Introduction to
AUDITING

Only Study Guide for
AUE1501

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PREFACE

1 Welcome

Welcome to the world of the auditor. We are going to introduce you to business entities, corporate governance, the internal and external auditing profession, auditing concepts, the audit process and the business cycles.

The study material is presented in the form of topics and study units. It consists of ten topics, each topic made up of various study units. The topics and study units follow one another and should be studied in the correct sequence. The length of time needed to study any study unit will depend on the volume of work it contains.

The study units will include learning activities that will give you the opportunity to put your newly acquired knowledge into practice. All learning activities are adequately referenced to your prescribed textbook, Jackson and Stent (refer to Tutorial Letter 101 for the correct edition). In other words, you will find the answer to the learning activities if and only if you refer to the study references to the prescribed textbook. This means that you cannot study this module successfully without the prescribed textbook.

1. Do I have a copy of the prescribed textbook? | Yes | No |

2 Purpose of the module

The purpose of this module is to introduce you to the basic principles that apply in the audit world. The general principles regarding the business world, the auditing profession and the role of auditors are covered. The purpose is also to enable students to identify business and audit risk areas in an entity and to identify control measures to mitigate risks; all restricted to small and medium-sized enterprises.

After completing this module successfully you will be able to demonstrate an understanding of, and describe elementary auditing/internal auditing principles applicable to small and medium-sized enterprises.
3 Framework of the module

Below is a schematic representation of the content of this module.

AUE1501
INTRODUCTION TO AUDITING

Topic 1  The business world and corporate governance
1. Various types of business entities
2. Corporate governance
3. Internal control

Topic 2  The internal auditor
4. Introduction to internal auditing
5. The responsibilities of the internal auditor
6. Professional conduct requirements for the internal auditor
7. Internal audit and good corporate governance

Topic 3  The external auditor
8. The development of the external auditing profession
9. Assurance by the external auditor
10. Professional conduct requirements for external auditors
11. The relationship between internal and external auditors

Topic 4  Auditing concepts
12. Assertions
13. Audit evidence
14. Materiality and audit risk
15. Risk assessment and further audit procedures

Topic 5  The audit process
16. The overall audit process
17. Planning and implementing the plan
18. Reaching conclusion and reporting

Topic 6  System and cycles within a business
19. Systems and cycles within a business entity

Topic 7  The revenue and receipts cycle
20. Ordering and warehouse/despatch functions
21. Invoicing and recording of sales functions
22. Recording of receipts and credit management functions
4 The teaching strategy

4.1 The study package
The study package for mastering this module consists of:

- the prescribed textbook that you must purchase (see Tutorial Letter 101 for the details).
- a printed study guide, the content of which is also on the myUnisa module site under Study Units. The material in the guide is intended to enhance your learning experience and is based on the prescribed textbook. Study units contain learning activities that will enable you to further develop insights and reveal to you how much you have actually learnt. The material has been structured in topic and study units.
- all the study material is also made available on the myUnisa webpage for this module under the Official Study Material tab.
- assignments, which are contained in Tutorial Letter 101.
- announcements on myUnisa which contain information to which we wish to draw your attention. You will be notified of new announcements.
- discussion forum activities activated by the e-tutor.

2. Have I noted the due dates of the assignments on my calendar? [ ] Yes [ ] No

4.2 Importance of study outcomes and self-assessment
Each topic will introduce you to a set of study units that belong to that particular topic. Each study unit will contain its own study outcomes. At the end of the study unit you will be reminded of the study outcomes and you will be asked if you are able to achieve the study outcomes. Do not proceed to the next study unit before you are able to answer these self-assessment criteria positively. The sequence of the study units is important.

4.3 Study and study activities
A variety of study activities and study activities (self-assessment) are included in each study unit. These are a combination of reading, studying, internet research,
reflecting and discussion activities that are presented in a flexible manner throughout the various study units. They have been designed to enable you to absorb the content of the topic, to practise your understanding and to direct your thoughts. This is a vital aspect of our learning approach because as you encounter these study activities and actually do them, you will become directly involved in controlling the extent and quality of your learning experience. In short, how much and how well you learn will depend on the extent of your progress through the study activities, and the quality of your efforts.

As you page through the study guide you will notice that spaces have been left open where you can write down your answers to some of the study activities. This is intended to guide you to complete the answer correctly when referring to the prescribed textbook. Your study guide thus becomes your workbook. Active use of your prescribed textbook is essential to achieve success in this module.

I would like you to buy a blank exercise book or exam pad to use with the study guide. In this exercise book you must respond to the study activities, reflect on what you have learned, make your own notes or add diagrams to assist you in the learning experience. The exercise book will become useful when revising for the examination because all your notes are then kept at one place. There are numerous activities in the study guide that you must complete. Besides helping you to learn, writing down the answers will also assist you in improving your writing skills.

3. Do I have a blank exercise book or exam pad to use as workbook?  

| Yes | No |

3.4 Meaning of words

Meaning of words is extremely important when attempting the assignments and the examination. In this module we require you to understand the meaning of certain words to enable you to interpret assessment criteria, comprehend what various activities in the study guide require you to do and interpret assignments and examination questions.

To indicate the length, scope and format of answers to study activities and questions, we have deliberately built limits or restrictions into the questions by using action verbs. These action verbs give you an indication of how to tackle the given problem and what style of writing is called for.

An analysis of the action verbs contained in a question will

- enable you to plan the answer systematically and organise your thoughts logically
- ensure that you comply with the lecturer’s requirements

You will also save yourself time and trouble by eliminating irrelevant material that falls outside the scope of the answer.

For the purposes of this module, the following meanings will be attached to the following action words:
<table>
<thead>
<tr>
<th>Word</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compare</td>
<td>Place side by side in order to observe similarities, relationships and differences</td>
</tr>
<tr>
<td>Complete</td>
<td>Finish; accomplish; supply whatever is missing</td>
</tr>
<tr>
<td>Define</td>
<td>Describe accurately; establish the exact meaning; explain the inherent meaning; make clear; give an account of the overall character</td>
</tr>
<tr>
<td>Describe</td>
<td>Give an account of the respective particulars or essential characteristics; outline clearly; give an accurate account</td>
</tr>
<tr>
<td>Determine</td>
<td>Establish; reach a conclusion or decision</td>
</tr>
<tr>
<td>Discuss</td>
<td>Examine; explain; examine by means of argument</td>
</tr>
<tr>
<td>Explain</td>
<td>Make clear or comprehensible; elucidate; give the meaning in detail</td>
</tr>
<tr>
<td>Identify</td>
<td>Establish through consideration; recognise; pick out</td>
</tr>
<tr>
<td>Illustrate</td>
<td>Explain; shed light on; use an example to elucidate something</td>
</tr>
<tr>
<td>List</td>
<td>Note/specify matters or objects that are related to one another</td>
</tr>
<tr>
<td>Name/mention/state</td>
<td>Specify by name; give names, characteristics, items, elements or facts</td>
</tr>
<tr>
<td>Organise</td>
<td>Divide into classes or groups according to certain characteristics; place in a particular order</td>
</tr>
<tr>
<td>Prepare</td>
<td>Make ready in advance; finish; get something ready on the basis of previous study</td>
</tr>
<tr>
<td>Record</td>
<td>Put in writing; set down for reference and preservation</td>
</tr>
<tr>
<td>Substantiate</td>
<td>Supply reasons or facts; support a view or argument</td>
</tr>
<tr>
<td>Summarise</td>
<td>Give a brief account; briefly state the essence of a matter</td>
</tr>
<tr>
<td>Tabulate</td>
<td>Arrange in tabular form</td>
</tr>
</tbody>
</table>
4.5 Meaning of icons

The icons that will be used in this module are listed below, together with a description of what each means:

<table>
<thead>
<tr>
<th>Icon</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Study**  | • Study requires you to refer to the selected sections in your prescribed textbook and study the sections in detail. Any section marked as “Study” may be examined and it is important that you master those sections.  
• Make good use of your prescribed textbook by highlighting or underlining important concepts in your textbook.  
• Make use of an exercise book to make notes that you can use later on when revising and preparing for the examination. |
| **Activity** | • Activities are similar to questions and are designed to assist you to master and apply the study content.  
• Activities follow a study reference; therefore first refer to the study activity. First read the text and then attempt the activity.  
• All activities can be answered if the prescribed textbook is used.  
• Space is provided in the study guide to complete the activities.  
• The activities are examples of typical examination questions. |
| **Suggested Solution** | • Suggested solutions are the answers to the activities.  
• All of the answers are explained or can be found in the prescribed textbook. |
| **Internet** | • Internet activities require you to access the Worldwide Web.  
• These links route you websites and YouTube video clips and are very useful. |
| **Reflection** | • Reflecting requires you to jot down your thoughts in your workbook.  
• Reflecting helps to link new knowledge to your existing experiences.  
• You may draw your own mind maps to assist you in your thinking. Be creative! |
| **Discussion** | • Discussion is an activity that the e-tutor will initiate on myUnisa and you are encouraged to participate.  
• The discussion forum is a public educational forum so think carefully before you express an opinion in the public domain.  
• Use suitable language writing skills, e.g. do not type a sentence in capitals; refrain from using writing in short message style (sms).  
• Use the discussion forum as a platform to improve your business writing and critical thinking skills.  
• The discussion forum allows group work. |
5 Study approach

The following are vital considerations that you should bear in mind when approaching your studies in auditing, and also some useful hints and aids that will help you to improve your learning experience.

5.1 Allocation of time for this module

The study material for this module has been developed on the assumption that you will have a total period of 15 weeks available to study the module. You will need to use the final three weeks before the examination to revise and prepare for it. You should devote a minimum of eight hours a week to your studies for this module. Therefore plan for consistent work throughout the semester.

The following breakdown of the estimated time required to work through the different topics contained in the study material, including the completion of assignment work, is provided. You can use it to compile your own study schedule for this auditing module. Bear in mind that it is only a guideline. You may, however, find certain topics more difficult and thus require more hours to master them. Note where more time will be required and plan accordingly.

<table>
<thead>
<tr>
<th>Week</th>
<th>Topic</th>
<th>Hours</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Topic 1: The business world and corporate governance</td>
<td>7</td>
</tr>
<tr>
<td>2</td>
<td>Topic 2: The internal auditor</td>
<td>7</td>
</tr>
<tr>
<td>3</td>
<td>Topic 3: The external auditor</td>
<td>7</td>
</tr>
<tr>
<td>4</td>
<td>Topic 4: Auditing concepts</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>Topic 5: The audit process</td>
<td>8</td>
</tr>
<tr>
<td>6</td>
<td>Topic 6: System and cycles within a business</td>
<td>10</td>
</tr>
<tr>
<td>7</td>
<td>Topic 7: The revenue and receipts cycle</td>
<td>10</td>
</tr>
<tr>
<td>8</td>
<td>Topic 8: The acquisition and payments cycle</td>
<td>10</td>
</tr>
<tr>
<td>9</td>
<td>Topic 9: Bank reconciliation</td>
<td>4</td>
</tr>
<tr>
<td>10</td>
<td>Topic 10: Payroll and personnel cycle</td>
<td>7</td>
</tr>
<tr>
<td>12–15</td>
<td>Revision</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Completion of assignments</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Total time</td>
<td>120 hours</td>
</tr>
</tbody>
</table>

4. Did I plot the study units on my calendar to ensure consistent studying? Yes | No

5.2 Mastering the study material

Use the study units to guide you through the study material. The prescribed textbook contains the information you are required to master and remains the primary source that you will need to study. Information, explanations and questions in the study units, tutorial letters and assignments are included in order to make the information in the textbook comprehensible to you and to provide you with an indication of how well you have mastered the study material.
Remember to make use of an exercise book to write down your own notes and file these notes for revision purposes. For example, use your workbook to make notes and write down keywords and any problems that you have encountered. You can jot down information which fits in with your particular study approach.

5.3 Self-study and self-assessment

Self-study and self-evaluation are key components of distance education. The activities are typical examination questions. During revision use these activities to assess yourself. Attempt these questions in your study guide and mark them. Should you do badly, that’s okay – it just means that you need to refine your thinking. Analyse your mistakes in the exercise book and make a persistent effort to get to the bottom of the uncertainty or problem. If you persevere until you have solved the problem, you will find that you derive great satisfaction from doing so.

As indicated in the Tutorial Letter 101 for each auditing module, the auditing lecturers responsible for the module are available to help you solve subject-related problems. You will also be allocated an e-tutor to assist you in your learning journey.

6 What you can expect from Unisa

You can expect us to do the following:

- We will provide you with up-to-date and relevant learning material.
- We will keep the learning material in line with the needs of industry and commerce by consulting regularly with the profession.
- We will assist you by giving you the opportunity to develop competencies and skills at a certain level. The outcomes correspond to the National Qualifications Framework (NQF) level 5. You will be assessed taking the level descriptors of the NQF into account.
- We will support you whenever you require assistance. You may contact your lecturers by making personal appointments; contact them by phone or via e-mail or via the internet. We understand that studying through distance education is more challenging than attending a residential university.
- We will provide you with clear indications of what we expect from you in terms of your assessment.
- We will give you timeous feedback on assignments.

7 Feedback from students

To enable us to continue improving and adapting study material in order to meet students’ needs, we need feedback from you on any sections which are not clear or any problems you may have experienced with the study material for this module.

If you wish to supply feedback on the study material or assignments for this module, you can either contact us directly or in writing. Please take this opportunity to bring problems and shortcomings to our attention.

8 Conclusion

We hope you will enjoy your studies! We are certainly looking forward to being your partners in this endeavour.

Best wishes
Your lecturers in AUE1501
TOPIC 1

The business world and corporate governance

Study unit 1

Various types of business entities 12

Study unit 2

Corporate governance 20

Study unit 3

Internal control 26
TOPIC 1: THE BUSINESS WORLD AND CORPORATE GOVERNANCE

TOPIC OVERVIEW

To address the dilemma of poverty in our country we need to think in terms of job creation. The state cannot be the only or main role player in job creation. Why not? The tax base needs to be expanded far beyond the people working for government. In other words, the more successful businesses that come to light who can contribute to the state through taxes, the more successful a country becomes. In this regard, government, in collaboration with business and labour, will roll out a number of packages informed by the National Development Plan (NDP) to boost economic growth and job creation in South Africa. You can read about the plans by government by opening the following link:

http://www.southafrica.info/business/economy/policies/minibudget-231013e.htm#V7reWPI95Mw#ixzz4I3jeHqiP

If the tax base is not expanded, where will the state find money to pay the civil servants, build hospitals, and improve other essential services? You cannot also simply increase tax rates, say from 28% to 45%, to balance the books! If you do that, what do you think will happen to that country’s investment base? Entrepreneurs are needed for prosperity. Perhaps you may just be that person.

Think about the current state of affairs in South Africa and the high rate of unemployment. We have the mineral resources, for example, iron ore. We export the raw iron ore to China and import the finished products. Where do you think job creation takes place? Why are we not the manufacturers? That is where you, as finance student (skilled labour), come into the equation in building a better future for the country. Have a look at the following document to fully understand the extent of the unemployment problem in South Africa:


Do yourself a favour, go and read up on the history of any mega business of your choice. Many of them started out very small, housed in a small room or garage. The Bearing Man Group was started by a housewife who sold bearings in her garage. How did Microsoft start? Remgro started with Dr Anton Rupert manufacturing cigarettes in a garage! They all eventually grew into a mega businesses listed on the stock exchange. No special favours, only vision and action! Think about it, what stops you from growing into a successful entrepreneur?

As we work through this module I want you to visualise your own business. Think of a business that you want to start. There must be something; you must have a dream. You can for example aspire to become a consultant, an inventor and manufacturer of a new gadget, or a retailer. Give your business a name. By thinking of your own business you have become the creator of adding value to an idea. The aim with your idea is to sell the commodity at a profit. You will be a job creator!
As we work through the business cycles I want you to “see” the accounting systems and internal control measures that you are going to implement to contain the risks that apply to your own business idea. Through visualising you will be learning.

Remember: successful businesses means upliftment of society. That is why this module is so important. Let me also add, I am talking of honest business where the forces of supply and demand are functional. I am not talking of political favours, or hacking systems to commit fraud. It is about good business principles.

(http://www.globalethicsuniversity.com/articles/greed.htm)

The aim of this topic is to explain the various types of business entities, learn about good corporate governance of business entities and internal control as part of corporate governance.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Various types of business entities</td>
<td>12</td>
</tr>
<tr>
<td>2</td>
<td>Corporate governance</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>Internal control</td>
<td>26</td>
</tr>
</tbody>
</table>

**Textual amendments and additions**

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that have been indicated.
VARIOUS TYPES OF BUSINESS ENTITIES

IN THIS STUDY UNIT WE ARE GOING TO
- explain the advantages and disadvantages of each type of business entity
- differentiate between the various categories of companies

1.1 INTRODUCTION
Think about that business that you want to start. The first question that comes to mind is: what form should it take?

1.2 VARIOUS BUSINESS ENTITIES
The Department of Trade and Industry in South Africa recognises that a business can be operated through certain types of legal entities. In this study unit, we are going to look at each of the following types of business entities:
- Sole proprietor
- Partnership
- Close corporation
- Company

ACTIVITY
Go and open the following link and read about the legal issues of the different types of business entities. Think of the business that you have in mind and use the questions on that page to assist you in deciding on the most appropriate business entity. Notice the factors that you have to consider.

http://www.seda.org.za/MyBusiness/Factsheets/Pages/Whatisthebestform.aspx
DISCUSSION 1.1

E-tutor assistance required

Consider the following questions and post your thoughts about any of them on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

- What is the name of your business?
- Which type of business entity will suit your business now?
- If your business grows, which business entity will suit your new needs?

We have taken your idea (business idea) and we have given it a body (legal entity)!

In the the remainder of this study unit I will make reference to a useful document published by the South African Revenue Services (SARS): The South African Revenue Services (SARS), Tax Guide for Small Businesses: 2014/2015. If you wish to access it for additional reading, you can open the following link:


The above links allow us to identify some of the advantages and disadvantages of each type of business entity. Most businesses initially start off as a sole proprietor. As soon as the entrepreneur recognises that he/she needs more expertise or funds he/she might think in terms of a partnership or even a private company.

1.2.1 Sole proprietor

According to The South African Revenue Services (SARS), Tax Guide for Small Businesses (2014/2015), a sole proprietorship is a business that is owned and operated by a natural person (individual). This is the simplest form of business entity. Only the proprietor has the authority to make decisions for the business. The proprietor assumes the risks of the business to the extent of all of his or her assets, whether used in the business or not.

