Auditor-to-Auditor Confirmations: A New Approach in Obtaining Accounts Receivable Confirmation and Its Empirical Investigation

Abstract

This paper discusses the evolution of the accounts receivable confirmations from the early 20th century to the present, followed by types of confirmation and why the format and process of obtaining accounts receivable confirmations cannot minimize problems associated with them. This paper offers a new approach, Auditor-to-Auditor Confirmations (ATAC) and discusses how the process of obtaining accounts receivable confirmations can be strengthened using this new approach. This technique would have auditor confirm balances with the client customer’s auditor if the customer employs an independent auditor. This new approach will reduce management manipulation and other problems associated with obtaining accounts receivable confirmations under current format. An investigation of perception of senior accounting students indicate that they believe the new ATAC is more effective and reliable than other methods of accounts receivable confirmations. Types of accounts receivable fraud and how ATAC can reduce such frauds are also discussed in the paper.

Keywords: Accounts Receivable Confirmation, Paper Confirmation, Electronic Confirmation, Auditor-to-Auditor Confirmation.

Data Availability: Data are available from the author.
Auditor-to-Auditor Confirmations: A New Approach in Obtaining Accounts Receivable Confirmation and Its Empirical Investigation

INTRODUCTION

Barry Minkow, owner of ZZZZ Best and one of the most recognized financial swindlers in the 1980s, made the following statement during a private, prison tape interview (Wells 2001, para. 7):

Accounts receivable are a wonderful thing for a fraudster like me. They immediately increase profits. But they also do something else—they explain why my company doesn’t have any cash; it’s all tied up in accounts receivable.

Managements has frequently used accounts receivable as fraudulent financial reporting since they provide many benefits for fraudsters, including increase in sales and profits, increase in current assets and total assets, and use as collateral for getting loans. Because of high potential for fraudulent financial reporting, auditors are highly concerned with the existence of accounts receivables. For existence assertion, auditors commonly examine the accounts receivable confirmations. As Caster et al. (2008, 253) note, “[c]onfirmations are considered to be among the most persuasive forms of audit evidence, because they are received directly from a third party.” But the collusion between management and the confirmees, as well as management manipulation of confirmation process could significantly reduce the usefulness of this type of evidence. Therefore, auditors may be placing too much reliance on accounts receivable confirmations on the ground that they are provided by outside third parties. In this paper, I suggest a new approach in obtaining accounts receivable confirmations; what could be called Auditor-to-Auditor Confirmations (ATAC).

This paper begins with a discussion of the evolution of the accounts receivable confirmations from the early 20th century to the present. The following section presents types of
confirmation processes and discusses why the current format of obtaining accounts receivable confirmations cannot minimize problems associated with them. The third section discusses how the process of obtaining accounts receivable confirmations can be strengthened and suggests a new approach, auditor-to-auditor confirmations, to improve its use in the future to reduce management manipulation and other problems. The fourth section presents the perception of senior accounting students with regard to the use of different types of accounts receivable. Types of accounts receivable fraud and how ATAC can reduce such frauds are discussed in the fourth section. Finally, the paper presents the conclusion and limitations of the study.

1. Accounts Receivable Confirmations During 20th Century and Early 21st Century

Prior to 1939, accounts receivable confirmations were not widely used except in the brokerage and banking industries (Peloubet 1939). Auditors performed basic tests of accounts receivables with attentions paid to defalcations. For example, Moussalli, Gray, and Karahan (2011) refer to Montgomery auditing book (1915, 72), stating “An old item in a running account or a bill partly paid, followed by others fully paid, usually means that an allowance has been or will be made, or that a defalcation exists.” Therefore, accounts receivable concerns at that time were mainly misappropriation of assets or employee fraud rather than fraudulent financial reporting or management fraud. This mainly changed with the Ultramares Corporation v. Touche, Niven & Company (1931) case.

Ultramares had loaned money to Fred Stern & Company, a rubber importing company, in 1924 on the basis of financial statements prepared by Touche, Niven & Co. Touche audited the books of Fred Stern & Co. and issued a clean report and furnished their client company with roughly 32 copies of the report to be reissued to the investors, creditors, and other users. The
report certified a net worth of over $1 million, even though the company was in fact insolvent and had debts of over $200,000 in excess of its assets. The assets were overstated by $950,000 through fictitious accounts receivables. Subsequently, in 1925, Fred Stern & Company filed for bankruptcy and Ultramares, a third-party user of these financial statements, filed a court complaint. A lower court found Touche guilty of negligence, but the firm was declared not liable to Ultramares because there was no privity of contract between the auditor and Ultramares. In 1931, seven years and several court appearances and appeals later, the New York Court of Appeals ruled on the case and agreed that third parties could not hold an auditor liable for ordinary negligence, only for fraud.

