Enhancing the effectiveness of Audit Confirmations

Confirmations have been widely used and is a valuable tool for auditor's primarily because it can provide persuasive information. If properly designed, confirmations can provide strong audit evidence when received directly from a third party and that corroborates relevant assertions about account balances, transactions, and disclosures.

Confirmations are typically used for cash, investments, accounts receivable, inventory on consignment, accounts payable, loans, capital transactions, and revenue. Other types of audits might include different information such as, employee benefit plans participant data. Use of confirmations are only limited by the Auditor's imagination.

Did you know that some of the largest corporations in the world, such as Amazon and Verizon have established a policy not to respond to audit confirmations? Ironically, they respond in writing that they don't respond to confirmations in writing. Corporate America has a vested interest – no obligation to respond to audit confirmations and that obligation should be formalized as outlined in this proposal.

In the era of looming disruptive technological change, this proposal is a simple, low tech high-quality initiative to improve audit confirmation efficiency. This article proposes changes to the audit confirmation process, standards, and related regulations to improve audit quality by addressing some of the risks to confirmation effectiveness. Adoption will require the consideration of new concepts for the audit confirmation process.

Limitations impeding the confirmation process exist preventing maximizing effectiveness of confirmations. Use of electronic confirmation has helped with faster turnaround times, improved response rates, reduced financial fraud, and minimizing human error, however this has been mainly limited to cash confirmations.

Risks to confirmation effectiveness

While many benefits are derived by its usage, confirmations are still fraught with risks that hamper its effectiveness. Some of the risk associated with utilizing confirmations include:

- Auditor cost to implement may be great
  - Staff time to design
  - Associated fees
  - Follow-up staff time
  - Authentication of respondent
  - Long turnaround times
  - Performance of alternative procedures, if necessary
- Low response rates
- Reliability of confirmation affected by possible respondent bias

- o Errors unfavorable to the respondent are more likely to be responded to
- o Errors favorable to the respondent are less likely to be responded to
- o Larger errors are more likely to be identified by respondent
- o Small errors are less likely to be identified by respondent
- Respondent unauthorized to respond
- Authentication of respondent
  - o Identity of respondent
  - o Verification of contact information
  - o Signature verification of respondent
- Respondent error
- Fraud risks
  - o Forgeries
  - o Collusion

Overview of the confirmation process

No significant change to the audit confirmation process is planned, however some steps will not be necessary depending on the type of response and the information requested. Here is an overview of the more significant steps in the audit confirmation process:

- Auditor determines the appropriateness of confirmation
  - o If no confirmation will be used for accounts receivable, then auditor documents the decision that confirms are not appropriate.
- Selection of items to be confirmed
- Design confirmation request
- Send signed confirmation to the appropriate third party
  - o Maintain control over the request
  - o Pay special attention to related parties
- If the third-party fails to respond
  - o Second requests are sent
  - o If no response, then alternative procedures are considered.
  - o Auditor will evaluate reliability of evidence
  - o Conclude whether the objectives have been met.
- When the third party responds
  - o Auditor review confirmation response
  - o Auditor should consider authenticating the identity
  - o Auditor determines if this evidence matches the records
  - o Differences are investigated and auditor may perform alternative procedures
  - o Auditor will evaluate the reliability of evidence
  - o Auditor will conclude whether the objectives have been met.

Overview of the initiative to improve the effectiveness of audit confirmations

The principal concepts of this initiative can be simply summarized as requiring all companies to publish where and how confirmations can be submitted, as well as, requiring all companies to

respond to a confirmation request. Recognizing the significant regulatory and operating differences between public and private companies the specifics of the initiative are as follows:

Required regulatory changes to improve audit confirmation effectiveness
All entities registered with the SEC would be required to do the following:
- All companies must publicly publish either a mailing address, website, or instructions to submit confirmations and publish information on both the Public Company Accounting Oversight Board (PCAOB) website and their own website.
- All companies must publish how the different kinds of information confirmations are to be submitted.
- All Public companies will establish guidelines for sending confirmations to streamline the process and minimize the burden of their response.
    - Require minimum information to facilitate response
- Applies to all confirmations submitted by auditors on behalf of their clients to a public company.
- All companies must send an email acknowledgement of receipt of the confirm with 24 hours.
- All companies must respond to automated confirmation requests received within 2 business days.
- All companies must respond to confirmation requests that require input from the respondent within 5 business days.
- Not responding to confirmations requests would carry a penalty.

Required Standard setting changes
Both the PCAOB and the American Institute of Certified Public Accountants Auditing Standards Board (ASB) should adopt the following:
- Require the use of cash confirmations like the accounts receivable confirmation requirement.
- Eliminate the use of negative confirmations
- Identification that the failure to respond to an audit confirmation received is a material weakness in internal control.
- Broaden the PCAOB audit standards to incorporate or require greater use of confirmations.
- Encourage the use of electronic confirmations when possible.
- Encourage the auditor to submit spreadsheets and other information necessary to assist the respondent to reconcile and respond to the audit confirmations.

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Private companies
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Accounting for the Common Good
The Committee of Sponsoring Organizations (COSO) framework uses a one-dimensional viewpoint of the objectives for internal control over financial reporting which does not address the prevailing business mindset. Its narrow focus is on the interest of the individual entity and does not address the interests of the broader collective group of all entities. Several events in

society have recently reflected the broadening obligation of the objectives of a corporation. From the growing importance of Environmental, Social, and Governance reporting, to the Business Roundtable, recently redefining the purpose of a corporation to a commitment to all stakeholders such as shareholders, customers, employees, suppliers, and communities.

The COSO reporting objectives pertaining to external financial/nonfinancial reporting should have a new objective relating specifically to responding or complying with all confirmation requests received. If policies and procedures are not in place to provide reasonable assurance that an entity has complied with this objective, then it should be considered a material weakness. Both private and public companies should seek to adopt the characteristics of a good system of internal control.

New considerations required

New factors will need to be considered for this confirmation initiative.

Nature of the respondent

Confirmations sent to a public company will need to be differentiated from a private company. Public companies will be penalized if they don't respond to a confirmation both financially as well as having a material weakness. Private companies that do not publish and respond to confirmations will have a material weakness.

Type of information requested

Information that can be corroborated automatically and directly from the books and records of the respondent via electronic means should be differentiated by information that requires research or input on the part of the respondent. Therefore, automated versus those confirmations requiring research will have to be identified. I.e., a blank positive confirmation versus a filled in positive confirmation. Example would include a cash balance only confirmation versus cash confirmation requiring authorized signatory.

In with the new out with the old

Negative confirmation will not have a place under this new initiative. A combination of a positive confirmation and alternative procedures will have to be performed to replace this technique.

Protecting confidential information

Respondent's will need to adopt protocols to protect personal identifiable information and privacy by implementing protections that address possible fraudulent requests (i.e., the news agency seeking confidential information).

Cost to Business respondents

The ongoing cost to the business respondent will be a function of their internal controls over accounts receivable and accounts payable, the accounting system they use, transaction volume and cost of personnel. These new costs will be partially offset by the cost of current resources allocated to responding to confirmations. There will also be initial start-up costs such as, website and software development. The respondent should be able to recoup the cost which should be

paid by the auditor. A fee should be paid for each auditor request with pricing for automated versus requiring input reflecting the difference in respondent time and effort.

This initiative will significantly improve overall audit quality by increasing confirmation response rates, reducing fraud, and address many of the respondent's risks associated with confirmations by publishing where to submit the request and identification of who is authorized to respond.