Like everything else in life, running an entity as a sole proprietor has advantages and disadvantages. These can be listed as follows:

**Sole proprietor:**

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple to set up and manage</td>
<td>A single owner has limited skills</td>
</tr>
<tr>
<td>The owner is free to make his/her own decisions</td>
<td>The owner can get business capital only as an individual</td>
</tr>
<tr>
<td>There are few legal requirements for setting up</td>
<td>All business debts are the owner’s responsibility</td>
</tr>
<tr>
<td>The owner gets all the profits</td>
<td>It is not a separate legal entity</td>
</tr>
<tr>
<td>It is easy to close down if you want to</td>
<td></td>
</tr>
</tbody>
</table>
1.2.2 Partnership

A partnership (or unincorporated joint venture) is the relationship existing between two or more persons who join together to carry on a trade, business or profession. A partnership is also not a separate legal person or taxpayer. Each partner is taxed on his or her share of the partnership profits and may contribute money, property, labour or skills, and each expects to share in the profits and losses of the partnership. It is similar to a sole proprietorship except that a group of owners replaces the sole proprietor. As is the case for a sole proprietorship, a partnership also has advantages and disadvantages. (South African Revenue Services (SARS), Tax Guide for Small Businesses: 2014/2015)

Partnership:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Simple to set up and manage</td>
<td>• It is not a separate legal entity</td>
</tr>
<tr>
<td>• It has greater financial strength</td>
<td>• Sharing the decision making can slow down the process</td>
</tr>
<tr>
<td>than a sole proprietorship</td>
<td></td>
</tr>
<tr>
<td>• All the partners’ skills benefit the entity</td>
<td>• All business debts are each partner’s responsibility</td>
</tr>
<tr>
<td>• Each partner has a personal interest in the entity</td>
<td>• Lower degree of business continuity as the partnership technically dissolves every time a partner joins or leaves the partnership</td>
</tr>
<tr>
<td></td>
<td>• Number of partners restricted to 20 except in the case of certain professional partnerships such as accountants, attorneys, etc</td>
</tr>
</tbody>
</table>

1.2.3 Close corporation (CC)

As mentioned in your prescribed textbook, Jackson & Stent (2016:3/67) the idea of a close corporation is that the members all work together for the good of the business. Close corporations were a simplified form of business. However, with the implementation of the Companies Act 2008, no new close corporations can be created.

STUDY

Jackson & Stent (2016:3/67)

(1) INTRODUCTION

Important to note when studying this section is that no new close corporations can be formed. The existing close corporations are still an acceptable business type, but no new ones can be formed. You can buy an existing close corporation.

(2) IMPORTANT CHANGES TO THE CC ACT 1984

Note from the studied information that a CC is a separate legal entity. A CC is similar to a private company. It is a legal entity with its own legal personality and perpetual succession and must register as a taxpayer in its own right. The CC has no share capital and therefore no shareholders. The owners of the CC are the members. Members do not hold shares in the CC and, therefore, they have a membership interest in the CC. This interest is expressed as a percentage.

**ACTIVITY 1.1**

Answer the following questions:

1. Can you still form new close corporations in South Africa?
2. If a CC is converted to a company, how will the legal status of the CC be affected?
3. What are the advantages and disadvantages of a CC?

**SUGGESTED SOLUTION 1.1**

Reference: Jackson & Stent (2016:3/69)

1. Currently in South Africa, no new close corporation may be established. The new Companies Act of 2008 provides that no new close corporation may be registered and that existing close corporations may be converted into companies or elects to remain as close corporations.

2. Such a conversion will affect the legal status of the close corporations as follows:
   - Members of the close corporation will be entitled to become shareholders in the converted company.
   - All assets, liabilities, rights and obligations of the close corporation will continue to be vested in the new company.
   - Any legal proceedings against or instituted by the close corporation may be continued.


**Close corporation:**

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relatively easy to establish and operate</td>
<td>There is a restriction of a maximum of 10 members</td>
</tr>
<tr>
<td>Life of the business is perpetual, that is, it continues uninterrupted as members change</td>
<td>There are more legal requirements than for a sole proprietor or partnership</td>
</tr>
<tr>
<td>Members have limited liability</td>
<td></td>
</tr>
<tr>
<td>Transfer of ownership is easy</td>
<td></td>
</tr>
<tr>
<td>Fewer legal requirements than a private company</td>
<td></td>
</tr>
</tbody>
</table>
1.2.4 COMPANY

A company means a juristic person incorporated in terms of the Companies Act, a domesticated company, or a juristic person that is registered in terms of the Companies Act (Companies Act, No 71 of 2008).

A company is therefore a separate legal entity.

The following are advantages and disadvantages of a company (See South African Revenue Services (SARS), Tax Guide for Small Businesses: 2014/2015.)

Company:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Life of the business is perpetual, that is, it continues uninterrupted as shareholders change</td>
<td>• It is subject to many legal requirements</td>
</tr>
<tr>
<td>• The shareholders loss is limited to the share capital contributed</td>
<td>• More difficult and expensive to establish and operate than other forms of ownership such as a sole proprietorship or partnership</td>
</tr>
<tr>
<td>• Shareholders are not personally responsible for the entity’s debts</td>
<td></td>
</tr>
<tr>
<td>• Transfer of ownership is relatively easy</td>
<td></td>
</tr>
<tr>
<td>• It is adaptable for small, medium and large entities</td>
<td></td>
</tr>
</tbody>
</table>

1.3 CATEGORIES OF COMPANIES

STUDY

Jackson & Stent (2016:3/15): 2. Sec 8 – Categories of companies

Using the above study reference a mind map (or a summary) of the different categories of companies is generated as follows:
Diagram 1: Categories of Companies

Companies

Profit

State owned
Eskom Holding SOC Ltd

Public
Sasol Ltd

Private
Tau (Pty) Ltd

Personal
Abed Inc

Non-Profit

Aidsrevive NPC

Characteristics
J&S note(f) Activity 1.5 J&S note(e) Activity 1.4

(source: Jackson & Stent 2016:3/15)

Activity 1.2
Refer to the above diagram. J & S refers to Jackson & Stent and the notes (f) and (e) are found on page 3/15. You are required to list the characteristics of a public and a personal company.

Activity 1.3
List four categories of profit companies that can be formed.

Suggested Solution 1.3
A state-owned company

Reflection 1.1
Did you know that the state owns companies that have a profit motive? Google “South African state-owned enterprises” and list two examples.

Reflection 1.1
TOPIC 1: THE BUSINESS WORLD AND CORPORATE GOVERNANCE

ACTIVITY 1.4
Explain the characteristics of a non-profit company.

SUGGESTED SOLUTION 1.4:
Incorporated for whose benefit?
How may income and property be used?
The company name ends with?

ACTIVITY 1.5
Explain the characteristics of a private company.

SUGGESTED SOLUTION 1.5:
A private company has a Memorandum of Incorporation that prohibits ____________________________
restricts ____________________________
cannot be ____________________________

INTERNET ACTIVITY 1.2
Are you unsure what a Memorandum of Incorporation is?
If your answer is “yes” then google:
“Memorandum of Incorporation for South African companies”

1.4 SUMMARY AND SELF-ASSESSMENT
In this study unit we had a look at the various types of entities as well as their advantages and disadvantages. We also had a look at the different categories of companies.

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Activity 1.1</th>
<th>Discussion 1.1</th>
<th>Self-Reflection 1.1</th>
<th>Internet Activity 1.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 1.2</td>
<td></td>
<td></td>
<td>Internet Activity 1.2</td>
</tr>
<tr>
<td>Activity 1.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 1.4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 1.5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references, are you able to
• explain the advantages and disadvantages of each type of business entity?
• differentiate between the various categories of companies?
CORPORATE GOVERNANCE

IN THIS STUDY UNIT WE ARE GOING TO

• introduce you to corporate governance
• define corporate governance and examine the objectives of the King IV Code of Corporate Governance
• describe the foundation stones of the King IV Code of Corporate Governance
• describe the first three principles of the King IV Code of Corporate Governance

2.1 INTRODUCTION

In the previous topic we looked at the different business types. As soon as your business grows from a small sole proprietor into a large company, more and more parties become involved. For example, you will appoint people to work for you; you will want to apply for a loan at a bank to expand your business; you will buy supplies on credit. As more parties become involved more responsibility and accountability is expected from business owners and leaders. People doing business with you will want to trust you.

The question arises: why do we read so much about fraud and corruption? This is a worldwide problem. Major international enterprises involved in corruption are Lehman Brothers, Enron, Worldcom, and Parmalat. In South Africa corruption is increasing rapidly (http://www.corruptionwatch.org.za/why-is-corruption-getting-worse-in-south-africa/). So, how can we address this worldwide problem? The aim of this study unit is to introduce you to corporate governance. Your way of doing business (even your start-up business) should be in the spirit of good corporate governance. An attempt to end corruption and fraud begins with your mindset towards good business practices.

You are going to be introduced to corporate governance. This knowledge will allow you to argue and think about current issues because you have a framework. When reading about bad business practices in the newspaper, you will have a framework based on which to judge actions (Jackson & Stent 2016:4/3). You will be able to make informed decisions. You will be able to measure people’s actions against the principles contained in the King IV Code of Governance.

In any business organisation, corporate governance helps to strengthen the roles and relationships between the organisation’s management, board of directors, and its stakeholders. Such stakeholders may include the shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the organisation’s activities, whereas the board of directors, executives, management and other employees are regarded as the internal stakeholders (see Jackson & Stent 2016:4/3). It further states that healthy, honest, open, competently and responsibly controlled companies will improve the quality of modern society.
Corporate governance is defined as “the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes: ethical culture; good performance; effective control, and legitimacy” (Jackson & Stent 2016:4/3).

INTERNET ACTIVITY 2.1

I want you to open this link and introduce you to the man himself, Judge Mervin King: https://www.youtube.com/watch?v=8meq3mPthqw

2.2 BACKGROUND TO THE KING IV REPORT

Why do we need a King IV?

INTERNET ACTIVITY 2.2

https://www.youtube.com/watch?v=h7G8hQxpDrM

Corporate Governance in South Africa has been an ongoing process since 1994. To obtain a sense of how the process evolved from the first King Report in 1994 until King IV in 2016, you can read the relevant sections in Jackson & Stent (2016:4/3–4/4).

The 21st century has been characterised by fundamental changes in business and society and new global realities are severely testing the leadership of companies and other organisations. Understanding these realities will give you context to understand the need for King IV.

ACTIVITY 2.1

Refer to Jackson & Stent (2016:4/5). List the business, society and new global realities that characterise the 21st century.

SUGGESTED SOLUTION 2.1:

1. A growing societal inequality
2. 
3. 
4. 
5. 
6. 
7. 
8. 

This brings us to the objectives of King IV (in the context of a company).

ACTIVITY 2.2

Study Jackson & Stent (2016:4/7). Describe the five main objectives of King IV.
SUGGESTED SOLUTION 2.2:

(1) Promote responsible corporate governance as integral to running the company and delivering outcomes such as an ___________; ___________; ____________; ____________, and ____________.

(2) Broaden (increase) the acceptance of the King IV Report by making it ____________ and ____________ for implementation across ____________.

(3) Reinforce corporate governance as a ____________ and ____________ set of arrangements to be understood and implemented in an ____________ manner.

(4) Encourage ____________ and meaningful ____________ to shareholders.

ACTIVITY 2.3

Certain concepts form the foundation stones of King IV and could be referred to as the “philosophical underpinnings” of corporate governance. There are seven concepts. The concepts of King IV is explained in Jackson & Stent (2016:4/8–4/12). The foundation stones are important and the following diagram provides you with some study structure. Make sure that you can list and explain the concepts.

DIAGRAM 2: FOUNDATION STONES OF KING IV

1. Ethical leadership
   - Ethical leadership
   - Responsibility
   - Accountability
   - Fairness
   - Transparency
   - Integrity
   - Competence
   - Effective leadership
   - Goal orientation
   - Ethics, values & culture

2. Company integral part of society
   - Social context

3. Corporate citizenship
   - Corporate citizen
   - Rights
   - Obligations & responsibilities

4. Sustainable development
   - Primary ethical & economic imperative
   - Inclusivity of stakeholders
   - Innovation, fairness & collaboration
   - Social transformation

5. Stakeholder inclusivity
   - Best interest of company (long-term)

6. Integrated thinking
   - Holistic decision making

7. Integrated reporting
   - Report meaningful to all material stakeholders

Source: Jackson & Stent (2016:4/8–4/12)
2.3 LEADERSHIP, ETHICS AND CORPORATE CITIZENSHIP

2.3.1 Leadership

STUDY


**Principle 1.** The board should lead ethically and effectively.

Principle 1 refers to the characteristics which directors should cultivate and exhibit in their conduct.

The following activity explores these characteristics in more detail.

**ACTIVITY 2.4**

Refer to Jackson & Stent (2016:4/19–4/21) to expand on what is meant by the six characteristics which directors should cultivate and exhibit in their conduct.

1. **INTEGRITY:**
   - Directors must act in good faith in the best interests of the company.
   - Directors should avoid conflict of _____________.
   - Directors should act _____________.
   - Directors should set _____________.

2. **COMPETENCE:**
   - The board as a whole and directors individually, assume ____________ for the ongoing ____________ to run the company effectively.
   - Directors should ensure that they have ____________ of the company, its industry and the ____________, ____________, _________ and _________ context in which it operates, as well as of the significant _________
   - Directors must act with due ____________, __________ and ____________, and take ____________

3. **RESPONSIBILITY:**
   - Directors should assume ____________ responsibility for steering and setting the direction of the company ____________
   - Directors should exercise ____________ and ____________ but in a ____________, ____________ of the company.
   - Directors should take responsibility for ____________, ____________ or _________ the negative outcomes of the company’s activities and outputs on the social, economic and environmental contexts in which it operates, and on the capitals that it uses or affects.
   - Directors should ____________ and devote ____________
4. ACCOUNTABILITY:
• Directors should be ________________________ (________________)
  the __________________ even __________________

5. FAIRNESS
• Directors must consider and balance the legitimate and reasonable needs, interests and expectations of __________________________
• Directors should direct the company in a way that __________________

6. TRANSPARENCY
Directors should be transparent in the manner in which they ____________
______________________________ ________________ .

2.3.2 Organisational ethics

**Principle 2.** The board should govern the ethics of the company in a way that supports the establishment of an ethical culture.

The essence of this principle is that an ethical culture cannot be established and maintained if the board does not set the tone, convey the company’s ethical norms and values to internal and external stakeholders (Jackson & Stent 2016:4/21).

**STUDY**

Jackson & Stent (2016:4/21)

The recommended practices set out in Jackson & Stent (2016:4/21) emphasises the board’s duties to establish an ethical culture.

**REFLECTION 2.1**

If an organisation obtains valid negative publicity due to fraudulent activities, to what extent do you think that the board must own up?

2.3.3 Responsible corporate citizenship

**Principle 3.** The board should ensure that the company is and is seen to be, a responsible citizen.

**STUDY**

Make sure that you are able to link a factor to be considered to be an action of a good corporate citizen in Jackson & Stent (2016:4/23).

REFLECTION 2.2

- Would you like to see leadership, ethics and corporate citizenship evident in government, municipalities, and state-owned enterprises?
- What will eventually (in the long term) happen to a business where these ethical values and standards are absent?

2.4 SUMMARY AND SELF-ASSESSMENT

In this study unit we introduced you to corporate governance, defined corporate governance and examined the objectives of the King IV Code of Corporate Governance. We described the foundation stones and the first three principles of the King IV Code of Corporate Governance.

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Activity 2.1</th>
<th>Internet Activity 2.1</th>
<th>Self-Reflection 2.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 2.2</td>
<td>Internet Activity 2.2</td>
<td>Self-Reflection 2.2</td>
</tr>
<tr>
<td>Activity 2.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 2.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- define corporate governance and examine the objectives of the King IV Code of Corporate Governance?
- describe the foundation stones of the King IV Code of Corporate Governance?
- describe the first three principles of the King IV Code of Corporate Governance?

In the next topic, we will discuss the role of internal control in the organisation.
STUDY UNIT 3

INTERNAL CONTROL

IN THIS STUDY UNIT WE ARE GOING TO

• form an understanding about where internal control fits into the business context
• define internal control
• describe the limitations of internal control
• list the five components of internal control
• link the elements of control to each of the five components of internal control

3.1 INTRODUCTION

Let’s summarise what you have learnt so far: You know what business you want to set up, and you have some idea of what corporate governance is about. However, we now have a new challenge. Let’s assume your business expands; this means you need more resources. For example, you need to appoint people – sales persons, accountants, drivers, cleaners, etc. You will need purchased or lease assets to expand the business, borrow money from banks or convince potential investors based on budgets and financial statements prepared by your people. You cannot do all of this on your own any more; you need some way to control what’s happening in the business. More resources mean there is more risk and responsibility over these resources. This study unit is going to introduce you to the concept of internal controls.

INTERNET ACTIVITY 3.1

To orientate you a little bit more view this video (although the video refers to a non-profit organisation the aim is to introduce you to a new concept, namely internal controls): https://www.youtube.com/watch?v=750q-ADn88g

3.2 DEFINITION OF INTERNAL CONTROL

Management is responsible for running all aspects of the entity. The objectives of the business will be set, the risks relating to achieving those objectives will be identified and suitable books, records and documents, and policies and procedures will be put in place to address those risks.
The policies and procedures that are put in place will include the implementation of effective internal controls to ensure, amongst others, the efficient effective and economic operating of the business. As stated above, internal controls are implemented in response to risk.

**STUDY**

Refer to Jackson & Stent 2016:5/3–5/5 paragraphs 1 to 3:
Use the following mind map to assist you in understanding the prescribed text.

**DIAGRAM 3: INTERNAL CONTROL OVERVIEW – A BUSINESS PERSPECTIVE**

**Source:** Jackson & Stent (2016:5/3–5/5)

**Paragraph 1: Introduction**

Paragraph 1.3 of Jackson & Stent 2016:5/4 identified interesting facts about internal control. These facts will assist you in understanding how internal controls function.

