

**Electronic Audit Confirmations:  
Leveraging Technology to Reduce the Risk of Fraud**

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**Introduction**

Since the McKesson & Robbins scandal in 1938, auditors have relied on the audit confirmation process to gather evidence at the assertion level regarding the existence and reliability of financial statement balances. Despite the auditing profession's concerted efforts to prevent fraud, there have been several notorious audit confirmations frauds in the past twenty years. Most of these frauds relied on a paper-based confirmation process that dates back to the nineteenth-century. In 2012, the National Futures Association (NFA), a self-regulatory organization of the Commodity Futures Trading Commission (CTFC), mandated the use of electronic audit confirmations for companies in the futures industry. All other private and publicly-traded companies are *allowed*, but *not required*, to use electronic audit confirmations. It is essential that the Public Company Accounting Oversight Board (PCAOB) and the American Institute of Certified Public Accountants (AICPA) update Generally Accepted Auditing Standards (GAAS) to mandate electronic audit confirmations to reduce the risk of future confirmation frauds.

**The Audit Confirmation Process**

To fully appreciate the magnitude of the problems associated with traditional, paper-based audit confirmations, we should first review the current GAAS for the confirmations process. AU Section 330.04 of Statement on Auditing Standards (SAS) 67, *The Confirmation Process*, states that:

“Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The process includes:

- Selecting items for which confirmations are to be requested.
- Designing the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining the response from the third party.
- Evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information.”

The reliability of third-party evidence (e.g., bank statements) is enhanced when it is obtained from a knowledgeable, but unbiased, respondent who is outside the company under audit. The respondent should have little or no motivation to falsify information. In addition, when the response from a third party is direct (that is, the auditor controls both the transmission and receipt of information), it may be considered more reliable than audit evidence derived indirectly or by inference. If evidence exists in documentary form (e.g., paper or electronic media), the evidence is even more reliable. However,

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responses in the form of faxes and e-mails are considered problematic because of the difficulty of validating their authenticity.

According to AU Section 330.15 of SAS 67, “[t]he auditor should exercise an appropriate level of professional skepticism throughout the confirmation process.” This includes the design of the confirmation request, the performance of associated procedures, and the evaluation of any results. The confirmation process is designed to gather evidence on the existence of and, to a lesser extent, the valuation of assets such as cash and accounts receivable. The quality of audit evidence is greatly enhanced when the confirmation process has been approved by all parties concerned (e.g., bankers and auditors for cash confirmations), is under the auditor’s direct control, identifies the proper respondent, requests information readily available to the respondent, and assures that the proper respondent not only completed the confirmation request but returned it directly and promptly to the auditor (see Sections AU 330.16 to AU 330.27 of SAS 67). The auditor then evaluates the results and takes appropriate action including the performance of alternative procedures for items with no responses.

***Disadvantages of Traditional, Paper-Based Confirmations: What Can Go Wrong?***

Manual or paper-based confirmations are severely limited because humans are free to intervene and, intentionally or unintentionally, subvert the process. The following list summarizes some of the major weaknesses of paper-based confirmations (see *Confirmation Fraud* undated).

1. The auditor selects the items for confirmation based on information in the audit client’s accounting records and books. Consequently, he does not test for completeness via tracing activities and may ignore information that was inadvertently or deliberately “kept off the books”.
2. The audit client provides the name of the person(s) to be contacted at third-party organizations (e.g., banks and customers) to confirm cash and accounts receivables. If the client does not name the “proper” respondents, the information obtained may be false.
3. The audit client also provides each respondent’s address, phone number, e-mail address, website, and other identifying information. Once again, if this data is bogus, the information obtained may be false.
4. It is very difficult, if not cost prohibitive, to authenticate the respondent’s signature or to ensure non-repudiation of participation (i.e., to refute a respondent’s signature).
5. The time and financial costs involved in the traditional confirmation process can be staggering. These costs include, but are not limited to, the preparation of written requests, paper and postage, verification of respondent names and addresses, snail-mail delays, and reconfirmation requests to clear up gaps in information or errors in responses.

***Advantages of the Electronic Confirmation Process: Welcome to the 21st Century***

To understand the advantages of electronic confirmations, one need only look at Capital Confirmation, Inc., a leader in the audit confirmations field. Founded by Brian Fox in 2000, this company now serves “[over] 12,000 accounting firms, 100,000 auditors and thousands of responding organizations around the globe...” (see *About Capital Confirmation*, data updated by Brian Fox interview). Fox and his staff created “the infrastructure for the first ever secure online confirmation clearinghouse.”

