Cash Intensive Businesses Audit Techniques Guide - Chapter 14 - Convenience Stores, Mini-Marts and Bodegas

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Convenience Stores Defined

Convenience stores, mini-marts and bodegas are small-sized stores that offer a limited range of grocery, drug and snack items that people are likely to need or want as a matter of convenience. Most convenience stores are located on busy street corners or in gas stations, where they can be utilized by both travelers and local residents. These stores usually allow for quicker shopping and faster check-out service. To compensate for the convenience they offer, prices are higher than at supermarkets.

Convenience stores usually open early in the mornings to accommodate early workers and commuters, and do not close until midnight or later. These hours allow commuters and other workers to stop in for breakfast. They will sell coffee in carryout cups and ready-to-go bakery items such as muffins and doughnuts. Convenience stores appeal to families who may need to replace just one or two items, such as milk, toilet paper or bread, as well as regular customers who buy lottery tickets, liquor or candy.

At lunch time students often buy cold drinks and snack foods from convenience stores. Many have microwaves for heating up prepared sandwiches, soups, and other food items they sell.

Because water, soft drinks and alcohol are the biggest selling items, there will be a long, refrigerated cooler along the back or side wall. The front counters may hold containers of candy, beef jerky, phone cards for sell, or whatever the owner thinks might be an impulse buy. Space is usually limited, so the store will not contain items that do not sell quickly.

The primary issues in the examination of a Convenience Store are:

- Unreported income,
- Handling and accounting for cash receipts,
- Cost of goods sold.

Cash and Internal Controls

Unless the serial numbers were recorded, no one can identify cash that is missing from a particular business. And, unlike checks, no one can trace who used it. For these reasons, the examiner must always ask about the procedures for handling and safeguarding cash.

A thorough understanding of how cash is handled is particularly important, so be sure to find out

- who collects the cash,
- where it is kept, and
- who reconciles it to sales at the end of the day or shift?

When cash is used to pay vendors or make purchases, the examiner must find out

- who is authorized to do this,

- what is the procedure, and
- how is it reported?

Even with weak internal controls, a taxpayer may be properly reporting income, but the only way to know this is to gather detailed information about how the business is conducted, documenting cash inflows and outflows and thoroughly interviewing the owner regarding cash receipts and expenditures.

It is important to find out who takes cash to the bank and what accounts it may be deposited into. If the same employee (or owner) who records the income and prepares the bank deposit slip also takes the cash to the bank, they could change the amount on the deposit ticket and skim some or all of the cash.

Fast food drive thru restaurants know that when cash is collected and entered by one employee at the first window, and the food is delivered by a different employee at a second window, it is less likely that food will be given away free or that cash will be stolen. Restaurants that offer a free meal if customers don't get a receipt is trying to make sure their employees record all sales in the cash register. Both of these are internal controls.

The examiner should ask the taxpayer what they do to make sure all cash is reported. If they have employees, ask what they do to make sure the employees don't steal from the business. If they can't describe the controls they have, or can't explain why there are no controls, there is probably some missing cash. If only family members are handling cash, and there is no external control in place, the cash reported may not be reliable.

The taxpayer may have a cash register, but that doesn't mean he uses it properly, so during the initial interview, ask what percentage of sales is attributed to cash compared to credit or check payments.

At the end of a shift an owner or manager will use a special key to print end of day sales reports (X report is detail tapes and Z report is summary tapes). The cash in the register will be compared to the sales on the tape.

If the taxpayer has a computerized cash register system and cannot provide the requested financial records, contact the cash register manufacturer for instructions on how to obtain the reports needed. Most programs made within the last decade can produce the essential reports.

Rarely will more than one employee use a single cash draw because the owner needs to know who is responsible for shortages and voids.

One way to hide missing cash is to report the wrong amount of cash, so it will reconcile to the register tape. This is why the person who collects cash should not count their drawer proceeds at the end of the shift.

Another way to hide missing cash is to destroy the register tapes and report only the amount "received". In this case, since the source documents are missing, an indirect method is needed to determine an accurate income.

The Role of Money Orders and other Money Transfer Systems

Money order payment instruments can be used instead of a checking account for monthly bills, catalog purchases, or loans. Western Union allows customers to send payments over the telephone or internet using credit cards, debit cards or a bank account. Using money orders or other transfer systems, such as Western Union, money can be moved between countries.

When an auditor tests gross receipts; consider money exchange schemes. Some taxpayers who sell money orders or Western Union money transfers will use unrecorded cash to purchase money orders. These can be held in a safe, taking up less space than cash, or they can be used to pay owners personal expenses, such as utilities or mortgages.

Sometimes, owners will purchase their money orders at a neighboring store and the neighboring store owner will purchase their money orders at your taxpayer's store. When money order purchases are sampled, be alert for the names of other local stores and their owners.

