

PKF PERSPECTIVES

TRUST, BUT VERIFY: The Audit Confirmation Process

Your company's independent auditors might be considered "professional skeptics". Although President Ronald Reagan was not specifically talking about auditors when he uttered those famous words - trust, but verify - he could very well have been.

The confirmation of accounts receivable and payable by direct communication with creditors and others was mandated by the American Institute of Certified Public Accountants (AICPA) in 1939 in response to the McKesson & Robbins case. Approximately \$19 million in accounts receivable and inventories of the \$87 million reported as the company's consolidated assets was found to be fictitious. Thus, a new auditing standard came into being.

Today, Statement on Auditing Standards (SAS) No. 67, The Confirmation Process, as well as the AICPA's Practice Alert 2003-01, among other publications, provide guidance on the use of the audit confirmation.

Let the Audit Begin

The preparation and dissemination of confirmations often signal the start of the audit. However, the audit actually starts in the planning phase. The auditors' understanding of the substance of their client's arrangements and transactions with third parties is key to determining the information to be confirmed. Risk factors must also be considered when determining what, how and with whom to confirm bank balances, receivables, payables, agreements, key elements of indebtedness and related-party transactions.

Generally, the auditors will prepare pre-printed confirmations for client signature and, in the cases where specific letters are required, will draft them for the client to transfer to its letterhead and sign.

Confirmations must be mailed by the auditors who will keep a control sheet and enclose a business reply envelope directly addressed to the audit firm.

Confirmation letters and forms can cover a variety of commercial activities, including, but not limited to, requests for and information related to:

- Bank statements for a particular period, including cancelled checks and a list of authorized signatories
- Post-retirement benefits
- Lines of credit
- Access to safe deposit boxes
- Accounts receivable and accounts payable
- Notes receivable and notes payable
- Warehoused inventory
- Merchandise on consignment
- Inventory at contractors
- Post Office and other deposits
- Construction contracts
- Intercompany accounts
- Lease agreements
- Insurance (fire, casualty, etc.)
- Securities held by others
- Contingent liabilities
- Legal counsel
- Related-party transactions

There are exceptions in which confirmation of accounts receivable may be omitted:

- (1) if the accounts receivable are considered immaterial; or,
- (2) if the use of confirmations would be ineffective, e.g. if audits of prior years had poor and unreliable response rates; or,
- (3) if the audit risk is assessed to be low and evidence from other sources, such as test of details and analytical procedures, is judged to be acceptable.

The auditors must document their reasons for not confirming accounts receivable.

Evaluating the Results of the Confirmation Process

There may be instances where the auditors, being the professional skeptics that they are, may apply procedures to ascertain that a confirmation response is bona fide. Such would be the case of receipt of a confirmation by e-mail or fax. The auditors should consider verifying the source and contents by a telephone call to the sender and requesting that the original confirmation be mailed directly to the auditors.

Often the auditors have to follow-up confirmations with second and third requests to non-responding third parties. If still not in receipt, the auditors should apply alternative procedures to significant information requested from non-responding third parties. The nature of these procedures would depend on the account and what other satisfactory sources of evidence are available. Should the combined evidence provided by confirmations, alternative procedures and other collection of data be insufficient in the judgment of the auditors, additional confirmations and extended tests should be performed.

Auditors may also request updated confirmations or confirmations from other independent third parties during the course of their audit.

Beyond Confirmation

The confirmation process could be considered the foundation on which the typical audit rests. No matter how diligent the auditors are, however, there still exists the possibility that the information confirmed - either by error or design - is false. On November 2, 2005, the Securities and Exchange Commission released an announcement of enforcement actions against certain individuals alleging they aided and abetted a financial fraud by signing and returning materially false audit confirmations. "As we enter the upcoming audit season, recipients of audit confirmations are reminded of the importance of returning nothing but truthful information to auditors," stated Susan Markel, Chief Accountant of the SEC's Division of Enforcement.

Conclusion

The objective of an audit is the expression of an opinion regarding the company's financial statements and to report whether they are presented fairly in all material respects as they relate to financial position, results of operations, and the cash flows of the company. Confirmation from independent third parties is one important procedure to obtain evidence from third parties of the financial statement assertions made by management.

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