

Cloud 9 Inc. Audit

W&S Partners is a U.S.-based accounting firm with offices located in most major cities. W&S Partners will be conducting the January 31, 2023, audit for Cloud 9, Inc., a publicly traded company. The audit team assigned to the client is:

- Partner: Jo Wadley
- Audit Manager: Sharon Gallagher
- Audit Senior: Josh Thomas
- IT Audit Manager: Mark Batten
- Experienced Staff: Suzie Pickering
- First-Year Staff: Ian Harper

Prior-year audits were conducted by Ellis & Associates. As part of the transfer of records process, Jo Wadley met with RJ Ellis (Managing Partner, Ellis & Associates) to discuss acceptance of Cloud 9 as a client and to inquire about access to Ellis & Associates' working papers. In the discussion, RJ Ellis stated that there were no issues that W&S Partners should be aware of before accepting the client or beginning the work.

Cloud 9 Inc. Company Background

Cloud 9 is a Sacramento-based manufacturer and retailer of athletic shoes. In 2021, Cloud 9 purchased McLellan's Shoes from Ron McLellan. As part of the sale agreement, Ron McLellan was appointed to the Cloud 9 board of directors.

Cloud 9 Inc. has wholly owned subsidiaries in Canada, Vietnam, and Brazil, and has built a reputation around the fact that its shoes have comfort and durability. The company promotes itself using its now well-known tagline, "Our shoes are so comfortable, it's like walking on Cloud 9." Currently, Cloud 9 is primarily a wholesaler of athletic shoes to its main customers All Day Sports, Mayer, Bob's, and Varsity Sports.

Cloud 9 receives about 25% of its inventory from the Vietnam production plant with the remainder coming from the United States. Also, about 20% of its property, plant, and equipment is located at the Vietnam production plant. All inventory is purchased on free on board (FOB) shipping terms, which means Cloud 9 takes ownership of the products once the international courier accepts the goods for delivery. The inventory is sent to the main warehouse in Sacramento, which is linked to retailers via an electronic inventory system. When retail inventory gets low, the company ensures deliveries are made using its own transport trucks, thus ensuring control throughout the entire process.

In February 2021, Cloud 9 launched its new product line that included the "Heavenly 456" walking shoe. Advertising campaigns and media coverage have been very successful, and sales for this style of shoe have steadily increased. For Cloud 9, the Heavenly 456 now makes up 20% of total sales.

A specific marketing campaign was initiated in 2022 to promote and build the Cloud 9 brand in the United States. Cloud 9 decided to sponsor a professional soccer team, Georgia Thunder, for the 2022 season. Under this sponsorship agreement, Cloud 9 is to provide all the athletic footwear for the team as well as have sole merchandising rights. The agreement also includes general advertising rights at the stadium.

In a separate contractual arrangement, Cloud 9 has signed Miguel Fernandez, the captain of Georgia Thunder, as spokesperson for the brand. This arrangement allows Cloud 9 to use Miguel's image to promote and build the brand.

To further establish the brand, the first Cloud 9 retail store was opened in San Francisco on June 1, 2022. The store operates on a just-in-time inventory system linked with the main warehouse in Sacramento. However, the management team reports that there have been a few hiccups in determining ideal stock quantities for the store to allow optimum availability of merchandise to its customers. Because some thefts of merchandise from the store have also occurred, the company has installed closed-circuit television cameras.

Personnel

The Cloud 9 corporate office has 358 full-time employees. In the retail store, the company employs two full-time managers and some part-time staff, with seasonal employees enhancing staff levels in the busier retail period.

Some key positions in the accounting and IT area are as follows:

- CFO: David Collier
- Financial Controller: Carla Johnson
- IT Manager: Will Burton.

These three employees are entitled to participate in the employee stock-purchase plan and receive stock options in Cloud 9 if revenue targets are met.

Financial Information

Cloud 9 set a goal to increase revenue by 3% for the 2022 fiscal year. One of the critical success factors for the company to achieve this 3% increase is to grow its share of the U.S. footwear market. However, with the new store opening and the subsequent increase in costs, as well as the costs related to the sponsorship deals, the management team is projecting a decline in earnings for the year.

