

Preliminary Inherent Risk Assessment

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Management policy of maintaining large inventory to meet customer demand – The auditee maintains large inventories to facilitate sales. However, this increases the risk of obsolete inventory due to slow turnover. Assessing the value of obsolete inventory involves management judgment and increases the risk that inventory valuations will be overstated. Thus, I would recommend careful scrutiny of Southwest's inventory valuation allowance based on the lower cost or market rule.

- Location policy that allows the ABC facilities to be located in the same area – All the facilities of ABC are located in the same which is along the highway. All the forklifts and other materials are located in the same area as the stationeries. This poses a big risk to the company in case of a loss. For instance, in case of a fire, all the facilities would be lost leaving the organization at a zero point. In addition, being located on the highway poses a big risk in case of an accident. I would therefore recommend that the facilities be located in different areas to reduce the loss in case of an accident. I also suggest that the facilities should be quite far from the highway and railroad to avoid possible accidents from the same.

- Having the same company auditor for a long time – It is notable that ABC has had the same auditor for the last five years. This could be said as a way of bringing consistency to the results of the audit. However, this increases the risk of having the auditor becoming quite used to the organization. A long stay in the organization could lead to a loss of professionalism on the part of the auditor and encourage collusion with the employees. The objectivity of the auditing process gets lost once the company stays with the same auditor for so long. The audit reports might not be helpful when collusion between the auditing officers and the employees is materialized (Kaal 2016). Therefore, I would suggest that ABC adopt a policy of replacing the new auditors from time to time. This will allow the auditors to retain their professionalism and thus offer an objective opinion to the organization. This will help ABC to improve on the aspects provided.

- Policy of including the executive in the board of directors – the company has a policy of having the president, the secretary as well as the controller in the board of directors. On the one hand, it is helpful in ensuring the best decision-making process. On the other hand, this creates a risk of conflict of interest. The president and the rest of the executive members represent the employees of the company. Therefore, they have a great interest in earning better interests from the organization. They are entrusted with having the organization succeed by all means. However, having them on the board of directors brings about the risk of conflict of interest as they might fight for higher bonuses as well as higher salaries. This will only work against the main objectives of the organization. I therefore recommend that the executive members of ABC should not be included in the board of directors. The president, Treasurer and controller ought to be retained at the management levels but should not be shareholders at the same time. This will help in the elimination of the conflict of interest.

- Policy of using personal computers to manage the inventory as well as the sales – ABC allows the use of personal computers in the management of organizational sales. This poses a great risk for the organization as there is limited control over the level of transactions that the employees engage in. Allowing the employees to use their personal computers to manage the sales gives them an opportunity to manipulate figures without getting noticed. In this regard, the employees have the chance to collude with the suppliers so as to have the company pay more for products that were not delivered. In addition, this amounts to the loss of the business information confidentiality, posing a threat to the company. Such information could be leaked to the competitors, leading to a worse competitive advantage in the future. I therefore recommend that the organization should have specific computers used for the management of the sales. The use of personal computers by employees should not be allowed as this creates room for collusion. The use of controlled ABC computers will allow all the transactions to be followed up and thus prevent the possibility of fraud.

Preliminary Analytical Procedures

- Days Inventory Increase – Days inventory increased by 19 days in 2015. This is a fairly large one-year increase and increases the risk of obsolete inventory. We should give some additional attention to valuing the inventory under the lower cost of the market rule.
- The occurrence of a cash outflow – ABC experienced a cash outflow of \$11,178. This is an indication that the company experienced a reduction in the level of cash at hand to meet the short-term obligations as they arose during the year. It could, therefore, have been difficult for the company to settle its short-term debts during the year, making it relevant to have them transferred to the next accounting period. As a recommendation, ABC ought to reduce the cash-reducing activities, such as the purchase of new fixed assets, to save on the cash paid out.
- Increase in the level of expenses– ABC experienced an increase in the level of expenses from the year 2014 to 2015. In this case, the expenses increased with an amount of \$28,359. This increases the risk of the business being unable to maximize its profits. As such, it is necessary that the expenses of the business be maintained at a minimum. I recommend that salaries be subjected to a suitable form of payment policy that rewards on the basis of productivity. This will enable the business to gain value for each cost it incurs along the way.
- Increase in the sales discounts – from the financial reports provided, it can be traced that the amounts of sales discounts increased. This increased the level of expenses that the business incurred from the year 2014 to the year 2015. The profitability level of the business is thus affected and reduced, risking the downfall of future progress prospects (Tony & Dean 2017). Therefore, the discounts ought to match the size of the purchases that the customers make as opposed to using them to entice the first purchase. This might end up reducing the financial ability of the firm to do well in the future.

- Increase in the current liabilities – the current liabilities increased by \$214354. This is an indication that the company took more debts within one year. Buying more products on credit increases the liabilities that the company will have in the future (Islam 2016). It also reduces the amount of money that the business will have due to the inducement of inflation as well as the inducement of discounts. It's therefore recommended that the business should make cash purchases to ensure that it makes the least payments to minimize the cash outflows.

Preliminary Materiality

- Balance Sheet – \$125593.4: This figure can be said to be the materiality level for the balance sheet. It is the 10% of the total assets of the company. Anything that is above 10% of the total value of the organization can be regarded as being material. Such an item is, therefore, bound to affect the major decisions made by the business. For instance, any change in the assets that amounts to an amount more than the stated figure proves to be material to the business. If there is a reduction in the financial value of the organization, corrective action is needed. On the other hand, amounts that are less than the stated figure could be taken to be immaterial. This is because their occurrences or non-occurrence may not be felt financially.
- Income statement – \$38341.4 – the income statement applies the same criteria as the balance sheet. This figure represents 10% of the net earnings at the end. If any of the income statement amounts are above the stated figure, then it is material to the decisions made. On the other hand, an amount that is less than the stated figure is immaterial. This is because its impact cannot derail the operations of the organization.

Elaboration Of The Percentage Criteria

The percentage criteria are quite effective in the determination of the materiality level. This is because it is tailor-made and thus considers the financial magnitude of the respective business under consideration. If the financial muscle of a business is big, the figure will be higher as well. If the value of the net value of the organization is low, the materiality level of the statement items will also be relatively lower. Another reason for the use of the percentage method is that it is simple in its application. The percentage method entails a simple calculation relative to the value depicted in the financial statements. It is, therefore, useful in the application of less professional firms.

References

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