According to a white paper on *Confirmation Fraud* on Fox’s website, electronic audit confirmations can be performed at any time, not just at year’s end, and as often as the auditor deems necessary, daily if required. In addition, the auditor can obtain 100 percent of the relevant data instead of a mere sample. This alone makes electronic confirmation far more efficient than the traditional system.

Electronic audit confirmations can also generate significant savings in time and money. In his 2010 *Guide to Electronic Confirmations*, Fox compared the efficiency of electronic confirmations, electronic alternative procedures, and paper confirmations. The *Guide* differentiated between in-network electronic confirmations (“established...network[s] of participating banks and other responding entities”) and out-of-network electronic confirmations (“platform does not include authentication and authorization of the

respondent”). Alternative electronic procedures include such things as “e-mail and direct access to a database...[which] may provide audit evidence...[but] are not a confirmation for audit and attest purposes.” The following table illustrates how the various categories compared with one another.

| <b>Table 1:</b><br>Item/Metric | <u>Electronic Confirmations</u> |                | Alternative<br>Electronic<br>Confirmations | Paper<br>Confirmations |
|--------------------------------|---------------------------------|----------------|--|------------------------|
|                                | In Network                      | Out-of-Network |  |                        |
| Response Rates                 | 100%                            | 50-60%         | 50-60%                                     | 71%                    |
| Average turnaround time        | 1.08 days                       | 3-5 days       | 3.5 days                                   | 21-40 days             |
| Reconfirmation rates           | 9.7%                            | 20-25%         | 20-43%                                     | 43%                    |
| Total Time Required*           | 1.1 hours                       | 5.5 hours      | Not computed                               | 8 hours                |
| Time Saved*                    | 6.9 hours                       | 2.75 hours     | Not computed                               | 0 hours                |

\*Assuming a typical CPA office in which a staff member audits six clients and a total of forty banks statements.

The auditor and the client both profit after switching to an electronic audit system. The auditor requires less staff, time, and other resources to perform his tasks, while the client pays for fewer billable hours. The cost of the service is minimal and often billed to the client as an out-of-pocket cost of the audit. The savings can then be used to perform other tasks, as needed.

The electronic audit process not only offers obvious advantages for both internal and external auditors, it also assists regulatory agencies in the performance of their tasks. For example, in 2012 a special committee of the NFA made up of representatives from the futures industry’s regulatory agencies implemented the following provisions to protect investors and reduce the risk of future frauds following MF Global’s \$1.6 billion scandal in October, 2011 (see Duffy 2012):

- “1. Requiring all Futures Commission Merchants (FCMs) to file daily segregation reports [demonstrating the mandatory segregation of customer funds held by FCMs].
2. Requiring all FCMs to file bi-monthly Segregation Investment Detail Reports (SIDR), reflecting how customer segregated funds are invested and where these funds are held.
3. Performing more frequent periodic spot checks to monitor FCM compliance with segregation requirements since... December [2011].”

The committee uses Fox’s Confirmation.com software to obtain FCM account statements and balances from third parties (banks and depositories), support the performance of regulatory audits, verify SIDRs, and review daily FCM segregation reports for accuracy. None of this would have been practical using traditional, paper-based audit processes. And according to a conversation between the lead author of this article and Brian Fox, Confirmation.com is being updated with additional tools to help regulators prevent future abuses of the system.

### **A Brief History of Audit Confirmation Frauds**

With regard to frauds involving the misappropriation of assets, cash was targeted 82.8 percent of the time (Association of Certified Fraud Examiners 2012). The following examples of cash confirmation frauds demonstrate how easy it is to misrepresent revenue.

| <b>Table 2:</b><br><b>Company</b> | <b>Date(S)</b> | <b>Amount</b> | <b>Country</b> | <b>Auditor</b>                             |
|-----------------------------------|----------------|---------------|----------------|--|
| Parmalat                          | 2003           | \$4.9 Billion | Italy          | GRANT THORNTON (ITALY)                     |
| Satyam                            | 2009           | \$1 Billion   | India          | PRICEWATERHOUSECOOPERS (INDIA)             |
| MediaExpress                      | 2011           | \$160 Million | China          | DELOITTE TOUCHE-TOHMATSU (CHINA/HONG KONG) |
| MF Global                         | 2011           | \$1.6 Billion | U.S.           | PRICEWATERHOUSECOOPERS (U.S.)              |
| PFG-Best                          | 1992-2012      | \$215 Million | U.S.           | VERAJA-SNELLING & COMPANY (U.S.)           |
| Major Play Fund                   | 2006-2013      | \$6 Million   | U.S.           | JOSEPH J. MAZZA, CPA (U.S.)                |

