

NAMA VENDING INDUSTRY ACCOUNTING AUDIT BEST PRACTICES

I. BACKGROUND

The service provider portion (Operators) of the Vending, Office Coffee Service (OCS) and Contract Foodservice Industry is stratified by size and geography. The vast majority of Operators are reported to have less than \$5 million in annual sales, with many being even smaller. Since most products sold are brand names and the equipment types fairly comparable, opportunities for service are based on client relationship, selling prices and a profit-sharing practice known as commissions.

II. THE PROBLEM

This is a highly competitive business with relatively low profit margins and Return on Investment. Profitability can be improved through better machine-front marketing, adjusting product mix, adjusting pricing, reducing commissions, adjusting service frequencies and reducing equipment levels. However, due to various competitive pressures, a different approach is sometimes taken. Commissions to clients are usually based on a percentage of net sales. But all the factors used in determining net sales are not always disclosed. Sometimes, a high commission rate may be offered to obtain business and sales are under-reported (sometimes as much as 25-30%!) to the client, thus paying the high rate on a lower sales base and reducing operator's cost. This practice may also be used to hide the under-reported sales from government for tax purposes. This practice can be referred to as "R-Factoring" (reduction). Without adequate disclosure to the client about which amounts will be subtracted from gross sales to obtain commissionable sales figures, use of an R-factor is a questionable practice.

The problem has been compounded because industry-specific software providers, citing demand, have built an R-Factor sub-routine into their products. This can produce legitimate-appearing reports for clients and government and more easily hide any accounting irregularities. Without specific knowledge of the problem and how to identify it, Accounting firms doing audits anyone using this practice could potentially produce a certified audit based on false information.

III. BEST PRACTICES

Working with a cross-section of Operators in the industry, NAMA has developed the following procedures that can be used to detect R-Factoring during audits. The general audit approach is one of reviewing inputs and outputs and not relying on computer produced reports; i.e. "audit around the computer".

A. Inquiry

The first step is to determine which industry accounting system is used and whether or not any adjustments are made to gross sales for commission calculation purposes or to the actual calculated commissions. Some companies freely admit the existence and use of an R-Factor, which may sometimes be thought to be necessary to legitimately reduce sales to account for spoilage, route shortages, overhead or other costs.

B. Analytical Procedures

Next, perform a top-level review of commission expenses. Take the sales by customer reports and contracts for the top customers (comprising at least 50% of total sales) and develop a weighted-average company-wide commission rate expressed as a percentage of sales. Then compare this percentage to the one on the company P&L. If the weighted-average percentage (by contract) exceeds the overall percentage (on the P&L) by any significant amount, it may indicate the existence of R-Factor usage.

C. Verification of Total Sales

The first detail audit step is to verify the total sales reported. This is generally done by comparing sales reported on the entity's profit & loss statement against banking records. If the period under audit is a full fiscal year for the entity, the extra step of agreeing sales per the P&L to the entity's federal tax return should also be performed.

D. Agreement of Sales Detail to Total Sales

Next, compare a detailed listing of sales by customer to the total sales reported by the entity. All of the commonly used vending accounting systems have the capability to summarize sales by customer. If these two steps disclose no errors or irregularities, it may be reasonably safe to proceed under the assumption that both the total sales and sales by customer amounts are correct. The next set of steps is designed to review the actual commission calculations. Select a sample of customers to review. Since experience indicates that R-Factors may be employed against any type of customer, pick a sample of customers comprising all elements of the sales volume spectrum. Also pick some accounts that are managed by third parties. For the period under audit, then request the contracts, sales and commission statements and cancelled commission checks for the selected customers.

E. Review of Contracts

For the selected customers, review the contracts noting commission rates by product category or machine type, payment due dates (monthly or quarterly) and any special arrangements (prepaid commissions, commission guarantees, scaled commissions, etc.). Also determine if the contract permits the customary deductions (sales tax and can/bottle deposits) or any other deductions to be made from gross sales to arrive at the commission sales base. Review the contracts to determine if there are any allowable deductions from the actual commission amounts.

F. Comparison of Contracts to Statements

Next, compare the terms of the contracts to the commission statements generated by the accounting system. The statements are first checked for mathematical accuracy and then are recalculated to ensure that contractual rates are being used. The statements are then reviewed to make certain that only the allowable deductions are being made from the gross sales to arrive at the commission sales base and/or that only allowable deductions are made from actual commission amounts. The deductions for sales tax and can/bottle deposits should be reviewed to ensure that the proper tax/deposit rates are being used and that only items subject to them have the deductions.

G. Comparison of Statements to Customer Gross Sales

This is the crux of the testing. Having already identified the gross sales by customer above along with successfully verifying total gross sales for the entity, compare the gross sales per the commission statements to the gross sales reported for the customer. This is done by manually totaling the gross sales per the commission statements. If the total sales per the commission statements do not agree to the total sales reported for the customer for the period under audit, the existence of an inappropriate R-Factor may be indicated. This is because the R-Factor module in most of the existing accounting systems reduces gross sales reported for the customer and only reports the lowered number on the commission statements. This allows the entity to show the true sales on their P&L while showing the customer a computer-generated commission statement which is mathematically accurate and agrees to the

commission check. Of course, the sales reported to the customer are lower than those reported on the P&L.

H. Review of Cancelled Checks

Next review the cancelled commission checks for the period under audit. The purpose is twofold. It is necessary to ensure that the commission checks agree to the commission statements and to make sure that the customers have been receiving their commission checks in a timely manner.

I. Sub-Contractor Sales

Many vending companies are sub-contracting some portion of their services to third parties. Where this occurs, manually review the sales statements provided by the third parties and then ensure that the appropriate amount of commissions are passed along to the customer. Care must be taken to ensure that commissions passed on to the customers are based on the sub-contractor's actual sales and not on the commission income received by the vending company from the sub-contractor.

J. System Concerns

Some vending companies still maintain manual accounting systems that do not rely on computerized accumulation of sales and calculation of commissions. These manual systems are easy to manipulate and there tends to be little audit trail of the manipulations. Where this situation exists, auditors must tend to rely much more on higher-level analytical procedures. Unfortunately, an audit firm may not be able satisfy themselves enough to express an opinion on the integrity of such a system and declare it to be not auditable. Where this happens, the accounting firm should issue disclaimers as to the results of the audit work that was done.

Another area of focus must be the accounting software being used. The support personnel at the various software companies may be able to give the auditors the requisite instruction and assistance to determine if the system has R-Factor capability and if the R-Factor is actually being used.

IV. CONCLUSION

NAMA believes that wide-spread communication of these procedures is in the best interests of our industry and of the accounting profession. It's said that behavior can be changed by simply knowing someone in authority knows what to look for and is watching. These procedures will help the accounting community do their job better and, as a by-product, help NAMA enhance industry professionalism and image.