Part 1

Non-quantitative Aspects of Inherent Risk

David Jones is Australia's oldest department store that has operated for nearly 200 years, and is claimed to be the oldest department store in the world that is still trading under its original name. It currently has 37 stores located in all over Australia (David Jones, 2008). David Jones is a traditional department store, which offers a range of fashion, cosmetics, home wares, electronics, as well as other products (Wikipedia, 2008).

David Jones' biggest competitor is Myer, the largest department store chain in Australia, with nearly 60 stores. Myer was formerly a part of Coles Myer Group, before it was sold to a consortium of American investors, Texas Pacific Group, in 2006. Since that time, Myer continuously reduced its discounting activity, resulting in increase in David Jones' net profit. For the financial year of 2007-2008, David Jones had earned profit after tax of $137.1 million, 25.1% higher than the previous year (David Jones, 2008). However, as Tony Pearce, a fund manager at Legg Mason Asset Management in Melbourne, has said, David Jones had been able to extract better selling prices because of the lack competition from Myer. If Myer tries to fight back, the amount earned by David Jones may drop significantly (Fenner, 2007). This will create an opportunity for the risk of material misstatement to occur.

The last year Australian economic downturn, more or less, affects almost all companies operating in Australia, including David Jones department store. In order to stay generating profit, David Jones had to cut expenses and reduce its inventory holdings to increase the company's margin, as said by Mark McInnes, the Chief Executive Officer of

David Jones (Fenner, 2007). These activities open a greater possibility for inherent risks to take place.

Another non-quantitative aspect is the fact that David Jones is one of many companies that gives rewards to its shareholders. In spite of the fact that this program will be discontinued after 1 February 2009, during 2007-2008 financial year, David Jones had consistently given discount of 2% to its owners (David Jones, 2008) Greg Hoffman, research director with The Intelligent Investor, said during an interview, that most CEOs would like to increase the loyalty of shareholders, especially the small ones, to maximise the share price. Analyst Simon Guzowski agreed that David Jones had performed well but “at current levels, it is on the expensive side and the cyclical nature of the business means it could suffer in an economic downturn” (Bekiaris, 2007).

The existence of director’s remuneration also creates a chance for material misstatement to happen. It is important for a company to provide a market level remuneration for its directors in order to attract and retain the best directors available (Directors Australia, 2008). David Jones is one of companies that gives remuneration to several of its directors (David Jones, 2008). Even though director’s remuneration helps company to increase the performance of its directors, material misstatement often occurs when those directors try to manipulate the figures on accounts balance in order to obtain larger amount of remuneration.

Part 2

Quantitative Aspects of Inherent Risk

Table 1: Annual Ratio of David Jones

Ratio	07/01	07/02	07/03	07/04	07/05	07/06	07/07	07/08
Quick ratio	1.86	1.71	1.69	1.64	1.79	1.17	1.17	1.24
Current ratio	0.48	0.38	0.34	0.61	0.74	0.81	0.79	0.81
Debt to equity	15.21%	0.07%	0.03%	0.38%	0.00%	109.30%	140.27%	82.67%
Net interest cover	4.25	7.82	19.79	157.03	-37.74	8.03	5.72	6.57
Inventory turnover	555.59%	596.63%	609.59%	578.10%	645.09%	693.67%	745.04%	859.66%
Asset turnover	232.16%	250.09%	267.53%	229.66%	239.38%	167.19%	127.75%	144.60%
Return on assets	5.35%	5.95%	6.16%	8.12%	9.57%	8.66%	8.43%	10.84%
Return on equity	7.04%	7.71%	8.92%	13.41%	15.36%	22.70%	21.34%	22.11%
Days inventory	65.7	61.2	59.9	63.1	56.6	52.6	49.0	42.5
Days receivables	10.56	5.80	6.37	6.87	8.30	75.21	68.06	63.22

Source: Aspect Huntley FinAnalysis 2009

Table 2: Department Stores in Australia

$million	**2005**	**2006**	**2007**	**2008**
Return on Assets	158.1%	15.2%	16.6%	16.8%

