirmation Inc., streamline the confirmation process by replacing the paper-based confirmation process with secure electronic confirmation processes. This solution provides authentication and authorization procedures that not only help CPA firms detect fraud but also serve as a deterrent to fraudsters hoping to circumvent the audit confirmation process.

Secure electronic confirmation solutions provide the following core capabilities:

- Multiple layers of authentication and security to validate the authenticity of responders;
- Web-based interface for performing audit confirmations; and
- A record of activity on every confirmation that provides a traceable path of accountability to each individual involved in the confirmation process.

Additionally, because the average response time for electronically sent confirmations is 24 hours, auditors can now respond to confirmation fraud risk by altering the nature, timing and extent of their confirmation procedures in accordance with the SAS No. 99 directives and:

- Perform confirmations throughout the fiscal year; and
- Confirm larger sample sizes to include confirming 100% of the accounts.

In a paper by the leading researchers and authors on continuous auditing, the authors summarize the benefits of electronic confirmations by asserting that:

“The usage of automatic confirmations will substantially change the nature, procedures, scope, and weight attributed to audit evidence. Confirmations, obtained automatically, and highly complemented by self-correcting procedures will eventually be the most important form of audit evidence. Automatic confirmations... will substantively resolve the audit objectives of existence, completeness, and to a certain degree accuracy at the transaction level and account aggregation levels.”¹⁴

For more information about secure electronic confirmations, contact us at:

1-888-716-3577 or visit www.confirmation.com.

Endnotes

¹ ACFE 2004 Report to the Nation on Occupational Fraud and Abuse.

² Norris, Floyd. The New York Times. "Technology to Fool Auditors: From Colored Pens to Computer Scanners." December 26, 2003. C1.

³ Fox and Wilson. Paper: "What Every Fraudster Knows-and What CPAs Need to Know About 'Confirmation Fraud.'" July 2004.

⁴ Microsoft Case Study: *CPA Firm Smith, Turner & Reeves Finds Solution to Help Improve Accuracy, Efficiency and Security of Audit Process*. May 2004. See Appendix ___ for a copy of the case study.

⁵ Panel of Audit Effectiveness. *Report and Recommendations*. August 31, 2000. 2.106.

⁶ Panel of Audit Effectiveness. *Report and Recommendations*. August 31, 2000. 2.107.

⁷ Panel of Audit Effectiveness. *Report and Recommendations*. August 31, 2000. 2.107.

⁸ Panel of Audit Effectiveness. *Report and Recommendations*. August 31, 2000. 2.107.

⁹ ASB. Recommendations for the Revision of SAS No. 67, *The Confirmation Process*. September 18, 2003 Draft.

¹⁰ ASB. Recommendations for the Revision of SAS No. 67, *The Confirmation Process*. September 18, 2003 Draft.

¹¹ PCAOB Standing Advisory Group Meeting. June 21, 2004. Afternoon Session 1, timeslot 1:52:00/2:18:53. <http://www.connectlive.com/events/pcaob/>

¹² Plumb, Christian. Reuters. "Parmalat Seeks \$10 Billion from Citigroup in Fraud Case." July 30, 2004. www.kpmginsiders.com/display_reuters.asp?cs_id=110627

¹³ PCAOB Standing Advisory Group Meeting. June 21, 2004. Afternoon Session 1, timeslot 1:52:00/2:18:53. <http://www.connectlive.com/events/pcaob/>

¹⁴ Vasarhelyi, Alles, Kogan. "Principles of Analytic Monitoring for Continuous Audits", July 2003.

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