In 1936, the American Institute’s 1917 joint pronouncement with the Federal Trade Commission on auditing standards was revised and recommended that auditors observe inventories and confirm receivables. The 1936 revision suggested, but did not require, the taking of physical inventory and direct mail confirmation of accounts receivables (Chatfield 1974).

The auditing profession had just started to implement the guidance in the revised version bulletin when the McKesson & Robbins fraud surfaced (Carmichael and Winters 1982). Philip Coster, the president of McKesson & Robbins, Inc., a large drug company, had embezzled funds from the company along with his three brothers. “The senior management of McKesson & Robbins had used a facade of false documents to conceal the fact that $19 million in inventory and receivables were nonexistent (Cangemi and Singleton 2003, 8-9). The scheme was to inflate the reported value of the assets while skimming cash into their own pockets. As it turned out, fictitious inventories and accounts receivable made up more than 20 percent of the company’s reported assets.
A Securities and Exchange Commission (SEC) investigation of the matter concluded that while Price Waterhouse and Company conducted their audit to what was considered acceptable\(^1\); they did not demonstrate the due diligence that the job required. The findings also stated that “…time had long passed when an audit was restricted to the books and records; the facts should be confirmed by physical inspection or independent confirmation (Baxter 1999, 172).” As a result, the American Institute of Accountants (AIA) appointed a committee to study the 1936 revised bulletin and make recommendation for changes. In 1939, AIA issued Statement on Auditing Procedures (SAP) No. 1 “Extensions of Auditing Procedures” that required auditors to observe inventories and confirm receivables. “The subsequent requirements for the use of accounts receivable confirmations were issued based on the belief that if the McKesson-Robbins auditors had sent confirmation requests, they likely would have discovered the fictitious accounts receivable (Caster, Elder, and Janvrin 2008, 256).” Despite requirement for confirmations since 1939, accounts receivable frauds continue to occur similar to McKesson-Robbins, such as Equity Funding, or more recent examples such as Royal Ahold (AAER No. 2124, 2004).

In 1964, managers at Equity Funding Corporation of America used a series of frauds to show false profits, thus increasing the company’s stock price. One of the fraud schemes was a deceptive tactic during confirmation of receivables. According to Cangemi and Singlton (2003, 19):

> When the external auditing firm tried to confirm receivables (policies) by phone, the Equity Funding switchboard operator simply patched them through to Equity Funding (EF) employees in the building. That is, EF employees were in on the fraud and actually provided external auditors with false information. The most amazing fact of the case is that it went undetected for so long. Many people inside the company knew about the fraud, and yet the fraud was a better-kept secret than some of our military secrets of the time. The fraud was exposed when a disgruntled ex-employee blew the whistle.

---

\(^1\) While Price Waterhouse and Company did not question the existence of numerous new customers over the previous fiscal year, they were compliant with the standards at the time.
In 1988, Harold Ruttenberg opened the first Just For Feet, a large free standing store with a basketball court and a “combat zone”, where shoes were sold at discount prices. In 1992, Just For Feet (JFF) purchased two small mall based athletic shoe chains, Athletic Attic and Imperial Sports. In 1994, the company went public. In 1997 and 1998, Just For Feet used just about all areas to create fictitious income and assets. The company even had a Nike employee (supplier) to confirm fictitious amounts to the auditors. Part of the fraudulent activities was related to fictitious receivables. Just for Feet routinely recorded anticipated vendor allowances as receivables. The vendor allowances increased from $400,000 at the end of 1997 to 29 million dollars at the end of 1998. In order to confirm the receivables, Ruttenberg used his influence to persuade executives to return false confirmations.

A more contemporary example, the Dutch company Royal Ahold, NV (Ahold) acquired U.S. Foodservice in 2000. U.S. Foodservice was the second-largest distributor of food and Ahold’s exclusive chains of U.S. grocery stores. According to Sanchez and Agoglia (2011, 238), “a material portion of U.S. Foodservice’s balance sheet was promotional allowances receivable from vendors (vendor rebates). As part of their normal audit procedures for U.S. Foodservice, Ahold’s independent auditors Deloitte and Touche sent confirmations for these receivables.” However, third party confirmations of rebates receivable had been provided by the vendors’ salespeople, not their accounting departments. Sanchez and Agolia (2011, 242) further note that:

According to complaints filed by the SEC, employees at U.S. Foodservice urged their vendors to complete and return to the auditors false confirmation letters with dollar amounts intentionally overstated, sometimes by as much as millions of dollars. Some vendors were pressured, some were provided with secret “side letters” assuring the vendors that they did not owe the amounts listed on the confirmations (Securities and Exchange Commission, 2006).
During the second half of the 20th century, the belief was that confirmations of accounts receivable are for authentication process and not detecting fraud. For example, Moussalli et al. (2011, 81) note that, in Montgomery 1975 book (Defliese, Johnson, and Macleod 1975), the “section on confirmation of accounts receivable declares that ‘the purpose of those procedures is not so much to protect against possible fraud on the part of the client (although that possibility is clearly implied) as to preserve the integrity of the confirmation procedure as a valid proof of authenticity (250).’”