Source: Aspect Huntley FinAnalysis, 2009

Annual Balance Sheet

	Jul-07	Jul-08
Current Assets		
Cash	161,308,000.00	66,564,000.00

Debtors	389,366,000.00	383,077,000.00
Other Debtors	17,821,000.00	31,903,000.00
Prepaid Expenses	9,570,000.00	7,769,000.00
Inventories	280,281,000.00	257,288,000.00
Current Investments	13,000.00	704,000.00
Other CA	0	0
Total Current Assets	858,359,000.00	747,305,000.00
Non-Current Assets		
Receivables	0	0
Investments	153,000.00	798,000.00
Inventories	0	0
PP&E	1,000,820,000.00	1,008,910,000.00
Acc. Depreciation	-334,651,000.00	-338,223,000.00
Intangibles Ex. Goodwill	8,912,000.00	6,605,000.00
Goodwill	30,305,000.00	30,305,000.00
FITB	70,745,000.00	73,910,000.00
Other NCA	0	35,000.00
Total NCA	776,284,000.00	782,340,000.00
Total Assets	1,634,643,000.00	1,529,645,000.00

Current Liabilities		
Accounts Payable	265,972,000.00	274,608,000.00
Provisions	93,429,000.00	77,737,000.00
S/T Debt	369,994,000.00	242,360,000.00
Other CL	1,438,000.00	8,828,000.00
Total CL	730,833,000.00	603,533,000.00
Non-Current Liabilities		
Accounts Payable	0	0
L/T Debt	350,000,000.00	270,000,000.00
Provisions	8,354,000.00	8,599,000.00
Other NCL	32,160,000.00	27,723,000.00
Total NCL	390,514,000.00	306,322,000.00
Total Liabilities	1,121,347,000.00	909,855,000.00
Shareholders Equity		
Share Capital	392,496,000.00	455,341,000.00
Reserves Ex. SPR	24,329,000.00	35,460,000.00
Share Prem Reserves	0	0
Retained Profits	96,471,000.00	128,989,000.00
Other Equity	0	0
Convertible Equity	0	0
Outside Equity	0	0
Total Equity	513,296,000.00	619,790,000.00

Source: Aspect Huntley FinAnalysis, 2009

Table 1 indicates there are significant improvements in David Jones' performance during 2007-2008. The increasing quick and current ratios shows that the company has higher liquidity and ability to cover its obligations. However, total current assets have gone down during the year. It is strengthened by the fact that cash has dropped sharply (see Balance Sheet). The liquidity of this company is questioned.

The decline in debt equity ratio is a good signal of company's performance. This is also supported by the fact that net interest cover is higher. However, the debt to equity ratio figure is still very high, indicating that the company is using more debt financing in doing business. The use of debt financing may bring greater risks to the company in term of solvency.

The other ratios, which are inventory turnover, asset turnover, RoA and RoE, all show progresses in company's performance. Audit plan does not need to change regarding this matter. Day inventory and day receivables are also better than the previous accounting period. The improvement in day inventory indicates that the company takes shorter time to convert its inventory into sales (Investopedia, 2009). Improvement in day receivables indicate that company deals with less risky customers. Lower day receivables means it takes the company fewer days to collect its debtor (Investopedia, 2009).

Despite the fact that this year's company performance is better than the previous financial years, the return on asset of the company of 10.84% is lower than the return on asset of department stores in Australia, which is 16.8%. This gives an idea that management using the company's assets to generate earnings less efficiently (Investopedia, 2009).

However, in spite of those all facts, the upward trend experienced by David Jones during 2007-2008 shows the perseverance of the management to create a better performance.

Part 3

Memo

To : Peter Richardson, Deakin University MAA303 Unit Chair

From : Lia Sagita Dewi (700368701)

Subject : Inherent Risk on the Audit Plan of David Jones Limited

Date : 12 January 2009

From all the non-quantitative and quantitative information that has been collected about David Jones Limited, these inherent risks of material misstatement are likely to take place.

1. The significant improvement on David Jones' performance is partly caused by the lack of competition from its bigger department store rival, Myer. If Myer then decides to compete with David Jones, there is a great possibility that David Jones' earnings decline. This opens a space for risk of material misstatement to occur, in order to keep the positive tendency of annual performance.
2. The activity of cutting expenses and reducing inventory holdings as a result of economic downturn create opportunity for the occurrence of inherent risk as the company will always try to produce as positive accounts balance as possible.
3. The trend of giving rewards that has been kept by David Jones for years may open a chance for material misstatement to happen if a great economic downturn causes the company to experience a decline in profit.
4. Director's remuneration may create material misstatement when the directors manipulate the accounts balance figure in order to get higher remuneration.
5. There is a possibility that the company is not liquid enough, indicated by the significant drop in cash balance. The high figure of debt to equity ratio also places the company in high risk of insolvency.
6. The return on assets of the company is much lower from the department stores in average. This indicates that the assets are not used as efficiently as possible to generate revenue.

All the points above give the audit team information about any possibilities of the occurrence of material misstatement. The audit plan needs to be adjusted in a way that all of those possibilities can be covered.

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