In addition, to build customer loyalty and promote sales in the retail store, Cloud 9 introduced a loyalty program whereby customers earn one point for every \$10 that they spend. Customers can then redeem points by going online to receive coupons that can be exchanged for merchandise in the store. On August 1, 2022, the company took out an additional loan of \$7 million with Windsor Bank to help fund the store costs and to purchase additional delivery trucks and vans. This loan is repayable over five years. The company's other debt relates to loans issued more than five years ago from various lending institutions.

All inventory is purchased in U.S. dollars, which the company acquires under forward exchange contracts. The company provides a 12-month warranty on all footwear. Historical claims have been 2% of total sales.

Cloud 9 Consolidated Statement of Income

	For the year ended January 31, 2022	For the year ended January 31, 2021
Revenues	\$364,953,846	\$345,965,385
Costs and expenses:		
Cost of sales	222,496,154	207,838,462
Selling and administrative	103,450,000	100,246,154
Interest expense	2,257,692	1,730,769
Other (income)/expense, net	<u>1,311,539</u>	<u>796,154</u>
Total costs and expenses	<u>329,515,385</u>	<u>310,611,539</u>
Income before income taxes	35,438,461	35,353,846
Income taxes	<u>12,757,692</u>	<u>13,080,769</u>
Net income	<u>\$ 22,680,769</u>	<u>\$ 22,273,077</u>

Cloud 9 Consolidated Balance Sheet

	January 31, 2022	January 31, 2021
ASSETS		
Current Assets:		
Cash and cash equivalents	11,692,308	9,780,769
Accounts receivable, less allowance for doubtful accounts of \$2,773,077 and \$2,515,385	62,361,538	60,361,539
Inventory	54,773,077	55,615,385
Investments (Derivatives)	14,460,577	14,852,885
Deferred income taxes	3,357,692	3,288,461
Prepaid expenses and other current assets	5,250,000	7,276,923
Total current assets	151,895,192	151,175,962
Property, plant and equipment, net	62,261,539	60,900,000
Identifiable intangible assets and goodwill, net	3,820,192	3,950,961
Deferred income taxes and other assets	5,853,846	9,238,462
Total assets	<u>\$223,830,769</u>	<u>\$225,265,385</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	207,692	1,926,923
Notes payable	32,896,154	35,546,154
Accounts payable	16,615,385	20,915,385
Accrued liabilities	18,157,692	23,336,581
Income taxes payable	842,308	582,650
Total current liabilities	68,719,231	82,307,693
Long-term debt	16,765,384	18,088,462
Deferred income taxes and other liabilities	3,942,308	4,253,846
Shareholders' equity		
Common stock at par value	107,692	107,692
Capital in excess of par value	17,669,231	14,192,308
Unearned stock compensation	(380,769)	(450,000)
Accumulated other comprehensive income	(5,850,000)	(4,273,077)
Retaining earnings	122,857,692	111,038,461
Total shareholders' equity	134,403,846	120,615,384
Total liabilities and shareholders' equity	<u>\$223,830,769</u>	<u>\$225,265,385</u>

Cloud 9 Condensed Cash Flow Statement

	For the year ended	
	January 31, 2022	January 31, 2021
Cash provided by operations	25,250,000	26,907,692
Cash used by investing activities	(13,165,385)	(16,923,077)
Cash used by financing activities*	(13,457,692)	(9,696,154)
Effect of exchange rate changes on cash	3,284,616	1,873,077
Net increase in cash and cash equivalents	\$ 1,911,539	\$ 2,161,538
Cash and cash equivalents, beginning of year	9,780,769	7,619,231
Cash and cash equivalents, end of year	<u>\$ 11,692,308</u>	<u>\$ 9,780,769</u>