This is also evident from adopting SAS No. 67, when two Board members (out of the seventeen), while affirming the Statement, expressed a reservation that the language used in the Statement usurped the freedom of the auditor in exercising professional judgment in how best to confirm accounts receivable. In addition, they expressed concerns that the language might also lead auditors to place undue reliance on third party confirmation when circumstances might suggest that the auditor choose a more effective test (AICPA 1991). As Sanchez and Agogila (2011, 246) note:

With the benefit of hindsight it is clear that the auditors of U.S. Foodservice could have, and should have, designed a more “effective test,” one that would have helped overcome the inherent weakness that existed in this situation where parties providing the confirmation may have either been uninformed about the existence and/or amount owed to the retailer or may have had a vested interest to overstate the amount that was owed to U.S. Foodservice.

These fraudulent schemes related to confirmations of accounts receivable clearly show that the process has not been properly working during the 20th century. In early 21st century, the Sarbanes-Oxley Act, commonly referred to as SOX, established the Public Company Accounting Oversight Board (PCAOB), which is overseen by the SEC. The PCAOB’s purpose is to oversee, regulate, inspect, and discipline the accounting firms for their roles as auditors of all public
companies. The PCAOB has issued a variety of Auditing Standards to improve audits of public companies, including Concept Release on Possible Revisions to the PCAOB’s Standard on Audit Confirmation on April 14, 2009 (PCAOB Release No. 2009-02). The concept release attempted to strengthen the confirmation process due to advances in technologies and other deficiencies embedded in the previous professional standards. As of writing of this paper, PCAOB still relies on AU 330 as an interim standard for external confirmation process.

**TYPES OF CONFIRMATIONS**

Two types of accounts receivable confirmations are used by the auditors, positive or negative confirmations. The positive confirmation requires a response by the customer and could take several forms: blank, information provided, and individual invoice confirmations. Blank forms request the recipient to fill in the balance or furnish other information without stating the amount (or other information) on the confirmation request (SAS, AU330, para.17) AICPA. Information provided forms request the respondent to confirm whether s/he agrees with accounts balance or the information stated on the request. Finally, the individual invoice form provides details of the invoices in place of accounts receivable balance. Each of these positive forms of confirmations has its own advantages and disadvantages. Blank form is the most reliable form of accounts receivable confirmation but has lower response rate. Individual invoice and information provided forms are less reliable but provide higher response rate. The literature on the response rate of the later two positive forms, i.e., confirming individual invoices in year-end accounts receivable rather than entire year-end account balance, is inconclusive. While Krogstad and Romney (1980) found individual invoice confirmations improved confirmation reliability, effectiveness, and response rate, Ashton and Hylas (1981) as well as Allen and Elder (2001) did not report any increase in response rates or effectiveness for invoice confirmation requests over
balance confirmation requests.

The negative accounts receivable confirmation form is formatted similar to the positive confirmation form. The only difference is that it requires a response from the customer only if the customer does not agree with the balance. In view of that, the use of negative confirmation requests generally provides less reliable evidence than positive confirmations. Existing guidance in SAS No. 67 indicates that negative confirmations may be used when: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances are involved, and (3) the auditor believes that the recipients of the requests are likely to give the request adequate consideration. International Standard on Auditing (ISA) 505 (IFAC 2008), paragraph 15, provides similar guidance and states that negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when: (a) the auditor has assessed the risk of material misstatement as low, (b) a large number of small, homogeneous balances, transactions or conditions comprise the accounts receivable balance, (c) expectation of exception rate is very low, and (d) the auditor has no reason to believe that the respondents will disregard the requests. The two definitions are essentially the same.

The use of positive confirmation is preferred when the individual account balances are relatively large, or where the entity’s internal controls are not working efficiently. A response to a positive confirmation request is ordinarily expected to provide reliable evidence to the auditor. A no response to positive confirmation suggests the auditor should send a reminder to the third party or do alternative procedures. Both ISA 505 (IFAC 2008) and AICPA Practice Alert 2003-01 (AICPA 2007) indicate that a combination of positive and negative confirmations can be used. According to Caster et al. (2008):
The evidence indicates that detection rates for negative confirmations are generally statistically significantly lower than those for positive confirmations. The detection rate for positive confirmations is also quite low. Warren (1974) noted that negative confirmations are the least informative, but they are also the least costly.

One important requirement for accounts receivable confirmation is that the auditor should maintain control over the whole process of confirmation requests, including (1) information to be confirmed or requested, (2) selection of confirming party, (3) mailing the requests, including follow-up requests when applicable, to the confirming party, and (4) requests are properly addressed and contain return information for responses to be sent directly to the auditor [see ISA 505, para. 7 (IFAC 2008)]. The professional standards also require that the auditor documents and justifies the reasons if no confirmations are being sent for accounts receivables. However, based on a comprehensive review literature, Caster et al. (2008) reported that some auditors do not confirm accounts receivable with proper documentation and do not submit proper documentation justifying the decision not to send confirmation as required under Statement on Auditing Standards (SAS) No. 67 (AICPA 1991).