Techniques to consider:

- Ask the taxpayer if they store cash or pay bills with money orders.
- Ask the taxpayer if they send money orders to friends or relatives.
- Consider summonsing a taxpayer's residential utility company, Mortgage Company, auto loans, etc. to determine how personal payments are made, if they cannot be found to be paid through any known bank accounts.
- Sample money orders purchased (the taxpayer should have copies or they can be summonsed from the money order company)

Self Consumed Items

Most businesses will have items withdrawn for personal use, but it is rarely reported in the books. Remember, an owner is not likely to leave a store full of goods that were purchased at cost, to travel to a grocery store to buy those same items at retail prices.

This should be addressed during the initial interview. Taxpayers may not understand that this is not an illegal act, so the examiner should explain that these self consumed items have an effect on income. It is beneficial to the taxpayer to report items withdrawn for personal use because those costs will not be considered when a percentage markup method is used. However, the examiner should also consider the identified self consumed items as part of personal living expenses.

Ask the taxpayer to describe the situations when there will be personal use: for example, when the children get out of school they stop in and get a soda, or, approximately once a week items are taken for dinner, or, milk for home is always supplied from the store, etc. Are drinks or food consumed by the taxpayer, family or friends on the premises when they work?

Ask whether food or beverages are sometimes used for parties and events. Taxpayers will even sometimes sell their inventory goods to friends or neighbors for their parties.

If guests or friends are provided free goods from the store, a separate key will be used on the register, if the transaction is recorded.

Get all information about the use and redemption of coupons. What type of coupons are accepted (in-house or manufacturers coupons). What cash register key records coupons? What happens to the coupon (Is it stapled to the ticket? Torn and half retained? Returned to someone for reimbursement?)

Inventory Issues

There are many small business owners who say they know exactly what is in their store at any time just by looking around. These types of owners will say this is why a physical year end inventory is not necessary.

Some inventory errors occur because taxpayers take inventory at the retail price, when it should be valued at cost.

The examiner has several options on how to consider the inventory issue.

- If inventory amounts are not supported by detailed worksheets, and the examiner believes they are estimates, it would be appropriate to consider ending inventory is the same amount as beginning inventory.

- A convenience store, according to industry averages reported on Bizstats, will have 59 days sales in ending inventory. The inventory turnover ratio is 6.4, which means the entire inventory is sold out 6.4 times during the year. The gross profit percentage is 25.5%. The examiner can use these statistics to correctly calculate inventories when the taxpayer has not maintained accurate records.

- Request the taxpayer take an immediate physical inventory. When that record is supplied, sales and cost of sales reported on the tax returns can be used to back into the inventory of the audit year.

Other Miscellaneous Income

- ATM

- Film Developing
- Movie Rentals
- Photocopier/Fax
- Vending Machines
- Video Games

Audit Techniques

- During the interview ask when financial tasks are usually performed. The shorter the delay in inputting data into the accounting records, the lower the risk of untracked changes. As input time delays increase, the potential risk related to alterations, manipulations and/or deletions increases. This means there is a greater chance of skimming or undisclosed items.
- During the initial interview, ask what percentage of sales is attributed to cash compared to credit or check payments. When analyzing the bank deposits, this percentage can be verified and any discrepancies can be questioned. If there is any question that the taxpayer gave inaccurate percentages, it will be resolved during the business tour.
- During the tour of the business be alert to the type of payments that are made and how they are handled. Spend some time watching the procedures at the register and stay long enough to observe several transactions. If the taxpayer has said he rarely receives cash, but in two hours the examiner notes 10 cash purchases, that observation must be recorded and analyzed.
- Compare the cash register tapes from the day the register was observed, to the tapes for the audit period.
- Match the taxpayer’s statements, cash register records or reports, against the findings.
- Total Gross Receipts divided by the Number of Days the Store was Open equals Average Daily Sales. This can be compared to the sales on the day the examiner toured the business.
- The examiner should match the cash register tapes to cash deposits for a sample period. If the tapes show cash received was $500, but the cash deposited that day was only $400 and there were no cash paid expenses – find out who operated the register that day, who counted the money, who deposited the cash. Sample more days when those individuals were working. If there are books, analyze every journal entry to the cash accounts and find out who authorized the entries.
- Contact state auditors or sales tax auditors for information on prior examinations and what markup percentages were used. Markup percentages do not usually change, so this information will be helpful even if the sales tax examination is old. Sales tax examinations are usually performed regularly in most states.
- Contact beer and wine suppliers to determine if the amount purchased agrees with the reported cost of goods sold.(Owners will sometimes under-report purchases to improve the ratio between sales and cost of sales.) Alcohol purchase is usually restricted by State regulations, and only certain, licensed suppliers can sell liquor to retailers. Therefore, only a few suppliers can be contacted for an accurate calculation of this aspect of cost of goods sold.

- If there are credit card transactions deposited to the bank account, test a sample of them by tracing them to the cash register tapes. If the credit card purchases cannot be found on the cash register tapes, ask the taxpayer why and consider the tapes may be unreliable.