**Smackey Dog Foods Inc.—Scenario Summary**

Smackey Dog Foods Inc. started in the kitchen of Sarah, Kim, and Jillian’s family home in the suburbs of Chicago. The three sisters initially bought the ingredients for their natural dog food recipes from the local grocery store. They used their dogs and the neighborhood dogs as their taste testers. Their dog food products were so good, the local kennels and veterinary offices were glad to distribute the sisters' products to their customers.

Local demand increased significantly. Local pet stores and small grocery stores discovered the products and became distributors. The sisters moved the expanding business into a larger facility and hired a few more workers. Although their competitors’ sales were flat or declining, Smackey Dog Food Inc.’s sales were on a vertical climb!

Sales were so good last year that the sisters opened a boutique division named Best Boy Gourmet, specializing in freshly manufactured, one-serving packages meant for consumption no later than 3 days after production. They sell this product at three times the cost of their other products and by special order only through their new website. Demand is high, but waste has been an issue.

Sarah is the president and general manager of the operation. Sarah has been very proactive in growing the business. She has met with her banker to discuss expanding the facilities and equipment with another $150,000 loan. Their first loan for $150,000 was secured by the industrial-size food production equipment purchased with the loan. The banker now demands an audit of the corporate financial statements before releasing another loan to the company. Sarah has offered to place the corporate account receivables up as collateral to secure the second loan. Based on revenue projections by her sister Jillian’s sales team, Sarah believes that the company will not have trouble paying down the loan in a short period of time.

Kim manages the production operations. She oversees the inventory, production, and shipment of dog food products. The Best Boy Gourmet line has taken almost all of her attention lately. The winter holidays are approaching, and sales demand based on forecasts from the sales force are higher than ever. Attaining fresh, raw ingredients is more difficult in the winter months. If any of the fresh ingredients are delayed, production comes to a standstill. There has been significant inventory waste as a result.

Kim’s assistant, Henry, monitors the production and shipment of Smackey Dog Food’s regular line of product. Henry takes pride in his work and is involved in every facet of the operation. With only one other warehouse employee to help, Henry personally is involved in preparing and approving all inventory records. Henry ensures that very little finished inventory sits in the warehouse. However, the shipping dock always seems to be full of returned dog food that should be restocked. When Kim asks him about it, Henry laughs and tells her that "first in, first out" applies to dog food returns as well. Kim smiles and just accepts that answer.

Jillian is not very good at understanding accounting. The sisters placed Jillian in charge of sales. She manages a sales team of 12 salesmen in Illinois, Indiana, and Wisconsin. Her fear of flying and poor driving skills limit her ability to get around to the areas outside of Chicago. As a result, she has placed a lot of faith in her sales team. The sales team complained last year that they did not like waiting for their commissions until after bookkeeping calculated the actual revenues. In order to keep their spirits fired up, Jillian has her sales people project what their sales will be in the upcoming quarter, and she pays commissions in advance on those projections. The sales team loves her, and Jillian loves their approval. Jillian has noticed that the projections typically are off by 11% on average.

The employees of Smackey Dog Food Inc. all own dogs. It was a hiring requirement on the job application. One employee was fired when it was discovered she never owned a dog when she was hired. A lawsuit is pending by the fired employee.

At this time, the receivables represent 29% of the corporate assets. The Chicago retail chain Pup Stores Co. is Smackey Dog Food’s largest buyer. It alone represents 31% of overall sales and usually pays within 30 days. However, Pup Stores is facing a major lawsuit from an animal rights group. The legal fees are eating into the company's cash reserves, and it is facing some store closures.

The accounts receivable aging indicates that 38% of the receivables are 30 days or less. Twenty-two percent are 31–60 days. Twenty-one percent of the receivables are 61–90 days old. Ten percent are 90–120 days. The remaining receivables are older than 120 days. Sarah has not written off any of the receivables, nor will she.