One major problem with accounts receivable confirmations is collusion between auditee management and their customers, which limits the usefulness of confirmations to provide support for existence assertion. Based on a review of cases in Accounting and Auditing Enforcement Releases (AAERs), Caster et al. (2008) report that management can persuade their customers to sign and return false confirmations and even pay customers to reply to the false confirmations. In addition, there were instances where auditee personnel responded to the confirmations with the forged signature of the customer.

In addition, many auditors fail to perform due diligence in the confirmation process. They rely heavily on the information provided by the management including contact information,
where confirmations to be sent, and what information to be confirmed. These problems, alongside management collusion with the third parties, makes it very difficult for the auditor to guarantee accuracy surrounding the accounts receivable confirmations as evidence of existence assertions related to accounts receivables.

**STRENGTHENING CONFIRMATION PROCESS FOR ACCOUNTS RECEIVABLE**

The recent SEC investigation into China Century Dragon Media, Inc. (CDM) shows why audit confirmations play an important role on the financial audit process. “It also supports recent decisions by the Auditing Standards Board (ASB), the Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) to update and strengthen their standards related to external audit confirmations (confirmation.com 2011, para. 1).”

CDM launched its initial public offering (IPO) on February 8 of 2011. Just six weeks after, “the New York Stock Exchange notified the company that its common stock was being delisted due to non-compliance with the exchange's listing standards (confirmation.com, 2011, para. 2).” The decision was made based on resignation of MaloneBailey LLP (MB), China Century's independent accounting firm, from its engagement with the company because of discrepancies found on customer confirmations and the auditor's inability to directly verify China Century's bank records (confirmation.com 2011, para. 2).

While management manipulates the confirmation process, oftentimes auditors also fail to follow the due diligence in obtaining accounts receivable confirmations. Both SAS No. 67 and ISA No. 505 require that the auditor:

- Use direct communication with the third party.
- Exercise professional skepticism.
• Make sure Respondent is free from bias.
• Maintain control in the confirmation process.

“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 (Capital Confirmation, Inc.\textsuperscript{2} 2010, p.7).” According to Capital Confirmation Inc. (2010), the problem is exacerbated because:

• Client provides false contact information,
• Client provides the contact name,
• Client influences the confirmation process, and
• Auditor cannot authenticate signature verification of the confirmee.

A recent SEC investigation of PW India (an affiliates of PricewaterhouseCoopers) shows that this is exactly the case. The SEC’s investigation (SEC 2011, para. 8) found that:

PW India staff failed to conduct procedures to confirm Satyam’s cash and cash equivalent balances or its accounts receivables. Specifically, the order found that PW India’s “failure to properly execute third-party confirmation procedures resulted in the fraud at Satyam going undetected” for years. PW India’s failures in auditing Satyam “were indicative of a quality control failure throughout PW India” because PW India staff “routinely relinquished control of the delivery and receipt of cash confirmations entirely to their audit clients and rarely, if ever, questioned the integrity of the confirmation responses they received from the client by following up with the banks.”

The audit profession’s failure to perform due diligence in the confirmation process shows that CDM’s case along with other recent accounts receivable confirmation fraudulent schemes such as Kmart are not isolated confirmation frauds. In response to these scandals and problems, the ASB and the IAASB have issued new standards in the last few years that now allow for secure electronic audit confirmations (confirmation.com 2011, para. 6). It is hoped that this new

\textsuperscript{2} Capital Confirmation Inc. is the same entity as Confirmation.com.
procedure would help auditors more easily detect financial frauds involving audit confirmation irregularities.

While the automation process may alleviate some of the problems in the confirmation process, it cannot not entirely eliminate collusion between management and the third party. In addition, it may create other problems related to automation and information technologies such as receiving email responses from fake confirmees. A better solution would be to allow auditors to communicate with each other with regard to accounts receivable confirmations (auditor-to-auditor confirmation or ATAC). The idea here is the practitioner asks the auditor of the client’s customer to confirm the balance owed by the customer to the client if customer employs an independent accountant to audit its financial statements. Advantages of the auditor-to-auditor confirmations are increase in the response rate for positive confirmation, higher reliability for negative confirmation, authentication of confirmations, and increased effectiveness of confirmations.

Opponents of this idea may claim several problems with this procedure, including confidentiality of information, impracticality, and costs. Confidentiality of information is most likely the major road block in this process. I, however, argue that when the public good is at stake, the rules can be amended to allow confidential information to be released, especially when it does not harm the company. This has been done in other areas. For example, Congress included provisions in the Sarbane-Oxley Act of 2002 directing the SEC to issue rules requiring attorneys serving public companies to report material violations by the company of federal securities laws. Consequently, The American Bar Association amended its attorney-client confidentiality rules to permit attorneys to breach confidentiality if a client is committing a crime or fraud. The same can be done by the PCAOB, AICPA, and IFAC with regard to accounts
receivable confirmations where professional standards related to confidentiality can be amended so that auditors can communicate with regard to accounts receivable confirmations.

