



Can we trust this source?

Why audit validation matters.

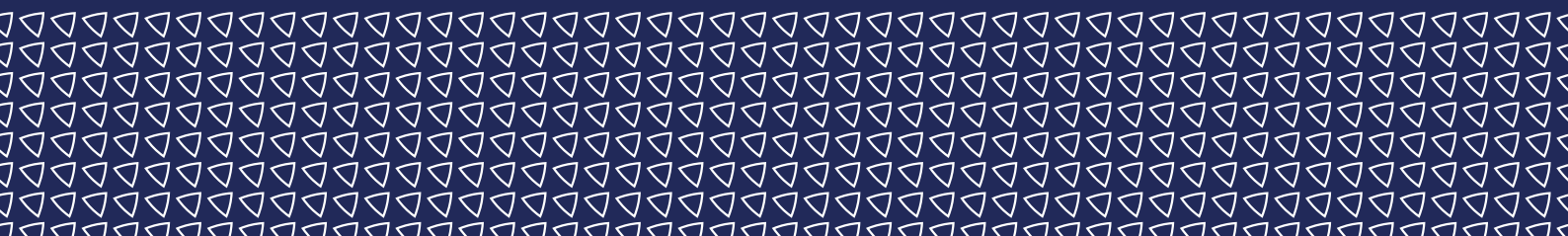




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Introduction

The auditing profession continues to evolve at a rapid pace, with ever-changing regulations and new technologies. The experience of COVID-19 has intensified the speed of change, both in the use of technology and in working practices. It has prompted many countries and organisations to rethink their traditional models and rely even more on technology in their strategic thinking. This extends to staff as well: There is a change in the workforce, with many employees working from home either most or all of the time.

The pandemic has also had a significant negative impact on the global economy, and these effects are set to continue.

Against this background, auditors know that the only constant within the profession is change itself. They also understand that, amidst all the complexities, it is they who are responsible for controlling the audit confirmation process and ensuring the reliability of audit evidence.

The UK government's Department for Business, Energy and Industrial Strategy (BEIS) has published a consultation white paper on audit reform, Restoring trust in audit and corporate governance. The proposals aim to strengthen the UK's framework for major companies and the way they are audited.

Proposed reforms will impose heavier responsibilities on auditors, with the aim of improving audit quality, restoring public trust and empowering investors, creditors, and other stakeholders by giving them access to reliable and meaningful information on a company's performance. The proposals are principally based on the 2018 Kingman review of the Financial Reporting Council (FRC), the Competition and Market Authority's Statutory Audit Services Market Study, and the 2019 Brydon Report.

For example, the BEIS white paper has adopted Brydon's recommendation for a clear duty on auditors to endeavour to detect material misstatement, whether from error or fraud, in all reasonable ways, and to state in their report the steps they had taken to do so. Auditors are also facing increased media scrutiny over their failure to detect several recent frauds, such as those that have been reported at Luckin Coffee, Wirecard and Commerzialbank Mattersburg.

In October 2020, the FRC published a consultation paper inviting interested parties to respond to its proposed revisions to ISA (UK) 240 – The auditor's responsibilities relating to fraud in an audit of financial statements. The amended standard emphasises that auditors must actively obtain "reasonable assurance" that the financial statements are free from fraud, not simply assess risks and react to them. Meanwhile in the US, the SEC withdrew the proposed relaxation of auditor independence requirements in Rule 2-01 of Regulation S-X, which had only been announced in October 2020.

The key to understanding the importance of confirmation

The pressure on auditors to maintain professional scepticism and control of the broad process has never been greater, which is why validation is an essential step in the audit workflow. It is instructive to examine this aspect of the audit process that auditors and banks often overlook. Validation ensures that companies and individual respondents have been authenticated – supporting a thorough and reliable audit.

Validation is a relatively new component of the audit confirmation process. To better understand the mission-critical nature of this procedural element, it's important to understand how the confirmation process has evolved.



The evolution of confirmations

The audit confirmation process has been around for more than 100 years. Despite advances in technology, regulation changes, and ever-evolving complexities, a paper-and-postal system endures – even though the average confirmation done this way requires 30+ steps, a 4 to 6 week turnaround per request, and a 43 percent lost or error rate. You can see why the profession was ready for a change. In 1991, the introduction of the fax machine updated the process to allow for faxed confirmations, but still supported a manual and time-consuming process.

What we've learned over the years is that the paper-based process is both inefficient and open to confirmation fraud. Consider the fact that the critical steps of validating the location of where confirmations are sent or whether an individual is an authorised responder are often skipped. In turn, when responding to confirmations and sending back sensitive or confidential information, companies or responders rarely validate the authenticity of the audit firm to which they are responding. In the end, what you have is a process where no one can be certain who is on the other end of the transaction.

