

# Identifying and Evaluating Audit Issues: The Case of VITALOGISTICS

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**ABSTRACT:** This case invites you to identify audit issues and evaluate an audit team's judgments and decisions on a new engagement (VITALOGISTICS). You will consider a variety of issues in the client acceptance, planning, execution, and reporting phases of an Integrated Audit. Identifying the audit issues and evaluating the audit team's decisions will enhance your: (1) appreciation of the role of research in audit practice; (2) recognition of the conflicting pressures faced by auditors and the potential for these pressures to compromise audit work; and (3) understanding of the requirements of the Integrated Audit and how it differs from the requirements of an audit of financial statements.

## CLIENT ACCEPTANCE

While attending a charity event in Miami on December 15, 20X3, Andy Card, audit partner of KVPI LLP, met Carl Bush, CEO of VITALOGISTICS Inc., a publicly owned corporation whose stock has been trading on the New York Stock Exchange (NYSE) since its incorporation some three decades ago. When Carl learned that Andy was a partner of the prestigious KVPI firm, he was immensely excited and asked Andy whether KVPI would be interested in providing audit services to VITALOGISTICS during the forthcoming year (1/1/20X4 to 12/31/20X4) and beyond.

When Andy inquired about what appeared to be a sudden interest in changing auditors, Carl responded that the change was motivated by the impending retirement of Alex Sevilla, a partner of the current audit firm. Carl emphasized that Andy could contact VITALOGISTICS' current audit firm, Sevilla & Mercer, LLP. Carl also mentioned that he may have briefly mentioned this opportunity to another auditor from a different firm.

At KVPI partners who bring in clients are highly regarded, and Andy correctly reasoned that bringing VITALOGISTICS on board would boost his reputation and compensation. Nevertheless, Andy realized that any decisions he made must be based on KVPI's staff availability, compliance with the KVPI's quality control procedures, and ability of VITALOGISTICS to pay for these services. Andy, therefore, promised to get back in touch with Carl after conferring with the necessary KVPI people and conducting the necessary background checks.

Faced with the prospect of a new client, Andy left the charity event and sped off directly to his office. He immediately summoned Al Rove, a trusted audit manager, and asked him to find out what he could about VITALOGISTICS and to put together a proposal for the 20X4 audit of VITALOGISTICS.

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With those instructions, Al went to his office immediately to commence his investigation of VITALOGISTICS. Using the Internet, Al learned that the company designs, develops, manufactures, markets, services, and supports a wide range of computer systems, including desktops, notebooks, workstations, and network servers. The company also markets software, computer peripherals, and post-sale service and support programs. The company's products are sold to a variety of customers, including distributors, health care facilities, educational institutions, and end-users (via an Internet online system). Occasionally, the company uses consignment sales when it markets new products or when it introduces existing products into new sales channels. Net Revenue for fiscal 20X3 was \$5 billion and is projected to increase by 5 percent in 20X4. Total consignment sales for 20X3 were about \$100 million and are not expected to exceed 2 percent of net revenue in the 20X4. In the last 5 years, the company has experienced continued growth in sales and profitability, reflected in its current stock price of \$25, representing a price/earning ratio of 25 (industry average is 15).

Al also found that the company's senior management comprises Carl Bush, the CEO and chairman of the board; Catherine Johnson, the COO; and Charles Glassman, the CFO. All three have been with the firm for two decades. The Board of Directors includes Carl, the dean of the local university's college of business, and three others, all with significant business experience.

Al contacted the prior auditors and spoke specifically to Mr. Sevilla, who was not surprised that VITALOGISTICS was considering a new auditor. He had audited the company for many years but, with his impending retirement and possible sale of his partnership interest, he could understand why VITALOGISTICS would seek a larger audit firm. Sevilla expressed no major concerns about the integrity of key management personnel, although he noted that occasionally the CFO adopted aggressive accounting methods. He mentioned that the CFO had been willing to "book" any proposed audit adjustments, which tended to be concentrated in estimates and new transactions where initial accounting policy had to be established. Sevilla remarked, however, that the company's accounting staff seems to be stretched thin.

Al felt fortunate because VITALOGISTICS looked similar to MaxPar, another KVPI publicly traded client, which allowed him to reason that the VITALOGISTICS audit parameters (staff, fees, risk analysis, audit programs, audit milestones) should be set approximately equal to those for MaxPar. This discovery allowed him to complete the proposal and to forward it to Andy within four days. The highlights of the proposal were that the audit would be completed by March 15, 20X5, and the audit fee would be \$5 million (MaxPar's audit fee is \$6 million).