Parmalat was one of Italy’s largest family-owned dairy companies (*The Economist* 2003, *Business Week* 2004). Although the fraud was uncovered in 2003, it may have gone on for at least ten years. When the company defaulted on a \$185 million bond payment in November 2003, auditors started taking a closer look at its financial assets. It turns out that the \$4.9 billion reported in a Caymans Island bank account was nonexistent, based only on a forged document. Nor was that Parmalat’s only bit of creative corporate writing. Other documents were forged to reflect inflated cash balances on a quarterly basis. Parmalat managed to evade detection for so long because its auditor, Grant Thornton—Italy, requested all financial information through the company’s internal mail system. The auditors never sent any confirmation requests directly to the company’s banks or other third parties. In short, they accepted Parmalat’s information at face value. One has to wonder how long the fraud would have gone on if the auditors had used electronic audit processes instead of nineteenth-century paper-based technology.

In early 2009, Satyam Computer Services, an Indian firm, was caught in a cash confirmation fraud that exceeded \$1 billion. The fraud was not uncovered by its independent auditor, PricewaterhouseCoopers – India. It came to light only after Satyam’s chairman confessed to the crime. A 2011 story in *The New York Times* cites a Securities and Exchange Commission (SEC) statement that Satyam’s auditors “did not seek confirmation of cash balances from the banks involved, but instead relied on management to provide them...” The statement goes on to note that the problems with Satyam’s audits were typical of PricewaterhouseCoopers—India’s substandard work.

“‘The failures in the confirmation process on the Satyam audit were not limited to that engagement,’ the S.E.C. stated in a cease-and-desist order issued against the firm, ‘but were indicative of a quality control failure throughout PW India.’ The commission added that audit ‘engagement teams throughout PW India routinely relinquished control of the delivery and receipt of cash confirmations to their audit clients and rarely, if ever, questioned the integrity of the confirmation responses they received from the clients.’

In some cases, banks sent confirmations to the audit firm directly—despite not being asked to do so—and those statements differed markedly from the ones the management provided.”

There is simply no excuse for the auditor’s unprofessional work. Nevertheless, the use of an electronic audit system would have made the Satyam fraud far easier to detect.

In 2011, China MediaExpress, a China-based advertising company, was caught in a \$160 million fraud (Capital Confirmation, Inc. Press Release June 24, 2013). The company’s Chief Executive Officer (CEO), Zheng Cheng, perpetrated the fraud by intercepting the real audit confirmations and replacing them with fakes. The CEO, however, did not plan on Confirmation.com entering the picture.

“‘Because one of the banks in this case had switched to responding to audit confirmations exclusively through Confirmation.com and no longer accepted mailed or faxed forms, the CEO

could not misdirect the auditor's confirmations,' said David Malone, vice president at Confirmation.com."

When the CEO objected to Confirmation.com, Deloitte Touche—Tomahtsu, China MediaExpress's independent auditor, "resigned citing suspicions concerning fraudulent bank confirmations and statements, and falsified confirmations of accounts receivables and payables."

The MF Global fraud of 2011 is especially noteworthy not only for its size, \$1.6 billion, but for the effect it had on regulators in the futures industry (Duffy 2012). MF Global was, as its name implies, a worldwide derivatives and commodities brokerage firm (Wikipedia undated). In late October 2011, the company suffered a major financial meltdown following the misappropriation of more than \$891 million in customer funds thanks to CEO Jon Corzine's attempt to cover up losses from European sovereign debt. By the time the company declared bankruptcy on October 31, the shortfall in customer accounts totaled at least \$1.6 billion. To reduce the risk of future frauds, the CFTC and its self-regulatory body, the NFA, decided to *require* companies in the futures industry to undergo electronic audit confirmations of customer account balances. The NFA then mandated that its staff use Confirmation.com. Fox, the founder of Capital Confirmation, Inc., told the lead author of this article during a phone conversation that the NFA first contacted him in mid-2011, months before the MF Global fraud was uncovered. This suggests that the NFA was already trying to find a better way to audit cash balances. Unfortunately, it was too late; other frauds were under way.