**ACTIVITY 3.1**

You are required to write down these facts and reflect on them. Do you agree with those statements?
STUDY UNIT 3: Internal control

SUGGESTED SOLUTION 3.1

<table>
<thead>
<tr>
<th>Internal control fact</th>
<th>Expanding on fact</th>
<th>Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Internal control is a process</td>
<td>It is a combination of systems, policies….</td>
<td>Yes</td>
</tr>
<tr>
<td>2.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

STUDY


ACTIVITY 3.2

Define the term internal control.

SUGGESTED SOLUTION 3.1

In writing down the definition ask yourself the following guiding questions:

Who makes it happen (effected by whom)? What do internal controls aim to attain? Which broad categories are focuses by internal control?

Internal control is defined as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- 
- 
- 

3.3 LIMITATIONS OF INTERNAL CONTROL

STUDY

Study Jackson & Stent (2016:5/4–5/5) about the inherent limitations of internal control. As a manager you have to be aware of these limitations.

ACTIVITY 3.3

Describe the inherent limitations of internal control.
SUGGESTED SOLUTION 3.3

The inherent limitations of internal control are summarised in the following diagram 4.

**DIAGRAM 4: INHERENT LIMITATIONS OF INTERNAL CONTROLS**

This is only a summary and you should be able to discuss the inherent limitations in detail by referring to Jackson & Stent (2016:5/4–5/4).

3.4 COMPONENTS OF INTERNAL CONTROL

**STUDY**

Jackson & Stent (2016:5/5–5/6)

This section refers to the framework for internal control that consists of five internal control components. This section is very important because if you master the framework then you have a good foundation on which to build your understanding of internal control. Studying this section will take time and may be difficult at first, but it is very important.

**ACTIVITY 3.4**

**Step 1:** Read the elements below each component in Jackson & Stent (2016:5/6).

**Step 2:** Refer to the table below as part of the suggested solution. Five components of internal control are listed in the table.

**Step 3:** In your own words, describe your understanding of each component based on the elements.

**SUGGESTED SOLUTION 3.4**

You should be able to formulate the description of the elements in your own words by studying the individual elements listed in Jackson & Stent (2016:5/6). However, if you are battling then read the introductory explanatory paragraphs listed below:
3.5 THE ELEMENTS OF EACH COMPONENT OF INTERNAL CONTROL

Refer to Jackson & Stent (2016:5/7–5/17) to increase your understanding of the elements of the five components you summarised above in more detail. Once you have studied the above reference you can attempt the following activities. Use the diagram in Jackson & Stent (2016:5/6) to obtain a holistic view of the material that you have to study.

ACTIVITY 3.5

Describe the characteristics of an effective control environment.

SUGGESTED SOLUTION 3.5

Refer to Jackson & Stent (2016:5/7–5/8) for characteristics of an effective control environment.

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of those charged with governance
- Management's philosophy and operating style
- Organisational structure
- Assigning authority and responsibility
- Human resource policies and practices
TOPIC 1: THE BUSINESS WORLD AND CORPORATE GOVERNANCE

ACTIVITY 3.6

List the stages in the risk assessment process.

SUGGESTED SOLUTION 3.6

Reference: Jackson & Stent (2016:5/6)

Risk has to be defined; risks have to be identified; and assessed, and risks have to be responded to.

ACTIVITY 3.7

List six types of control activities.

SUGGESTED SOLUTION 3.7

Reference: Jackson & Stent (2016:5/12–5/16)

- Approval, authorisation
- Segregation (division) of duties
- Isolation of responsibility
- Access/custody (security)
- Comparison and reconciliation
- Performance reviews

ACTIVITY 3.8

Segregation of duties (activity 3.7) was one of types of control activities. The table below sets out five functions of segregation of duties. You are required to explain the “rule” that should be present for each of the five functions that will ensure effective segregation of duties.

SUGGESTED SOLUTION 3.8

Refer to Jackson & Stent (2016:5/13–5/14) for an explanation of segregation of duties.

Note that the biggest enemy of segregation of duties is collusion.

<table>
<thead>
<tr>
<th>Segregation of duties function</th>
<th>“Rule” behind the segregation function</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Initiation and approval</td>
<td>The person initiating and approving the transaction should not be the same person.</td>
</tr>
<tr>
<td>2. Executing the transaction</td>
<td></td>
</tr>
<tr>
<td>3. Custody of the items</td>
<td></td>
</tr>
<tr>
<td>4. Recording the transaction</td>
<td></td>
</tr>
<tr>
<td>5. Reviewing the function</td>
<td></td>
</tr>
</tbody>
</table>
3.6 SUMMARY AND SELF-ASSESSMENT

In this study unit we had a look at the definition of internal control, its limitations and the components of internal control within the organisations.

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Activity 3.1</th>
<th>Activity 3.2</th>
<th>Activity 3.3</th>
<th>Activity 3.4</th>
<th>Activity 3.5</th>
<th>Activity 3.6</th>
<th>Activity 3.7</th>
<th>Activity 3.8</th>
<th>Internet Activity 3.1</th>
</tr>
</thead>
</table>

After having worked through the study unit and the study references are you able to:

- demonstrate an understanding where internal control fits into the business context?
- define internal control?
- describe the limitations of internal control?
- list the five components of internal control?
- link the elements of control to each of the five components of internal control?

This topic dealt with the selected aspects of the internal control. In the next topic, we will discuss the role of internal audit in the organisation.
TOPIC 2

The internal auditors

Study unit 4  
Introduction to internal auditing  35

Study unit 5  
The responsibilities of the internal auditor  41

Study unit 6  
Professional conduct requirements for internal auditors  43

Study unit 7  
internal audit and good corporate governance  47
TOPIC 2: THE INTERNAL AUDITORS

TOPIC OVERVIEW

The aim of this topic is to enable you to demonstrate an informed understanding of the key terms, concepts, facts, general principles, rules and theories of the internal auditing profession.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Introduction to internal auditing</td>
<td>35</td>
</tr>
<tr>
<td>5</td>
<td>The responsibilities of the internal auditor</td>
<td>41</td>
</tr>
<tr>
<td>6</td>
<td>Professional conduct requirements for internal auditors</td>
<td>43</td>
</tr>
<tr>
<td>7</td>
<td>Internal audit and good corporate governance</td>
<td>47</td>
</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that have been indicated.
INTRODUCTION TO INTERNAL AUDITING

IN THIS STUDY UNIT WE ARE GOING TO

- discuss the basic function and organisational position of the internal auditor
- explore internal auditing as a career

4.1 INTRODUCTION

In Study Unit 1 we spoke of you starting your own business. Assume your business has grown and you need funding to expand. You want to list your company on the stock exchange to raise funds through issuing shares to the public. Who do you think will invest in your company and why? Many factors will be considered.

Now ask yourself this question: Will you invest your hard-earned money in any business? The answer will likely be no, you don’t want to gamble. You would probably invest in a business that is, inter alia, well managed. In other words, a business managed in terms of the code of corporate governance principles. In Study Unit 2 you were introduced to corporate governance. If you look at the 17 principles listed in the table of contents in Jackson & Stent (2016:4/2), you will gather that corporate governance is about strengthening the relationship between management (board of directors), and stakeholders (shareholders, creditors, employees, and the general public). If you reflect on the above, management has a huge responsibility to society.

In this study unit we are going to look at the internal audit function as a component of ensuring good corporate governance and explore the career possibilities of the internal auditor.

4.2 POSITIONING THE INTERNAL AUDIT FUNCTION

We realised in Study Unit 2 that a business has certain risks and the controlling body (board of directors) and the executive management (which we will refer to as management) are responsible for establishing the organisation and then ensuring that it operates successfully and efficiently. The board of directors are responsible mainly for the governance process (i.e. establishes and maintains corporate policies and provides information about its stewardship – accountability). The executive management is responsible for conducting the risk management and control processes. The audit committee is a subcommittee of the board overseeing the internal audit activity and external auditors (Jackson & Stent 2016:4/33).
TOPIC 2: THE INTERNAL AUDITORS

In terms of the Companies Act, state-owned companies, listed companies and larger private companies must have an audit committee.

Diagram 5 below shows you a bigger picture of the management structure in a large organisation. The diagram will assist you to better understand the important role that the internal auditor fulfills within the organisation. Study the diagram. The board of directors reports financial information to external interested parties in an organisation. The external interested parties include the shareholders, and other stakeholders for example banks, creditors and regulators. However, someone must see to it that the information reported by the directors is creditable. This is the duty of the audit committee.

The audit committee oversees and monitors the audit process. In terms of King IV Part 5, paragraph 50, the audit committee "should provide independent oversight of auditing and assurance requirements; independence of the auditor and other assurance providers; audit quality, and integrity, also known as the reliability and usefulness of reports." Therefore, the audit committee, in its independent oversight role, fulfills a pivotal role between the external auditor, the internal auditor, executive management and the board of directors to achieve its objectives.

The executive management (Chief Executive Officer or CEO and Chief Financial Officer or CFO) fulfill an operational function (day-to-day operations) with the assistance of the internal audit function. Notice that the internal audit function is on the same level as that of the executive management and not on a lower level. Therefore, the internal audit function operates at executive level. One would now ask a very important question: How “independent” can the internal auditors operate in an organisation that pays its salaries? Besides the Code of Ethics for internal auditors requiring the internal auditor to function independently, the internal audit function maintains its independence by reporting to the audit committee.

Notice the interaction between the internal auditor, external auditor and the audit committee. In the study units to follow, we will examine the interaction between the external and internal auditor.
Management must set goals; plan what has to be done and what means are to be used; organise to have the necessary means/people available at the right time; give guidance (direct), and exercise control to ensure that objectives are met; and keep records of all activities so that they are able to give account of their curatorship over the interests of the stakeholders (Jackson & Stent 2016:4/8).

The overall objective of an internal audit is determined by the needs of the board and executive management, and the internal auditor must ensure that these needs are satisfied by the internal audit report, which he or she submits to the board and the audit committee.

4.3 THE AUDIT COMMITTEE

To enhance your understanding of the audit committee let us examine some of its duties within the organisation.

STUDY 4.1

Jackson & Stent (2016:4/33) – Responsibilities and function

Complete the following section:

The role of the audit committee is to provide independent oversight of:

- The effectiveness of ____________________________
- The integrity of ____________________________
- The audit committee carries ultimate ____________________________
- The management of financial and ____________________________
- The audit committee should meet ____________________________
TAKE NOTE
(Note the oversight function that the internal audit fulfils between the external and internal auditors.)

4.4 DEFINITION OF INTERNAL AUDITING

Let us begin with a definition of internal auditors. In order to understand their field of specialised knowledge, we need to describe (define) it clearly so that you have an accurate idea of the basic objective(s) and limiting factors relating to it, as well as the methodology followed to attain the objective(s). The definition of internal auditing is the cornerstone of internal auditing practice. It explains what internal auditing is and what internal auditors should do.

The Institute of Internal Auditors (IIA) in terms of their International Standards for the Professional Practice of Internal Auditing (the Standards) (2012), accepted the following definition:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

In order to properly grasp any definition it is important to have a comprehensive understanding of all the components that make up the definition. The different components of the definition are described in the Collins English dictionary of 1998 as follows:

INDEPENDENT: free from the control or influence of others
OBJECTIVE: aim or purpose; when used as an adjective, not biased
ASSURANCE: promise or guarantee (assure: convince; make certain)
OPERATION: method or procedure of working
SYSTEMATIC: methodical; according to a plan
DISCIPLINED: able to behave and work in a controlled way
APPROACH: begin to deal with; make a proposal or suggestion to
EVALUATE: find or judge the value of
IMPROVE: make or become better
EFFECTIVENESS: producing the desired result
RISK: hazard, for example, loss or damage
CONTROL: power to direct something; regulate
GOVERNANCE: government, control or authority; the action, manner or system of governing

Analysing the meaning of all the different concepts or words in the definition should enhance your understanding of the definition. Do you see that the definition is very powerfully packed with meaning?

From the above definition you can conclude that one expects certain behaviour of the internal auditor. Imagine if you cannot trust the internal auditors! Therefore, one expects a code of ethics. The code of ethics states the principles and expectations governing the behaviour of individuals and organisations in the conduct of internal auditing. It describes the minimum requirements for conduct
and behavioural expectations rather than specific activities. We will look at the code of ethics in the next study unit.

In addition one expects the internal auditor when performing their assurance activities to conform to certain standards. Therefore, the internal auditor is subject to the *International Standards for the Professional Practice of Internal Auditing* (the Standards). Standards are principle-focused and provide a framework for performing and promoting internal auditing. The Standards provide guidance for the conduct of internal auditing at both the organisational and individual auditor levels. They are the result of careful study, consultation and deliberation about the basic principles for providing internal audit services.

**4.5 THE ROLE OF THE INSTITUTE OF INTERNAL AUDITORS IN SOUTH AFRICA (IIA-SA)**

**INTERNET ACTIVITY 4.1**

Open the "Home" page of The Institute of Internal Auditors South Africa (IIA SA) on the following link [http://www.iiasa.org.za/](http://www.iiasa.org.za/) and read their welcoming page. Open “About us” to reinforce your understanding of the role of the internal auditor. Also open [http://www.iiasa.org.za/?page=CareerPath](http://www.iiasa.org.za/?page=CareerPath) and read about the education and training requirements of the internal auditor. Some of you may be working at the Auditor-General or in an environment where you were exposed to the internal auditors. This is definitely a career path to explore if you enjoy auditing.

From the [http://www.iiasa.org.za/](http://www.iiasa.org.za/) website you can gather that the Institute of Internal Auditors South Africa (IIA SA) is part of an international network representing the interests of internal auditors worldwide. As a part of this international network, the IIA SA upholds and supports the fundamental tenets of the profession – the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing. The IIA SA supports the profession by providing a wide range of services dedicated to the education and advancement of internal auditors and dynamically promoting and developing the profession in South Africa. The IIA SA's objectives are to build the profession, its credibility and a thriving business environment in South Africa. The IIA SA serves internal auditors in South Africa by offering Technical Guidance, Professional Training Programs, Certification Programs, Continuing Professional Development Opportunities, Conferences and Networking Opportunities.

The Institute of Internal Auditors South Africa (IIA SA) facilitates the advancement of the profession through an on-the-job training program (professional training program), a test of competence (internal audit technicians (IAT)), general internal audit training (GIA) and certified internal auditors (CIA)). Accordingly, all these professional offerings help the internal auditor's competence and accountability towards a code of ethics.

The professional level of competencies of internal auditors can be categorised into the following levels:

**Internal Audit Technician (IAT)**

This is the entry-level designation and indicates that an IAT should be able to perform routine audit tasks, execute audit programs, prepare working papers and draft audit findings.
**General Internal Audit (GIA)**

This is the next step in the career path. The GIA is a supervisory level designation and the format of this program is the same as for the IAT – comprising training modules and structured workplace training. The focus is on being able to perform some senior and supervisory tasks, and conducting multiple audit duties. A GIA should be able to perform duties with limited or no supervision. Entrance to the GIA program is by two means – having successfully completed the IAT program, or having being assessed as competent against the IAT training logbook specifications.

**Certified Internal Auditor (CIA)**

The CIA is the premier global designation of the internal auditing profession. The CIA is recognised by individuals and organisations throughout the world as “The Global Mark of Excellence in Internal Auditing”.

The professional elements in internal auditing are developed and maintained by the Institute of Internal Auditors to offer the internal audit practitioners a full range of internal audit guidance. The Code of Ethics and the professional standards are the exemplary to the guidance.

**REFLECTION 4.1**

Talk to friends or colleagues in the workplace who are internal auditors about their role in the organisation and appreciate the important and responsible task that they perform.

**4.6 SUMMARY AND SELF-ASSESSMENT**

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Study 4.1</th>
<th>Internet Activity 4.1</th>
<th>Reflection 4.1</th>
</tr>
</thead>
</table>

After having worked through the study unit and the study references are you able to:

- discuss the basic function and position of the internal auditor?
- make a more informed decision about becoming an internal auditor?

In the next study unit we are going to look at the role of the internal auditor in more detail.
STUDY UNIT 5

THE RESPONSIBILITIES OF THE INTERNAL AUDITOR

IN THIS STUDY UNIT WE ARE GOING TO

• describe the duties associated with internal auditing

5.1 INTRODUCTION

The IIA has made an informative document of nine pages available, titled All in a day’s work: A look at the varied responsibilities of internal auditors. You will find the document under Additional Resources or you can open the following link https://na.theiia.org/about-ia/PublicDocuments/06262_All_In_A_Days_Work-Rev.pdf.

We are going to refer to this document in this study unit. Please access this document before continuing.

5.2 OBJECTIVES OF INTERNAL AUDITING

STUDY 5.1

Open and read All in a day’s work: A look at the varied responsibilities of internal auditors.

Refer to page 2 & 3: What is internal auditing?

ACTIVITY 5.1

What is internal auditing?

Complete the following sentence:

At its simplest, internal auditing involves identifying the ____________________________ that could keep an organisation from achieving its ____________________________, making sure the organisation's ____________________________ know about these ____________________________, and proactively recommending improvements to help reduce the ____________________________.

The organisation's leaders must be open to discussing tough issues and seizing the opportunities to make necessary changes for improvement. The internal
TOPIC 2: THE INTERNAL AUDITORS

The internal auditor must have an independent reporting line to the highest governing body. This body is the ____________________.

Internal audit add value to their organisation. Internal audit = A____________ + I____________ + O______________.

ACTIVITY 5.2

Refer to page 4 & 5: Who are internal auditors?

Who are internal auditors?

Study the main differences between the internal and external auditor. The difference between the internal and external auditor is significant. Notice that the internal auditor has a broad focus and uses historical information (backward-looking) but is very concerned with future events (forward-looking).

ACTIVITY 5.3

Refer to page 6 & 7: Internal audit responsibilities

Internal audit responsibilities

The internal auditors may perform some or all of the following tasks:
(1) Offer insight and advice.
(2) __________________________________________________
(3) __________________________________________________
(4) __________________________________________________
(5) __________________________________________________
(6) __________________________________________________
(7) __________________________________________________
(8) __________________________________________________
(9) __________________________________________________
(10) __________________________________________________

After reading the pamphlet and completing the activities you should have a basic idea what the internal auditor’s career is about.

5.3 SUMMARY AND SELF-ASSESSMENT

In this study unit we learned about the important role of the internal auditor in an organisation and advantages of the internal audit activity.