The next morning, Andy called Carl and relayed the information that Al had provided. Carl accepted the proposal and VITALOGISTICS became a client. Al then drafted an engagement letter that was mailed to the chairman of the client's audit committee. The engagement letter clearly set forth the arrangements concerning the predecessor auditor, the fees, and the timing of the engagement.

### PLANNING PHASE

With the engagement set, Al's first task was to assemble the engagement team for the 20X4 audit. The team included Andy (engagement partner, billing rate of \$500 per hour), Al (as the manager, billing rate of \$350 per hour), another younger manager (who bills at a respectable \$250 per hour), 3 seniors (billing between \$150 and \$175), 4 associates (billing at \$100 per hour) and 3 interns (who bill at \$50 per hour). Ace Fritz, another

manager in the office, was considered for the engagement but was eventually left off the team when AI discovered that Ace, a member of the office's Quality Control Team, owned 5,000 shares of VITALOGISTICS's stock bequeathed to him by his grandfather.

The team held a planning meeting in February 20X4 and made various audit decisions. First, the team decided that overall audit risk should be set at moderate (the audit firm uses a three-point scale [Low, Moderate, High] to assess audit risk). This assessment was primarily based on the company's strong earnings history and a conversation with the CFO, who promised to cooperate with the audit staff in making available all relevant information in a timely manner. The team set planning materiality for the financial statements as a whole at \$4 million, which was based on 5 percent of annualized net income.

Although the audit plan was to understand and test controls over all significant accounts, the team concluded that detailed testing of all significant balances was still necessary. This conclusion was based, in part, on KVPI's lack of prior experience with VITALOGISTICS. It was also based on the discussions with the predecessor auditor, who suggested that controls were not well designed or operating effectively. Further, because the substantive detailed approach had proven to be efficient for the MaxPar engagement, the team reasoned that the same substantive approach should be used. Therefore, a senior associate was asked to "import" the audit program for MaxPar into the working papers set up for VITALOGISTICS. This "import" exercise was flawlessly executed and replicated to each team member's laptop. The engagement itself was conducted over three phases: (1) interim activities; (2) year-end activities; and (3) post-year-end activities.

### **INTERIM WORK**

Interim fieldwork commenced in August 20X4 and continued through October 20X4. During this phase, the team identified and disposed of several issues.

The client leased certain hardware to select customers. Such leasing transactions represented approximately 10 percent of total revenue and 20 percent of pre-tax income. Revenue from these transactions was determined from a complex lease accounting macro written within a spreadsheet. The spreadsheet was not password-protected; however, data for all new transactions entered into the lease accounting spreadsheet were reviewed by the leasing revenue manager. On the termination of a lease, the leasing revenue manager verified that the transaction had been removed from the spreadsheet. The CFO reviewed leasing revenues and margins monthly and investigated variances from expected results. The interim audit did not identify any error in this area.

The client plans to introduce a new version of its PC Tablet to the market in 20X5. This hardware will allow users to use a pen-like instrument to input and access information on a computer, thereby making the pencil, pen, and exercise book antiquated. The client has entered into a marketing agreement that would make InfoC the exclusive distributor of this product. Under this agreement, InfoC would use its existing telemarketing facilities and other retail channels to sell the PC Tablet. The marketing rights have been assessed at \$50 million, which InfoC considers reasonable, and has promised to pay as the products are sold. InfoC has been very successful in marketing for the resort industry, but has no experience in the PC Tablet market. Because the audit team was able to successfully confirm these terms with InfoC, the \$50 million was included in the current year's (i.e., 20X4) revenue.

On August 18, 20X4, the client entered into a \$240 Million Senior Secured Credit Facility with a new group of lenders. The \$240 Million Senior Secured Credit Facility consisted of a maximum availability of \$190.0 million and a term loan of \$50.0 million,

with all borrowings to mature on August 18, 20X7. The Credit Facility includes both a subjective acceleration clause and a lockbox arrangement, which requires all lockbox receipts from the client's customers be used to repay revolving credit borrowings. After reviewing this transaction, the audit team concurred with the client that the facility should be classified as a long-term debt on the year-end financial statements. This concurrence was based on the debt's maturity date and the subjectivity of the accelerated clause.