Sales are projected to steadily grow at 16% next year if the company does not expand its facilities. With the expansion, sales are projected to rise 26%, with the most significant jump in the last quarter after expansion is completed and holiday sales pick up

You and your firm, Keller CPAs, have never audited a dog food manufacturer. Although it is late in the year to be accepting a new calendar-year-end audit, you need the work and have the time to devote to the audit before your 2-week ski vacation in February.

**Your Role**

You begin the audit process just prior to year-end by sending your audit manager, Pete, and two audit staffers, Ben and Maureen, out to the client. They spend time assessing the client and planning the audit.

During the first month of field work after year-end, Ben and Maureen note that the dog food bags piled high on the docks are marked “Returned.” One employee is seen throwing bags of the premium Best Boy Gourmet dog food into the dumpster in the morning and pulling it out and throwing it into Henry’s car during the employee lunch hour.

Pete’s new best friend, Alan, was married to Smackey Dog Food Inc.’s owner, Kim, 4 years ago. Alan is also good friends with the banker from whom Sarah is seeking the loan. Pete is unaware of the relationship. Pete has talked about some of the details of the audit to Alan over a few beers.

**Questions:**

**Q1**: Discuss how the SEC has influence (if any) over the audit of Smackey Dog Foods, Inc.

**Solution:**

The Securities and Exchange Commission does have influence on the audit of Smackey Dog Foods, Inc. The influence is through the audit standards that have to be followed in establishing the independence of auditors involved in the audit of Smackey Dog Foods, Inc.

 **Q2**: Discuss the essential activities involved in the initial planning of an audit. How do these all specifically to the Smackey Dog Food client?

**Solution:**

Planning is one of the most demanding and important aspects of an audit. A carefully planned audit increases auditor efficiency and provides greater assurance that the audit team addresses the critical issues. Auditors prepare audit planning documents that summarize client and industry background information and discuss accounting and auditing issues related to the client’s financial statements.

There are 3 major benefits from planning the audit. First, it helps the auditor in obtaining sufficient data and evidence for the situations; secondly,it helps in keeping the audit costs reasonable and lastly it helps in avoiding misunderstandings with the client.

The 8 main steps in the audit planning are:

1. Accept the client and initiate the planning

2. Understand the industry and business of the client

3. Assess the business risk of the client

4. Follow preliminary analytical procedures

5. Set materiality and measure the acceptable risk of audit and inherent risk

6. Understand the internal control system and evaluate the risk of control

7. Collect the information for assessing the risk of fraud

8. Develop the full audit plan and audit program

The auditors of Smackey Dog Food, Inc begin the audit process just prior to year-end by sending their audit manager, Pete, and two audit staffers, Ben and Maureen, out to the client. They spend time assessing the client and planning the audit. It is expected that they will perform the 8 steps above in the planning phase. What

**Q3**: Discuss the 4 stages of the audit and the major activities performed by the auditor in each phase. Give an example of how each of these specifically applies to the Smackey Dog Food, Inc audit. For instance, examine the apparent internal control weaknesses and possible negative outcome of each.

**Solution:**

The Four Phases of audit are as follows:

1. Plan and design an audit approach

As discussed in Q2, this was done prior to year-end by the auditors

2. Perform tests of controls and also substantive tests of transactions

In the case of Smackey Dog Food, Inc, there are at least two major internal control weaknesses:

a. Inadequate segregation of duties: Henry, the guy who monitors the production and shipment of the the products, has only one warehouse employee to help; moreover, he is involved in preparing and approving all inventory records. This may result in fraud and theft issues. Also, it may result in a shortage of inventory, since he is not restocking the returned products, and there is no one who can control that.

b. Insufficient control consciousness: Jillian, who is in charge of sales, and manages a sales team of 12 salesmen, has placed a lot of faith in her sales team, more than she should. Again, this may result in fraud. Specially that the salesmen get commissions on projected sales, which may lead to misrepresentation of the projected sales figure, resulting in overestimated commissions.

3. Follow analytical procedures and test of balances details

(Details not discussed in problem)

4. Perform the audit and issue an audit report

(Details not discussed in problem)

**Q4**: Describe Keller CPAs’ responsibilities related to communications regarding internal control matters. What internal controls issues do you identify?

