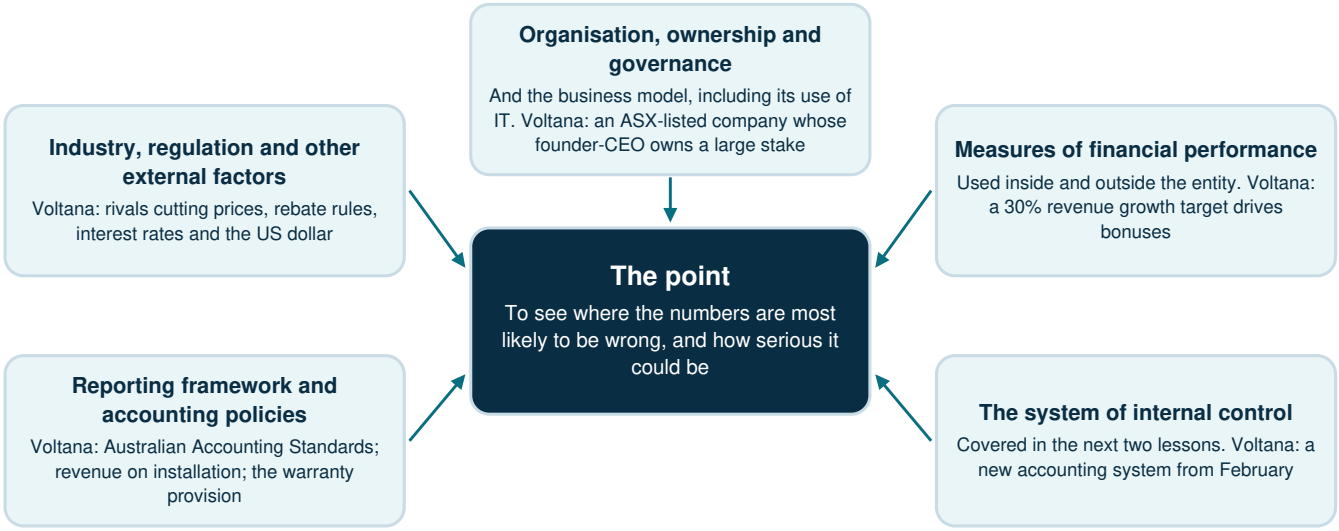
Understanding the entity and its environment

MODULE 2 | 2.4 | STUDENT COMPANION

Before assessing risk, the auditor must understand the entity well enough to see **where misstatements are likely** and **how serious** they could be: its organisation, ownership, governance and business model; its industry, regulation and economy; its performance measures; its reporting framework and accounting policies; and its system of internal control. **Business risks** usually have financial consequences that land on specific assertions.

What the understanding covers



The revised risk assessment standard requires this understanding before risks are assessed

Starting outside the entity

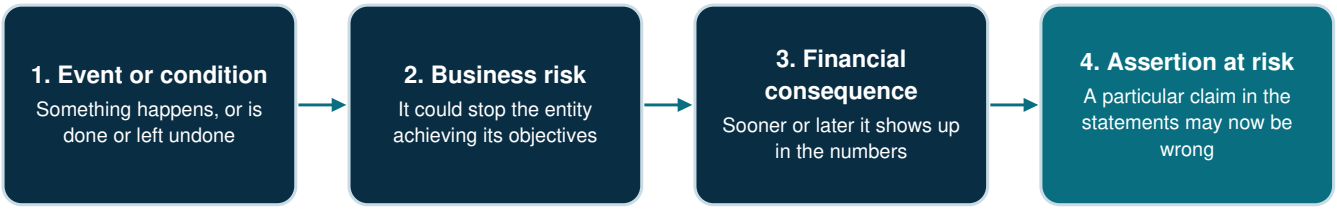
Auditors learn about these from industry reports, government statistics, trade publications, analysts' reports and their own experience with similar clients.

Area	What the auditor looks at	At Voltana (imagined)
Industry conditions	The market and competition, cyclical or seasonal patterns, changes in technology, the reliability of supply	Battery technology changing fast; rivals cutting prices
Regulatory environment	Industry accounting practices, licensing, safety and environmental laws, tax, tariffs, government programs such as subsidies or rebates	Household rebate rules can change at short notice
Other external factors	The general economy, interest rates, inflation, exchange rates, access to finance	Interest rates affect whether customers borrow to buy; the US dollar drives the cost of every imported cell

Inside the entity

Area	What the auditor learns
Operations	Where revenue comes from, the products and customers, suppliers, locations and people
Investments	Acquisitions, and spending on plant and equipment
Financing	The structure of the debt, the conditions in loan agreements, and any arrangements with related parties
Accounting policies	Whether they suit the business and the framework, how unusual or significant transactions are accounted for, and the reasons for any changes. A change of policy in a year when profit is under pressure deserves a particularly careful look.

How a business risk reaches the statements



A business risk

Any significant situation, event, action or inaction that could stop the entity achieving its objectives, or the risk of setting the wrong objectives and strategies in the first place

Business risks are a wider set than the risks of material misstatement, but most of them land on a specific assertion in the end

Performance measures matter twice. The targets the board watches, the measures analysts follow and the measures that decide bonuses show what management cares about, and they can create pressure to make the numbers look better than they are.