Two years ago, the client leased an asset from a lessor in Texas. In the current year (i.e., 20X4), that asset was sold to another company owned by Roger Martin, a savvy industrialist who sits on various boards, including the VITALOGISTICS board. Under the terms of the sale, Martin's company will make the lease payments directly to the lessor. As a condition of sale, VITALOGISTICS has also agreed to guarantee the obligations assumed by Martin. A \$5M profit on this sale transaction is included in 20X4's (i.e., current year's) revenue. Martin is current with all lease payments to date, and the firm concluded that there is a high likelihood that these payments will continue.

### YEAR-END AUDIT WORK

At year-end, an associate was assigned to test the validity of the receivables from end-users. The terms of those sales are 45 days same as cash. That is, customers can defer payment for 45 days and still pay the sales price. As of December 31, 20X4, there are about 500 customers under this program who still owe, with an expected collection of \$3 million. The associate selected a sample of customers whose invoices totaled \$600,000 and sent them confirmations. The returned confirmations revealed a difference of only \$30,000. Since tolerable misstatement for this sample application was \$170,000 and no misstatements were expected, the associate concluded that the end-user receivable balance was fairly stated and properly noted that there was a 5 percent risk of incorrect acceptance. This work was reviewed by a senior, who concluded that no further work was needed.

A material portion of receivables is attributed to credit sales to Canadian customers. Because the receivables from the Canadian customers were evaluated as presenting an unusually high risk, one of the seniors was assigned to that section of the audit. The senior reasoned that the high level of risk required the use of negative confirmations. She sent a sample of negative confirmations using the firm's sampling guide. Based on the responses that she received (only small exceptions noted), she concluded that the Canadian receivables existed.

Vendor rebates are an important source of revenue for VITALOGISTICS. Typically, a vendor offers VITALOGISTICS a rebate of a specified amount of cash or other consideration that is payable only if VITALOGISTICS completes a specified cumulative level of purchases or remains a customer for a specified period of time. VITALOGISTICS is entitled to a rebate from one of its vendors in the amount of \$5M. Because VITALOGISTICS has met the condition to receive the rebate, the rebate was included in the Trade Accounts Receivable.

In February 20X5 (i.e., the next period), a significant lawsuit was initiated against VITALOGISTICS. The plaintiff asked for \$100 million in damages. The CEO told Andy, the partner, that the suit was frivolous and did not warrant any audit attention. The company's senior legal counsel seemed to concur and their legal opinion stated the chances of recovery by plaintiff are less than probable. Based on these assurances, Andy instructed the team not to document any lawsuit-related items in the 20X4 working papers.

The fieldwork was completed on March 15, 20X5, in time for KVPI to issue unqualified reports on the company's 20X4 Internal Control over Financial Reporting as well as the

Financial Statements. Carl, the CEO, was pleased with the quality of the audit, instructed the CFO to pay the service fees, and commended Andy for providing a high-quality engagement.

The engagement team planned to celebrate the 20X4 audit on May 15, 20X5. No sooner had the celebration started than Andy Card, the engagement partner, walked in and gave them the news that VITALOGISTICS's revenue for 20X4 was misstated by \$85 million (arising from revenue booked on consignment sales). Andy discovered this problem from the Director of Internal Audit and confirmed the existence and magnitude of the misstatement from the Controller.

## REQUIREMENTS

In addressing the questions below, consult the relevant professional standards of auditing and financial reporting. Unless specifically mentioned, assume that standard required audit procedures were completed. Your instructor will identify the requirements you are assigned to complete.

### Client Acceptance

1. Did KPVI's client-acceptance process follow the applicable standards and regulations? Evaluate the engagement letter in light of the decision in the *1136 Tenants' case (1136 Tenants' Corp. v. Max Rothenberg & Co., 36 A.D.2d 804, N.Y. App. Div. 1971)*.
2. Identify and discuss the pressures faced by Andy Card, the audit partner. How might those pressures affect the decision to accept the client and the performance of the audit?
3. Ace Fritz, an audit manager in the office, was left off the audit team because he owned 5,000 shares of VITALOGISTICS stock. Is KPVI required to disqualify Ace? How does the analysis change if you assume Ace was (a) a partner? (b) an associate?

### Planning Phase

4. At the team planning meeting in February 20X4, the audit team set overall audit risk at moderate and concluded that detailed testing of all significant balances was still necessary. Identify and evaluate the factors relevant to these decisions. Explain why you agree or disagree with the decisions made.

