

Confirmation Fraud

How auditors can overcome confirmation fraud challenges



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Introduction

It is customary practice for CPAs to use confirmations as a substantive procedure during an audit, but the paper process is often considered time-consuming because the average turnaround takes four – six weeks. Yet this process is perceived as a relatively low-benefit procedure since it requires only routine thought and effort.

To address this complacency, in January 2003 the American Institute of Certified Public Accountants (AICPA) issued *Practice Alert No. 03-1 Audit Confirmations* to emphasize the importance of performing confirmations and to highlight the need to perform them correctly. This alert was one of only three practice alerts published by the AICPA within that calendar year.

In December 2003, just 12 months after the practice alert was issued, an approximate \$5 billion confirmation fraud took place involving Parmalat, Italy's largest food company. To date this is the world's largest confirmation fraud and Europe's largest financial disaster by any cause. Ironically, one month before the practice alert was released and exactly one year before the \$5 billion Parmalat bank confirmation fraud occurred, a retired managing partner for a Big 4 firm, stated that "The auditing of cash is rarely one of the critical audit areas. Confirming cash balances is one of the least important things to do in an audit."¹ Then Parmalat happened.

Fraudsters with ingenuity identified this attitude and neglect, and time and again have taken advantage of it to hide their frauds and to misrepresent a company's financial statements. Three weeks after the

Parmalat confirmation scandal broke, a former auditor with Deloitte said, "What is the one line in an audited balance sheet that no one questions? Answer: the cash and other short-term assets line. And that is precisely where this fraud was directed."²

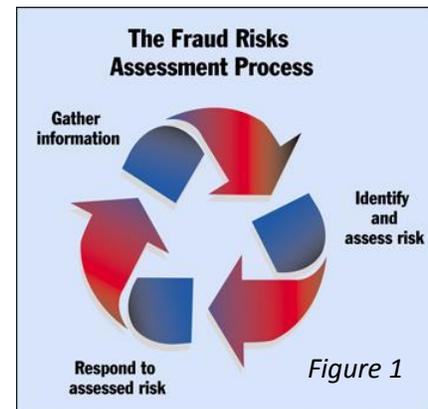
Accounting firms have now been sued for over \$10 billion because of the false Parmalat bank confirmation, with more lawsuits potentially on the horizon from those that relied on the audit report.

The *Parmalat* fraud is the largest cash and investment confirmation fraud ever discovered, but it is not the only case of confirmation fraud used to steal cash or falsify financial reports. Here is just a sampling of some of the more significant public and private company confirmation frauds from recent years:

- Satyam 2008 – 2009
- Take Two 2007
- Ahold 2005 – 2006
- Kmart 2005 – 2006
- Refco 2004 – 2006
- Parmalat 2003
- All First Financial 2002
- HealthSouth 1999 – 2001
- Quintas 1999 – 2001
- Three Points Digital 2000
- Digital Lava 2000
- Logo Athletic 1999
- Converse 1999
- Adidas 1999
- Fila 1999
- Just For Feet 1999
- CF Foods 1999
- North Face 1997 – 1999

An Auditor's Duties Under SAS No. 99

The overriding theme throughout SAS No. 99 is the auditor's obligation to exercise professional skepticism. SAS No. 99 requires an auditor (1) to hold a brainstorming session to *identify and assess* the risks of material misstatement due to fraud and (2) to *respond* to those identified fraud risks in a way that effects how the audit is conducted and is reflected in the nature, timing and extent of the auditing procedures performed. Figure 1 shows The Fraud Risks Assessment Process.³



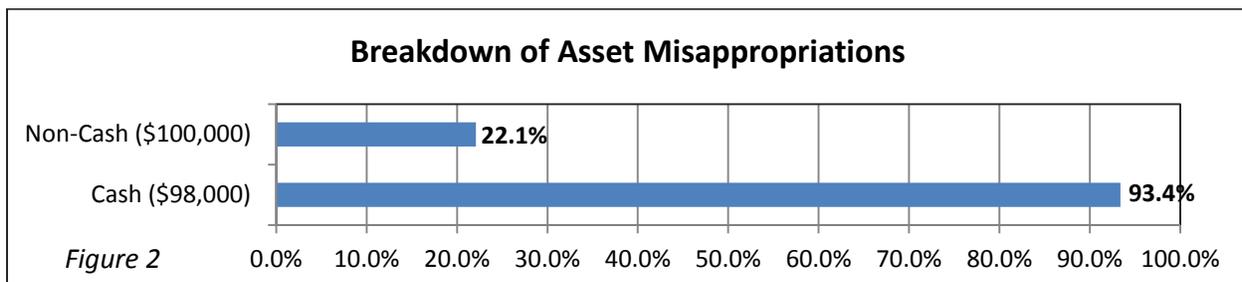
SAS No. 99 defines two types of fraudulent misstatements that are relevant for the auditor to consider – misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets.

