How to identify a risk

Key definitions:

Risk: The possibility that an event will occur and adversely affect the achievement of objectives.

Inherent risk: The combination of internal and external risk factors in their pure, uncontrolled state, or, the gross risk that exists, assuming there are no internal controls in place.

Residual risk: The portion of inherent risk that remains after management executes its risk responses (sometimes referred to as net risk)

Risk appetite: the amount of risk, on a broad level, an organisation is willing to accept in pursuit of its business objectives.

Risk tolerance: the acceptable levels of risk size and variation relative to the achievement of objectives, which must align with the organization's risk appetite.

Risk response: an action, or set of action, taken by management to achieve a desired risk management strategy. Risk responses can be categorised as risk avoidance, reduction, sharing or acceptance. Exploiting opportunities that, in turn, enable the achievement of objectives, is also a risk response.

How to identify a risk?

When identifying a risk one should ask the following questions to ensure that one completely understands the risk:

As a result of…..

There is a risk that…..

Which may result in…..

This can be mitigated by….

Example:

As a result of salaries not being market related

There is a risk that staff may leave the organisation

Which may result in low staff morale and increased training costs

This can be mitigated by conducting an exercise to make salaries market related

The above will identification procedure will assist you with your exam technique as well. We find that many students identify the control weakness and not the risk. The weakness is that the organisation did not structure salaries according to the external market. The risk is that staff may leave the organisation and the consequence is low staff morale and increased training costs. If one gets confused between the concepts of risk and consequence, you should include both to ensure you get maximum marks in the exam. Furthermore, the control/mitigation strategy should speak to the control weakness. In this case, by conducting the exercise and making the salaries market related, the control weakness will be addressed.

Questions on risk identification

Question 1

You have recently joined Countryboy (Pty) Ltd, a company which operates a large general dealer outlet in rural Eastern Cape as an internal auditor. The company sells a wide range of products from bicycle parts to foodstuffs and clothing. Due to difficulties in staffing (and very erratic electricity supply) the company's systems are not computerised.

As your first assignment you have been asked to evaluate certain aspects of the acquisitions and payments cycle. The financial director (also newly appointed) has asked of you to indicate to him the risks surrounding ordering of goods.

Due to the location of Countryboy (Pty) Ltd's premises, it has been necessary for the company to work closely with suppliers with regard to reliability, pricing etc, and as a result, purchases are only made from approved suppliers. The system is currently not computerized.

YOU ARE REQUIRED TO:

a) Identify the risks which a company faces if it does not implement (put in place) sound control procedures over its "***ordering of goods***" function. (7)

Question 2

You have recently been appointed as a junior internal auditor at Bits & Bobs (Pty) Ltd. To prepare for your job interview you did some desktop research on the company and found that a leading business magazine rated Bits & Bobs (Pty) Ltd as the leading retailer in its field. The journalist evaluated the performance and short-term liquidity ratios of 90% of the companies in the same industry and found Bits & Bobs (Pty) Ltd to be the most successful.

The company is a retailer that sells spare parts for small electrical appliances.

On your first day at Bits & Bobs (Pty) Ltd, one of the internal audit managers informs you that in accordance with the internal audit plan, an internal audit of the revenue and receipts' cycle for the period 1 April 2011 to 31 March 2012 is scheduled to commence within the next week and that you have been assigned to the audit. The internal audit manager has compiled the following narrative description of the cycle:

- The company receptionist is responsible for opening the daily incoming mail. All the orders received from customers are placed in a box marked “Incoming Orders”. The box is then sent to the senior warehouse clerk who initiates the collection of the items ordered.

- Some customers fax their orders directly to the senior warehouse clerk prior to sending their orders through the mail. The company does not accept telephonic orders – when customers phone to place an order they are requested to either fax or submit a hardcopy order.

- Sales are only made on credit. No cash sales are permitted.

- On receipt of the customer orders/faxes, the senior warehouse clerk makes a photocopy of each. He files the originals alphabetically (by customer name) in a file. He divides the photocopies of orders roughly into two piles and hands a pile to each of the junior warehouse clerks who, among other duties, are responsible for collecting the ordered items from the shelves in the warehouse.

Required

In respect of the revenue and receipts cycle of Bits and Bobs (Pty) Ltd as described in the scenario (Part A) above, identify **four (4)** weaknesses and indicate the business risks related to each weakness.

Solutions:

Solution to question 1

a) If a company does not implement sound control procedures over its ordering of goods function, the following risks may arise:

- Incorrect goods may be ordered (quantity or type).
- Goods of inferior quality, resulting in obsolescence, sales returns, etc, may be ordered.
- Unnecessary goods may be ordered resulting in wastage/ obsolescence, cash flow problems.
- Orders may be placed fraudulently by buyers or others, resulting in payment by the company for goods never received or used by the company.
- The company paying unnecessarily high prices either because competitive prices are not sought, or because of fraud, e.g. buyers taking bribes or kickbacks.
- Requisitions from stores, manufacture or sales departments not acted upon (timeously or at all) by the ordering department resulting in production delays, lost sales due to items being “out of stock”.
- Orders placed, not timeously acted upon or not acted upon by suppliers resulting in the same problems as in 1.6.
- Order forms misused e.g. to facilitate private purchases by employees, for which the company will ultimately pay.

Solution to question 2

Weakness	**Business risk**
• There is a lack of basic division of duties as there is no separate order department to receive and authorise customer orders. The receptionist is not required to record all incoming orders in a register. √½	• The risk that orders are lost and not processed is increased. This may result in a loss of income and customer goodwill. √½
• The internal documentation initiating sales transactions is inadequate. √½	• The risk of orders not being filled or being lost is significant. This will result in a loss of sales income and customer goodwill. √½
• No credit management controls are in place. All orders received are filled	• All orders received are filled without verifying whether the order is from an

Weakness	Business risk
without verifying whether the order is from an existing customer or if the client has credit available. √½ • There appears to be no method for identifying orders which have been both faxed and sent through the post. √½ (4)	existing customer or if the client has credit available. This will increase the risk of bad debts. √½ • Therefore the same order can be filled twice. There is the risk of loss of inventory, and a decrease in sales income. √½ (4)