

## Assignment 1: Understand the business

### *General and industry-specific economic trends and conditions*

The Canadian economy is expected to grow at an average of approximately 2 to 3 percent each year to 2016.

- After a period of spending and debt accumulation, Canadians are now focusing on reducing debt levels while interest rates are at historic lows. Today, the overall trend is toward more prudent spending, resulting in modest growth. As the Bank of Canada signals interest rates will increase in the future, the timing of such increases are uncertain. Future interest rate increases may decrease the amount of disposable income available for expensive running shoes.
- Greater movement of U.S. retail chains into Canada continues to put pressure on the retail sector. With increased competition, price wars are common, putting pressures on profit margins. There is an adequate supply of workers and there are no special or unique labour relations requirements.
- However, sales of the product will depend on the target market. Who is most likely to buy—Generation Y? Baby Boomers? Gen X? Millennial's? House prices and interest rates don't affect Millennial's, Gen Y's, and the Baby Boomers as greatly as Gen Xers, who are experiencing the prime years of home ownership. Therefore, the target market may not be significantly impacted by future interest rate increases.
- Lower pricing levels and improved quality of Chinese imports have resulted in large volume increases. Cloud 9 has responded well to this shift by obtaining the majority of its good from its China distribution plant.
- The strength of the Canadian dollar against the U.S. dollar has improved the foreign currency exchange issues (dollar parity makes imports cheaper).
- Seasonality is not a specific concern for running shoes.
- Having a retail outlet/store increases the risk of theft (and has been proven) and need for skilled or at least consistent labour.
- Cloud 9's growth expectations are in line with the industry.

### *Competitive environment/Product information/Customer information/Supplier information*

Competition is high and increasing, with price and quality the deciding factors.

- The ability to supply footwear retailers with products in a timely manner is an important success factor against competitors. Footwear is subject to fashion trends.
- Image and functionality are two of the most important characteristics consumers use to differentiate footwear. An aggressive marketing campaign, often using sports and fitness preferences, is key to establishing brand recognition.
- The industry is relatively capital intensive. The need for warehousing, transportation, and stock is high and may create barriers to entry.
- While entry from new wholesalers can be difficult based on agreements between existing wholesalers and retailers, the trend in the industry is for the customer to

buy directly from the manufacturer. Cloud 9 has responded well to this trend by opening its own store, thereby taking out the wholesaler.

- Discount stores/outlets and online shopping also complete in this sector. This may impact Cloud 9's current customer base and sales opportunities.
- To boost repeat customer visits, retailers are developing loyalty programs. While Cloud 9 started a program this year, it remains to be seen if the benefits will be achieved given the low regularity of consumers purchasing athletic footwear.

#### *Technological advances and the effect of the Internet*

Technological advances in this industry have mainly been in the areas of replacing the need for skilled labour with computerized automation of inventory control.

- Computers allow inventory to be stored on an international basis, allowing for more efficient transportation and distribution.
- Distribution management software allows advanced order management, inventory management, and delivery systems to be combined into one seamless supply chain.
- An online presence will provide a competitive advantage through increased marketing power and the ability to provide product information.

#### *Laws and regulatory requirements*

- As Cloud 9 is a public company it must adhere to the stock exchange regulations. Things to consider include corporate governance guidelines and filing requirements.
- As the majority of Cloud 9's products are manufactured in China with the remainder made in the US, Cloud 9 should be aware and in compliance with the laws and regulations of these foreign jurisdictions. This includes the consideration of labour law requirements in these foreign countries.

By considering these factors, the auditor would identify key business risks that would have a material effect on the financial statements. These risks are inherent to the business operations. Based on the research above, the Cloud 9 audit team have identified the following audit risk areas:

#### **NOTE TO THE LECTURER:**

##### **Additional discussion points**

It is important to clearly distinguish between business risks and significant risks. Business risks are faced by management in its operation of the business. Significant risks are those that increase the risk of material misstatement and require attention by the auditor.

From a big picture perspective, you may want to highlight the key risks in respect of understanding the wholesale/retail industry. This does not directly affect the outcome of the case study for Cloud 9 given the limited company background provided.

- How does the company control the suppliers/manufacturers? Are they local or international?

- How does Cloud 9 determine the quantities and styles for its purchases from the manufacturer? Ultimately, the wholesaler inherits some of the risk when determining inventory balances to effectively service the retailers.
- What are the terms and conditions with the retailers? What rebates or discounts are provided? As price is the key driver in retail, this will be the area of concern when dealing with retailers.