In mid-2012, PFG-BEST (Peregrine Financial Group Inc./BEST Direct Securities LLC) billed itself as the nation's second largest non-bank, non-clearing FCM with nearly 200 employees and more than \$400 million in customer accounts (see PFG-BEST Timeline undated). As recently as 2011, *Smart Money Magazine* hailed the company for its leadership in foreign exchange trading (forex) and customer service. However, unbeknownst to PFG-BEST's investors, auditors, and futures industry regulators, the company's founder and CEO, Russell Wasendorf Sr., had been cooking the books for twenty years (see Excerpts From Russell Wasendorf Sr.'s Confession 2012). He used twentieth-century technology ("Photo Shop, Excel, scanners, and...printers") to forge bank statements reflecting grossly inflated customer account balances. He also made sure no one else had access to the real bank statements and set up a bogus post office box so that all confirmation requests would go directly to him. He even learned how to falsify online bank statements when they first became available to his auditors and regulators. By mid-2012, he had embezzled a total of at least \$215 million from his clients. Wasendorf, however, was finally taken down when the NFA pressured him to allow electronic audit confirmation of his accounts using Confirmation.com software. On the day when the electronic confirmations were completed, July 9, 2012, Wasendorf attempted suicide (Philips 2012). He left a detailed suicide note explaining how and why he committed the fraud. He pointed out just how easy it was to fool the auditors and regulators who relied on traditional, paper-based audit processes. However, as soon as electronic audit processes were brought to bear, the fraud was uncovered and the sixty-four-year-old Wasendorf was sent to prison for fifty years, a virtual life sentence.

Unlike the other frauds discussed above, the Major Play Fund investment fraud was relatively small, a mere \$6 million during the years 2006 through 2013, but accounted for sixty percent of the clients' assets (Bramwell 2013). The company's owner, James Shepherd, derailed the annual audits by giving his independent auditor the name of a fictitious bank employee, Charles Fisher, and an equally bogus post office address and fax number for Mr. Fisher. As a result, the auditor's confirmation requests went directly to Shepherd who then used Adobe Acrobat to create false bank statements with appropriately inflated cash balances. Shepherd signed each confirmation request as "Charles Fisher" and mailed the information back to the auditor who was none the wiser. In March 2013, however, with Shepherd on the path to becoming the next Russell Wasendorf or Bernie Madoff, the auditor finally insisted on verifying the cash balances using Confirmation.com's service in accordance with the NFA mandate. Not surprisingly Shepherd refused, and the auditor advised the NFA that "his opinion could no longer be

relied on”. The mere threat of electronic audit confirmation was enough to end Shepherd’s misappropriation of investor funds, just as it had done with Wasendorf and PFG-BEST nine months earlier.

### **Conclusion**

The six examples of confirmation audit fraud discussed above illustrate how absurdly easy it is to deceive auditors and regulators who rely on traditional, paper-based audit processes rather than the more sophisticated electronic system. They also remind us that the most likely asset to be targeted in a fraud is cash. Unfortunately, some auditors simply do not demonstrate the appropriate degree of professional skepticism when confirming cash balances. The paper-based confirmation process developed in the nineteenth-century lulled us into accepting signed documents at face value. But technology has changed since then. Criminals are ingenious in the use of fax machines, scanners, printers, software, and the Internet to forge bank statements and other documents. They also are very adept in creating bogus snail mail and e-mail addresses, impersonating bank officials and other third party respondents, and otherwise deceiving inattentive, complacent auditors. The NFA took a bold, but necessary, step when it *mandated* electronic audit confirmation for its membership in 2012. Now it is time for the AICPA and the PCAOB to do the same for private and public companies. *Allowing* the use of electronic audit confirmations is simply not good enough. Witness the role Confirmation.com played in uncovering the frauds at China MediaExpress, PFG-BEST, and Major Play Fund. Just the threat of electronic confirmations was enough to make the CEO of PFG-BEST attempt suicide. Capital Confirmation, Inc.’s *Guide to Electronic Confirmations* summed up the problem nicely: “You can’t do a twenty-first century audit using nineteenth-century technology.”

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