Impracticality deals with timing of financial statements. For example, while the client’s year-end may be December 31, the customer year-end could be other dates but December 31. Therefore, the auditor of the customer may not have the audited balance of accounts payable on December 31 to confirm it to the client’s auditor. Although this poses some problems in the process, I still believe the balance of unaudited accounts payable confirmed by the customer’s auditor is more reliable than a confirmation by the customer, which may misrepresent the accounts payable balance on the confirmation without manipulating the accounts payable balance. Direct confirmation from the customer’s auditor to the client’s auditor would require the customer also record fictitious journal entries in its books should they decide to collude with the client’s management. This will create problem in the customer’s internal control system and therefore, it is less likely to be implemented.

Finally, the costs involved in this process will need to be reviewed. Since auditors will need to perform additional work to respond to these confirmations and possibly to assist in resolving the differences, the question becomes who should bear the costs. Will costs be absorbed by the client or the customer of the client? I argue that the benefits of implementing this process include both the client and its customers. Therefore, the costs should be absorbed by both. Auditors can incorporate in their fees an amount for such a service. Additionally, with technological advancements similar to ACH that banking system uses⁴, the cost would most likely be minimal and, when it is for public good, the benefits overweight the costs.

---

⁴ The Automated Clearing House (ACH) system is used by banks to transfer money. In addition to being faster than most other transfer options, the ACH is more secure.
EMPIRICAL INVESTIGATION OF ATAC EFFECTIVENESS AND RELIABILITY

This study uses senior accounting students at a liberal-art college in the Northeast of the United States of America to examine the effectiveness and reliability of three methods of accounts receivable confirmations: paper, electronic, and auditor to auditor. As part of the learning effect related to confirmation of accounts receivable, surveys were distributed to 67 students taking the auditing course in Fall 2017 (see Appendix A). Prior to the administration of the survey, the course covered audits of accounts receivable and process of obtaining accounts receivable confirmation. In addition, students performed an electronic accounts confirmation project through confirmation.com website. Students responded to eight statements, on a rating scale of 1(very low) through 7(very high), to rate various aspects of accounts receivable confirmation for the three methods. For example, the first question was "Response rate to positive accounts receivable confirmation" with three options of Paper Audit Confirmation (PAC), Electronic Audit Confirmation (EAC), and Auditor-to-Auditor Confirmation (ATAC).

Of 67 surveys distributed, one was deleted as the students responded 7 to all questions. Of 66 students for the study, 35 were male and 31 were female with average age of 22 years. In addition, at the time of this survey, 65 percent of students had accepted offers from public accounting firms (30 percent Big-4 and 30 percent regional firms), five percent from industry, and the remaining had not received an offer.

A Friedman test was run to determine if there were differences in responses to the three types of obtaining accounts receivable confirmations PAC, EAC, and ATAC. Pairwise comparisons were performed with a Bonferroni correction for multiple comparisons. The results are presented in Table 1.

[insert Table 1 about here]
As Table 1 shows, students believed that there are significant differences among the three methods of accounts receivable (A/R) confirmation with regard to response rate ($\chi^2 = 33.445$, p=.000), authentication of A/R confirmation ($\chi^2 = 11.598$, p=.003), efficiency of the audit of A/R confirmation ($\chi^2 = 33.954$, p=.000), effectiveness of the audit of A/R confirmation ($\chi^2 = 8.373$, p=.015), reliability of negative confirmation for A/R ($\chi^2 = 8.373$, p=.015), cost to implement ($\chi^2 = 16.217$, p=.000), and practicality to implement ($\chi^2 = 16.300$, p=.000). Students perceived no significant difference among the three methods for the amount of alternative procedures needed when responses to positive A/R confirmation are not received. Post hoc analyses, as shown on Table 2, were performed on each of the eight statements to investigate where differences exist.

[insert Table 2 about here]

Compare to paper A/R confirmation, the results in Table 2 indicate that students perceived electronic A/R confirmation provides higher response rates (p < .001), efficiency (p<.001), and practicality to implement (p<.05). In addition, students believed electronic A/R confirmation is less costly than paper A/R confirmation (p<.05).

Compare to paper A/R confirmation, the results in Table 2 also indicate that students perceived auditor-to-auditor A/R confirmation provides higher response rates (p < .001), efficiency (p<.001), effectiveness (p<.10), and reliability (P<.10). Furthermore, while students perceived that auditor-to-auditor A/R confirmation provide better authentication than electronic A/R confirmation (p<.05), they believed that electronic A/R confirmation was less costly but more practical than auditor-to-auditor A/R confirmation.
Overall, the findings from senior accounting students indicate that ATAC is superior to PAC in response rate, efficiency, effectiveness, and reliability. In addition, although ATAC could be costly and less practical than EAC, students perceived ATAC provides a more authentic A/R confirmation than EAC. It has been the poor or lack of authentication of A/R confirmation in the past that has resulted in fraudulent overstatement of A/R by companies. Therefore, ATAC seems to be a good substitute for PAC and EAC.