Enter electronic confirmations...

In 2009 and 2010, as a much-needed replacement for a highly inefficient paper-and-mail process, the auditing standards authorities approved the use of electronic confirmations. The advent of online confirmations offered a much more efficient process, and it has since become the standard. It has also brought with it updated criteria to ensure the integrity of the audit process, as well as the steps auditors must take to ensure that a confirmation from a third party is reliable as audit evidence.

Given their understanding of the long-standing issues of the audit process, and to ensure “reliable audit evidence”, auditors have a duty to control confirmations – whether working within a paper, electronic, or hybrid process. Controlling the process means that auditors must ascertain where they are sending the confirmation: where did it go? Is it a valid address? They must also determine if the third-party responder is authorised to respond on the client's behalf. And they must judge if the responder has the appropriate knowledge. With all this in mind, at the heart of the ideal confirmation process is the critical step of validation.

The importance of validation

In order to understand what steps auditors go through to “control the confirmation process”, it is helpful to be familiar with the evolution and current status of the relevant standards. In the UK, auditors can refer to a series of International Standards on Auditing (UK) documents, namely ISA (UK) 200 to ISA (UK) 805, together with the International Standard on Quality Control (UK) document. One of a number of international equivalents is the European Union directive 2014/56/EU.

In the US, the AICPA issued its own relevant Statement on Accounting Standards, SAS 67, to help American auditors identify errors in the auditing process.

SAS 67 creates a framework for how to send confirmations, and it dictates that auditors must:

- ▽ **Maintain control** of the process
- ▽ **Maintain direct communication** with third-party responders who are knowledgeable and free from bias
- ▽ **Maintain professional scepticism** throughout the process.

The Public Company Auditing Oversight Board (PCAOB) has defined another relevant standard – AU Section 330.15, which defines the auditor's responsibilities throughout the confirmation process. It states that: “the auditor should exercise an appropriate level of professional scepticism throughout the confirmation.

Such scepticism is important in designing the confirmation request, performing the confirmation procedures, and evaluating the results of the confirmation procedures.” The Brydon Report reinforces the requirement, by stating that professional scepticism “assists the auditor in remaining unbiased and alert to both corroborative and contradictory audit evidence” and in evaluating the authenticity of records and documents.

With emphasis on controlling the audit process and exercising professional scepticism, validation is clearly a key step within the audit confirmation workflow. Validating where confirmations are sent and authenticating individual responders allows auditors to maintain a bias-free process, support audit opinions with reliable evidence, and reduce the risk of confirmation fraud.

There are too many recent instances of major financial statement frauds for auditors to be complacent. Although enhanced technology exists to assist the auditor in the detection of fraud involving external confirmations, we have continued to see a steady stream of cases in the media where the external confirmation process has, in some way or another, gone wrong.

Recent fraud

We have learned from the Wirecard scandal, for example, the impact of an auditor's failure to identify fraudulent documents and fake third parties or to investigate suspect addresses. Wirecard's growth to DAX-30 status was supported by faked invoices, invented contracts, and many other deceptions. It had taken a combination of whistleblowers, journalists, and short-sellers to expose the €1.9bn hole in the company's accounts.



Today's audit confirmation process

Investors, lenders, government agencies, and the public rely heavily on an external auditor's independent opinion – expressed in a financial audit – on whether a company's financial statements are accurately presented. An uncomplicated way for a company to inflate its cash balance is to create fake invoices used in its general ledger or financial statements. With so much at stake, auditors must obtain "sufficient and appropriate audit evidence" to support their opinion:

- ▽ **"Sufficient"** relates to the quantity of audit evidence obtained. Has the auditor gathered enough?
- ▽ **"Appropriate"** relates to relevance and reliability. Is the evidence gathered appropriate to support the conclusion drawn?

Key tenets of a proper audit confirmation

To comply with these baseline items, auditors must follow the four key tenets of a proper audit confirmation:

1

Communicate directly with – and receive an active response from – the third party

2

Exercise professional scepticism

3

Identify and validate a respondent who is free from bias and authorised to respond