### Interim Work

5. Evaluate the audit team's consideration of the password protection for lease revenue. How does the analysis change if you assume that VITALOGISTICS is a private company?
6. InfoC, an external source, confirmed the terms of the marketing agreement. Generally, evidence coming from external sources tends to be more persuasive than evidence coming from sources within the company. Therefore, the confirmation from InfoC provides persuasive evidence that the transaction was properly recognized in 20X4 financial statements. Explain why you agree or disagree with this conclusion.
7. Do you agree that the Secured Credit Facility should be classified as long-term debt? Provide support for your answer.
8. Evaluate the accounting for the sale of the asset to Roger Martin.

**Year-End Audit Work**

9. At year-end, VITALOGISTICS has three types of receivables outstanding: (a) receivables from end-users, (b) the Canadian receivables, and (c) vendor receivables. Evaluate KPVI's approach to auditing each of these receivables.
10. Evaluate KPVI's handling of issues arising subsequent to year-end and its reporting choices.



## CASE LEARNING OBJECTIVES, IMPLEMENTATION GUIDANCE, AND OUTCOME ASSESSMENT

### Case Learning Objectives

The case raises issues in the client acceptance, planning, execution, and reporting phases of an Integrated Audit. Along the way, students are challenged to analyze financial reporting issues, sampling decisions, and control matters. Some of the issues in the case were excerpted from the PCAOB 2003 limited inspection reports for the major auditing firms (PCAOB 2004) and past SEC enforcement actions (these are identified in the Teaching Notes). In this vein, the case can be a valuable tool for bringing these contemporary problems to the classroom. The case is not meant to portray auditors as having a high propensity to do substandard work; rather, it illustrates some of the problems that have been found by the SEC (via enforcement releases) or the PCAOB (via inspection reports) on a few audits out of the numerous engagements that take place. Just as the training of pilots emphasizes distress situations, which tend to be rare but fatal, here we also emphasize those rare situations that have troubled auditors in the past. The case has the following specific learning objectives:

1. To enhance students' research abilities in searching through auditing and financial accounting standards to address issues. This case requires students to research and determine guidance from professional standards. These research skills are extremely important in practice. The case seeks to show the close connection between financial reporting and auditing by asking students to focus both on the adequacy of financial reporting choices and the competence of audit procedures.
2. To provide insights on practice development issues and conflicting pressures faced by auditors (e.g., client acceptance and partner compensation). This insight should allow students to better understand the factors to consider (and their sources) prior to accepting a prospective client as well as how these factors flow into subsequent planning decisions. Students also learn about the importance of a systematic approach to evaluating independence of audit team members and should help them spot potential independence violations.
3. To provide a setting for the students to consider the impact of financial statement errors and control weaknesses on the opinion on Internal Controls over Financial Reporting. The case allows the students to identify the various reporting requirements under the Integrated Audit and the conditions under which they are triggered. Students who complete the case should be able to distinguish among material weaknesses, significant deficiency, and control deficiencies, and better appreciate the linkage between control weaknesses and financial statement errors. Students should also appreciate the differences between evaluation of controls under an Integrated Audit and a traditional audit of financial statements (e.g., for a private company).
4. To provide students with an opportunity to integrate their knowledge of diverse topics encountered during the auditing class in an engagement setting. When various auditing topics are covered in a typical auditing class, they often appear to be independent. Therefore, the first learning objective is valuable in helping students to integrate and synthesize topics, which are, in actuality, interdependent or co-exist in audit practice.
5. To improve students' abilities to identify relevant problems and unresolved issues. Identifying relevant problems is a critical audit skill for entry-level auditors (American Institute of Certified Public Accountants [AICPA] 1999). The Accounting Education Change Commission (AECC 1990, 1992) also concluded that the accounting curriculum

should enable students to analyze and solve unstructured problems. In many textbooks, problems are structured for the students, masking the reality that defining (or identifying) a problem is often the most important part to arriving at a solution. VITALOGISTICS has many embedded issues, but students must struggle to identify them, especially if the instructor assigns the case and asks the students to identify the relevant audit issues (see the “Implementation Guidance” section, and the Teaching Notes, “Alternative Use of Case”). Even when specific questions are assigned, we have designed those questions to require the students to analyze and synthesize a complex fact pattern.