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Study 5.1</th>
<th>Activity 5.1</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Activity 5.2</td>
</tr>
<tr>
<td></td>
<td>Activity 5.3</td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:
• describe the responsibilities of internal auditing?
6.1 INTRODUCTION

We know that the internal auditor performs independent assignments on behalf of the board of directors of the company (Jackson & Stent 2016:1/3). In the previous study unit we examined the various functions performed by the internal auditor. We will now examine the professional conduct of internal auditors.

Like for soccer, there must be rules for the team players in an audit team. The internal auditor has to behave a certain way so that reliance can be placed on the assurance he/she provides to management, the board and the audit committee. Remember: corporate governance is as strong as its weakest link. Therefore, if the internal auditors behave unethical then their important function that they are supposed to fulfil in corporate governance collapses.

The code of ethics of the Institute of Internal Auditors (IIA) comprises the principles relevant to the profession and practice of internal auditing and rules of conduct that describe the behaviour expected of internal auditors. This study unit presents the purpose of the IIA’s code of ethics, applicability, principle and rules of conduct.

6.2 PURPOSE OF THE CODE OF ETHICS

The IIA Code of Ethics is found on the IIA’s website (www.theiia.org). You can access the Code of Ethics at https://na.theiia.org/standards-guidance/Public%20Documents/IPPF_Code_of_Ethics_01-09.pdf. The Code of Ethics is recognised in terms of the International Standards for the Professional Practice of Internal Auditing (the Standards). The purpose of the Institute’s Code of Ethics is to promote an ethical culture in the profession of internal auditing. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about governance, risk management and control.
TOPIC 2: THE INTERNAL AUDITORS

The Institute’s Code of Ethics extends beyond the definition of internal auditing to include two essential components:

1. principles that are relevant to the profession and practice of internal auditing
2. rules of conduct that describe behavioural norms expected of internal auditors

These rules are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors.

“Internal auditors” refers to Institute members, recipients of or candidates for IIA professional certifications, and those who perform internal audit services within the definition of internal auditing.

6.2.1 Applicability and enforcement of the Code of Ethics

This Code of Ethics applies to both entities and individuals that perform internal audit services.

For IIA members and recipients of or candidates for IIA professional certifications, breaches of the Code of Ethics will be evaluated and administered according to the Institute’s bylaws and administrative directives. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member, certification holder, or candidate can be liable to disciplinary action.

6.3 PRINCIPLES

Internal auditors are expected to apply and uphold the following principles:

6.3.1 Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

6.3.2 Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

DISCUSSION 6.1

E-tutor assistance required

- Discuss whether or not an internal auditor can be objective in the organisation it works for.
- What can happen if management refuses to take corrective action on a reported finding?
6.3.3 Confidentiality
Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

6.3.4 Competency
Internal auditors apply the knowledge, skills and experience needed in the performance of internal audit services.

Based on the above principles, the rules of conduct are formulated.

6.4 RULES OF CONDUCT

6.4.1 Integrity
Internal auditors
- Shall perform their work with honesty, diligence, and responsibility.
- Shall observe the law and make disclosures expected by the law and the profession.
- Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- Shall respect and contribute to the legitimate and ethical objectives of the organization.

6.4.2 Objectivity
Internal auditors
- Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organisation.
- Shall not accept anything that may impair or be presumed to impair their professional judgment.
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

6.4.3 Confidentiality
Internal auditors
- Shall be prudent in the use and protection of information acquired in the course of their duties.
- Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organisation.

6.4.4 Competency
Internal auditors
- Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- Shall perform internal audit services in accordance with the *International Standards for the Professional Practice of Internal Auditing* (Standards).
• Shall continually improve their proficiency and the effectiveness and quality of their services.

(Source: International Professional Practice Framework of the Institute of Internal Auditors, 2009)

DISCUSSION 6.2

**E-tutor assistance required**
Discuss the practical application of the rules of conduct.
For example:
• Explain how integrity affected you this week in decisions that you had to make.
• Explain the meaning of diligence and how you have applied it.
• Discuss/share examples that reflect objectivity.

State, with reasons, whether or not the following action of the internal auditor is a breach of the Code of Ethics:

John Khumalo, a junior internal audit staff member, discussed with his friends the incidence of fraud he had discovered during his audit of the company's debtors.

**SUGGESTED SOLUTION 6.1**

This is a violation of the Integrity and Confidentiality principles in the Code of Ethics. Mr Khumalo is guilty of misconduct.

**Integrity** – Internal auditors shall perform their work with honesty, diligence, and responsibility.

**Confidentiality** – Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties.

This was a violation since John had no legal obligation to divulge this information.

6.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we had a look at the professional conduct of the internal auditor. We also had a look at its applicability to the individual and organisations practicing internal auditing.

Refer to your notes you made in your workbook when you completed the following activities.

<table>
<thead>
<tr>
<th>Activity 6.1</th>
<th>Discussion 6.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 6.2</td>
<td>Discussion 6.1</td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

• explain the professional conduct principles and rules for internal auditors?

In the next study unit, we will discuss the role of internal audit in good corporate governance.
INTERNAL AUDIT AND GOOD CORPORATE GOVERNANCE

IN THIS STUDY UNIT WE ARE GOING TO

• explain role of internal audit in terms of good corporate governance
• list the attributes of the Chief Audit Executive (CAE)

7.1 INTRODUCTION

In Study Unit 2, we looked at leadership, organisational ethics and responsible corporate citizenship (the first three principles of King IV). We also focussed on the board and its directors. I think that by now you have a good understanding of the objectives and value that internal auditors add to business and how they should behave. In this study unit we are going to refer back to the King Code IV and we will focus on Jackson & Stent (2016:4/51), that covers principle 15 of King IV dealing with assurance that relates to the internal auditor.

Principle 15: The board should ensure that assurance services and function enable an effective control environment and that these support the integrity of information for internal decision making and of the organisation's external reports.

As part of good governance, the internal auditor is commonly known to be involved in measuring the compliance with the entity’s policies and procedures. The internal auditor advises management and the board of directors with its committee structures regarding how to better execute their oversight responsibilities (Jackson & Stent 2016:4/53).

7.2 THE EIGHT RECOMMENDED PRACTICES PERTAINING TO INTERNAL AUDIT

ACTIVITY 7.1

ACTIVITY 7.2

You are responsible for writing the advertisement for the Chief Audit Executive (CAE) of a listed company. List the required attributes of a CAE.

SUGGESTED SOLUTION 7.2

Jackson & Stent (2016:4/55) Note (g)
7.3 SUMMARY AND SELF-ASSESSMENT

In this study unit we had a look at the role of internal audit in good corporate governance. The discussion in this study unit focused on the need for and the role of internal audit.

Refer to your notes you made in your workbook after completing the following activities.

Activity 7.1
Activity 7.2

After having worked through the study unit and the study references, are you able to:

- explain the role of internal audit in terms of good corporate governance?
- list the attributes of the CAE?

In the next topic, we will discuss the external auditor.

BIBLIOGRAPHY FOR TOPIC 2


TOPIC 3

The external auditor

Study unit 8
The development of the external auditing profession 53

Study unit 9
Assurance by the external auditor 58

Study unit 10
Professional conduct requirements for external auditors 52

Study unit 11
The relationship between internal and external auditors 66
TOPIC 3: THE EXTERNAL AUDITOR

TOPIC OVERVIEW

The aim of this topic is to guide you in acquiring an informed understanding of the key terms, concepts, facts, general principles, rules and theories of the external auditing profession.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study units</th>
<th>Title</th>
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<tbody>
<tr>
<td>8</td>
<td>The development of the profession of external auditing</td>
<td>53</td>
</tr>
<tr>
<td>9</td>
<td>The role of the external auditor</td>
<td>58</td>
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<tr>
<td>10</td>
<td>Professional conduct requirements for external auditors</td>
<td>62</td>
</tr>
<tr>
<td>11</td>
<td>The relationship between internal and external auditors</td>
<td>66</td>
</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that have been indicated.
The development of the external auditing profession

IN THIS STUDY UNIT WE ARE GOING TO
- discuss basic aspects regarding the external auditing profession

8.1 INTRODUCTION
This study unit presents an overview of the development of the profession of external auditing. In the previous study unit we worked with the King Code of Governance Principles, in particular the internal audit. In Study Unit 4 we looked at the role of the audit committee in the appointment and overseeing the planning and execution of the external audit. Now go back to Study Unit 4 diagram 5. Let’s recap: Where are we now in the operational business environment represented in diagram 5? You have learned about the audit committee (go and tick it), internal audit (go and tick it), and operational management (go and tick it). We are going to look at the independent auditor (external auditor).

8.2 THE EXTERNAL AUDITING PROFESSION

DISCUSSION 8.1

E-tutor assistance required
Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Refer back to diagram 5 in Study Unit 4. Do we really need external auditors and why?

Reference: Jackson & Stent (2016:1/5)
8.2.1 The Auditing Profession Act

The Auditing Profession Act (Act 26 of 2005) (APA) regulates the External Auditing Profession by instituting the Independent Regulatory Board for Auditors (IRBA), which has the responsibility of controlling the auditing profession in South Africa. In other words, the APA created IRBA. An external auditor has to complete the education, training and professional requirements before he/she can register as a Registered Auditor (RA) with IRBA.

The South African Institute of Chartered Accountants (SAICA) (https://www.saica.co.za/Default.aspx) is an accredited professional body. IRBA outsources the education, training and professional requirements to SAICA. Remember, there is a difference between a Registered Auditor (RA) and a Chartered Accountant (South Africa) (CA(SA)). The CA(SA) is a professional accounting (not auditing) designation. A prospective RA has to undergo all the CA(SA) education and training requirements and an additional specialised auditing professional development period of 18 months before he/she can register as a RA. Therefore, a CA(SA) is not automatically a RA.

Go and explore the IRBA website at http://www.irba.co.za/.

8.2.2 Accounting bodies

There are a number of accounting bodies in South Africa and you can explore each body’s website if you are interested in an accounting career. Remember, members of the accounting bodies may not be public auditors.

STUDY UNIT 8: The development of the external auditing profession

• The Charted Institute of Management Accountants (CIMA): http://www.cimaglobal.com/Our-locations/Africa/South-Africa/
• The South African Institute of Professional Accountants (SAIPA): http://www.saipa.co.za/

DIAGRAM 8: EXTERNAL AUDITOR AND ACCOUNTING BODIES

Only RA can perform external audit functions

8.3 THE NATURE OF PROFESSIONAL STATUS

Up to now you have noticed that internal auditors, registered auditors, chartered accountants are referred to as professionals. What does it mean to obtain professional status?

ACTIVITY 8.1

List six attributes describing professional status.

SUGGESTED SOLUTION 8.1

Refer to Jackson & Stent (2016:1/10–11).

<table>
<thead>
<tr>
<th>1. Specialised skills</th>
<th>4.</th>
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<tr>
<td>2.</td>
<td>5.</td>
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<tr>
<td>3.</td>
<td>6.</td>
</tr>
</tbody>
</table>
8.4 PRONOUNCEMENTS WHICH REGULATE THE AUDITING PROFESSION

Auditors have to behave in a certain way and perform their work in terms of internationally recognised standards.

STUDY

Refer to Jackson & Stent (2016:1/12) and note all the legal and professional requirements that the auditing profession is subject to. Throughout this module we will make reference to the International Standards on Auditing (ISAs), Rules regarding Improper Conduct and the Code of Professional Conduct for Registered Auditors, the Companies Act, and the Auditing Profession Act. The auditing profession is thus highly regulated and the South African auditors are very sought after internationally.

ACTIVITY 8.2

Answer the following questions:

1. What does the designation CA (SA) stand for?
2. Can all CA (SA)s perform auditing services in terms of the Auditing Profession Act?
3. What is the responsibility of the IRBA?
4. What are the requirements to register as a member of the IRBA?
5. What designation can be used by individuals registered with the IRBA?
6. What is meant by the term “designated auditor”?
7. What is the role of the ISAs?

SUGGESTED SOLUTION 8.2

Reference: Jackson & Stent (2016:1/11–12)

1. Designation CA(SA) stands for Chartered Accountant (South Africa).
2. No. Offering accounting services such as bookkeeping, taxation, management or financial advice is not restricted to members of SAICA. As indicated above, there are other accounting bodies such as SAIPA, ACCA or CIMA who also offer these services, but if an individual or firm wishes to offer auditing services they must be, in terms of the Auditing Profession Act, registered with the Independent Regulatory Board for Auditors (IRBA).
3. The IRBA has the responsibility of looking after the professional interests of auditors. It deals with such matters as registration, education and training, accrediting professional bodies (such as SAICA) for membership, and prescribing standards of competence and ethics. The IRBA is also there to protect the public in their dealings with registered auditors, and to discipline IRBA members who “break the rules”.
4. Currently to register as a member of the IRBA, an individual must in essence do the following:
   - Satisfy the educational requirements of SAICA (see note below), i.e. obtain a recognised qualification from an accredited university, and pass the Initial Test of Competence (ITC) and the Assessment of Professional Competence (APC).
• Complete a training contract in public practice (in a registered training office).
• Obtain an audit specialist qualification.

(5) The official designation for individuals registered with the IRBA, is “registered auditor” (RA).

(6) The Act also stipulates that the individual who is responsible for the audit is identified and named the “designated auditor” (APA, Sec 44(1)).

(7) The ISAs provide the standards which the auditor must attain and provide guidance on how this should be done. The ISAs do not provide detailed lists of audit procedures; this is left up to the individual auditor or audit firm, for example, auditing firm A will have their particular methods of doing things and auditing firm B will have their own methods. Auditing is not an exact science and provided the ISAs are complied with, an audit of the appropriate quality will be achieved.

The ISAs cover the entire audit process. They provide guidance ranging from preliminary engagement activities, through planning the audit, gathering sufficient appropriate evidence, and deciding on the appropriate audit opinion.

8.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we had a look at the external auditing profession. We also had a look at the pronouncements that regulate the external auditing profession.

Refer to your notes you made in your workbook after having completed the following activities.

<table>
<thead>
<tr>
<th>Activity 8.1</th>
<th>Activity 8.2</th>
<th>Discussion 8.1</th>
</tr>
</thead>
</table>

After having worked through the study unit and the study references are you able to discuss the basic aspects regarding the external auditing profession?

In the next study unit, we will discuss the role of the external auditor.
Assurance by the external auditor

IN THIS STUDY UNIT WE ARE GOING TO
• explain the objective of an audit
• identify the level of assurance provided by external auditors
• identify organisations subject to an financial statement audit

9.1 INTRODUCTION

In the previous study unit we looked at the auditing profession and noticed that it is highly regulated through legislation, standards and codes. Although external auditors perform many different functions in practice (non-assurance engagements), for the purposes of this module the main function of the external auditor registered with the IRBA is to perform the external audit of financial statements (assurance engagements). So, what do auditors really do when they audit financial statements? All of the auditor’s work is summarised in an audit report that accompanies the annual financial statements. The end product of the auditor’s work is reflected in the audit report.

9.2 THE EXTERNAL AUDITOR

INTERNET ACTIVITY 9.1

We all have bought something from Shoprite, so let’s go to their annual financial statements. Google “annual financial statements Shoprite” and then select and open an example of their latest annual financial statements. Scroll through the document (heavy stuff) but I want you to read the page titled “Independent Auditor’s Report to the Shareholders of Shoprite Holdings Limited”. Note that the report sets out the director’s responsibilities, the auditor’s responsibilities and the audit opinion.

As stated in Jackson & Stent (2016:1/2) registered external auditors are auditors who express an independent opinion on whether the annual financial statements of a company fairly present the financial position and results of the company’s operations. The external auditor is not an employee of the company. The external auditor enhances the degree of confidence which users of the financial statements will have in the information in those financial statements. Registered auditors offer their services to the public. They are described as being “in public practice” and must be registered with the Independent Regulatory Board for Auditors.
9.3 LEVELS OF ASSURANCE

In terms of the International Framework for Assurance Engagements, an assurance engagement is one in which the professional accountant (registered auditor) “expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against the criteria”.

The work performed by the auditor can be divided into levels of assurance.

STUDY

Jackson & Stent (2016:1/8-9) – Levels of assurance

ACTIVITY 9.1
Refer to the Shoprite annual financial statements. Identify the level of assurance provided by their auditors.

ACTIVITY 9.2
You are required to:
(1) describe what the level of assurance in an audit of financial statements entails
(2) explain the meaning of reasonable assurance in an auditing context

SUGGESTED SOLUTION 9.2
Reference: Jackson & Stent (2016:1/5–1/9)

(1) In an audit as a reasonable assurance engagement, a registered auditor gathers sufficient appropriate evidence to be in a position to express an opinion on whether the directors, who are responsible for the financial statements, have applied the International Financial Reporting Standards (or other suitable
reporting framework) appropriately in presenting fairly the financial position, financial performance and cash flow information and accompanying notes of the company for the financial year.

(2) The auditor does not certify or confirm the absolute correctness of financial information, but rather, expresses an opinion on its fair presentation. The audit is designed to provide reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, not that they are one hundred per cent correct. The International Standards of Auditing, defines reasonable assurance as a “high but not absolute” level of assurance.

9.4 BUSINESSES SUBJECT TO AN AUDIT

Determining which businesses are subject to an audit depends on the extent to which the annual financial statements will affect or influence the general public. Therefore, all public companies and state-owned companies will automatically be subject to an audit. What about the private companies and close corporations? The audit of financial statements is legislated to protect the general public. For example, it will be senseless for a very small company (low turnover), with one shareholder and three employees to be subjected to an audit. In this case, an independent review will be adequate.

STUDY

- Jackson & Stent (2016:1/13–14) – The public interest and public interest scores
- Jackson & Stent (2016:1/14) – Chart summary

ACTIVITY 9.3

A private company or close corporation with a public interest (PI) score of 350 points and above is subject to an audit in terms of the Companies Act.

List the four elements that make up the public interest score calculation.

SUGGESTED SOLUTION 9.3

1. The average number of employees per year equals the same number of points.
2.
3.
4.

9.5 THE FINANCIAL STATEMENT AUDIT ENGAGEMENT

Close corporations and private companies with a public score of 350 points and more are subject to a financial statement audit. All public and state-owned companies, regardless of their public interest score, are subject to a financial statement
audit. Private companies with a public score between 100 to 349, who compile their own annual financial statements, are also subject to an audit. As mentioned earlier in this study unit, the level of assurance provided by a financial statement engagement is one of “reasonable assurance”.

ACTIVITY 9.4

Describe the overall objectives of the auditor in a financial statement audit.