4

Maintain control of the confirmation process

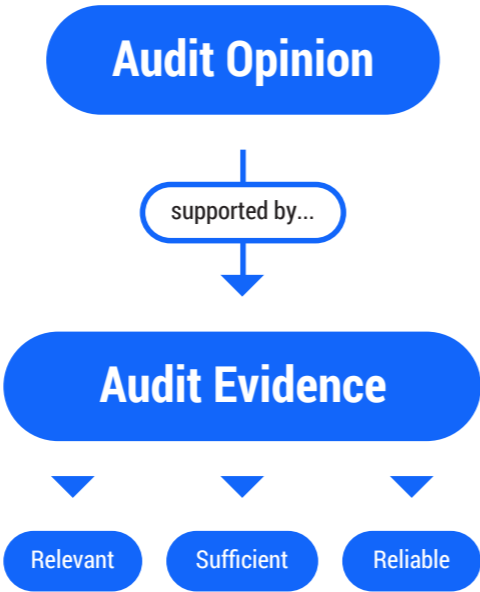


Critical to the reliability of the process is Tenet 3: "Identify and validate". A reliable audit confirmation process means the auditor has assurance that he or she is sending the confirmation request to the intended recipient. At the entity level, the auditor should determine that the confirming entity is who they claim to be by validating various items of information, including:

- ▾ Primary mailing address
- ▾ Physical address
- ▾ Website
- ▾ Phone number

Today's audit confirmation process requires sufficient, appropriate evidence.

At the individual level, verification of the respondent's identity is required. The auditor must obtain assurance that the respondent is qualified and authorised to respond, and has access to the necessary data.

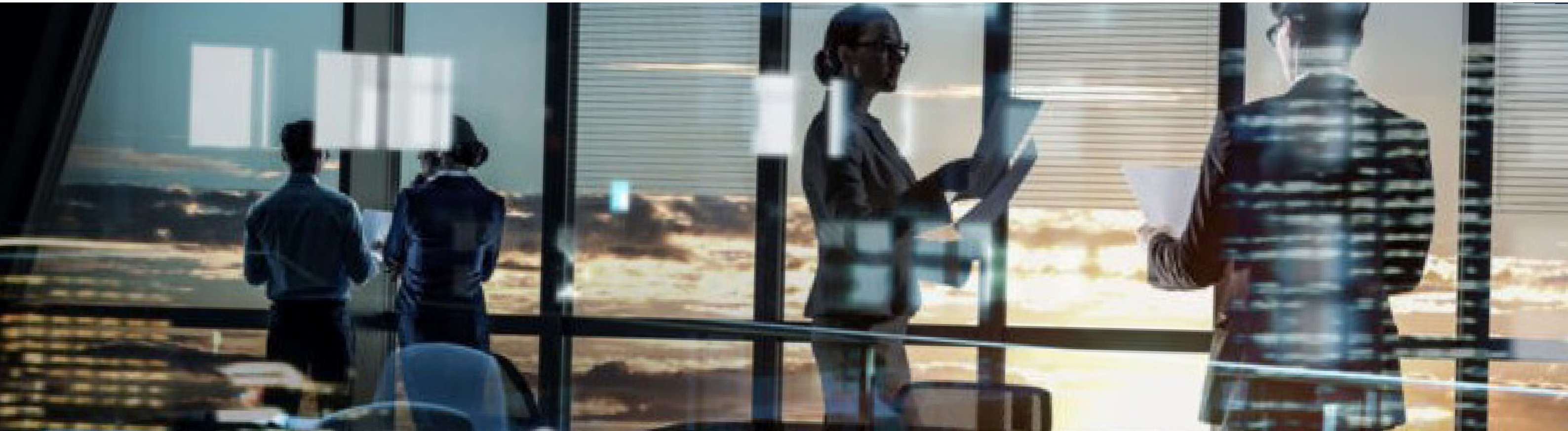
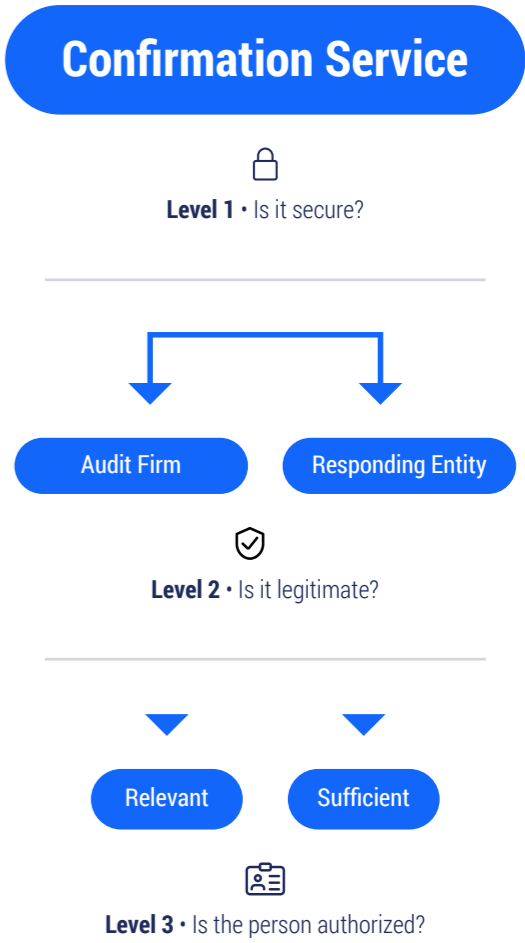


It is important that the responding entity knows who they're sending confidential information back to – that is, an actual accounting firm. And it's important they have the authority to share this information, obtained from the audited client.