This paper identifies confirmation fraud as a significant fraud risk that falls into both categories of fraudulent misstatements that every auditor must now respond to as they perform their duties under SAS No. 99 and offers solutions for the auditor to incorporate into the audit program.

Misappropriation of Assets

Misappropriation of assets is also referred to as theft or defalcation and involves the theft of an entity's assets. Misappropriation of assets accounts for 92.7 percent of all occupational frauds.⁴ In applying SAS No. 99 to an audit, the auditor must determine what assets are most likely to be targeted for theft. While performing this assessment the auditor must also consider the "inherent risk" of fraud at the individual account and transaction level.

Now that it is publicly available, the auditor should utilize and incorporate the findings from The Association of Certified Fraud Examiners' (ACFE) *2004 Report to the Nation on Occupational Fraud and Abuse* into the audit. In specifically looking at frauds involving the misappropriation of assets, the ACFE identified that cash is the targeted asset 93.4 percent of the time. This is an increase from the ACFE's 2002 Report which found that cash was the targeted asset in 90.1 percent of the cases studied.

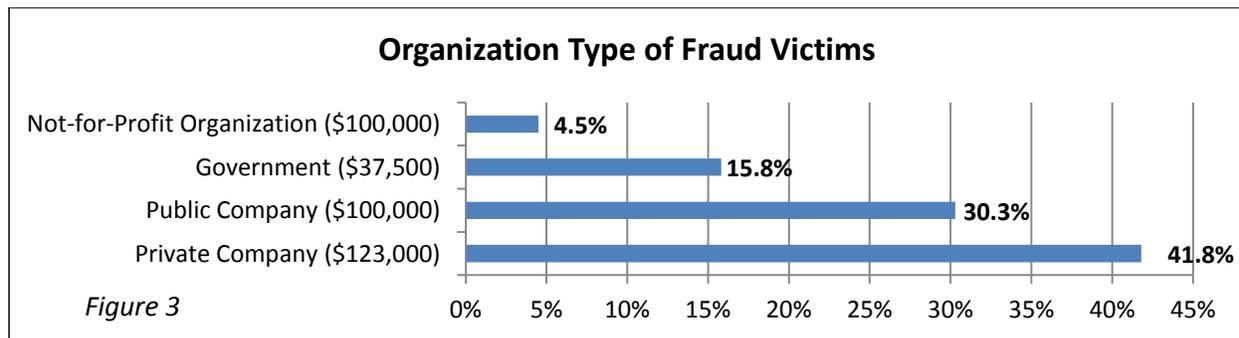


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As the auditor assesses the risks of fraud related to the misappropriation of assets, cash fraud should be a primary focus during the brainstorming session. SAS No. 31 states that “When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity,”⁶ and therefore properly confirming cash balances becomes an excellent audit procedure when auditing cash and investment accounts.

Even though some auditors may believe their client would never commit fraud, or that only the largest public companies are susceptible to fraud, SAS No. 99 demands that auditors recognize that fraud may exist in every audit and this supposition is supported by the ACFE’s Report that found fraud occurs in companies of all sizes and is perpetrated by low-level employees and top executives. The study actually revealed that *“Small businesses suffer disproportionately large losses due to occupational fraud and abuse.”*

Confirmation fraud schemes are not restricted to public or private, or large or small companies. Large, high dollar public company frauds make the headlines, but the ACFE study found that public companies only represented 30 percent of the fraud cases that were studied and that the median loss due to fraud for private companies was 23 percent higher than the median loss due to fraud for public companies.



Because audit fees are typically higher for public company audits than for private company audits, the 23 percent higher median loss for a private company fraud may indicate that private company audits have more risk associated with each revenue dollar than public company audits.

Fraudulent Financial Reporting – Presumption of Revenue Recognition Fraud Risk

Fraudulent financial reporting involves the intentional misstatement of financial statements in order to deceive the users of those financial statements. SAS No. 99 states that management is in the best position to perpetrate a fraud, and that auditors must presume that there is a material risk of fraud related to revenue recognition for all audits. Unlike many audits where materiality is determined to be a specific dollar threshold, the SEC’s Staff Accounting Bulletin 99 states that a small dollar amount can be material if it accomplishes something significant such

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as getting a bank loan approved or meeting projections to achieve a certain stock price or to qualify for a bonus.

A company booking entries to fraudulently increase revenue, could book the opposing journal entry to either cash or accounts receivable. Using third-party confirmations to validate the status of these accounts will help the auditor determine if the revenue is real or was fraudulently booked by management.

“The most common way companies create fictitious revenues is to dummy up sales that did not occur. The accounting transaction created is a credit to sales with an offsetting debit to accounts receivable, which boosts both assets and income.”