### **Implementation Guidance**

The case can serve a variety of purposes. For instance, based on our extensive background in teaching auditing and experiences using the case, we believe it could be used as a discussion tool in either an undergraduate or graduate auditing class. The case is designed to be flexible in its uses. The instructor who uses the case in the undergraduate curriculum has various options. One option is to assign requirements of the case as the topics are covered in class. Another approach is to use the case toward the end of the class, where the case can serve as an effective tool to tie the semester’s material together. The instructor can then ask students to identify and evaluate the issues raised by the 20X4 VITALOGISTICS audit or perhaps direct students to assume the role of a PCAOB Inspection Team and write the inspection report based on the VITALOGISTICS audit. In a graduate second-level auditing class, the case can be used early in the semester to review fundamental concepts of auditing and to serve as a springboard for a more detailed analysis of the concepts. There are enough issues involved in the case that we recommend a minimum of two hours of class discussion time.

In both classes, we recommend that the case be assigned a few weeks in advance of the class discussion. The instructor may challenge the students to identify their own sources of research. This approach is recommended for the graduate class. Alternatively, the instructor may give the students a guide on the sources of relevant professional standards. This approach may be necessary in an undergraduate class if the students have not had a course on research techniques. The Teaching Notes provide a list of relevant sources. Alternatively, the case can be used as a take-home examination. Outcome assessment data are provided in the next section where the case was used as an individual assignment. However, we believe the case may also work well as a group project.

### **Classroom Experiences with Using the Case**

One of the coauthors used the case during the Spring 2005 semester as a discussion tool in the last week of a graduate auditing class. This was the first auditing course for students enrolled in the Master of Science in Accounting program. Students were required to provide an individual written response to the case, followed by a class discussion. Students were called upon randomly to discuss their findings.

The case counted as 5 percent of the overall semester grade. Grading of the case was based on the thoroughness of responses vis-à-vis the issues identified in the Teaching Notes. Collectively, the students did an excellent job in identifying the relevant issues in the case. Overall, students did competent research and a good job in identifying the issues in the case. However, further discussion (see the Teaching Notes) was needed to clarify the following matters:



- Independence (Who are “covered” persons under SEC and AICPA guidance?);
- Substantive testing (How does the performance of an Integrated Audit affect the level of substantive testing?);
- Sale of the leased asset (students had difficulty understanding the substance of the transaction);
- Allowance for sampling risk (students had difficulty understanding how the allowance will be booked);
- Documentation requirements related to the February lawsuit (What exactly should be documented and why?); and
- Auditor responsibilities for subsequent discovery of facts (students had difficulties distinguishing this from subsequent events and/or did not fully appreciate auditors’ responsibilities after the issuance of the audit report).

Although class experiences may vary, instructors should be aware of these potential difficulties. The Teaching Notes provide additional discussions of these issues and the prompts used to assuage students’ difficulties.

### Outcome Assessment

Students’ feedback of their experiences is described in Table 1. As shown, on a seven-point scale from strongly disagree (1) to strongly agree (7), for 10 of the 11 questions the means were 5 or 6, indicating strong positive perceptions by students. The final question

**TABLE 1**  
**Feedback from Students**  
(n = 27)

<u>Question</u>	<u>Mean</u>	<u>Median</u>	<u>Mode</u>
I have a better understanding of the audit process.	5.41	6	6
I better understand when and why auditors who may not be involved in the audit have to be independent of the client.	5.30	6	6
I better understand the importance of client acceptance.	5.81	6	6
I better understand how a partner’s compensation can lead him to accept risky clients.	5.37	6	6
I better understand why I must contact various sources when evaluating a client.	5.67	6	6
I better appreciate the risks involved in using an existing program for another client.	5.41	6	6
I have a better understanding of how information imported from spreadsheet information poses a control risk.	5.33	5	5
I have a better understanding of the differences between a material weakness and a significant deficiency.	4.63	5	5,6
I have a better understanding of subsequent events and how it impacts the audit.	5.48	6	6
I have a better understanding of the auditor’s role when facts are discovered subsequent to the issuance of the audit report.	5.48	6	6
Overall, I found the case to be a valuable learning experience.	5.70	6	6

Response scale: Strongly disagree = 1 to Strongly Agree = 7.

asks whether, overall, students found the case to be a valuable learning experience. Nearly three-quarters (74 percent) indicated strong agreement (6 or 7 on the scale).

### TEACHING NOTES

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