*Includes dividends paid of \$4,988,462 in 2021 and \$5,119,231 in 2020

Cloud 9 Trial Balance				
	October 31, 2022		October 31, 2021	
	Debit	Credit	Debit	Credit
Cash and cash equivalents	13,446,154		6,123,884	
Accounts receivable	70,485,625		64,867,910	
Allowance for doubtful accounts		704,856		648,679
Inventory	55,100,000		57,900,000	
Investments (Derivatives)	13,419,231		13,805,769	
Deferred income taxes (current)	2,857,692		3,584,615	
Prepaid expenses and other current assets	9,265,385		6,446,154	
Property, plant and equipment	103,803,846		97,576,923	
Accumulated depreciation		39,761,538		35,207,692
Identifiable intangible assets and goodwill	3,723,007		3,851,923	
Accumulated amortization				
Deferred income taxes and other assets (noncurrent)	9,557,692		8,410,849	
Current portion of long-term debt		2,115,385		-
Notes payable		21,376,923		34,823,077
Accounts payable		14,986,457		22,561,538
Accrued liabilities		25,803,846		24,150,000
Income taxes payable		2,211,539		3,726,923
Long-term debt		23,661,538		17,419,231
Deferred income taxes and other liabilities (noncurrent)		4,915,384		4,330,769
Common stock at par value		111,538		107,692
Capital stock in excess of par value		19,415,385		16,484,615
Unearned stock compensation	253,846		480,769	
Accumulated other comprehensive income	5,011,538		4,746,154	
Beginning Retained Earnings		122,857,692		98,150,473
Dividends	3,866,838		3,299,423	
Repurchases of Common Stock	4,627,381		2,939,393	
Revenue		277,338,461		269,442,308
Cost of sales	169,346,154		163,003,846	
Selling and administrative	79,092,308		78,246,154	
Interest expense	1,438,461		1,773,077	
Other expense	453,846		757,692	
Income tax expense	9,511,538		9,238,462	
Totals	<u>555,260,542</u>	<u>555,260,542</u>	<u>527,052,997</u>	<u>527,052,997</u>

Transcript of Meeting with Carla Johnson

Present: Carla Johnson, Chief Financial Officer, Cloud 9, Inc.

John Thomas, Audit Senior, W&S Partners

JT: Thanks for seeing me, Carla.

CJ: You're welcome, Josh. What can I do for you?

JT: I need to ask you some questions about Cloud 9's process for recording wholesale revenue transactions, including the trade receivables and cash receipts aspects. After I understand the process from you, I will be doing a system walkthrough and confirming my understanding by talking to the individuals who are involved in each step of the process.

CJ: We've got a pretty complex inventory management software system called Swift. It was designed by some of our tech guys. It tracks inventory and it integrates with our sales system.

JT: How do customers decide the quantity and know the price?

CJ: The customers complete a purchase order online through a site that is linked to Swift. The site will tell customers the price for each item in inventory, as well as the quantity we have in stock.

JT: How often are prices changed?

CJ: Price changes really depend on the market. While they don't change that often, our marketing managements meets weekly to discuss prices changes. Price changes are initiated after that meeting. Only the marketing manager and a few of her staff members have access to update the master price list.

JT: What if a customer logs on and you don't have the products?

CJ: The system doesn't allow a customer to place an order greater than our current inventory levels. If a customer needs more inventory, the customer should fill out a separate request for inventory not on hand. That then gets e-mailed to our production manager and our marketing manager, who determine if we need to manufacture more goods. The decision about manufacturing more goods is complex as it integrates with our production decisions, or whether we can purchase additional inventory from a subcontractor that manufactures for us.

JT: OK. This is helpful. Let's stay focused on the sales process. Once a customer's purchase order is complete, then what?

CJ: The submitted purchase order goes through a credit check and then becomes a sales order. If a customer exceeds his or her credit limit, there are a few people in my office that can approve a credit override, on a case by case basis. We tend to allow this only for good customers with good payment history. Then, the purchase order becomes our sales order.

JT: I guess this electronic process saves a lot of time and trees!

CJ: Yes, there's so much that we rely on the system to do for us, it's scary. I worry about things like what happens if we are hit by a storm or lose power. We do have the whole system backed up off-site.

JT: That is nice to know, and probably gives you some comfort. What happens to the sales order – how does it get filled?

CJ: Every day, the system assigns shipments to the warehouse location nearest to the customer's location that can fulfill the entire order. The warehouse manager then downloads the outstanding sales orders to these little hand-held computer/scanners. It's very *Star Trek*. Warehouse personnel use these to identify inventory in the warehouse, then the warehouse personnel put boxes of ordered shoes onto pallets. The pallets are taken to a staging area where each product is then scanned.

JT: Are the shipping documents approved before the goods go out the door? How do you know that what got sent is what was ordered?

