ILLUSTRATION 4.2 **Entity factors that influence inherent risk**

Lower Inherent Risk Assessments	Factors That Influence Inherent Risk	Higher Inherent Risk Assessments
Satisfied customers who pay on time and are likely to remain a customer in the future Client has many customers	**(1) Major customers**	Dissatisfied customers who may withhold payment or decide to not purchase from the client in the future Client has only one or very few customers
Reputable suppliers that supply goods on a timely basis Few goods are returned to supplier as faulty Client pays suppliers on a timely basis	**(2) Major suppliers**	Suppliers may not supply goods on a timely basis Significant amounts of goods are returned to the suppliers because they are faulty Client does not pay suppliers on a timely basis
Trades with countries that are stable Trades in stable foreign currencies Minimal tariffs or barriers to trade Client maintains effective risk management policies regarding foreign trade	**(3) Importer or exporter**	Trades with countries that are not stable Trades in unstable foreign currencies Complex tariffs and other barriers to trade Client does not maintain effective risk management policies regarding foreign trade
Client well-positioned to adjust to changes in technology	**(4) Changes in technology**	Client falls behind with changes in technology and has not "kept up with the times"
Client does not offer warranties on its products If client does offer warranties, product quality is high and the likelihood that goods will be returned is low	**(5) Warranties**	Client offers warranties on its products History of poor product quality and goods being returned for the same problem
Few discounts are given by the client to its customers Client takes advantage of discounts offered by suppliers	**(6) Discounts**	Client offers discounts to its customers, possibly because it does not have much bargaining power Client misses opportunities to take advantage of supplier discounts
Client has good reputation with customers, suppliers, employees, and the wider community in which it operates	**(7) Client reputation**	Client does not have a good reputation with customers, employees, and/or the wider community in which it operates
Client has few locations and primary operations are centralized No international operations	**(8) Operations**	Client has larger number of locations and operations are decentralized Multiple locations operated internationally
No recent implementation of new standards No change in the application of accounting standards Personnel involved in the selection and application of accounting standards are competent and experienced	**(9) Selection and application of accounting principles**	Recent implementation of new accounting standard Change in the application of an accounting standard Personnel involved in the selection and application of accounting standards lack competence and experience
Determination of account balance is objective and supported by transactions with third parties Transactions are routine and relatively homogeneous Account has low volume of transactions	**(10) Significant accounts and classes of transactions**	Determination of account balance involves considerable subjectivity Transactions are complex and unique Account has high volume of transactions
Less complex payroll system and benefit structures Defined-contribution pension plans	**(11) Relations with employees**	More complex payroll system and benefit structures Defined-benefit pension plans
Less reliance on debt for financing Pays interest payments on time Less risk of violating terms of debt covenants	**(12) Sources of financing**	Heavy reliance on debt as a source of financing Struggles to pay interest payments on time Higher risk for violating terms of debt covenants which could indicate going concern issues
Simple capital structure Pays dividends from operating cash flow	**(13) Ownership structure**	Complex capital structure Struggles to pay dividends from operating cash flow

or a sales return was not recorded correctly, sales (and profit) could be overstated. Is Cloud 9 liable for warranty expenses if the shoes are faulty? The auditors would need to read the terms of the contract to determine if a warranty liability should be recorded on the balance sheet. What about the balance of inventory? Do the shoes belong to Cloud 9 when they are being shipped from Vietnam, or only after they arrive at the warehouse? Is Cloud 9 exposed to foreign currency exchange risk and how is this accounted for?

Suzie points out that the answer to each of these questions could be different for Cloud 9 than for other clients because of its different circumstances. Auditors need to gain an understanding of these circumstances so they can assess the risk that accounts receivable, sales, sales returns, inventory, and liabilities are misstated. Once they understand all the risks, they are in a position to decide how they will audit Cloud 9.

Gain an Understanding of the Industry and Business Environment

At the industry level, auditors are interested in the client's position within its industry, the level of competition in that industry, and the client's size relative to its competitors. Auditors evaluate the client's reputation among its peers and the level of government support for companies operating in that industry. Another consideration is the level of demand for the products sold or services supplied by companies in that industry and the factors that affect that demand. For example, an ice cream manufacturer is affected by the weather, which causes revenue to be seasonal. This would be important for auditors to know because during the slow season, revenue may be at higher inherent risk if the client is trying to maintain a certain profit target. A summary of some key industry and business environment factors that can influence inherent risk is provided in **Illustration 4.3**. Each factor in Illustration 4.3 is numbered, and the following paragraphs provide more discussion of these industry and business environment factors that auditors consider when gaining an understanding of the client.

ILLUSTRATION 4.3 **Industry and business environment factors that influence inherent risk**

Lower Inherent Risk Assessments	Industry Factors That Influence Inherent Risk	Higher Inherent Risk Assessments
Less competitive industry, which puts less stress on the client's ability to generate a profit	**(1) Level of competition**	Very competitive industry, which puts more stress on the client's ability to generate a profit
Good reputation relative to others in the industry Customers and suppliers may be attracted to conduct business with the client versus a competitor	**(2) Reputation**	Poor reputation relative to others in the industry Customers and suppliers may shift business to a competitor
A new industry with considerable government support and incentives New or established industry with intense international competition with considerable government support and incentives Industry with minimal government regulation and no special taxes or unique financial reporting requirements	**(3) Legal, political, and regulatory environment**	A new industry with little or no government support New or established industry with intense international competition with little or no government support Heavily regulated industry with special taxes and unique regulations and financial reporting requirements
Demand is not seasonal, which provides steady revenue flow Industry minimally affected by trends/customer preferences Industry has low risk of technological obsolescence	**(4) Demand**	Seasonal demand for products, which leads to sporadic revenue flow Industry subject to changing trends/customer preferences Industry subject to technological obsolescence
Economy as a whole experiences an upturn, which leads to easily sustainable profit levels	**(5) Economy**	Economy as a whole experiences a downturn, which leads to pressure to maintain expected profit levels