In the following section I will discuss different types of accounts receivable fraud schemes and explain how direct auditor-to-auditor confirmations of accounts receivable can prevent these types of fraud.

**TYPES OF ACCOUNTS RECEIVABLE FRAUD**

Several methods are used to overstate accounts receivable and the corresponding sales. These include

- Improper treatment of sales (e.g., fictitious sales).
- Holding books open past close of period.
- Billing and holding schemes.
- Conditional sales (return after year-end).
- Channel Stuffing.
- Delayed posting of sales returns.

Improper treatment of sales happens when management creates fictitious sales to existing or fake customers. Since no cash is actually collected when a sale on account has been made, it leaves an opportunity for a dishonest management to record “fraudulent additional sales by simply creating fictitious customers and recording fictitious sales” (Elmaleh 2006, para. 2). A recent example is when WorldCom’s Chief Executive Officer (CEO), Bernard Ebbers, persuaded
the Chief Operating Officer (COO), Ron Beaumont, to find and record one-time revenue items that were fictitious (Blumenstein and Pulliam 2003). The fictitious entry was booked to the Uncollected Revenue Account and increased WorldCom’s revenue. These fictitious entries were significant and round numbers (Beresford, Katzenbach, and Rogers, Jr. 2003). In other words, the fictitious journal entry was debited to the allowance for doubtful accounts with the corresponding revenue account. These types of manipulations would not be discovered by the accounts receivable confirmations because it deals with valuation assertion rather than existence assertion. Other auditing procedures could have uncovered this manipulation, though they will not be discussed in this paper. Nonetheless, if fictitious revenue entries are directly made to the accounts receivable, a confirmation received from the customer’s auditor most likely will uncover the fraud unless the customer also makes a fictitious journal entry into its accounts payable which is unlikely to happen.

Another popular method for inflating accounts receivable is “keeping the books open” at the end of the accounting period” (Elmaleh, 2006 para. 3). In this method, the corporation has real customers and sales but the sales made for the next period are recorded as part of sales for the period under the audit, which will cause overstatements of accounts receivable and revenues for the year under audit. The auditor-to-auditor confirmation should discover this type of overstatement of accounts receivable and revenue. That is, since the customer records the sales in the next period, its accounts payable do not correspond to the accounts receivable of the client at the financial statement date and this will be reflected in the confirmation received.

Under billing and holding scheme, the management creates receivables but holds the goods for later shipment, or does not ship the goods at all. This scheme is often used with large customers. Sometimes bill-and-hold schemes are the product of collusion between a seller and a
customer, whereby the seller requests that the customer orders additional goods before year-end, and books the sale in order to achieve a target sales level. The goods remain with the seller, and are not shipped until the subsequent period. In exchange for placing the order, the seller offers the customer the goods at a reduced cost. An example of a bill-and-hold scheme in recent years occurred at Sunbeam, where in 1998, Sunbeam CEO, Al Dunlap used a bill-and-hold strategy in order to make Sunbeam's financial performance better than it really was by artificially inflating Sun Beam's revenue by 18%. Management overstated revenues by some $95 million and net profits by $71 million (Zweighaft 2003). While there are other procedures to examine whether bill-and-holding scheme is affecting the financial statements (see Zweighaft 2003 for the procedures to uncover bill-and-holding schemes), if bill-and-holding schemes are recorded to the accounts receivable, a confirmation received from the customer’s auditor most likely will uncover the fraud unless the customer also makes a fictitious journal entry into its accounts payable which is unlikely to happen.

Conditional sales involve sales to customers with the condition of returns after the year-end to overstate the revenue and accounts receivables in the current period. A recent example is Coca-Cola’s conditional sales by coercing its biggest distributors to accept delivery of more syrup than they needed at the end of each quarter, thus inflating revenue by about $10 million a year (Lovel 2003). Since conditional sales are generally done by coercing customers to accept the sales and return the goods later, it is difficult to be detected through accounts receivable confirmation process. However, auditor-to-auditor confirmation may request the customer’s auditor to look for any material return of merchandise in the next period and report it to the client’s auditor.
Channel stuffing is another form of conditional sales which involves shipping substantially more inventory to a reseller than he can reasonably use, but agrees to accept it based on unusual or extraordinary terms, like extended payment terms, deep discounts, or allowing the return of unsold goods for full credit beyond the company’s normal returns policy. Two recent cases of channel stuffing include Bristol-Myers and Lucent Technologies. In the Bristol-Myers case, 2001 revenues were inflated by as much as $1.5 billion by providing sales incentives to wholesalers who would make the delivery of the product without intent to sell the products until the following year (Patsuris 2002). Lucent Technologies improperly booked $678 million in revenues during 2000 of which $452 million reflected products sent to its distribution partners that were never actually sold to the end customers (Pellegrini 2001). While auditor-to-auditor confirmation may not directly uncover channel stuffing schemes, it may provide the customer’s auditor with adequate information to check for channel stuffing sales if individual invoices are provided in confirmations. Any possible channel stuffing sales can then be communicated between the two auditors for final evaluations.