Case note: Dick Smith

Dick Smith was an Australian electronics retailer that Woolworths sold to a private equity firm in 2012. The new owners floated it on the stock exchange in December 2013. Like many retailers, it earned rebates from suppliers, and a large part of those rebates depended on how much stock it bought. Through 2015 its inventory grew heavily, and much of it sold slowly. In October 2015 it cut its profit forecast, and on 30 November it announced a $60 million write-down of inventory and said it could no longer stand by that forecast. In January 2016 the company went into administration and its lenders appointed receivers; within a few months, every store had closed. The administrators later reported that buying decisions had been driven by supplier rebates rather than customer demand, building up stock that customers didn't want. **The lesson:** if rebates for buying stock are counted as profit before that stock is sold, buying more makes profit look better even as the shelves fill with products nobody wants. An auditor who understands that business model looks at how rebates are recognised, whether inventory is carried above what it will sell for, and whether reported profit is turning into cash.

Source: Dick Smith Holdings ASX announcements (30 November 2015; 5 January 2016); administrators' report (July 2016).

From business risk to assertion at Voltana

Event or condition	Business risk	Financial consequence	Assertion at risk
A rival launches a cheaper, longer-lasting battery	Falling demand for Voltana's current model	Stock may sell only at a discount	Valuation of inventory
The US dollar strengthens	Costs rise and margins fall	Pressure on management and on costing	Accuracy of inventory costing
The rules of a rebate program change	Demand may drop	Rebate amounts Voltana expects to receive may not be collectable	Valuation of the rebate receivable
The 30% growth target drives bonuses	Pressure to record sales before installation	Revenue recorded too early	Occurrence and cut-off of revenue
The bank facility falls due in about 13 months	Refinancing may be uncertain	Going concern questions	Classification of the debt; going concern disclosures

Practice questions

MODULE 2 | 2.4 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Identify the business risks

Gumnut Grove Early Learning Ltd (imagined) is a listed company running 46 childcare centres in Victoria and New South Wales. Identify the business risks each fact creates.

Fact	Business risk(s)
(a) Average occupancy has fallen from 86% to 78% since two rival operators opened large new centres nearby.	
(b) About 70% of fees come through a government childcare subsidy, which can be clawed back if attendance records are wrong. Centre managers earn bonuses based on occupancy.	
(c) Centres must keep minimum educator-to-child ratios, and several have turned families away because they couldn't recruit enough staff.	
(d) Educators' wages are rising sharply, and a government grant that pays for part of the increase ends in two years.	
(e) Ten new centres are planned, funded by a bank loan that requires profit to cover interest at least three times.	
(f) Most centres are leased for 10 to 15 years with fixed rent increases, including some in suburbs where occupancy is falling.	

Question 2 - Trace three risks to the assertions

Choose three of Gumnut Grove's business risks and trace each one through to its financial consequence and the assertions at risk.

Business risk	Financial consequence	Assertion(s) at risk

Question 3 - Sources of industry knowledge

List five sources of information an auditor could use to understand the childcare industry, and what each would tell you.

Source of information	What it would tell you about the childcare industry

Worked answers

MODULE 2 | 2.4 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Gumnut Grove's business risks (suggested)

	Business risk(s)
(a)	Competition is taking customers, so revenue falls while costs stay fixed; some centres may stop being viable.
(b)	Heavy dependence on one government program whose rules can change; subsidy may have to be repaid if attendance records are wrong; occupancy bonuses give managers a reason to overstate attendance.
(c)	Staff shortages cap revenue; breaching the required ratios could bring fines or threaten a centre's approval to operate.
(d)	Wage costs squeeze margins, especially when the grant ends; fees may not be raised enough to cover them.
(e)	New centres may fill slowly; lower profits could breach the loan's interest cover condition.
(f)	Long, fixed leases lock in rising rent at centres that are losing children.

Question 2 - Three risks traced (suggested)

Business risk	Financial consequence	Assertion(s) at risk
Falling occupancy at leased centres (a, f)	Lower revenue and cash flows at some centres, so their fit-outs and leased premises may be worth less than their carrying amount	Accuracy, valuation and allocation of property, plant and equipment and right-of-use assets; impairment disclosures
Subsidy depends on accurate attendance, and bonuses reward occupancy (b)	Revenue may include subsidy for children who didn't attend, and amounts may have to be repaid	Occurrence of revenue; completeness of the liability for repayments; disclosure of possible claims
Expansion funded by a loan with an interest cover condition (e)	A breach could let the bank demand early repayment	Classification of the loan as current or non-current; going concern disclosures

Question 3 - Five sources (suggested)

Source	What it would tell you
Industry reports and industry association publications	Occupancy and fee trends, competition, new centres opening, typical margins
Government statistics and regulator publications	Subsidy rules and changes, numbers of approved services, quality ratings, staffing requirements
Trade publications and news	Wage developments, staff shortages, policy debates, new entrants
Analysts' reports on listed childcare operators	What the market expects and the measures it watches, such as occupancy and earnings per centre
The audit firm's own experience with similar clients	Common risks and errors, such as subsidy reconciliations and lease accounting