SUGGESTED SOLUTION 9.4

Reference: Jackson & Stent (2016:1/7)

The overall objectives of the external auditor are to:

• obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared in all material respects in accordance with an applicable financial reporting framework

• report on the financial statements and communicate as required by the International Standards on Auditing (ISA), in accordance with the auditor’s findings (SAICA, Handbook: Volume 2)

9.6 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed the role of the external auditor.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 9.1</th>
<th>Internet Activity 9.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 9.2</td>
<td></td>
</tr>
<tr>
<td>Activity 9.3</td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

• explain the objective of an audit?
• identify the level of assurance provided by external auditors?
• identify organisations subject to a financial statement audit?

In the next study unit we will discuss the professional conduct requirements for external auditors.
PROFESSIONAL CONDUCT
REQUIREMENTS FOR EXTERNAL AUDITORS

IN THIS STUDY UNIT WE ARE GOING TO
• explain the professional conduct requirements for external auditors

10.1 INTRODUCTION
In the previous study unit we gathered that all public, state-owned and private companies, subject to the public interest score, are subject to an audit. The duty to perform an audit is legislated by law (Companies Act) to protect the general public. Due to the nature of the auditor’s duties it is essential that the auditor be seen (perceived) by the public as being a professional. If auditors were to lose their professional status then the profession would become as extinct as the dinosaurs. A financial scandal like Enron resulted in the collapse of an international audit firm. Therefore, both SAICA and IRBA will guard their professional status with all that they have. The professional conduct of their members is considered in a very serious light and has codes of conduct to govern their members’ behaviour. Therefore, it is very important to understand these principles. Although these principles apply to auditors and CAs, you can adapt it to your own life by embedding them in your lifestyle.

10.2 THE SAICA AND IRBA CODES OF PROFESSIONAL CONDUCT
As stated in Jackson & Stent (2016:2/3), there are two Codes of Professional conduct which provide ethical guidance to professional accountants and auditors in South Africa respectively, namely the South African Institute of Chartered Accountants (SAICA) Code of Professional Conduct and the Independent Regulatory Board for Auditors (IRBA) Code of Professional Conduct. These codes are very similar and we are going to examine some of the principles, threats and safeguards.
10.3 INTRODUCTION TO THE FUNDAMENTAL PRINCIPLES

STUDY

Jackson & Stent (2016:2/5–2/8)

ACTIVITY 10.1

This activity is very important. While completing the table below reflect on the meaning of each word. Use a dictionary if you are uncertain of the meaning of some of the words. If you do not own a dictionary or do not have one close by, you can access the Oxford Learner’s Dictionary here: http://www.oxfordlearners-dictionaries.com/.

There are five fundamental principles. List and describe each of the principles.

SUGGESTED SOLUTION 10.1

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Integrity</td>
<td>• Be straightforward, honest, fair and truthful.</td>
</tr>
<tr>
<td></td>
<td>• Should not be associated with false or misleading information (including omission or obscurity).</td>
</tr>
<tr>
<td></td>
<td>• Take steps to be disassociated from false or misleading information</td>
</tr>
<tr>
<td>2.</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
</tr>
<tr>
<td>5. Professional behaviour</td>
<td>• Avoid any action that will discredit the profession.</td>
</tr>
<tr>
<td></td>
<td>• Examples: Bad advertising; sign your own reports; manners when recruiting; responsibilities to colleagues, and discrimination.</td>
</tr>
</tbody>
</table>

DISCUSSION 10.1

E-tutor assistance required

Consider the following questions and post your thoughts about any of them on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

- Working students: Share your practical experiences where you comply with these principles.
- Non-working students: Share your practical experiences where you comply with these principles as a Unisa student.
- Refer to Study Unit 6. Identify the similarities and differences (if any) in the fundamental ethical principles between internal and external auditors.
10.4 THREATS AND SAFEGUARDS

10.4.1 Threats

Based on the above principles the code went further and identified some practical factors that need to be considered by the auditor. These factors are referred to as threats.

STUDY

Jackson & Stent (2016:2/10–2/11)

ACTIVITY 10.2

This activity is also very important.

List the five threats identified by the code which can threaten compliance with the fundamental principles and summarise the core concept of each threat, giving one example for each. Link the example with a principle.

SUGGESTED SOLUTION 10.2

<table>
<thead>
<tr>
<th>Threat</th>
<th>Core concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Self-interest</td>
<td>Financial interests that may inappropriately influence judgement</td>
</tr>
<tr>
<td></td>
<td>Example: Holding shares in the client’s business: Objectivity</td>
</tr>
<tr>
<td>2.</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td></td>
</tr>
</tbody>
</table>

10.4.2 Safeguards

Rather be safe than sorry! The auditor is obliged to apply measures that will reduce the threat to an acceptable level. Safeguards are divided into two categories, namely:

- safeguards created by the profession, legislation or regulation
- safeguards in the work environment

The first category is regulatory measures brought about the profession and legislation. For example, the auditor must rotate after five years to enhance objectivity. These are rules and must be complied with.

The second category is how the auditor manages his/her business that will contribute to good management procedures.

STUDY

Jackson & Stent (2016:2/12)
ACTIVITY 10.3

The following activity is an example of applying the knowledge you have mastered above.

Mr Bodibe Mathabe CA (SA) qualified as a chartered accountant five years ago. He is a partner at Anders Arthur (firm of auditors). He encountered the following situation in his current audit assignment:

Gregory Italiano is the financial director of Italian Pizzas (Pty) Ltd and requested Mr Mathabe to disclose financial information on one of this audit client’s business affairs to him.

Required

Describe which fundamental principle is involved and explain with reasons how Mr Mathabe, in terms of the Code of Professional Conduct, should react to the above matter.

SUGGESTED SOLUTION 10.3

Reference: Jackson & Stent (2016:2/7)

Mr Gregory Italiano’s case

In terms of the Code of Professional Conduct, members have an obligation to respect the confidentiality of information about client’s business affairs. Confidentiality should always be observed unless specific authority has been given by the client to disclose information or there is a legal or professional duty to disclose. In this case there is no legal or professional duty to disclose the information.

Mr Mathebe should refuse to disclose the financial information of his audit client unless specific authority has been granted by the audit client involved for disclosure of information.

10.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed the professional requirements of external auditors. The SAICA and IRBA codes of professional conducts were also emphasised.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 10.1</th>
<th>Activity 10.2</th>
<th>Activity 10.3</th>
<th>Discussion 10.1</th>
</tr>
</thead>
</table>

After having worked through the study unit and the study references are you able to:

• explain the professional conduct requirements for external auditors?

In the next study unit we will discuss the relationship between internal and external auditors.
THE RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

IN THIS STUDY UNIT WE ARE GOING TO

discuss the relationship between internal and external auditors

11.1 INTRODUCTION

In topic 2 you were introduced to the internal auditor. In this topic you were introduced to the external auditor. You would have gathered that there are some similarities between the two professions. One could argue that the external auditor can rely on some of the work performed by the internal auditor. The internal auditor would probably know more about the daily operations of a business than the external auditor.

There are also important differences between the internal and external auditors. In this study unit we are first going to identify the most important differences. Thereafter we are going to look at some rules in terms of the International Standards of Auditing (ISAs), should the external auditor wish to use or rely on the work of the internal auditor. Think of the benefits of relying on the work of the internal auditor, for example the operational knowledge of the internal auditor, flagging of high-risk areas identified by the internal auditor that the external auditor could consider when planning an audit, and saving on the audit fees, to name but a few. It is important, however, to realise that the relationship is based on the coordination of internal audit activities with external audit activities.

11.2 DIFFERENCES BETWEEN THE EXTERNAL AND INTERNAL AUDITOR

Understanding the differences allows us to understand and appreciate the respective professions better. You would have come across some of these differences while you studied topics 2 and 3.
ACTIVITY 11.1

List the differences between internal and external auditors.

SUGGESTED SOLUTION 11.1

Reference: Jackson & Stent (2016:1/2–1/3)

<table>
<thead>
<tr>
<th>Internal auditors</th>
<th>External auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain a mandate from management/</td>
<td>Obtain a mandate through legislation</td>
</tr>
<tr>
<td>the audit committee</td>
<td></td>
</tr>
<tr>
<td>Perform a management function</td>
<td>Perform an external attestation function (auditing</td>
</tr>
<tr>
<td></td>
<td>function)</td>
</tr>
<tr>
<td>Are contracted by the company they are working with</td>
<td>Work for an independent audit firm</td>
</tr>
<tr>
<td>Function independently in the organisation, but</td>
<td>Function independently from the organisation</td>
</tr>
<tr>
<td>remain part of it</td>
<td></td>
</tr>
<tr>
<td>Report to management (including the audit committee)</td>
<td>Report to the shareholders</td>
</tr>
<tr>
<td>Internal audit covers all the organisation's operations</td>
<td>External audit works primarily with those financial</td>
</tr>
<tr>
<td></td>
<td>systems that have a bearing on the final accounts</td>
</tr>
<tr>
<td>Internal audit performs audits throughout the year</td>
<td>External audit tends to be a year-end process, even</td>
</tr>
<tr>
<td></td>
<td>though some testing may be carried out during the year</td>
</tr>
<tr>
<td>Registered with the Institute of Internal Auditors</td>
<td>Registered with the Independent Regulatory Board for</td>
</tr>
<tr>
<td>(IIA)</td>
<td>Auditors (IRBA)</td>
</tr>
</tbody>
</table>

11.3 USING THE WORK OF INTERNAL AUDITORS

As stated in Jackson & Stent (2016:16/5), certain parts of the internal audit work may be useful to the external auditor.

Before the external auditor can rely on the work of the internal audit department, certain requirements must be met for external audit to be in a position to make use of the internal audit department’s work (see Jackson & Stent 2016:16/4).

STUDY

Jackson & Stent (2016:16/5–16/7) – ISA 610 Using the work of internal auditors
The introduction and definition of the internal audit function in Jackson & Stent (2012:16/5) serves as revision of topic 2.

Jackson & Stent (2016:16/6) paragraph 5: Evaluating the internal audit function deals with the considerations that the external auditor must consider before he/she can rely on the work of the internal auditor. This section is important and is divided into three categories:

- objectivity of the internal auditor (operational environment)
- competence of the internal auditors (the people)
- systematic and disciplined approach, including quality control (the process followed)

Make sure that you are able to describe the aspects for each category.

**ACTIVITY 11.2**

Describe the aspects that the external auditor should consider to evaluate the adequacy of the work of internal audit for the external auditor’s purposes.

**SUGGESTED SOLUTION 11.2**

Reference: Jackson & Stent (2016:16/6)

To determine the adequacy of specific work performed by the internal auditors for the external auditor’s purposes, the external auditors shall evaluate whether

- the work was performed by internal auditors having adequate technical training and proficiency
- the work was properly supervised, reviewed and documented
- adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions
- conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed by the external auditors
- any exceptions or unusual matters disclosed by the internal auditors are properly resolved

**11.4 COORDINATION BY INTERNAL AUDITORS**

It is further important to note that not all aspects of coordination comes from the external auditor’s point of view; the internal auditors may also benefit from the coordination of work with the external auditors by ensuring proper coverage and minimising duplication of efforts.

The Institute of Internal Auditors: Standard 2050 – Coordination, indicates the following steps:

The chief audit executive (CAE) takes the steps necessary to understand the work performed by the external auditors, including:

- the nature, extent and timing of work planned by external auditors, to be satisfied that the external auditors’ planned work, in conjunction with the internal auditors’ planned work
• the external auditor’s assessment of risk and materiality
• the external auditors’ techniques, methods, and terminology to enable the CAE to:
  • coordinate internal and external auditing work
  • evaluate, for purposes of reliance, the external auditors’ work
  • communicate effectively with external auditors
• access to the external auditors’ programs and working papers, to be satisfied that the external auditors’ work can be relied upon for internal audit purposes. Internal auditors are responsible for respecting the confidentiality of those programs and working papers.

Therefore, the CAE is responsible for regular evaluations of the coordination between internal and external auditors. Such evaluations may also include assessments of the overall efficiency and effectiveness of internal and external audit activities, including aggregate audit cost. The CAE communicates the results of these evaluations to senior management and the board, including relevant comments about the performance of external auditors.

11.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed the relationship between internal and external auditors. We have seen that it is important that the internal and external auditors meet periodically to discuss issues of common interests that could help them to benefit from each other in terms of skills, expertise and also to minimise the duplication of efforts.

Refer to your notes you made in your workbook after completing the following activities.

| Activity 11.1 |
| Activity 11.2 |

After having worked through the study unit and the study references are you able to
• discuss the relationship between internal and external auditors?

In the next topic we will discuss certain auditing concepts.
TOPIC 4

Auditing concepts

Study unit 12

Assertions .................................................. 73

Study unit 13

Audit evidence ............................................. 78

Study unit 14

Materiality and audit risk ............................... 84

Study unit 15

Risk assessment and further audit procedures .... 89
TOPIC OVERVIEW

Any profession, for example a medical doctor, lawyer, and scientist uses a certain vocabulary. This is necessary to ensure that communication between colleagues and record keeping of events is concise. There is no room for misunderstanding in a profession. Everyone in that particular profession will know the meaning of a certain term without someone explaining it to them. In the previous topics we concluded that internal and external auditors are professionals. Therefore, we can expect them to use certain terms in their day to day activities. In this topic you will be introduced to certain auditing concepts and methods, procedures and techniques that auditors use. The next time the auditor visits the business where you are employed, you will be able to form a good understanding about some of the questions that they ask.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Assertions</td>
<td>73</td>
</tr>
<tr>
<td>13</td>
<td>Audit evidence</td>
<td>78</td>
</tr>
<tr>
<td>14</td>
<td>Materiality and audit risk</td>
<td>84</td>
</tr>
<tr>
<td>15</td>
<td>Risk assessment procedures, test of controls and substantive procedures</td>
<td>89</td>
</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that have been indicated.
In this study unit we are going to
• list the two main categories of assertions
• describe the various assertions
• interpret an assertion

12.1 INTRODUCTION

In Study Unit 9 we gathered that the end product of the external auditor is the audit report. Why is the audit report important? To provide assurance to the shareholders and other interested parties that the annual financial statements (AFSs) prepared by management fairly present the financial position and results. More to the point, in the audit report the auditor expresses an opinion addressed to the shareholders, that the annual financial statements fairly present, in all material respects the financial position of a company on a particular date (financial year-end) and its performance (results) and cash flows (movements) for that particular financial year. You can deduce that everything revolves around the AFS. In this study unit we are going to examine how the AFS are made up of various “assertions” implied by management. Why does the auditor want to assess the assertions? During the planning of an audit the auditor will assess each assertion and consider the risk or likelihood of material misstatement applicable to that particular assertion. Once the assertions at risk are identified the auditor can focus his/her audit procedures to address those risk areas. Does this make sense?

INTERNET ACTIVITY 12.1

The following YouTube clip gives a good overview of assertions and I recommend you watch it before continuing with this study unit. From 15 December 2016 the International Standards Auditing Standards have amended their definition for assertions and if you use older textbooks they will not incorporate these changes.

https://www.youtube.com/watch?v=TmgcCwE1wtE
## 12.2 THE ANNUAL FINANCIAL STATEMENTS

The focus of the external auditor is on examining the annual financial statements. From your accounting studies you know exactly what a set of annual financial statements looks like. Please refer to your accounting module to refresh your knowledge.

Remember: the directors (management) are presenting financial reports to the shareholders of the business through annual financial statements (AFS). Are the AFS a fair presentation of financial results and position? The auditors have the function to report to the shareholders of a business that these financial statements presented by the directors are a fair presentation of the financial position and results.

Let’s assume the reporting period of a business entity is from 1 January to 31 December of a particular year. You have a “snapshot” at year-end, reflecting the financial position on a particular date, in our case 31 December. This snapshot is referred to as the statement of financial position at 31 December. You also have a “documentary” of events or results for a year from 1 January to 31 December and this is referred to as the statement of comprehensive income and retained earnings for the year ended 31 December. The net results from the statement of comprehensive income is captured as retained income in the statement of financial position. Financial statements have to presented and disclosed in terms of an acceptable financial reporting framework and standards, for example IFRS. Presentation and disclosure is extremely important for shareholders and analysts. Proper presentation and disclosure allow one to know exactly what assumptions are used and therefore “apples can be compared with apples”.

### INTERNET ACTIVITY 12.2

For an example of a statement of financial position open the following link: http://accounting-simplified.com/financial/statements/statement-of-financial-position.html

For an example of a statement of comprehensive income open the following link: http://accounting-simplified.com/financial/statements/income-statement-profit-and-loss.html

To refresh your knowledge about presentation and disclosure open the following link: http://accounting-simplified.com/financial-accounting/accounting-concepts-and-principles/

## 12.3 CATEGORIES OF ASSERTIONS

When presenting the annual financial statements the directors are making certain statements or assertions to the shareholders. These assertions are divided into two major categories:

- assertions about classes of transactions and events, and related disclosures for the period under audit (statement of comprehensive income activities)
- assertions about account balances, and related disclosures at the period end (financial position)

### STUDY

After completing activities 12.1 to 12.3 you must be able to list and describe the financial statement assertions for classes of transactions and events and for account balances and their related disclosures including the notes and policies accompanying the AFS.

ACTIVITY 12.1

List the assertions for transactions and events, and related disclosures with the implied meaning made by directors with the particular assertion.

SUGGESTED SOLUTION 12.1

<table>
<thead>
<tr>
<th>Assertions about transactions and events, and related disclosures (statement of comprehensive income activities)</th>
<th>Implied meaning made by directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Occurrence</td>
<td>That all the transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.</td>
</tr>
<tr>
<td>6. Presentation</td>
<td>That transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.</td>
</tr>
</tbody>
</table>

ACTIVITY 12.2

List the assertions for account balances with the implied meaning made by directors with the particular assertion.

SUGGESTED SOLUTION 12.2

<table>
<thead>
<tr>
<th>Assertions about account balances, and related disclosures (financial position)</th>
<th>Implied meaning made by directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Existence</td>
<td>That the assets, liabilities and equity interests exist.</td>
</tr>
<tr>
<td>5. Classification</td>
<td>That assets, liabilities and equity interests have been recorded in the proper accounts.</td>
</tr>
<tr>
<td>6. Presentation</td>
<td>That assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.</td>
</tr>
</tbody>
</table>
ACTIVITY 12.3

Complete the following table of assertions and categories. For each given assertion you are required to mark (“x”) the category that that assertion applies to. For example, the assertion occurrence is applicable to transactions and presentation and disclosure but not to account balances.