- Joseph T. Wells, CPA, CFE
Founder and Chairman of the
Association of Certified Fraud
Examiners
Journal of Accountancy Oct. 2000

Over an estimated ten-year period, Parmalat grew its fictitious cash account to almost \$5 billion to sell public debt and qualify for commercial lines of credit. Some of the off-setting entries to the erroneous booked cash and investment accounts may have been to the revenue account.

According to the complaint filed by the Securities and Exchange Commission, HealthSouth used its auditing firm’s own processes against it to perpetrate financial statement fraud. HealthSouth executives knew that the auditing firm did not question fixed-asset additions below a certain dollar threshold (materiality), so it made random

entries to its balance-sheet accounts for fictitious assets worth less than the known materiality amount. HealthSouth’s senior accounting personnel then created false documents to support cash accounts that were overstated by a combined total of \$300 million. This overstatement represented 20 percent of the originally identified \$1.5 billion fraud.

Nature, Timing and Extent

SAS No. 99 requires auditors to adjust the nature, timing and extent of their audit procedures in response to identified audit fraud risks. For confirmation procedures, this should include performing confirmations at other than year-end times and confirming balances and information at dates other than just the fiscal year-end date. As well, auditors should increase the sample sizes for confirmations, and may want to confirm 100 percent of all the accounts instead of just a sample. With four – six week turnaround times, this may be impractical when using paper-based confirmations. As well, paper-based confirmation procedures come with their own set of fraud risks.

Confirmation Fraud Schemes

Third-party bank confirmations are, by definition, sent to a client’s bank and therefore, CPAs must remember that the ultimate exposure to confirmation fraud lies within the identity of the “responder.” The CPA must determine that the respondent is both legitimate and free from bias.

Providing false statements and documents, like HealthSouth employees did to their auditors, is only the first step in a confirmation fraud scheme. The second step is accomplished by providing a false response to a confirmation request either through impersonating the responder or conspiring with the responder as to how they should “confirm” information to auditors.

SAS No. 67 specifically focuses on the confirmation process and outlines the four tenants of performing a “proper” confirmation. They are:

1. Direct communication with the third party
2. Professional skepticism
3. Respondent free from bias
4. Maintaining control

Unfortunately, many auditors fail to follow the proper confirmation procedures and simply believe that receiving a signed response to a confirmation request provides them the proper audit evidence needed for the audit. The following fraud schemes identify the fallacy in this belief and serve as notice to the auditor who does not properly put in place confirmation procedures that follow the four tenants of SAS No. 67 that they are not following SAS No. 99’s directive to exercise a heightened level of professional skepticism.

1. Client Provides False Contact Information

In a survey of over 150 accounting firms (without regard to sizes of the firms) researchers discovered that the mailing addresses for confirmations are being provided to the auditor by the client or taken directly off the client-provided bank statements (already in the client’s possession). In one case, the auditor called the toll-free number on the client’s bank statement in an honorable attempt to validate the mailing address for the confirmation. However, the risk associated with any client-provided documentation is that a dishonest client attempting to thwart the confirmation process can easily “scan” data and produce fake statements, including names, addresses and phone numbers.

“The auditor should consider whether there is sufficient basis for concluding that a confirmation request is being sent to a valid respondent from whom a response will be meaningful and provide competent evidential matter. If there is not a sufficient basis for that conclusion, the confirmation process is useless.”

- Doug Carmichael
“Pitfalls of the Confirmation Process”

The 2004 *Wall Street Journal* cover story reported that this was exactly what happened with SafeScript’s \$2.5 million of missing cash, “(Management) accomplished this deception by cutting, pasting and supplementing genuine bank statements, and then copying the carefully altered final product.”⁸ CPAs should never confuse the obtaining of evidence with the attainment of proof. Data, from any source, may be evidence, but is not necessarily proof.

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Sufficient, competent objective evidence must be professionally and properly subjected to audit.

During the PCAOB's June 2004 Standing Advisory Group meeting in Washington D.C.,⁹ 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:

"Auditing firms are not only risking their reputation, but also their survival if they don't make finding fraud the central goal of their auditing services."

- Michael P. Glynn, October 4, 2004
Technical Manager of the AICPA's Audit & Attest Standards

"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:

"(T)here was no process and no attempt by the auditor (to meet the objectives 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. When the General Accounting Office has looked at failed audits, (they) 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."

2. Client Provides the Contact Name

Auditors do not inherently know the proper parties that should or may sign the requested confirmation responses and there is very little the auditor can do to validate a signature. A client may direct the auditor to send confirmations to a dishonest confederate who will fraudulently complete the confirmation responses and sign the name of another employee or a fake name, in hoping to avoid detection.