Potential risk—description	Account(s)	Assertion(s) (assignment 3)	Level of inherent risk (assignment 3)
<p><b>Growth of revenues given industry outlook and management incentive</b>  Consumer discretionary spend is low and expected to grow by only 2 percent for the year. Management is to receive bonuses based on revenue targets, which is set at 3 percent; therefore, there is a management bias to overstate assets and revenues and understate liabilities and expenses. General economic conditions will also impact retail businesses with their recoverability of accounts receivable and valuation of assets.</p>	Revenue  Accounts Receivable  Accrued Bonuses Payable	Occurrence, Accuracy  Existence, Valuation  Existence, Valuation	HIGH
<p><b>Use of IT for inventory management system</b>  Retail businesses are reliant on a smooth supply chain process. Where a business uses products with a long lead time, there is significant pressure to ensure that the correct type and quantity of inventory is ordered to meet the requirements of customers.</p>	Inventory  Cost of Sales	Completeness, Existence, Valuation  Completeness, Occurrence, Accuracy	HIGH Where there is a high reliance on timing of supply or one supplier, this can affect the level of sales, making the assessment “High.” The company’s early implementation issues of the JIT system and FOB shipping point terms also contribute to the higher assessment.
<p><b>Nature of the fashion industry and its trends</b>  Rapidly changing fashion trends and slow sales outlooks can result in obsolete inventory.</p>	Inventory	Existence, Valuation	LOW Based on the stability of the athletic footwear market, this inherent risk is “Low” as the fashion trends are not as exaggerated as with other footwear producers or retailers.

Potential risk—description	Account(s)	Assertion(s) (assignment 3)	Level of inherent risk (assignment 3)
<p><b>Misappropriation of inventory and cash</b> Retail businesses selling highly desirable and moveable products (such as PC games, CDs, and designer sunglasses) will be exposed to an increased risk of theft. In addition, employees handling cash at various store locations increases the risk of fraud through theft.</p>	<p>Cash</p> <p>Inventory</p> <p>Cost of Goods Sold</p>	<p>Existence, Valuation</p> <p>Existence, Valuation</p> <p>Existence, Accuracy</p>	<p>HIGH</p> <p>Previous thefts, easy portability of cash and inventory.</p>
<p><b>Rebates/discounts to retailers</b> For the wholesale business, there is significant pressure from retailers to receive generous rebates or volume discounts. Retailers are heavily influenced by landlords and consumers; therefore, they control their profits through the supply chain, thus impacting the wholesaler.</p>	<p>Discounts Given (Expenses)</p> <p>Revenues</p> <p>Cost of Sales</p>	<p>Valuation and allocation</p> <p>Accuracy</p> <p>Accuracy</p>	<p>HIGH</p> <p>Management incentives and pressure from ownership for growth.</p>

## Assignment 2: Calculate materiality

W/P ref: A2-1  
 Prepared by: \_\_\_\_\_  
 Date prepared: \_\_\_\_\_

**Cloud 9 Ltd.**  
**December 31, 2014**

### Setting materiality

Users	Financial statement area of most concern to the user
Cloud 9 Inc.	This is the parent company of Cloud 9 Ltd. They are concerned with the company's ability grow its market share of the North American footwear market. This would best be reflected by revenues.
Bank	Concerned with the ability of Cloud 9 to repay borrowed funds. As a result, it is mostly concerned with net income as this is the best predictor of an entity's future ability to repay.
Management	Concerned primarily with revenues as this is the basis for their bonuses.

Base selected for planning materiality (PM): \_\_\_\_\_

Justification for selection:

Revenue is the most appropriate basis for calculating PM. This is the preferred method because:

- Cloud 9 is currently in a loss for the year ended December 31, 2014; therefore, net income before tax is not an appropriate basis.
- The parent entity (main users of the accounts) is concerned with increasing the market share of the Canadian market—essentially revenue.
- Management has an incentive to manipulate revenue based on growth targets expected and compensation attached to meeting those targets.

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### Calculation of PM

	Current Year	Prior Year
Trial balance amount:	\$ 37,194,932	\$ 34,038,192
<u>Normalizing adjustments</u> (that is, non-recurring items)	\$ 0	\$ 0
Annualized (if required):	NA; full-year balances used	NA; full-year balances used