SUGGESTED SOLUTION 12.3

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Transactions, events and related disclosure</th>
<th>Balances (assets, liabilities, equity) and related disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cut-off</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Existence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy, rights and obligations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valuation and allocation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Presentation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Compare your entries with the table in Jackson & Stent (2016:5/24). Did you notice that some assertions are only applicable to transactions and others to balances? Are you able to recognise the assertions for each category?

DISCUSSION 12.1

E-Tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Your friend presents you with a set of annual financial statements (AFS) of his company Tau (Pty) Ltd and he wants you to loan him R30 000. You open the AFS, the page titled Statement of financial position at 31 December 20XX. A line item catches your eye:

Trade Accounts Receivables R136 145

Required

Discuss what your friend is actually asserting with the above line item in the AFS.

(Jackson & Stent 2016:1/18 – Financial statement assertions)
ACTIVITY 12.4

In each of the following situations, indicate which category of assertions applies to the situation and list the assertions associated with that category:

1. Inspect a sales invoice recorded in the sales journal of a company during the financial year.
2. Agree the inventory balance disclosed in the annual financial statements of a company to the inventory control account balance in the general ledger.
3. Examine the purchase contract of a motor vehicle purchased during the financial year, which is included in the motor vehicle balance in the statement of financial position of a company at year-end.

SUGGESTED SOLUTION 12.4

Reference: Jackson & Stent (2016:5/24)

1. The inspection of a sales invoice refers to assertions about classes of transactions and events, as a sales invoice is made out for a sales transaction which took place. The assertions about classes of transactions and events are occurrence, completeness, accuracy, cut-off and classification and presentation.

2. Agreeing the inventory balance disclosed in the annual financial statements refers to assertions about account balances at the period end. The assertions for account balances at period end are existence, rights and obligations, completeness, accuracy valuation and allocation, classification and presentation.

3. Examining the purchase contract of a motor vehicle purchased during the year refers to assertions about classes of transactions and events, as the purchase of a motor vehicle is a transaction which took place during the financial year. The assertions about classes of transactions and events are occurrence, completeness, accuracy, accuracy, cut-off and classification and presentation.

12.4 SUMMARY AND SELF-ASSESSMENT

In this study unit we stressed that the financial statements assertions are important to assist the auditor to gather audit evidence about the transactions and events and account balances and the related disclosures.

Refer to your notes you made in your workbook after completing the following activities:

Activity 12.1
Activity 12.2
Activity 12.3
Activity 12.4
Discussion 12.1
Internet Activity 12.1
Internet Activity 12.2

After having worked through the study unit and the references to the prescribed study material, are you be able to

- list the two main categories of assertions?
- describe the various assertions?
- interpret an assertion?

In the next study unit, we will discuss audit evidence.
AUDIT EVIDENCE

IN THIS STUDY UNIT WE ARE GOING TO

• discuss the nature, reliability, sufficiency and relevance of audit evidence
• recognise the various sources of audit evidence
• explain audit evidence which can be collected through tests of controls and substantive procedures

13.1 INTRODUCTION

In the previous study unit we learned about management’s assertions embedded in the AFS prepared for the shareholders and that the auditors must express an opinion on these AFS. As stated in Jackson & Stent (2016:5/20), before the auditor can express an opinion, evidence must be collected and examined to support his/her opinion. You cannot just grab an opinion out of thin air. The day-to-day activities of the auditor is collecting and examining evidence. If you ask me how I picture an auditor, I would say a person with a formal wardrobe carrying a huge magnifying glass!

In this study unit we will be examining audit evidence. Audit evidence has to comply with certain criteria to be of any value.

13.2 SUFFICIENT APPROPRIATE AUDIT EVIDENCE

In Jackson & Stent (2016:5/20) reference is made to ISA 500 – Audit evidence. This international auditing standard defines the objective of audit evidence as follows: “The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient, appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.” If audit evidence is not sufficient then the auditor may not draw a conclusion. If audit evidence is not appropriate then the auditor may not draw a conclusion. So, what do these two terms mean?
13.2.1 Sufficient evidence

STUDY

Jackson & Stent (2016:5/20) – Sufficient evidence

ACTIVITY 13.1

Complete the following statements/questions:

- The sufficiency of audit evidence relates to the ___________ of audit evidence.
- Can one expect the auditor to examine all the evidence of a client? Yes/No Substantiate your answer.
- The quantity of audit evidence relates to the ___________ of testing which is a ____________________________ of the audit plan.

13.2.2 Appropriate evidence

STUDY

Jackson & Stent (2016:5/21) – Appropriate evidence

ACTIVITY 13.2

Complete the following statements/questions:

- The appropriateness of audit evidence relates to the ___________ of evidence. This can be further broken into the ___________ of the evidence and the ___________ of the evidence to the assertion which is being audited.
- Select the most reliable source of evidence.
  A. The director tells you that equipment was purchased from Limpopo Pumps for R120 000 on 1 September 20XX.
TOPIC 4: THE EXTERNAL AUDITOR

B. You examine the tax invoice reflecting the information of the purchase of the pump.

- **Relevance** of audit evidence means that it is relevant to the __________ which is being audited.

ACTIVITY 13.3

The following activity is very important for you to see how assertions and relevance of audit evidence works. The following is an example of a credit sales invoice issued by the company Africa Computers Ltd for commodities sold by the company on credit.

<table>
<thead>
<tr>
<th>Africa Computers Ltd</th>
<th>Tax invoice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa Computers Ltd</td>
<td>INV 1001</td>
</tr>
<tr>
<td>PO Box 1234</td>
<td>Date: 30 May 20XX</td>
</tr>
<tr>
<td>Polokwane</td>
<td></td>
</tr>
</tbody>
</table>

**To Vendor:**

B Beautiful

PO Box 25031
Durban

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
<th>Price</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Laptop computers</td>
<td>2</td>
<td>13 500</td>
<td>27 000.00</td>
</tr>
<tr>
<td>Genius mouse</td>
<td>1</td>
<td>100</td>
<td>100.00</td>
</tr>
<tr>
<td>Envelopes</td>
<td>1</td>
<td>125</td>
<td>125.00</td>
</tr>
<tr>
<td>Debtors statements</td>
<td>1</td>
<td>370</td>
<td>370.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>27 595.00</strong></td>
</tr>
<tr>
<td>Approved by: H Moale</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Received by: B Beautiful</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

VAT 3 863.30

Paid 31 458.3

**Required:**

Describe how the information shown on the above credit sales invoice could be used by the company auditor in support of the following assertions:

(a) Occurrence
(b) Completeness
(c) Accuracy
(d) Cut-off
(e) Classification
(f) Presentation
SUGGESTED SOLUTION 13.3

Reference: Jackson & Stent (2016:5/21)

Information on the credit sales invoice that can be used by the company’s auditor in support of the assertions.

(a) Occurrence
- By inspecting the sales journal to see whether the sales invoice has been recorded, the auditor obtains an indication that the transaction actually took place.
- By inspecting to see that the name of XY Ltd does appear on the invoice and that the name of the other party to the transaction (B Beautiful) was correctly accounted for in the accounting records, the auditor can satisfy him or herself that a valid transaction was concluded between the two parties.
- By inspecting that the responsible person authorised the transaction under his or her signature, the auditor gets assurance that the transaction did actually take place.
- Inspecting to see whether the other party signed for the receipt of the goods provides an additional assurance that a valid transaction did actually occur.

(b) Completeness
- By inspecting the date on the sales invoice, the auditor can ensure that the transaction was recorded at the time it was carried out.
- By inspecting the sequential recording of sales invoices and ensuring that the number of the sales invoice in question has been sequential accounted for, the auditor can ensure that all the sales invoices have been recorded in the accounting records.

(c) Accuracy
- By recalculating the accuracy of the calculation of quantities and prices on the sales invoice and also checking the addition of the amounts on the invoice and the resultant total, the auditor is able to satisfy him or herself about the amount (value) of the transaction.
- By inspecting that the total amount of the invoice has been accounted for in the accounting records, the auditor is able to satisfy him or herself that the transaction was recorded at the correct amount.

(d) Cut-off
- By comparing the date on the invoice with the date of recording in the accounting records, the auditor can obtain satisfaction that the transaction was accounted for in the correct accounting period.

(e) Classification
- By inspecting that the transaction has been correctly allocated in the accounting records according to the particulars that appear on the sales invoice (credit sales), it is possible to obtain satisfaction that the sales transaction was correctly classified in the sales journal.
- By inspecting that the sales invoice has been posted to the correct ledger account and that the total of the credit sales account has been correctly reflected in the trial balance, the auditor can satisfy him or herself that the sales transaction has been correctly classified in the accounting records.
TOPIC 4: THE EXTERNAL AUDITOR

(f) Presentation

- Although this cannot be determined from inspection of the credit sales invoice alone, sales are eventually appropriately aggregated or disaggregated and clearly described as turnover in the AFS. The accounting policies to account for turnover is set out as an understandable note in the AFS.

13.3 SOURCES OF AUDIT EVIDENCE

Where does the auditor find audit evidence? Think of a business. You have the accounting records, for example the purchases journal and the general ledger. You have the source documents generated by the business used to initiate transactions for example the order and goods received note. You have the documents provided by third parties, for example the invoice and bank statements. You have evidence generated by personnel of the business, for example budgets and ratio analysis. Minutes of meetings and explanations by management are also examples of audit evidence. That is why the concept of reliable evidence is so important.

13.4 AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

We know the criteria for good audit evidence. We know the sources of audit evidence. We now have to examine the audit procedures for obtaining audit evidence.

STUDY

Jackson & Stent (2016:5/22) – Audit procedures for obtaining audit evidence

ACTIVITY 13.4

Drawing reasonable conclusions on which to base the auditors’ opinion is obtained by performing audit procedures. The following entails the audit procedures followed by the auditor to obtain audit evidence:

Step 1: The auditor performs a risk assessment to determine where to focus.

Step 2: The auditor performs “further” audit procedures and this entails:

A. .................................................................................... and
B. ....................................................................................

We will focus on the above steps in more detail in Study Unit 14.
13.5 SUMMARY AND SELF-ASSESSMENT

In this study unit you learned about the nature, reliability, sufficiency and relevance of audit evidence, and how audit evidence is obtained through test of controls and substantive procedures.

Refer to your notes you made in your workbook after completing the following activities.

Activity 13.1
Activity 13.2
Activity 13.3
Activity 13.4

After having worked through the study unit and the references to the prescribed study material, are you be able to

- discuss the nature, reliability, sufficiency and relevance of audit evidence?
- recognise the various sources of audit evidence?
- explain audit evidence which can be collected through test of controls and substantive procedures?

In the next study unit we are going to look at two important auditing concepts, namely materiality and audit risk.
14.1 INTRODUCTION

Materiality and audit risk are the auditor’s magic formulas. In this study unit you are going to learn how auditors think when collecting audit evidence. If a business was small and there were no costs involved in auditing then one could have audited each and every transaction and certify (opposed to fairly present) the annual financial statements. But in practice this cannot happen. Imagine if the auditors were to examine each and every transaction of Standard Bank – you will never see the audit report because their work will never end! With the limited resources on the one hand and reporting on the fair presentation of the annual on the other, one can expect a formula to reach a balance. That is exactly where materiality and audit risk plays a vital role in the daily life of the auditor.

Users of the AFS want to be satisfied that the audited financial statements on which they are relying, are free of material misstatement and their reliance is an implied acceptance that the auditor has performed his or her function properly. However, there is always the risk that the auditor will "get it wrong" and give an incorrect opinion. Therefore the auditor must plan and perform audit procedures so they do not get it wrong. In other words the auditor must plan and perform audit procedures so that the audit risk is at an acceptable level. We will first be looking at the term materiality and then the term audit risk and how these concepts make up the magic formula.

14.2 MATERIALITY

If you search the word “material” in this study unit you would notice that it appeared several times. What does this term mean? Let’s take an practical example. Assume you are a waiter at a restaurant and the practice is that if you serviced your guests well you would probably earn a gratuity (tip) of 10% of the account value. Assume the bill of the table you served was R1 200. How would you feel if the client added a tip of R115 instead of your expected R120? You would probably think it’s okay. On the other hand, how would you feel if they left you with only a R10 note? Your reaction would now be different. What we are effectively saying is that the R5 difference in the tip was immaterial – it resulted in no emotions. However, undertipping of R110 becomes material and you would feel cheated.
STUDY UNIT 14: Materiality and audit risk

ACTIVITY 14.1

Define the term materiality in an auditing context.

SUGGESTED SOLUTION 14.1

Refer to Jackson & Stent (2016:7/22) for the definition of materiality in an auditing context.

Note that your answer should refer to:

- an omission or misstatement
- the influence of such an omission or misstatement on the economic decisions of users/shareholders
- based on the information in the financial statements

14.3AUDIT RISK

What is audit risk?

INTERNET ACTIVITY 14.1

To orientate yourself go to the following link and watch the explanation of audit risk: https://www.youtube.com/watch?v=Ry7dmbUnNLo

Audit risk is the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated. As illustrated in diagram 9 below, audit risk has three elements, namely control risk (that which management does – Study Unit 3); inherent risk (a weakness or exposure to error), and detection risk (that which the auditor does and controls).

Study the diagram in Jackson & Stent (2016:7/6-7/7) and note the differentiation between risk of material misstatement and detection risk to form audit risk.

14.4THE COMPONENTS OF AUDIT RISK

Let us begin by understanding and describing the components of audit risk.

STUDY

Jackson & Stent (2016:7/5–7/7)
TOPIC 4: THE EXTERNAL AUDITOR

14.4.1 Inherent risk

ACTIVITY 14.2

Define the term inherent risk.

SUGGESTED SOLUTION 14.2

**Inherent risk** is the **susceptibility** of an account balance or class of transactions to misstatements that could be material, either individually or when aggregated with misstatements in other balances or classes of transactions, assuming that there were no related internal controls.

- What does susceptibility mean? (Use a dictionary.)
- Provide three examples of inherent risk.

Example 1: complex lease agreement calculations compared to a cash purchase
Example 2: __________________________
Example 3: __________________________

14.4.2 Control risk

ACTIVITY 14.3

Define the term control risk by completing the sentence:

**Control risk** is the risk that a misstatement that could occur in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes of transactions, will not be prevented.

Describe control risk in your own words.

When considering control risk one must remember that internal controls do have their own limitations. In **Study Unit 3** we examined the inherent limitations of internal control. To refresh your memory, list six limitations inherent to internal control.

1. Cost versus benefit
2. ______________________________________
3. ______________________________________
4. ______________________________________
5. ______________________________________
6. ______________________________________
14.4.3 Detection risk

ACTIVITY 14.4

Define the term control risk by completing the sentence:

Detection risk is the risk that the auditors will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes of transactions.

- Detection risk relates to the ____________, timing and ____________ of the auditor’s procedures.
- Who is in control of detection risk? ______________
- List five examples how the auditor constructively reduce detection risk.
  1. by complying with the relevant International Standards of Auditing
  2. sound planning
  3. ______________
  4. ______________
  5. ______________

14.5 RELATIONSHIP BETWEEN THE DIFFERENT COMPONENTS OF AUDIT RISK

Understanding the relationship of $AR = (IR + CR) + DR$ is the ultimate goal of this study unit.

STUDY

Jackson & Stent (2016:7/5–7/7)

ACTIVITY 14.5

During your planning of the audit of Laduma (Pty) Ltd, you assessed the preliminary reliance that could be placed on the company’s internal controls as low. Explain the influence of your preliminary reliance on the internal controls on your assessment of control risk and the impact on the test of controls, as well as substantive procedures which you should carry out.

SUGGESTED SOLUTION 14.5

Reference: Jackson & Stent (2016:7/5)

Control risk would be rated as high, as you can place less reliance on the company’s internal control systems. The auditor is compelled to accept a lower level of detection risk. In order to achieve this, the auditor would have to increase the extent of his or her substantive procedures.
14.6 SUMMARY AND SELF-ASSESSMENT

In this study unit you learned about the nature of materiality and audit risk, as well as the relationship between materiality and audit risk.

Refer to your notes you made in your workbook after completing the following activities.

| Activity 14.1 | Activity 14.2 | Activity 14.3 | Activity 14.4 | Activity 14.5 | Internet Activity 14.1 |

After having worked through the study unit and the references to the prescribed study material, are you able to:

- discuss materiality and audit risk and the relationship between them?

In the next study unit we will discuss how the auditor can identify and assess the risks of material misstatement.
STUDY UNIT 15

RISK ASSESSMENT AND FURTHER AUDIT PROCEDURES

IN THIS STUDY UNIT WE ARE GOING TO

• explain risk assessment procedures to assess the risk of material misstatement
• explain test of controls and substantive procedures as further audit procedures

15.1 INTRODUCTION

Without knowing it you are performing risk assessment procedures daily and you act according your assessment of the risk. I too was a student once, so let’s look at this example to illustrate the point. When studying for an examination you want to pass – passing is your objective (for the auditor = audit report). You have limited time. What do you do? You identify the topics that you think the examiner would most likely assess in the examination and focus on those areas (auditor = risk assessment). If you identified the wrong topics then you fail. (auditor = inappropriate or wrong audit opinion i.e. audit risk). You have control over what you study. The auditor has control over their audit procedures (auditor = detection risk). To reduce your audit risk or examination risk, what do you do? You master more study units! Thereby you are reducing your chances of failure. Think of any other aspects in your life where you are in fact assessing risk, acting thereon to manage that risk to meet your objective. Do you see the auditing principles are not that complex as you thought?

In this study unit we are going to examine how the auditor obtains audit evidence by performing risk assessment procedures and then performing “further audit procedures” to reduce audit risk. Further audit procedures comprise tests of control and substantive procedures.

15.2 UNDERSTANDING THE CONTEXT OF RISK ASSESSMENT PROCEDURES

The following diagram is a simplified overview of identifying and assessing the risks of material misstatements. Use the diagram when reading the following study text.
DIAGRAM 11: OVERVIEW OF THE RISK ASSESSMENT PROCESS

The auditor:

Understand the business

allows

Identify areas of material misstatements

broad focus

Determine materiality

specific focus

Plan audit procedures and sample sizes

field work

Collect audit evidence

auditor evaluates evidence

Problems identified?

YES

Focus on specific areas

More audit procedures

Conclude

NO

ACTIVITY 15.1
Define the objective of the auditor.