Finally, under delayed posting of the sales returns fraud scheme, management does not record returned items until the next period, which again causes overstatement of revenue and accounts receivables for the current period. The auditor-to-auditor confirmation should discover delayed posting of the sales returns fraud schemes because the customer accounts payable do not correspond to the accounts receivable of the client at the financial statement date and this will be reflected in the confirmation received.

It should be noted that most of these fraudulent financial reporting schemes should be uncovered by proper accounts receivable confirmations under current professional standards. However, several factors affect the effectiveness of confirmations as it is currently done. First,
collusion between management and/or employees and their customers reduces the effectiveness of accounts receivable confirmations. Caster et al. (2008) report from reviewing SEC AAERs that over 40% of the auditees’ account receivable confirmation fraud involved such collusion. “Auditee management persuaded one or more of its customers to provide the auditors with false information, such as failing to admit to side agreements that permitted the right of return or represented sales on consignment, or simply agreeing to sign and confirm a balance that was clearly incorrect (Caster et al. 2008, 261).

Second, the low response rate of accounts receivable confirmations also contribute to the effectiveness of the evidence accumulation. While auditors are supposed to perform other audit procedures to satisfy themselves of the existence assertion, the alternative procedures are also subject to manipulation by the management.

Finally, the process of sending accounts receivable confirmations is subject to manipulation by the management. For example, management provides the address of the customers. Auditors rely on this information and send the confirmation accordingly. Auditor-to-auditor confirmations of accounts receivable can improve these deficiencies and provide more reliable, effective, and timely confirmations of accounts receivable, which consequently will prevent major fraud schemes related to overstatement of accounts receivable and revenues.

In addition, the format of accounts receivable confirmation should also be modified to allow better communication about possibility of fraud schemes between the auditors. For example, the confirmation can be modified to include questions about possibility of returned merchandize in the next period, possibility of channel stuffing, and so on. The modified format should provide more information to the client’s auditor to uncover potential fraud in overstating accounts receivable and revenues.
CONCLUSION AND LIMITATIONS

Prior research indicates that confirmations of accounts receivable are somewhat effective in testing for existence assertion but this effectiveness is hampered by the low response rate from confirmees, as well as collusion between auditee management and the confirmee. The evidence also suggests that confirmations of accounts receivable response rates may have fallen over time (Caster et al. 2008). In addition, a review of AAERs showed “a significant number of cases involving collusion and also forged and false confirmations, suggesting that confirmation evidence may not be as persuasive as it is generally perceived (Caster et al. 2008, 258).”

In response to these problems, the ASB and the IAASB have amended and issued new standards in the last few years to strengthen the confirmation process. The new amended standards allow for secure electronic audit confirmations with the hope that it would help auditors more easily detect financial frauds involving audit confirmation irregularities. I argue that while the automation process may alleviate some of the problems in the confirmation process, it could not eliminate collusion between management and the third party. In addition, it may create other problems related to automation and information technologies such as receiving email responses from fake confirmees.

This paper presents a new approach, Auditor-to-Auditor Confirmation (ATAC), to overcome the problems associated with current process of obtaining accounts receivable confirmations. That is, the client’s auditor will communicate with the customer’s auditor to obtain accounts receivable confirmations. Advantages of the ATAC approach are increase in the response rate for positive confirmation, higher reliability for negative confirmation, authentication of confirmations, and increased effectiveness and reliability of confirmations. While there are some road blocks to this approach, this study argues that they are minimal and
can be overcome for the sake of public good. In addition, this paper also suggests that the format of accounts receivable confirmation should be modified to allow more information to be obtained from auditor confirmees.

The new approach suggested in this study is subject to several limitations. First, the new ATAC approach could be more useful for public companies than private companies because private companies’ customers are small businesses, which may not have auditors. Second, this study only addresses the management fraud or financial reporting fraud related to the accounts receivable and revenues and not the employee fraud or misappropriation of assets. Third, this paper does not address the situation when management requests auditors not to send confirmations to the customers. However, this limitation should not be of much concern because the client’s auditor is not communicating with the customer but the customer’s auditors. Fourth, although it would be rare, it is also important to note that collusion could also happen when ATAC is used. For example, in the case of ESM Government Securities, the audit partner colluded with the company management to falsify financial statements. Finally, this study uses student subjects to assess desirability of different types of accounts receivable confirmation. In addition to usual survey method limitations applicable to the analyses related to student responses, students may not be a good substitute for professionals (Peterson, 2001) and therefore, the results may not be generalizable to auditors. Future studies may replicate this study to see if the results hold with professional auditors.

