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Unresolved confirmation differences at termination of field work

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UNRESOLVED CONFIRMATION DIFFERENCES

at termination of field work

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The Client:

In this discussion, the client is engaged in what is currently referred to as "old line factoring" as well as commercial financing. In old line factoring, the factor enters into an agreement with a manufacturer to purchase receivables arising from the sale of the manufacturer's product. The receivables are usually purchased at "factor's risk", which means that the factor has assumed the credit risk and has no recourse to the manufacturer for uncollectible accounts. Sometimes, receivables are purchased at "manufacturer's risk", which means that uncollectible accounts are charged back to the manufacturer; in this instance the factor acts primarily as a collection agent. The factoring fee, of course, is considerably lower than that charged under a "factor's risk" agreement.

Under a commercial financing agreement, the factor advances funds to the manufacturer secured by a pledge of the manufacturer's receivables. The manufacturer performs all of the collection work and remits the actual checks received from his customers directly to the factor. In commercial financing the credit risk is assumed by the manufacturer.

Our client has a strong system of internal control with periodic internal audits. The internal audit encompasses the confirmation (in negative form) of the receivables by direct correspondence with the debtors. This confirmation procedure is followed for all accounts, whether they are factor's risk, manufacturer's risk or commercial financing (in the latter instance our client sends the confirmation in the name of the manufacturer as these accounts are usually on a non-notification basis). The client sends the requests in our name as auditors, and uses a special post office box rented in our name and to which we have access.

The Confirmation Differences

In response to one of these requests, the debtor stated that its records showed a balance of $27,557.79 as compared with the client's balance of $268,015.39 at April 26, 1963. The debtor suggested that we (since the reply was addressed to us) get in touch with our Dallas office which was then in the process of auditing the debtor's records. Our client contacted us and the information was forwarded to our Dallas office.

The Investigation:

Upon investigation, Dallas learned that it was the debtor's practice to place blanket orders with suppliers each year in October and November for total quantities to be purchased in the coming twelve months, specifying quantities to be shipped each month. The quantities were fairly small for the first few months because the debtor's old season ended in April. Large quantities were specified for May and subsequent months when the debtor's new season began. The debtor also specified that materials for May delivery were not to become his property prior to May 1 (although the goods could be shipped prior thereto) since its fiscal year ended April 30. In checking out the details of the account, Dallas found that some $90,000.00 worth of goods had been received at the debtor's plant before the April 30th date. Since the shipping labels, etc. had been addressed by the supplier to himself in care of the debtor, the receipt of this shipment was not recorded by the debtor until May 1, 1963. Dallas noted, however, that while the date on the debtor's copy of the invoices was May 1, 1963, the supplier had dated the invoices submitted to our client, the factoring company, in November, December and January. The supplier, therefore, collected from the factoring company on the basis of invoices for merchandise not yet shipped. While checking out the details on May 14, 1963, Dallas was informed by the debtor that he had just received a shipment of some $25,000 of goods from the supplier. Dallas was able to trace a portion of the shipment to the supplier's invoice of May 1, 1963 as compared with

January and February dates on the invoices submitted to the factoring company. All of these facts were transmitted by letter to our client after obtaining the agreement and permission of the debtor.

Promptness of Reporting:

We now come to the importance of prompt reporting. Realizing the possibility of fraud in the amount of $125,000 (confirmation differences of $241,000 less subsequent shipments of $90,000 and $25,000) Dallas telephoned us giving an outline of their findings. We immediately got in touch with our client. They were extremely grateful for this prompt service, since they were meeting with the supplier within a few hours to discuss the account. We later learned that when our client confronted the supplier with our findings, the company's president promptly admitted the fraud and promised to make restitution.

The Breakdown:

Our client's ordinary collection procedures, including aging of receivables, failed to indicate the possibility of fraud because the supplier repeatedly extended the credit terms to cover the period between the "pre-billing" and the actual shipping dates. The debtor had a high credit rating, and the client's credit man approved these extensions without investigating the reason for their frequency. Again, because of the debtor's credit rating, management did not question the collectibility of the unpaid balance.

A further investigation of the account by the internal auditor disclosed that the supplier had been "pre-billing" this account and repeatedly extending credit terms for a period of more than a year. No question was ever raised as to the discrepancy between invoice dates per the debtor's check vouchers and the invoice dates per the client's records. The internal auditor pointed out to the controller of the parent company that management had had many opportunities to discuss the pre-billing fraud before it reached its present amount.

The Audit Confirmation:

During our 1962 year-end audit we had also requested a confirmation of this debtor's account and had received a reply stating that there were a number of invoices, amounting to $60,179, of which the debtor had no record. In accordance with our regular procedure, the reply was given to the internal auditor, who recorded it and turned it over to the accounts receivable department for tracing. Procedure requires that the internal auditor obtain an explanation or reconciliation of differences, and that he must check such information before returning the confirmation replies to us. We review the explanations and test 10% in number to supporting information. In this instance, the client's accounts receivable department sent copies of the invoices in question to the debtor, who replied that he had no record of such invoices, and that the supplier must be using some basis other than shipment dates for invoicing. The replies were not turned over to the internal auditor until after the discrepancy in the April 1963 balance was disclosed. At the conclusion of our field work for the 1962 year-end audit there were, as usual, a number of confirmation differences still to be reconciled or explained. At that time the senior and the internal auditor inquired about the status of the unreconciled or unexplained differences and were informed that all major differences had been cleared, but that the replies could not be released to us because of a number of small unresolved differences. This explanation was accepted. The replies were left with the accounts receivable department for follow-up by the internal auditor and review by us at the date of our next audit. It is apparent that the individual who was tracing the differences was doing a mechanical job, and did not have enough experience to realize the significance of the difference in invoice dates. The client's tracer was further misled by the fact that, despite the debtor's comments, payments were being made for the disputed invoice amounts. (The tracer merely sees the tabulating run of paid invoices; he does not see the debtor's check voucher.)

Change in client's procedures:

The client discharged the credit man and has instituted a requirement that extensions of credit terms for invoices in excess of $5,000 be approved by the senior credit man or his assistants. In addition, all future confirmation differences and explanations are to be referred to a designated person in the credit department.

TRB&S program revision:

In view of this experience, we are revising our audit procedures to review the remaining unresolved differences at the conclusion of our field work to satisfy ourselves that such unresolved differences are in fact immaterial rather than to rely on the client's staff to make that determination. We are also expanding our procedures to include a test check of debtors' check vouchers where subsequent payment is offered as an explanation for unknown invoices.