The viccio and martin audit controversy case

Finance

FACTS

Viccio & Martin, an accounting firm tangled up in an audit discrepancy problem with its largest client, Models. Inc. Jane Ashley a newly hired staff accountant of Viccio & Martin, on her first assignment of auditing the client company's Accounts Payable Cut-Off, discovered an audit-related issue involving her senior accountant, Frankie Small. During the year-end date inventory count, Frankie Small together with a coop-student did not exercise correct auditing procedures. The two audit staffs were only present to observe inventory count in one of the company's three warehouses, and instead based audits on the other two remaining warehouses in an statistical samples provided by the company, without even reviewing the accuracy of the company's inventory management system.

Further, Jane, on her review of the company's financial reports found out that the company's inventory documents were messy and disorganized, and the inventory section of the reports were hard to interpret. While conducting audit on the client company's accounts payable records, she had found out that many of its invoices were unrecorded on its accounts payable master ledger. After auditing both recorded and unrecorded invoices, she reported an estimated $400, 000 cut-off problem. When she brought this problem to Frankie and Mr. Viccio, the firm engaged in many discussions with Mrs, Hyst, the head manager and 50% shareholder of Models, Inc.

While the re-audit is going on, the auditors reported a loss of $150, 000, in contrast to a reported healthy profit of $150, 000 prior to the controversy. As a response, Models Inc, under representation of Mrs. Hyst, give suspicious claims to the auditors. Mrs. Hyst submitted a new listing to the auditors showing inventories amounting to $200, 000 stored in other locations which she claimed left-out of count during the year-end date inventory count. After investigating the list, the auditors found no concrete evidences for the claim.

Mrs. Hyst again showed and explained that their suppliers would not extend them more credit, and their bank loan of $1 million would be called if such loss will be reported. After series of discussions, Mr. Viccio decided that to solve the case, they must help the client. An amount of $150, 000 would be added back to inventory, and be subtracted from the cost of goods sold. Jane knowing the real value of the audit, was astonished with the decision, and is determined to perform adequate measures to give justice to the case.

RELEVANT ISSUES

Based on thorough analysis of the case, and of conducting reviews on relevant accounting standards from the American Institute of Certified Public Accountants online site and other auditing guidelines, these issues must be given utmost attention.

“ Failureto Comply correct Auditing Procedure during the Year-end Inventory audit”

Frankie Small’s auditing procedure is questionable under the Auditing Standards (AU) Section 331, titled “ Inventories”. Based on Frankie’s statement, he confirmed that audit staffs were only present to observe the inventory count in the Windsor warehouse. No audit staffs were present in Toronto warehouse and Michigan drop-off point, but instead based his audit reports on statistical sampling provided by the company for the two locations. Under the circumstances described, utilizing the company’s statistical sampling of previous inventories is not in accordance to the paragraph 10 of AU Section 331.

The paragraph permits the use of “ statistical sampling” provided that the auditor satisfies himself that the client’s procedures or methods are sufficiently reliable, and in case required, the auditor must be present to observe the count to ensure the effectiveness of the counting procedures used (The American Institute of Certified Public Accountants (AICPA), 2008, AU Section 331, p. 10).

The absense of audit staffs during the inventory count in Toronto warehouse and michigan drop off point is a contributing factor to the controversy. If audit staffs had been responsible with their works, the discrepancy would have been discovered earlier.

Adding the amount of $150, 000 back to inventory is an Unlawful decision

After series of discussions with the client, Mr. Viccio’s decided to help the company and cover up the discrepancy. Mr. Viccio will hide the identified losses by adding the amount of $150, 000 back to inventory. However, the auditors failed to verify the actual existence of the said inventory after conducting investigations with the locations found on the list provided by the client. Therefore it would be unjustifiable to add the amount back to inventory.

The act would fail to comply the “ Ingredients of Reliability“ of SFAC 2, titled “ Qualitative characteristics of Accounting Information” which says, that accounting information should be able to represent what it purport to represent (CPA Class Website). Since no actual evidences can be found on the said amount of inventory, the decision to add it back to inventory is generally unacceptable.

Further, the decision would breach of the Auditing Standards (AU) section 110, titled the “ Responsibilities and Functions of the Independent Auditor”. The section’s first paragraph requires preparation of financial reports by independent auditors to observe fairness, and conformity with the generally accepted accounting principles:

“ The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles… (The American Institute of Certified Public Accountants (AICPA), 2008, Section 110, p. 1). “

Its second paragraph further places theresponsibilityof ensuring that financial statements are free of material misstatement whether caused by error or fraud to the independent auditor (The American Institute of Certified Public Accountants (AICPA), 2008, Section 110, p. 2).

The decision would also breach the Auditing Standards (AU) Section 220 titled “ Independence”. Its first paragraph says:

“ The auditor must maintain independence in mental attitude in all matters relating to the audit (The American Institute of Certified Public Accountants (AICPA), 2008, AU 220, p. 1)”

The standard requires the auditor to be independent, and free from bias to keep the impartiality which dictates the dependability of his findings as an obligation not only to management and owners of the business, but also to its creditors and to those who rely on auditor's report (p. 2), and to maintain the confidence of the general public to the profession (The American Institute of Certified Public Accountants (AICPA), 2008, AU 220, p. 3.)