With so many standards in place to maintain the integrity of the audit confirmation process, auditors have a great deal of responsibility on their shoulders. Ensuring reliability requires attention to detail in building the confirmation process, specifically in relation to validating sources. The following diagram illustrates the relationship between the auditor and the responder to an electronic confirmation request. It indicates that authentication, validation, and security are required at their respective levels.

Auditors are seeing significant benefits from a widespread use of electronic confirmations. They are also armed with powerful online tools to expedite validation to ensure the reliability of audit evidence. The result is likely to be a far better confirmation process.

The ideal audit confirmation process is streamlined and highly efficient.



Realising the ideal process

Implementing the ideal audit confirmation is possible when auditors have the right technology in place. While digital confirmations are ubiquitous, paper has yet to be eliminated from the process. Even leading confirmation solutions do not house every responding entity, such as every bank in existence. There will always be an instance where paper confirmations must be sent. The ideal confirmation process, then, should be supported by a solution that not only offers electronic validation within a highly secure platform, but also provides tools for sending paper confirmations when needed.

Consider all the elements that make up the ideal confirmation process and the value of a streamlined, secure, and highly efficient workflow:

1 Ability to perform electronic confirmations

CONFIRMATION, the leading online confirmation solution, supports a highly secure digital confirmation process. By communicating with respondents directly via an online platform, auditors save countless hours and can eliminate a great deal of manual, time-consuming tasks.

2 Powerful validation functionality

With such demands on auditors to maintain control of the process and ensure reliability of information, they must be armed with a solution for authenticating both the responding entity and the individual respondents.

More than 16,000 audit firms, 4,000 banks and departments, and 5,000 law firms have put the CONFIRMATION platform to work. The most helpful solutions are those with a comprehensive in-network base, where entities and individuals are vetted and entered as "authentic." This feature ensures reliability of audit evidence, saves countless hours, and helps reduce fraud. Over 580 banks use CONFIRMATION exclusively, no longer accepting alternative methods.

3 Support for paper-based confirmations

While digital is preferred, the need will occasionally arise to send a few paper confirmations. Not every bank can be registered in any one solution – there will always be outliers. Robust solutions will be required to provide auditors with tools to streamline the paper confirmation process, such as the convenient look-up of a contact's mailing address. CONFIRMATION also offers API integrations for full efficiency gains, resulting in improved response times, reduced errors, and saved staff time for both audit firms and banks. Supporting paper confirmations within an online confirmation solution further increases efficiency and streamlines the broad process.

CONFIRMATION exceeds the industry standards for privacy and security, maintaining a secure and reliable environment for all customers. To illustrate our commitment to effective operational controls, privacy, and security best practices, the company undergoes all three System and Organization Controls (SOC) for Service Organization examinations and passes 450 security and compliance reviews annually.

4 The highest level of security

The overall online audit process, despite all measures to obtain sufficient and appropriate evidence, is not worth much if it is insecure. Confirmations contain extremely sensitive and confidential data, such as the audit client's bank account numbers, loan numbers, and bank balances. Therefore, the ideal process requires a platform that supports the highest level of security for all parties.

In this way, the electronic confirmation process will have the right controls in place to provide a secure communication channel between the auditor and all the responders.

Final thoughts

The advent of online confirmation solutions such as CONFIRMATION, which validate requesting and responding parties, has altered the audit landscape forever. They offer a far more efficient and streamlined process and have armed auditors with the tools required to maintain control over the process, together with the ability to communicate with and validate responders directly. Today's leading online confirmation solutions offer auditors in-network capabilities to accomplish such key requirements as:

- ▽ Controlling the broad audit confirmation process
- ▽ Maintaining the integrity of data and data transmission
- ▽ Authenticating entities, such as websites and physical addresses
- ▽ Establishing direct communication with entities and validating respondents

Leading online technologies better prepare auditors to meet ever- changing audit standards, support professional scepticism, and ensure reliable audit evidence. Today, auditors can make the ideal audit confirmation process a reality.

About CONFIRMATION

CONFIRMATION, part of Thomson Reuters, is the digital platform and global network trusted by audit firms, banks, law firms, and other businesses to quickly and securely verify financial data. CONFIRMATION invented electronic confirmations 20 years ago, reshaping the audit confirmation process. Today, CONFIRMATION helps 1.5 million users across 170 countries confirm more than \$1 trillion in financial data every year.

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