SUGGESTED SOLUTION 15.1
Reference: Jackson & Stent (2016:7/7): Introduction paragraph

The objective of the auditor is to identify _________________, whether due to fraud or error at the _______________ through _______________ the entity and its ____________.
including the entity’s ________________, thereby providing a basis for ________________ to the assessed risks of ________________

ACTIVITY 15.2

Why is understanding of the client’s business so important to the auditor?

SUGGESTED SOLUTION 15.2

Reference: Jackson & Stent (2016:7/7): Introduction paragraph

Without proper understanding of the client’s business the auditor is not able to identify and assess the _________________________________.

15.3 CONDITIONS AND EVENTS THAT MAY INDICATE RISKS OF MATERIAL MISSTATEMENTS

The list that you are going to study may become very important in your accounting career. This will help develop an instinct to know that something may be wrong and needs to be investigated.

STUDY

Jackson & Stent (2016:7/8)

ACTIVITY 15.3

List the 15 conditions and events that may indicate a risk of material misstatement.

REFLECTION 15.1

Next to each item consider/argue why you think that the condition and event may indicate a risk of material misstatements.

15.4 RISK ASSESSMENT PROCEDURES

How does the auditor go about to gather information about the client to identify and assess risks of material misstatements? Study Jackson & Stent (2016:7/9).

ACTIVITY 15.4

List methods used by the auditor to obtain useful information about the client.
TOPIC 4: THE EXTERNAL AUDITOR

SUGGESTED SOLUTION 15.4

Reference: Jackson & Stent (2016:7/9)

(1) Client acceptance of continuance procedures
(2)                                                                                         .
(3)                                                                                         .
(4)                                                                                         .
(5)                                                                                         .
(6)                                                                                         .
(7) Discussion among the audit team
(8)                                                                                         .

ACTIVITY 15.5

Give an example of using the inspection procedure to obtain information about the client.

SUGGESTED SOLUTION 15.5

Reference: Jackson & Stent (2016:7/10)

Along with enquiry, inspection will be a major provider of information in gaining an understanding of the entity. At this stage of the audit, we are not carrying out a detailed inspection of “everyday” documents such as sales invoices or purchase orders. This is more likely to be a detailed review of the following kinds of documents:

- Business plans and strategies
- Internal control procedure manuals, flow charts, organisational charts
- Management reports, minutes of board meetings and board committee meetings
- The company’s integrated report and prior year financial statements
- Relevant trade and financial journals and internet sites
- Important contracts

15.5 FURTHER AUDIT PROCEDURES

Activities 15.4 and 15.5 were examples of how the auditor obtains information to understand the business in order to identify the areas of material misstatements (risk assessment procedures). Once this stage is completed the auditor is ready to do the audit field work, referred to in auditing literature as “further audit procedures”. We are going to look at what these further audit procedures entail.

Examine diagram 12. You will notice that there are two main types of audit procedures. Tests of controls enables the auditor to determine if he/she can rely on the internal controls implemented by management. If the outcome of the tests of controls is positive it means that the auditor can rely on the internal controls. Substantive procedures are procedures that test assertions e.g. completeness, accuracy, etc. Substantive procedures consist of analytical procedures and tests of detail.
Note that the procedures of inspection, observation, external confirmation, recalculation, reperformance, analytical procedures and inquiry are to be used when performing risk assessment procedures, carrying out test of controls or carrying out substantive procedures.

ACTIVITY 15.6

Define test of controls.

Reference: Jackson & Stent (2016:5/27)

SUGGESTED SOLUTION 15.6

Test of controls are performed to obtain evidence of whether controls are material misstatements and these controls operated effectively throughout the period being audited.

ACTIVITY 15.7

Is it possible to only perform tests of controls?

SUGGESTED SOLUTION 15.7

No, even if the auditor finds that the accounting system and related control activities are excellent, he or she must realise that

- all internal control systems have inherent limitations which make them less than 100% efficient (see study unit 3)
- the internal control system may have been excellent at the time the auditor performed his/her tests but not at other times during the year
- there will still be inherent risk to consider

Successful test of controls will reduce the extent, and possibly change the nature of substantive tests, but cannot eliminate the need to perform substantive tests.

**ACTIVITY 15.8**

Define the term substantive procedures.

**SUGGESTED SOLUTION 15.8**

Reference: Jackson & Stent (2016:5/28)

Substantive procedures may be broadly distinguished as ________ and ________ procedures. Substantive procedures seek to provide evidence to support the financial statement ________________.

**ACTIVITY 15.9**

Describe why the auditor performs substantive procedures?

**SUGGESTED SOLUTION 15.9**

Reference: Jackson & Stent (2016:5/28)

Substantive procedures seek to provide evidence to support the financial statement assertions. When performing substantive tests the auditor is interested in the following:

- Balances
- ________________________________
- ________________________________

**ACTIVITY 15.10**

Explain the types of procedures that can be used for carrying out risk assessment procedures, tests of controls and substantive tests.
SUGGESTED SOLUTION 15.10

Reference: Jackson & Stent (2016: 5/26)

Essentially the procedures that the auditor carries out during risk assessment or when testing controls or performing substantive tests are described as follows:

- **Inspection**: involves examining records or documents, whether internal or external, in paper form, electronic form or other media, or a physical examination of an asset.
- **Observation**: consists of looking at a process or procedure being performed by others, or at the performance of control activities.
- **External confirmation**: obtaining a direct written response from a third party to a request/query from the auditor to that third party in paper form or by electronic or other medium.
- **Recalculation**: consists of checking manually or electronically, the mathematical accuracy of documents or records.
- **Reperformance**: involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.
- **Analytical procedures**: evaluating financial information through analysis of plausible relationships among both financial and non-financial information.
- **Inquiry**: seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

It is not possible to categorise each of the above procedures as simply either a risk assessment procedure, a tests of controls procedure or a substantive procedure. The procedure will be categorised in terms of what the auditor is trying to achieve, therefore the objective.

Refer to the following example to explain this.

Example 1 (Jackson & Stent 2016:5/26)

- **Inquiry – risk assessment**
The auditor inquires of the head of internal audit as to his assessment of the likelihood of material misstatement of inventory.

What is the objective of this procedure?

*To gather information about the client so that the identification and assessment of risks of material misstatement at the financial statement and assertions level can take place.*

- **Inquiry – test of controls**
The auditor inquires of the credit controller as to exactly what functions each member of her department carries out and what control procedures are in place.

What is the objective of this procedure?

*To determine how the internal control measure in question should be evaluated.*

- **Inquiry – substantive test**
The auditor makes inquiries of the factory manager as to the impairment writedowns for a particular machine.

What is the objective of this procedure?

*To obtain audit evidence to detect material misstatements in the financial statements relating to the valuation of machinery.*
15.6 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed risk assessment procedures, tests of controls and substantive procedures and why should they be performed by the auditor.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 15.1</th>
<th>Reflection 15.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 15.2</td>
<td></td>
</tr>
<tr>
<td>Activity 15.3</td>
<td></td>
</tr>
<tr>
<td>Activity 15.4</td>
<td></td>
</tr>
<tr>
<td>Activity 15.5</td>
<td></td>
</tr>
<tr>
<td>Activity 15.6</td>
<td></td>
</tr>
<tr>
<td>Activity 15.7</td>
<td></td>
</tr>
<tr>
<td>Activity 15.8</td>
<td></td>
</tr>
<tr>
<td>Activity 15.9</td>
<td></td>
</tr>
<tr>
<td>Activity 15.10</td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- explain risk assessment procedures to assess the risk of material misstatement?
- explain test of controls of controls and substantive procedures as further audit procedures?

In the next topic we are going to look at steps in performing an audit, that is, the audit process.
TOPIC 5

The audit process

Study unit 16
The overall audit process 99

Study unit 17
Planning and implementing the plan 105

Study unit 18
Reaching conclusion and reporting 112
TOPIC OVERVIEW

In this topic we are going to examine the stages of performing an audit. In literature this is referred to as the audit process. What are the steps that you follow everyday from the time you wake up until you go to bed? Similar to your routine, the auditor also follows certain steps in the conduct of an audit.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>The audit process</td>
<td>99</td>
</tr>
<tr>
<td>17</td>
<td>Planning and implementing the plan</td>
<td>105</td>
</tr>
<tr>
<td>18</td>
<td>Reaching conclusions and reporting</td>
<td>112</td>
</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that have been indicated.
THE OVERALL AUDIT PROCESS

IN THIS STUDY UNIT WE ARE GOING TO

- describe the stages of the audit process that an auditor would follow to complete an audit

16.1 INTRODUCTION

In this study unit we will introduce you to the audit process and the stages within each process. This will give you a very good idea of what happens in the conduct of an audit.

16.2 THE AUDIT PROCESS

STUDY

Jackson & Stent (2016:6/6)

The diagram in the above study reference gives a bird’s eye view of the audit process. Study the diagram and notice that there are four stages and various activities within each stage. Let us begin with an overview of the process as described in the diagram below (based on Jackson & Stent 2016:6/6). The auditor has to decide whether or not to accept the audit. Once the audit engagement has been accepted, the audit has to be very carefully planned. The audit risk is assessed and further audit procedures are carried out. The auditor evaluates the audit evidence and concludes and issues the appropriate audit report.
Now let’s compare the stages of the audit process to the stages of your studies. Notice the similarities!

<table>
<thead>
<tr>
<th>Audit stages</th>
<th>Studying stages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary engagement activities</td>
<td>Apply for registration.</td>
</tr>
<tr>
<td>Planning activities</td>
<td>Planning of assignment dates, study unit allocation in calendar, do activities, self-reflection activities etc.</td>
</tr>
<tr>
<td>Responding to assessed risk</td>
<td>In your case, you study everything!</td>
</tr>
<tr>
<td>Concluding stage</td>
<td>Revise your notes in your workbook; textbook and study guide.</td>
</tr>
<tr>
<td></td>
<td>Consider what you know and which areas need more attention.</td>
</tr>
<tr>
<td></td>
<td>Write the exam.</td>
</tr>
<tr>
<td></td>
<td>Get the results.</td>
</tr>
</tbody>
</table>

Now that you have been introduced to the audit process let’s study this following section in detail. Bear in mind that the stages of the audit process are not “standalone units” but interrelated and dependent on each other (Jackson & Stent 2016:6/6).
STUDY


This section will allow you to complete all of the activities unless an additional study reference is provided.

16.3 THE PRELIMINARY STAGE

As stated in Jackson & Stent (2016:6/6) this stage consists of preliminary engagement activities which take place before an audit engagement is accepted.

DIAGRAM 14: THE ACTIVITIES INVOLVED IN THE PRELIMINARY ENGAGEMENT STAGE

ACTIVITY 16.1

Preliminary stage: List the aspects considered by the auditor in the preliminary stage of an audit.

SUGGESTED SOLUTION 16.1

Reference: Jackson & Stent (2016:6/6–6/7)

(1) Establishing whether any pre-conditions for an audit are present.
(2)
(3)
(4)
(5)

REFLECTION 16.1

Do you notice that an auditor cannot just accept any client?
STUDY

Jackson & Stent (2016:6/3) – Acceptance of client relationships

ACTIVITY 16.2

List the three key aspects that an engagement partner must continuously evaluate before accepting or continuing an existing client relationship.

SUGGESTED SOLUTION 16.2

1. The integrity of the principle owners, key management and those charged with governance of the entity
2. 
3. 

Note that the preliminary engagement activities do not apply to internal auditors. Internal auditors will gain an understanding of the division he or she is going to audit. Internal auditors cannot choose whether they wish to accept an audit or not, as they are employees of the company.

DISCUSSION 16.1

E-tutor assistance required

Consider the following questions and post your thoughts about any of them on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

- Discuss why the preliminary stage of an audit is important.
- Provide practical examples of possible mishaps that can be avoided with a properly implemented preliminary stage.
- Describe possible reasons why an audit firm may not wish to accept an audit engagement.

16.4 THE PLANNING STAGE

ACTIVITY 16.3

Planning stage: List the aspects considered by the auditor in the planning stage of an audit.

SUGGESTED SOLUTION 16.3

Reference: Jackson & Stent (2016:6/7)

1. Establishing an audit strategy.
2. 
3. 


DISCUSSION 16.2

**E-tutor assistance required**

Consider the following questions and post your thoughts about any of them on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Discuss why the planning stage of an audit is important.

Provide practical examples of possible mishaps that can be avoided with a properly planning stage.

16.5 RESPONDING TO ASSESSED RISK STAGE

**ACTIVITY 16.4**

**Responding to assessed risk stage:** List the aspects considered by the auditor in the responding to assessed risk stage of an audit.

**SUGGESTED SOLUTION 16.4**


1. Respond in a general sense at financial statement level.
2. _______________________________________________________________________
3. _______________________________________________________________________

16.6 CONCLUDING STAGE

**ACTIVITY 16.5**

**Concluding stage:** List the aspects considered by the auditor in the concluding stage of an audit.

**SUGGESTED SOLUTION 16.5**


1. Evaluate and conclude on the audit evidence gathered.
2. _______________________________________________________________________
REFLECTION 16.2

In this study unit you have been introduced to the four stages of the audit process. Go to your workbook and create your own spider diagram that connects all the elements of each stage so that you create your own bigger picture.

Google “spider diagram” and look at examples of images of spider diagrams. Be creative and design your own unique spider diagram. Use colours if you want to. If you complete this study unit properly then this is all you need to learn when revising for the exams!

16.7 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed the overall audit process and how it assists the auditor to achieve his or her objectives.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 16.1</th>
<th>Discussion 16.1</th>
<th>Reflection 16.1</th>
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</thead>
<tbody>
<tr>
<td>Activity 16.2</td>
<td>Discussion 16.2</td>
<td>Reflection 16.2</td>
</tr>
<tr>
<td>Activity 16.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 16.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 16.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- describe the stages of the audit process that an auditor would follow to complete an audit?

In the next study unit, we will discuss the planning and implementing of the plan.
PLANNING AND IMPLEMENTING THE PLAN

IN THIS STUDY UNIT WE ARE GOING TO
• explain the planning of an audit
• explain how the plan is implemented

17.1 INTRODUCTION
In Study Unit 16.4 we looked at the steps in planning an audit. In this study unit, we are going to expand on the planning stage of an audit. We need to understand why planning is important and how the plan is implemented. Planning is a concept that we need to apply in our daily lives. Again this illustrates that auditing is not as abstract as students perceive it to be. View this short motivational clip https://www.youtube.com/watch?v=RZ45Rlu_TS8 to illustrate the point.

17.2 IMPORTANCE OF PLANNING

REFLECTION 17.1
Why would you say planning is so important for the auditor?
Remember: the auditor wants to express an opinion on the fairness of an entity’s annual financial statements. On the one hand the auditor does not want to be held liable for negligence. Time is limited. On the other hand the auditing practice is a business and the partners want to make a profit. Therefore, balancing the two extremes’ effectiveness is the deciding factor (Jackson & Stent 2016:6/13). The auditor must be smart and therefore aim to plan and perform an audit effectively.

INTERNET ACTIVITY 17.1
Google the word “effective” and write down its meaning in your workbook.

<table>
<thead>
<tr>
<th>Effective</th>
<th>Meaning:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>
17.3 PLANNING

In this section we begin by looking at the importance of the planning of the audit. Then we look at the overall audit strategy. This section is followed by the characteristics and matters to be considered in formulating the audit strategy. Finally, we look at the audit plan itself.

STUDY


If you work through the above study reference you will be able to do all the activities.

17.3.1 Importance of planning an audit

ACTIVITY 17.1

Explain why it is important to plan an audit.

SUGGESTED SOLUTION 17.1


(1) To ensure that appropriate attention is devoted to important areas of the audit (significant risk).

(2) To ________________________________

(3) To assemble a competent and capable audit team (experts).

(4) To ________________________________

(5) To ________________________________

REFLECTION 17.2

Do you notice the above answer fits into the definition of the word effectiveness?

17.3.2 Difference between the overall audit strategy and the audit plan

As stated in Jackson & Stent (2016:6/15), the audit strategy and audit plan are interlinked, but the audit plan is far more detailed than the overall strategy. The audit strategy focuses on the bigger picture of the client and based on that the audit plan focusses on the nitty gritty of the audit.

The objective of the overall audit strategy is to set the scope, timing and direction of the audit and to guide the development of the audit plan (Jackson & Stent 2016:6/14). Let us look at these terms to understand the objective better.
INTERNET ACTIVITY 17.2

Google the word “scope” and write down its meaning in your workbook.

<table>
<thead>
<tr>
<th>Scope</th>
<th>Meaning</th>
</tr>
</thead>
</table>

17.3.3 Characteristics and matters to be considered in formulating the audit strategy

17.3.4 Characteristics of the engagement which define its scope

ACTIVITY 17.2

List four characteristics that define the **scope** of an audit engagement.

SUGGESTED SOLUTION 17.2:

Reference: Jackson & Stent (2016:6/14)

(1) The financial reporting standards applicable to the client
(2) The number of branches and locations of the client
(3) The specialised knowledge required to do the audit
(4) The effect of IT on the client

REFLECTION 17.3

Do you notice the above answer fits into the definition of the word scope?

Let us now look at time and direction. Direction in this context means the focus.

17.3.5 Matters to be considered in formulating the audit strategy

ACTIVITY 17.3

List the factors that define the timing and direction of an audit engagement.

SUGGESTED SOLUTION 17.3

Reference: Jackson & Stent (2016:6/14)

(You may add more to the list by referring to your prescribed activity text)
TOPIC 5: THE AUDIT PROCESS

### Timing and Direction (focus)

<table>
<thead>
<tr>
<th>Timing</th>
<th>Direction (focus)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The financial year-end</td>
<td>1. Account headings</td>
</tr>
<tr>
<td>2. Interim statements</td>
<td>2. High risk areas</td>
</tr>
<tr>
<td>3. Scheduled meetings with audit committee</td>
<td>3. Discussions with managers</td>
</tr>
<tr>
<td>4. Reporting deadlines</td>
<td></td>
</tr>
</tbody>
</table>

From the above activities you should have formed a good idea what an audit strategy is all about. We are now going to look at the audit plan. Remember we said the strategy provides the auditor with the big picture and the audit plan then goes into the detail.

#### 17.3.6 The audit plan itself

**ACTIVITY 17.4**

What aspects must the audit plan contain?