CJ: Swift matches the quantities and products on the packing slip to the sales order. If they don't match, the order is set aside for follow-up to ensure that the order is accurately filled. Once they match, the approval box is activated, and the shipping supervisor can enter his or her passcode. This officially approves the packing slip and bill of lading, and each gets printed.

JT: OK, so once the goods are shipped to the customer, how do you bill for this shipment?

CJ: We go into the billing system and pull up a draft invoice that was generated when the shipping document was approved. At this point, the Swift performs a number of checks. The system matches the quantities in the invoice against the packing slip and sales order. Prices are also matched to the sales order. The customer number should also match on the sales order, shipping documents, and draft invoice. A report is run daily of any shipments that have not resulted in invoices. The reverse is also true. A report is run of any invoices that are not supported by shipping documents. At month-end, we run a report to compare dates on shipping documents with the month that transactions are recorded in the sales journal. If there are any discrepancies, the transaction is reported for manual follow-up. I believe discrepancies are rare as the system is very tight, and we ship only what was

ordered. Then, the sales invoice is processed. Processing the sales invoice enters the transaction in a database from which we build the sales journal and accounts receivable subsidiary ledger. Also, at the end of each day, we compare the totals for accounts receivable with the total of each customer's balance in the accounts receivable subsidiary ledger.

JT: When you do have discrepancies, who follows up on them and are they cleared?

CJ: We have a data control group that follows up on discrepancies in a variety of systems. Discrepancies have to be cleared daily. Once the reason for the discrepancy is identified, changes to the underlying data must be approved by a manager in the data control group. The data is then corrected, and the invoice is processed. As I noted, discrepancies are very rare. We don't ship goods unless the order is completely filled.

JT: Does finance ever go back to the sales order?

CJ: No. Since the shipping document can't get generated unless it agrees to the sales order, Swift only looks at the sales order for prices. Do you think we should do otherwise?

JT: I wouldn't say so at this stage. But you'd have to be sure to have some tight controls around Swift, given that it seems to do everything.

CJ: Yes, good IT general controls over the Swift program, and other programs, are extremely important. I meet with the IT manager monthly, to talk about the few discrepancies found, reasons for discrepancies, and the importance of controls. I think you will find that our IT manager understands the importance of strong IT general controls, and strong controls over clearing any discrepancies identified in transaction streams.

JT: Let's talk about accounts receivable. Who follows up on past-due receivables?

CJ: That is the sales manager's responsibility. In my opinion, we do a good job of screening credit upfront so we don't have a significant problem with past due receivables. We send statements to customers with their receivable balances monthly. The sales manager and I discuss past-due accounts on a regular basis. The sales manager, controller, and I review the allowance for doubtful accounts monthly. A monthly adjusting journal entry is made by the controller which I review and approve. You will find that our allowance for doubtful accounts is only about 1% of outstanding receivables. I think this is good as we do a good job of screening customer's credit upfront.

JT: What is the cash receipts process?

CJ: We get most payments via EFT. If a customer pays by check, it goes to a lockbox where it also is directly received by our bank. Our AR clerk is able to download the previous day's cash receipts from online banking. She then merges this information with our accounting system, which first screens the data, matching customer numbers with the master customer file. On occasion, the bank has made errors in entering customer numbers, and we have to follow up on these transactions before they are processed in our accounting system. This is done the same day. Once the transaction is processed, it is posted to the database from which we build our cash receipts journal and accounts receivable subsidiary ledger. Finally, every morning someone reconciles what was posted to cash receipts with what has been deposited in various bank accounts. I believe it is critical that all cash receipts are posted timely and accurately.

JT: Are bank reconciliations done in a timely manner?

CJ: Yes, someone in my office does bank recs every month for the main operating account and other bank accounts. Our standard is to complete this by the fifth business day of each month. My assistant reviews and approves the bank reconciliations. Keep in mind that what I explained is for the wholesale transactions. We have separate procedures for the retail store regarding daily cash balance reconciliations to the deposits in the operating bank account.

JT: Yes, we have another auditor who will be handling the retail store side of the sales-to-cash-receipts process. She or he will probably come and talk to you in a day or two. Well, I think that should do it for now. I may have some follow-up questions for you as I start getting my head around the revenue process.

CJ: The door is always open.

JT: Thanks for your time.