X Company – Is Audit Work Justified?

X Company is now a TSX listed company. In its the first three years of operations of its traditional call center business, it did well by industry standards. With revenues approaching $ 27 Million dollars and a gross profit margin of $10 million, its gross margin was in line with industry standards. However, because of its rapid expansion and investment in high tech call center equipment and software, its depreciation and amortization costs as well as marketing and administrative costs are currently much higher than industry standards. The result has been a continuing loss of about $1.7 million on an annual basis for the last three years of operation.

X Company has adequate equity having done a well-financed take-over of another call center four years ago as part of its expansion plans. That acquired company had significant structured debt, and its client base had added diversification and the ability to serve multi-national corporations on a breadth of services that allowed for one stop shopping for outsourced customer contact services, including social media marketing, customer service follow up, technical services for software products, and customer survey services in a multi-language and cultural environment.

While the equity allocated for the continuing business remained sufficient, at $15 million, the continuing losses and the need for continuing investment in technology meant that more prudent spending was necessary. X Company needed to focus on profitability and selecting the right cost cutting strategies.

To satisfy X Company's directors and its bankers, the auditors were asked for their observations for operational improvements and cost savings measures for improved profitability. The auditors immediately focused on revenue recognition, billings and collections as being an area for immediate improvement. An analysis of this area produced the following information about operations:

- Clients signed formal contracts in consultation with the company. A detailed two-day study was conducted for new each contract to determine how long each call should take, when a call should be escalated to a supervisor, and the number of calls an operator could handle per hour. Once the parameters were established, a cost per call could be established for the average operator and a corresponding revenue rate could be established with the customer for the services to be provided. The rate of course had to be compared to competitive market rates and agreed with the customer.
- The company's software monitoring system kept the following statistics on each operator:
    - Number of calls answered per hour and the service level provided.
    - Number of calls "dropped" by each operator including transfers to a new operator if not answered on the fourth ring.

- The number of “transferred” calls to other operators for language accommodation and the language connected. (This was later operationalized using customer selection.)
    - The length of each call was monitored for billing purposes
    - Each call was recorded by the system for follow up, if required, for service level, courtesy and as proof of billing.
    - As call centers go, this system was one of the most sophisticated, efficient, multi-purposes systems available to the market in North America.
- The terms of trade with suppliers were as follows:
    - Accounts were billed within 5 business days of the month end based upon the system statistics. Detailed statistics accompanied each billing.
    - Accounts were due within 20 business days of electronic billing.
    - Billing disputes had to be raised within 60 days of invoicing date or the account was considered to be final, by agreement.
    - Call records of billings were available for customer audit review for a 90-day period after each billing. In actual fact the records were available for a minimum of 120 days, maximum 150 days, and would be archived longer in the event of a challenge. Destruction was mutually agreed with the customer but could be for a longer period at an additional price or server costs etc.
    - Reviews of the two-day contract study period could be requested 3 times during the contract period by either party at that party’s expense. The contract period was usually a minimum of 1 year or additional set-up costs were negotiated at the start of the contract.

Other areas of operations were also challenged such as:

- Sales costs related to each new contract
- Set up costs for new contracts in relation to fees and hourly rates charged.
- Location and operation cost in relationship to other costs such as availability of multi-lingual staff, staff costs etc.
- All other costs were challenged including supplies of service such as legal, audit, security verification services, technical advisors. Etc.

When the review was finished each of the outside contractors used by the corporation received a “request for Proposal” for continuing their services for the following year including terms, conditions and anticipated billings. The auditors were included in this process. The auditors put forward a fee proposal of $750,000 which was equivalent to the fee charged in the current year. When their proposed fee was challenged based upon the size of the organization, it was defended on the basis that:

- To verify revenue recorded and to determine if revenue was being over-billed and subject to a reserve requirement or if revenue was being lost, statistical samples of about 480 calls had to be taken covering the full 12-month period. Calls had to be listened to, length determined, repriced for revenue, traced to the daily summaries and to the actual monthly billings. (Total 13 weeks of work for 4 people because of the time required to do the call selection and locate the computerized voice recordings and analyses them for time spent, quality control and content accuracy).

- Pricing of the call had to be compared to the "normal" billing for such a call to determine if revenue was being over billed or under billed and the result statistically analyzed for the impact on the financial statements. (2 weeks for 3 people)
- Cost of service, i.e. The payroll costs had to be verified on detailed basis including additions and terminations, hours worked per person to the personnel records and a detailed build up the largest expense of the business completed. (2 weeks for 3 people)
- Confirmational audits had to be performed on software acquisitions and the related amortization costs.
- A complete audit of executive compensation was also required including review of Compensation Committee documents.
- Comparisons of overhead costs to new contract generation had to be analyzed.
- Compliance with CPAP recommendations were also being referred to in the scope of work.
- Additional costs included: Partner review, Senior quality control and second partner review, tax review Plus administrative costs including CPAB fees.

As a result of concerns with the explanation provided and the absolute quantum of the fees involved, the audit services and all other professional and outside services were put out to tender with a detailed description of the fee quote to be provided, along with detailed descriptions of the audit approach. The request was made of 3 of the incumbent auditors' closest competitors. The result was a fee quote from two comparable firms of $250,000 and $295,000 respectively. The third firm chose not to quote based on the technical expertise required. Based on the fee quote accepted, the result was a reduction in outsider serve costs of $1.2 million of which the audit fee reduction was $ 0.5. Other administrative costs were reduced by $1.3 million resulting in a stunning $ 0.8 profit after analysis.

Questions:

1. Was the auditors' approach reasonable? Why and why not?
2. Is there evidence of runaway skepticism? What was the evidence?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.