**Solution:**

According to the Generally accepted auditing standards, auditors should communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

The following internal control issues at Smackey Dog Food, Inc. should be communicated:

1. Inadequate segregation of duties: Henry, the guy who monitors the production and shipment of the the products, has only one warehouse employee to help; moreover, he is involved in preparing and approving all inventory records. This may result in fraud and theft issues. Also, it may result in a shortage of inventory, since he is not restocking the returned products, and there is no one who can control that.
2. Insufficient control consciousness: Jillian, who is in charge of sales, and manages a sales team of 12 salesmen, has placed a lot of faith in her sales team, more than she should. Again, this may result in fraud. Specially that the salesmen get commissions on projected sales, which may lead to misrepresentation of the projected sales figure, resulting in overestimated commissions.
3. Lack of control procedures and guidelines in handling and recording accounts receivable.

**Q5**: You decide that you will address Smackey Dog Food, Inc.’s accounts receivables through confirmations. Discuss the various types of confirmations and what forms you will implement and why.

**Solution:**

The main characteristics of confirmations are receipt of evidence (oral or written), receipt from an independent third party, a response, and confirmation requested by auditor.

The audit objectives of confirmations are to test for existence, accuracy and rights. Sometimes they are also used to test cut off -ie completeness objective.

Auditors generally use two types of confirmations, negative confirmations and positive confirmations.

**Positive confirmation** letters are sent debtors to confirm the stated amount in accounts receivable. A positive confirmation is one in which the customer is required to send back a document, either confirming or disputing the account information sent to it by the auditor.

**Negative confirmation letters** are also sent to debtors. The letter asks the customers to respond to the auditor only if they find a discrepancy between their records and the information about the client company's financial records that are supplied by the auditor. If the customer agrees with the balance in the letter, it does not have to contact the auditor to confirm the supplied information. The auditor will then assume that the customer agrees with the information presented to it in the confirmation.

A negative confirmation is designed for use in situations where a client company's internal controls are already considered to be quite strong, so that the confirmation process is used as a secondary audit method for the accounts under review.

A negative confirmation does not require as much follow-up work by auditors as a positive confirmation, but is also not considered to be as high-quality a source of audit evidence as the positive confirmation, since some customers may not be bothering to send back a confirmation document, even though they have detected a discrepancy. For this reason, most auditors prefer to use positive confirmations over negative confirmations, despite the additional cost.

A negative or positive confirmation is not restricted for use with a client company's customers. They are also commonly used with suppliers to confirm small-dollar account balances. A negative confirmation is rarely used with a lender, since auditors want to be very sure about the ending debt balances reported by their clients. In this case, positive confirmations are nearly always used.

In the case of Smackey Dog Food, Inc, since the internal controls related to sales are weak, it would be best to send out positive confirmation letters to the clients.

**Q6**: What are the major factors affecting sample size for confirming accounts receivable?

**Solution:**

Factors affecting the sample size for confirming accounts receivable are:

1. Allowable misstatements
2. Inherent risk (relative size of entire receivable, total numbers of accounts, expected errors, and results of preceding years).
3. Detection risk realized form performing other tests
4. Control risk
5. Type of confirmation (negative confirmation needs a large size of samples)

**Q7**: A major issue in verifying the ending balance in property, plant and equipment is the possibility of legal encumbrances. Discuss what specific concern do you have. Describe the procedures your firm will perform to obtain evidence about existing legal encumbrances.

**Solution:**

The basic concern would be that the company will not be able to pay back the loans through which the property, plant and equipment were purchased. Specially that in the case of Smackey Dog Food, Inc, Sarah, the president and general manager of the operation has offered to place the corporate accounts receivable up as collateral to secure a second loan. The problem is that the company has bad debts and is facing lawsuits from clients; moreover, the revenue projections prepared by her sister, Jillian, who does not control her sales team well, are most probably not accurate, and it would be a risk to rely on them.