Notwithstanding these limitations, until further technological advances such as Blockchain which may eliminate the need for confirmations, ATAC can be used to minimize flatulent activities related to accounts receivable.


<table>
<thead>
<tr>
<th>Statement</th>
<th>$X^2$</th>
<th>$p$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Response rate to positive accounts receivable confirmation</td>
<td>33.445</td>
<td>.000</td>
</tr>
<tr>
<td>Authentication of account receivable confirmation</td>
<td>11.598</td>
<td>.003</td>
</tr>
<tr>
<td>Efficiency of the audit of accounts receivable confirmation</td>
<td>33.954</td>
<td>.000</td>
</tr>
<tr>
<td>Effectiveness of the audit of accounts receivable confirmation</td>
<td>8.373</td>
<td>.015</td>
</tr>
<tr>
<td>Reliability of negative confirmation for accounts receivable</td>
<td>8.032</td>
<td>.018</td>
</tr>
<tr>
<td>Cost to implement</td>
<td>16.217</td>
<td>.000</td>
</tr>
<tr>
<td>Practicality to implement</td>
<td>16.300</td>
<td>.000</td>
</tr>
<tr>
<td>Amount of alternative procedures needed when responses to positive accounts receivable confirmation are not received</td>
<td>4.647</td>
<td>.098</td>
</tr>
</tbody>
</table>
Table 2: Post Hoc Friedman’s Two-Way ANOVA by Ranks

<table>
<thead>
<tr>
<th>Statement</th>
<th>Mean Rank</th>
<th>Asymptotic Significance (2-sided Test)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PAC</td>
<td>EAC</td>
</tr>
<tr>
<td>Response rate to positive accounts receivable confirmation</td>
<td>1.47</td>
<td>2.18</td>
</tr>
<tr>
<td>Authentication of account receivable confirmation</td>
<td>1.93</td>
<td>1.78</td>
</tr>
<tr>
<td>Efficiency of the audit of accounts receivable confirmation</td>
<td>1.50</td>
<td>2.40</td>
</tr>
<tr>
<td>Effectiveness of the audit of accounts receivable confirmation</td>
<td>1.81</td>
<td>1.97</td>
</tr>
<tr>
<td>Reliability of negative confirmation for accounts receivable</td>
<td>1.84</td>
<td>1.92</td>
</tr>
<tr>
<td>Cost to implement</td>
<td>2.12</td>
<td>1.54</td>
</tr>
<tr>
<td>Practicality to implement</td>
<td>1.86</td>
<td>2.36</td>
</tr>
<tr>
<td>Amount of alternative procedures needed when responses to positive accounts receivable confirmation are not received</td>
<td>2.15</td>
<td>1.95</td>
</tr>
</tbody>
</table>

PAC= Paper Audit Confirmation

EAC= Electronic Audit Confirmation

ATAC= Auditor-to-Auditor Confirmation
Confirmation of accounts receivable is a generally accepted auditing procedure. However, history has shown that companies may overstate accounts receivable and subsequently manipulate the process of obtaining accounts receivable confirmation by the auditors. Several approaches can be used to obtain accounts receivable confirmation including paper mailing to the third party, electronic audit confirmation, and Auditor to Auditor Confirmation. The following statements are asking you opinion with regard to each of the approaches and are not necessarily what the Generally Accepted Auditing Standards is. Below is the definition of each approach:

**Paper Audit Confirmation** (PAC): A procedure where the auditor mails the accounts receivable confirmation letter directly to the customer of the client.

**Electronic Audit Confirmation** (EAC): A procedure where the auditor uses a third party (e.g., confirmation.com) to obtain accounts receivable confirmation via electronic means.

**Auditor to Auditor Confirmation** (ATAC): A procedure where the auditor can communicate to each other to obtain accounts receivable confirmation.

Please rate the following statements using the scale 1=strongly disagree to 7=strongly agree for each of the above approaches. Circle the number you believe explain the best each approaches.

<table>
<thead>
<tr>
<th>In your opinion, this approach</th>
<th>PAC</th>
<th>EAC</th>
<th>ATAC</th>
</tr>
</thead>
<tbody>
<tr>
<td>will increase accounts receivable response rate to positive confirmation</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>will increase authentication of accounts receivable confirmation</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>will increase efficiency of the audit of accounts receivable</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>will increase effectiveness of the audit of accounts receivable</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>will increase the reliability of negative confirmations</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>is very costly to implement</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>is not practical to be implemented</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
<tr>
<td>can reduce cost of accounts receivable audit because of higher response rate and less alternative procedures needed</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
<td>1 2 3 4 5 6 7</td>
</tr>
</tbody>
</table>