Wayne Kolins, the National Director of Assurance for BDO Seidman stated at the PCAOB's June 2004 Standing Advisory Group meeting¹⁰ that:

"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."

3. Client Influences the Confirmation Process

Numerous case studies illustrate how dishonest clients succeed at influencing an auditor's confirmation procedures. If a client knows that the auditor may attempt to authenticate the client provided fake contact information, with a little effort and a few dollars the fraudster can create third-party credentials which closely resemble legitimate credentials.

For example, an inexpensive “fake” website (built for under \$300), displayed as if it were for a legitimate financial institution, can be created to provide incorrect contact information, including email addresses, telephone and FAX numbers, and fake mailing addresses. Fraudsters might purchase a website address, also known as a URL, similar to the legitimate company's website, paying an Internet Service Provider (ISP) to host the website, and then simply copy and paste the source code from the original site into the fraudulent site while changing only the contact information.

In some cases, not only is the fraudulent website almost an exact replica of the original and valid website, the website and email extension appear to be legitimate to those who do not have a day-to-day working relationship with that specific financial institution.

4. Impracticality of Signature Verification

Given all the possible loopholes that exist, which may allow circumvention of the paper confirmation process, auditors may lack the available resources needed to validate the legitimate signatures on responses to confirmation requests.

Fraudsters falsely responding to a confirmation request may simply scribble the signature of anyone to create the appearance of effective validity.

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.”

When utilizing confirmations as an audit procedure and by relying on the responses as audit evidence, under SAS No. 99, the professional auditor must respond to the above identified risks of confirmation fraud. Merely being mentioned as a party to a fraud case can have a career-damaging effect. The financial consequences of being involved in a lawsuit or criminal investigation may be substantial. Juries are not very forgiving when a fraud, or even a potential fraud, goes undiscovered by auditors, regardless of how immaterial the effect on the financial statements taken as a whole. Auditors must realize that:

“Malpractice cases are litigated with 20/20 hindsight, with all the facts out for the world to see. If you don't pursue the red flags of fraud – even those not listed in SAS 99 – you likely will be held liable for resulting losses.”¹¹

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. This is accomplished through the secure online network maintained by an independent third-party where all the responders to confirmations are validated before they can respond to an auditor's confirmation request.

In addition to the fraud detection and prevention capabilities that electronic confirmation solutions provide, the chart in Figure 4, made available by Capital Confirmation, illustrates how electronic confirmation solutions are much more efficient compared to mailing paper confirmations. Where auditors often experience lengthy turnaround times and

<i>Figure 4</i>	Electronic Confirms	Paper* (Mailed)
Response Rate	100%	70%
Reconfirmation Rate	5.6%	35.0%
Ave. Turnaround (days)	1.12	21.00
Min. Turnaround (minutes)	3 min.	7,200 min.
Max. Turnaround (days)	10.69	56.00
% Turned in 2 days	94.5%	0%
% Turned in 3 days	97.0%	0%
% Turned in 5 days	99.5%	< 1%

* Based on feedback from survey of selected CPA firms.

often never even receive a mailed confirmation back, the highlights of electronic confirmations include a 100 percent response rate, an average turnaround of 1.12 days and the fact that 99.5 percent of all electronic confirmations are returned in five days. The mailed paper confirmation statistics do not even come close to those response rates, and with mailed paper confirmations there is no inherent fraud protection provided.

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 about one day, 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 percent 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.”¹²

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 Gethan Ward, "Brentwood Company Develops Application to Electronically Confirm Bank Account Balances," *The Tennessean*, December 17, 2002.

² "Parma Splat: What are the lesions from the scandal at Europe's largest dairy-products group?," *The Economist*, January 15, 2004.

³ Michael Ramos, "Auditors' Responsibility for Fraud Detection," *Journal of Accountancy*, January 2003.

⁴ Association of Certified Fraud Examiners (ACFE), "2004 Report to the Nation on Occupational Fraud and Abuse," (2004), 12.

⁵ ACFE, 13.

⁶ SAS No. 31, *Evidential Matter* (AU sec. 326).

⁷ ACFE, 5.

⁸ "Trying to Copy Celebrity Stock-Pickers," *Wall Street Journal*, October 15, 2004, Section A1.

⁹ PCAOB Standing Advisory Group Meeting, June 21, 2004, afternoon session 1, timeslot 1:52:00/2:18:53. <http://www.connectlive.com/events/pcaob>.

¹⁰ PCAOB Standing Advisory Group Meeting, June 21, 2004.

¹¹ Gary D. Zeune, "SAS 99 – Friend or Foe? How not to get sued under the new fraud auditing standard," (www.cpamutual.com)

¹² Vasarhelyi, Alles, Kogan, "Principles of Analytic Monitoring for Continued Audits," July 2003.