As far as the procedures that should be performed to obtain evidence about existing legal encumbrances, there are two main ones:

1. Confirmation should be sent to the lenders
2. Because the source of debts in the asset accounts is the acquisition journal, the documents backing up the transactions in the acquisition journal should be verified.

**Q8**: The client wants to know if you will be present at the year-end inventory. What is your decision and why? What role or actions will you take at the inventory if you decide to attend the inventory. Why?

**Solution:**

It is important to be present at the year-end inventory count, for two main reasons:

1. The internal controls in the production and shipment unit are very weak; accordingly, the company does not have accurate inventory records.
2. The cutoff of accounts payable at the balance sheet date requires that auditors coordinate their tests with the physical observation of inventory, in order to determine that they are created at the same time.

Actions that should be taken by us, the auditors, during the count:

* Cutoff analysis: We will examine the client’s procedures for halting any further receiving into the warehouse or shipments from it at the time of the physical inventory count, so that extraneous inventory items are excluded. We will typically test the last few receiving and shipping transactions prior to the physical count, as well as transactions immediately following it, to see if the client is properly accounting for them.
* Observe the physical inventory count: We want to be comfortable with the procedures the client uses to count the inventory. This means that we will discuss the counting procedure with the client, observe counts as they are being done, test count some of the inventory themselves and trace their counts to the amounts recorded by the company's counters, and verify that all inventory count tags were accounted for. Reconcile the inventory count to the general ledger. They will trace the valuation compiled from the physical inventory count to the company's general ledger, to verify that the counted balance was carried forward into the company's accounting records.
* Test high-value items: If there are items in the inventory that are of unusually high value, we will likely spend extra time counting them in inventory, ensuring that they are valued correctly, and tracing them into the valuation report that carries forward into the inventory balance in the general ledger.
* Test error-prone items: If there has been an error trend in prior years for specific inventory items, we will be more likely to test these items again.
* Test item costs: we need to know where purchased costs in the client’s accounting records come from, so we will compare the amounts in recent supplier invoices to the costs listed in the client’s inventory valuation.
* Inventory allowances: we will determine whether the amounts the client has recorded as allowances for obsolete inventory or scrap are adequate, based on the clients’ procedures for doing so, historical patterns, "where used" reports, and reports of inventory usage (as well as by physical observation during the physical count). If the client does not have such allowances, we may require you to create them.
* Inventory ownership: we will review purchase records to ensure that the inventory in the client’s warehouse is actually owned by the company (as opposed to customer-owned inventory or inventory on consignment from suppliers).

**Q9**: Considering the general six functions that make up the inventory and warehousing cycle for Smackey Dog Foods, Inc., identify the related documents and/or records that would be used. From your analysis of the internal controls related to the inventory and warehousing cycle of Smackey Dog Foods, Inc., what internal control weaknesses exist?

**Solution:**

The six functions are as follows:

1. Process purchase orders – purchase requisitions
2. Receive (raw) materials – inventory inspection documents
3. Store raw materials – material requisitions
4. Process the goods – job processing cost sheets
5. Store finished goods – inventory tags
6. Ship finished goods – invoices and shipping documents

The internal control weakness in the inventory area is the inadequate segregation of duties discussed previously. also, there are no specific procedures for the receipt, storage and disposal of returned dog foods.

**Q10**: Discuss if Keller CPAs or its auditors are breaching any Professional Rules of Conduct and why or why not?

**Solution:**

Yes, Keller CPAs audit manager is definitely breaching the Professional Rules of Conduct by discussing the details of the audit with his new best friend, Alan. Auditors should abide by the confidentiality rules.

**Q11**: Discuss the CPA firm’s legal liability concerns for this audit if they make a material unintentional or intentional mistake. Include any other legal liability concerns regarding possible Professional Rule violations.

**Solution:**

If the CPA firm does not uncover material misstatements which resulted in the issuance of an incorrect audit opinion results in questioning if the audit firm provided their services with due care. The ensuing legal liability depends on the extent of the damage caused.