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.

**Your Role**

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.

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.