Models Inc.'s discrepancy in Record Keeping and Accounting Procedure

Models Inc.'s manner of recording its accounts payables invoices are not in accordance to the Accounts Payable Recognition rules. According to Section A3. 2. 2, recognition of accounts payables are made when goods or services are invoiced or received (Northern Territory Government Australia, 2006). During the auditing procedure, many invoices were found unrecorded for unknown reasons.

Further, the manner of recording its inventories is unsystematic. Even though, the company is using the periodic inventory system, under such condition, the company is still required to keep working papers properly organized, and ensure inventory management policies are well observed during the in and out of inventories. Under this circumstances, the complexity of auditing inventories has been intensified due to the company's poor inventory system.

Under such condition, the company failed to ensure that every information of particular value to their operation must be " useful for decision making" stated under SFAC 2, titled " Qualitative characteristics of Accounting Information" which requires that submitted information be " Relevance and Reliable" for it to be able to make a difference in decision making (CPA Class Website).

Mrs. Hyst Fraudulent claims

According to US GAAP, Inventory refers to tangible properties (CPA Class Website), and is having significant value for proper determination of operating income (CPA Class Website). The Auditors found that Mrs. Hyst's claims pertaining to the amount of inventories which according to her were left-out of count during the year-end date is impossible to trace. No evidence were found on goods in transit, also in goods stored in other locations, therefore, based on GAAP definitions, those items can't be included in inventory. If the claimed amount of $150, 000 are added back to inventory, it can be considered a fraudulent act.

Fraudulent Financial Reports

The Syrbanes-Oxley Act of 2002 Section 7421 requires that financial reports be free from false statements or omitted facts necessary to fairly present the financial condition and results of operation of the issuer (Securities and Exchange Commission, 2008). Fraudulent financial reporting is a violation of Section 17(b) of Securities Act. The paragraph prohibits the obtainment ofmoneyor property through false or misleading statements (The University of Cincinnati College of Law).

The company as a going concern and the Full disclosure Policy

For the welfare of the company's creditors and investors, auditors should ensure every information appearing on the company's financial reports after the audit are free from errors and is not bias. The company as a going concern always requires sufficient funds to conduct its operation. It is understood in the case, that the company's bank is already questioning its operating loan, for it was observed that the amount was increasing.

And also, its suppliers are also having hesitations of extending them more credit. It is very apparent that the management of Models Inc. are aware of their financial position. The loss figure of $150, 000 will have significant value for the company's investors and creditors. It may indicate that the business could no longer afford to pay its debt if it should incur further debts. Or it may also dictate that it already needs to liquidate its assets to pay its creditors.

The purpose of full disclosure act in accounting is to foster investor's confidence, inhibit fraud in public offering, trading, voting, and tendering of securities (Securities and Exchange Commission). Therefore, it is entrusted to the auditors of the client company to observe full disclosure for its financial reports. Investors, suppliers and the bank extending credit or funds to the company are entitled to know its real financial position. The audited financial report, if religiously based on all accounting standards will be very useful in decision making purposes for all of its creditors and investors.

ALTERNATIVE COURSES OF ACTION

1. *Seek Legal counsel then schedule a meeting with other people involve while discussing legal issues.*

The case tackles legal issues and therefore, in any case, can be further understood in the presence of legal counsel. During consultation with an expert, it is of utmost importance not to disclose any confidential information about the client. The consultation can be generalized to cover up all related cases. After the consultation, Jane needs to schedule a meeting involving the client, Mr. Viccio, and Frankie to discuss the legal issues present in the case.

1. *Follow Mr. Viccio's decision because he is the superior*

The case doesn't call for superiority status, but of integrity of profession. It would be unlawful to pursue the decision. Based on the auditing standards stated above, manipulating the financial report to cover the client's discrepancies can place both the firm and the client in a serious situation. First, the firm places its integrity at stake and can be in danger of losing the general public's confidence.

Second, the client can further place itself in an unhealthy situation in case it'll fail to cover up the problems challenging its operation. If the client can hide its real condition and further extend credits from suppliers and acquire additional loan from the bank, it would further put their liquidity at risk. Creditors will in turn found out in the near future about the problem and blame the firm for releasing fraudulent audit reports.

BEST COURSE OF ACTION

Seek Legal Counsel

Under the circumstances stated in the case, to free both parties from further risks, the situation can be further understood by seeking a legal counsel. To cover up the discrepancy by creative accounting practice, as according to the initial decision of Mr. Viccio, would place both parties in serious situations in the end. Sticking with the Auditing standards is of utmost importance in all auditing issues.

Auditing Standards section 110 requires auditors to observe generally accepted accounting procedures at all times (The American Institute of Certified Public Accountants (AICPA), 2008, AU section 110, p. 1). This also preserves the independence of the auditor in conducting audit works to maintain the confidence of the general public to the profession (The American Institute of Certified Public Accountants (AICPA), 2008, AU 220, p. 3).

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