**SUGGESTED SOLUTION 17.4**

**Reference:** Jackson & Stent (2016:6/15)

The audit plan must contain:

- a description of the nature, timing and extent of planned *risk assessment procedures*, sufficient to assess the risks of material misstatement
- a description of the nature, timing and extent of planned *further audit procedures* at the assertion level for each material class of transactions, account balance and disclosure
- any *other audit procedures* which may be required to comply with the ISAs

#### 17.4 PLANNING AND CONDUCTING RISK ASSESSMENT PROCEDURES

Planning and conducting risk assessment procedures happen at two levels, namely at the financial statement level and at the assertion level.

**STUDY**

Jackson & Stent (2016/15-6/17) – *Planning and conduction risk assessment procedures*

#### 17.4.1 Risk at financial statement level

**ACTIVITY 17.5**

Describe the concept of *risk at financial statement level*. 
Risk at the financial statement level is the risk which affects which make up the financial statements.

An example of risk at financial statement level is if the client’s management lacks integrity, the audit as a whole is inherently more risky than for the audit of a client whose management has a proven record of integrity. The effect of management’s lack of integrity may filter down into the financial statements as they attempt to manipulate the account balances and totals to suit their own purposes.

What does the auditor do when he/she assesses that the risk of material misstatement exists at the financial statement level?

ACTIVITY 17.6
Describe the auditor’s overall response to assessed risk of material misstatements at the financial statement level.

SUGGESTED SOLUTION 17.6

Overall responses may be summarised as follows:
- Emphasise professional scepticism.
- Assign more experienced staff with special skills or use experts.
- Provide more supervision.
- Incorporate elements of unpredictability into the audit procedures adopted (do things in a manner which the client may not expect), e.g. surprise visits to client.
- Make general changes to the nature, timing and extent of audit procedures conducted in the past.

REFLECTION 17.4
Do you notice that the way in which the auditor adjusts to risk assessment will affect the audit plan?

17.4.2 Risk at assertion level

ACTIVITY 17.7
Describe the concept of risk at assertion level.
SUGGESTED SOLUTION 17.7


Risk at the assertion level relates to the risk of material misstatement at assertion level for classes of ____________, ____________ and ____________.

An example of risk at assertion level is inclusion of sales which have not actually occurred or which do not pertain to the entity i.e. the occurrence assertion relating to a class of transaction.

17.4.3 Response to assessed risk

What does the auditor do when he/she finds risk to exist during the planning stage of the audit?

The answer is to plan further audit procedures. This will entail developing a plan which describes the nature, timing and extent of further audit procedures, both tests of control and substantive tests, which will be conducted to reduce the risk of material misstatement relating to the assertions remaining undetected. Diagram 15 explains the auditor’s response to assessed risk.

**DIAGRAM 15: AUDITOR’S RESPONSE TO ASSESSED RISK**

- **Auditor’s response to assessed risks**
  - **Overall responses:** Auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.
  - **Response to assessed risks:** Auditor to design and perform further audit procedures whose nature, timing and extent are based on the assessed risks of material misstatement at the assertion level for each class of transaction, account balance or disclosure.
  - **General actions include the following:**
    - assign more experienced staff with special skills
    - assign experts
    - emphasise to the audit team the importance of professional scepticism
    - incorporate elements of unpredictability
    - make general changes to the nature, timing and extent of audit procedures
  - **Audit procedures:** The auditor must respond to the risks by ensuring that the nature, timing and extent of tests of control and substantive tests are correct to reduce audit risk to an acceptable level.

*Source: Jackson & Stent (2016:6/21)*
17.5 SUMMARY AND SELF-ASSESSMENT

In this study unit the focus was on audit planning, the overall audit strategy and audit plan, risk assessment and responding to assessed risk.

Refer to your notes you made in your workbook after completing the following activities.

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<tr>
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<th>Internet 17.1</th>
<th>Reflection 17.1</th>
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<tbody>
<tr>
<td>Activity 17.2</td>
<td>Internet 17.2</td>
<td>Reflection 17.2</td>
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<td>Activity 17.3</td>
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<td>Activity 17.4</td>
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<td>Activity 17.6</td>
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<tr>
<td>Activity 17.7</td>
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</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- explain the planning of an audit?
- explain how the plan is implemented?

In the next study unit, you will learn about the concluding stage of the audit process.
REACHING CONCLUSIONS AND REPORTING

IN THIS STUDY UNIT WE ARE GOING TO

• explain how you will report the outcomes of the audit tests performed

18.1 INTRODUCTION

Throughout this module we indicated that the outcome of an auditor’s work is the audit report. Remember: on the one hand we have management that run a business on behalf of the shareholders. Management prepares annual financial statements for the shareholders to report on the financial position and results. On the other hand we have the owners of the business: the shareholders. The shareholders need to know how their business performed and if the results prepared and presented by management can be relied on. The auditor performs this assurance function and formulates an audit report that accompanies the annual financial statements. In this study unit we are going to look at the final stage of the audit process, namely the concluding stage.

18.2 EVALUATING, CONCLUDING AND REPORTING

In the planning stage we focussed on performing audit procedures based on the risk assessment. Once the evidence is collected the auditor examines the evidence. The auditor asks him/herself: Have I collected sufficient audit evidence to reduce the audit risk to an acceptable level? The auditor keeps trying until sufficient audit evidence is obtained. The question arises, what happens if the auditor is unable to obtain sufficient audit evidence after retrying? This is where the audit report fulfils an important function. The auditor issues a modified opinion which can be either an adverse opinion or a disclaimer of opinion.

STUDY


Diagram 16 provides on overview of the evaluating, concluding and reporting stage of the audit process. Use the diagram to assist you in learning the applicable content.
18.3 THE MODIFICATIONS

If the auditor is satisfied with the audit procedures and sufficient appropriate audit evidence was obtained to reduce the assessed audit risk to an acceptable level, the auditor can issue an **unmodified** (unqualified) audit opinion. The opinion mainly says “*In our opinion the annual financial statements present fairly, in all material respects….*” This means that the shareholders and analysts can rely on the annual financial statements.

There are various levels of **modified** audit opinions.

- We have the **except for** opinion, describing the effect of the error that management did not adjust. Users can then make those adjustments on the AFS and then “read” the AFS.
- We have an **adverse opinion** that says that financial statements are not fairly presented. The users cannot even make their own adjustments. This should result in legal steps against management.

**Reference**: Jackson & Stent (2016:7/7)
• We have a disclaimer in opinion that says I do not know. This could for example happen when no backups were made and there are no records to audit. This too should result in legal steps against management.

18.4 SUMMARY AND SELF-ASSESSMENT

In this study unit we discussed how the auditor reaches conclusions and undertakes reporting.

After having worked through the study unit and the study references are you able to:

• explain how you will report the outcomes of the audit tests performed?

In the next topic we will discuss control activities within the various business cycles.
TOPIC 6

Systems and cycles within a business entity

Study unit 19
TOPIC OVERVIEW

In this topic you will familiarise yourself with the various business cycles that normally forms part of the accounting system of a business undertaking.

This topic is comprised of the following study unit:

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<th>Study unit</th>
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<tbody>
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<td>Systems and cycles within a business entity</td>
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Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions as indicated in the tutorial letter.
STUDY UNIT 19

SYSTEMS AND CYCLES WITHIN A BUSINESS ENTITY

IN THIS STUDY UNIT WE ARE GOING TO
• identify the different business cycles
• explain the sequence of events in the revenue and receipts cycle and the acquisitions and payments cycle
• explain the purpose of inventory and the payroll and personnel cycle

19.1 INTRODUCTION
The aim of this study unit is to introduce you to the business cycles as part of the accounting system. Once you grasp the activities within each cycle and the sequence of events, then understanding the risks and control activities will become easier to learn (subsequent study units). Remember to always integrate the knowledge that you have gained from your other accounting subjects.

19.2 SYSTEMS AND CYCLES WITHIN A BUSINESS ENTITY
One of the outcomes of an accounting system is to compile financial information that is complete, accurate and valid and – from this information – prepare annual financial statements (AFS). To this end, a business entity establishes procedures and records to:
• initiate, record, process and report transactions
• capture events and conditions other than transactions
• accumulate, record, process and summarise information for the preparation of the AFS
(Jackson & Stent 2016:5/10)

The above procedures and events can be designated to systems and cycles within a business entity. If you refer to the table of contents of Jackson & Stent, you will notice that the designated cycles are the following:
• Revenue and receipts cycle (chapter 10)
• Acquisitions and payments cycle (chapter 11)
• Inventory and production cycle (chapter 12)
• Payroll and personnel cycle (chapter 13)
• Finance and investment cycle (chapter 14)
In this module we are going to examine a retailing business and not a manufacturing (production) business. We are also not going to examine the finance and investment cycle.

Refer to diagram 17 to obtain an understanding of how the five business cycles function. Goods (inventory) are purchased (acquisitions) and paid for through the bank account (payments). The idea is to sell (revenue) the inventory at a profit and deposit (receipts) the money into the bank account. To execute the functions you need employees (payroll) and they too get paid from the bank account.

As a business expands it may need additional long-term financing. The need arises for example to buy furniture and fittings or build a bigger warehouse. A loan is negotiated and obtained and the money is deposited into the bank account. Over time, as the business makes profits it starts accumulating money in its bank. Instead of leaving it in the bank where it earns no interest the business saves or invests it to earn interest, dividends or capital growth. The investment enables the business to expand its operations over time.

**DIAGRAM 17: REPRESENTATION OF THE FIVE BUSINESS CYCLES IN RELATION TO THE ACCOUNTING SYSTEM**

In the introduction to this module you were required to visualise your own business. We are going to take your own business idea and design the functions, identify the risks and design control activities to reduce risks.

Let us begin by first obtaining a bird’s eye view of the revenue and receipts cycle and the acquisition and payments cycle. In the study units that follow we will examine the functions, documents, risks and controls of each cycle in more detail.
19.3  REVENUE AND RECEIPTS CYCLE

As explained in section 19.2, the revenue and receipts cycle is about selling inventory (at a profit) and collecting the money for the inventory sold.

STUDY

Jackson & Stent (2016:10/2) – Basic functions for any revenue and receipts cycle

DIAGRAM 18: OVERVIEW OF THE SEQUENCE OF EVENTS IN THE REVENUE AND RECEIPTS CYCLE

From the above study reference you should have gathered that six basic functions were identified. After studying the study reference, refer to diagram 18 to assist you to understand the sequence of events. (Follow the numbering in the diagram.)
We are starting this cycle on the assumption that we have inventory in the warehouse to sell and that we are selling the goods on credit (30 days). We are therefore not looking at cash sales.

A customer has a need for inventory that your business sells and places an order that will be handled by the order department. Before an internal sales order is processed by your business you need to establish if the customer will be able to pay you for the goods after 30 days. Therefore, your credit manager examines the credit profile of the customer (credit management). If the customer is creditworthy and within his/her existing credit limits, the order is processed. In processing an order, the goods are picked from the warehouse and despatched to the customer. The order is accounted for by initiating an invoice. The invoice is recorded in the sales journal and posted to the debtors’ ledger. The accounting treatment in the general ledger: revenue account is credited and the debtors account debited. At the end of the month a statement of account is issued to the customer. The statement of account is extracted from the debtors’ ledger. The customer receives the statement of account and pays the account. As soon as the money is received your business issues a receipt. The receipt is used to record the payment from the customer and allocating the payment to his/her debtor’s account in the debtors’ ledger. The accounting treatment in the general ledger: bank account is debited and the debtors account credited. The money is deposited and your bank account balance increases.

REFLECTION 19.1

You have completed an overview of the sequence of events in the revenue and receipts cycle.

Involve a friend and tell him/her of your business idea.

• Take them step by step through the sequence of events of the revenue and receipts cycle.

19.4 Aquisitions and Payments Cycle

As explained in section 19.2, the acquisitions and payment cycle is about buying inventory (at the best price) and paying the creditor within 30 days.

STUDY

Jackson & Stent (2016:11/2–11/3) – **Basic functions for any acquisitions and payments cycle**
From the above study reference you should have gathered that five basic functions were identified. After studying the study reference, refer to diagram 19 to assist you to understand the sequence of events. (Follow the numbering in the diagram.)

Again, let us assume that this is your business. Your warehouse needs inventory to sell to customers. A requisition is placed by the warehouse at the ordering for goods department. The ordering for goods department must purchase the best quality goods at the best price. They place the order at the appropriate supplier. The goods arrive at your premises and are checked against the order and delivery note. A goods received note is made out to acknowledge receipt of the goods. The goods are moved to the warehouse. The accounting department uses the goods received note, the purchase order and the supplier’s invoice to record the transaction in the purchases journal and the creditor’s ledger. The accounting treatment in the general ledger: cost of sales account is debited and the creditor’s account is credited.

At the end of the month the supplier statement arrives and preparation of the payment begins. From your creditor’s ledger in your books of account a statement of account of the creditor is extracted. This is used to reconcile it with the supplier’s statement of account. As soon as the reconciliation is completed the payment is made. The accounting treatment in the general ledger: creditor’s account is debited and the bank account is credited.
REFLECTION 19.2

You have completed an overview of the sequence of events in the acquisitions and payments cycle.

Involving a friend and tell him/her of your business idea.

• Explain to them step by step the sequence of events of the acquisitions and payments cycle.

19.5 INVENTORY.

Refer to diagram 17. Both the acquisitions cycle and revenue cycle connect to the inventory cycle. Goods are received for resale in the warehouse and goods are despatched from the warehouse and sold at a profit.

STUDY

Jackson & Stent (2016:12/2) – Characteristics of the cycle (2.1–2.3)

The above study reference requires you to study three paragraphs to reaffirm what we have learned so far on where inventory fits into the business cycles.

19.6 PAYROLL

According to Jackson & Stent (2016:13/2) the payment of salaries and wages is an integral part of any business. Since it is a cycle which results in an outflow of funds from the business, it is extremely important that the accounting system and related control activities are sound, so as to prevent potential significant misappropriation of funds.

19.7 FINANCE AND INVESTMENT CYCLE

According to Jackson & Stent (2016:14/2) this cycle essentially deals with those transactions which a company enters into to raise finance, for example by raising start-up capital to hire a business premises, purchase equipment and inventory. The cycle also deals with the investment the company makes, whether it is in property, plant and equipment, making long-term loans or investing surplus funds.

STUDY

Jackson & Stent (2016:14/2) – Introduction
19.8 SUMMARY AND SELF-ASSESSMENT

In this study unit we identified the various business cycles and introduced you to the sequence of events in the revenue and receipts cycle and the acquisitions and payments cycle.

Refer to your notes you made in your workbook after completing the following activities.

Reflection 19.1
Reflection 19.2

After having worked through the study unit and the study references are you able to:

- identify the different business cycles?
- explain the sequence of events in the revenue and receipts cycle and the acquisitions and payments cycle?
- explain the purpose of inventory and the payroll and personnel cycles?

In the next topic we will identify the accounting functions (including documents) within the revenue and receipts business cycle, identify the risks within each function and design controls to reduce the identified risks.
TOPIC 7

The revenue and receipts cycle

Study unit 20
Ordering and warehouse/despatch functions 127

Study unit 21
Invoicing and recording of sales functions 141

Study unit 22
Recording of receipts and credit management functions 148
TOPIC OVERVIEW

In Study Unit 19 we briefly looked at the revenue and receipts cycle. We are going to split the revenue and receipts units in three study units. The purpose of this topic is to introduce you to the documents, risks and controls for credit sales and receipts. Although sales can consist of credit and/or cash sales, in this topic only the part that relates to credit sales and receipt of payments from debtors are being dealt with.

This topic is divided into the following study units:

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</tr>
<tr>
<td>22</td>
<td>Recording of receipts and credit management functions</td>
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</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions as indicated in the tutorial letter.
ORDERING AND WAREHOUSE/DESPATCH FUNCTIONS

IN THIS STUDY UNIT WE ARE GOING TO

- explain the overall risk of the revenue and receipts cycle
- identify the six functions within revenue and receipts cycle
- identify the activities and purpose of the ordering and warehouse/despatch functions
- identify the documents involved in the ordering and warehouse/despatch functions
- identify the risks involved in the ordering and warehouse/despatch functions
- describe the controls to mitigate (reduce/prevent) the risks in the ordering and warehouse/despatch functions

20.1 INTRODUCTION

In Study Unit 19 you were introduced to the five business cycles. In this topic, comprising three study units, we are going to examine the revenue and receipts cycle.

We will follow a certain structure (four steps) that we can apply to all the cycles. This will simplify your learning experience. For an overview of how we are going to unpack the content, refer to Jackson & Stent (2016: 10/10 to 10/17).

We are going to do the following:

**Step 1:** Identify the activities and purpose of each function.

**Step 2:** Identify the documents involved in each function and their purpose

**Step 3:** Identify the risks involved in each function.

**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks.
20.2 THE OVERALL RISK OF THE REVENUE CYCLE

REFLECTION 20.1

You have a business and you sell your products on credit (account) to your customers. What is the overall risk arising from selling to customers on account (credit sales)?

STUDY

Jackson & Stent (2016:10/2) paragraph 2.3

ACTIVITY 20.1

Use the above study reference and complete the following statement:

When a company allows a customer to buy on account (opposed to cash sales) there is a risk that the customer will not _____________________________.

20.3 FUNCTIONS FOR THE REVENUE AND RECEIPTS CYCLE

Let us first look at the bigger picture of the revenue and receipts cycle and all of the functions. In Study Unit 19 we discussed the sequence of events in the revenue and receipts cycle. In doing so, we touched on the functions for credit sales. Refer to diagram 18 to refresh your memory.

STUDY

Jackson & Stent (2016:10/2)–Basic functions for revenue and receipts cycle

20.3.1 Identify the activities within the revenue and receipts cycle

In terms of the above study reference, six functions are identified for the revenue cycle. If you refer to diagram 20 below, it may appear at first that there are seven functions. However, if you study the diagram carefully you will notice that the credit management function has been split into two functions, namely approving credit at the beginning of the sales transaction and collecting amounts due afterwards.
### REFLECTION 20.2

Are you able to list the six functions of the revenue and receipts cycle?

Are you able to briefly describe the activity within each function?

In this study unit we are going to examine the order department comprising the receiving customer order function and sales authorisation function.

### 20.4 THE ORDER DEPARTMENT

In terms of Jackson & Stent (2016:10/2) the order department consists of two functions; the first being the receiving of a customer order and the second authorising the sales function.

#### 20.4.1 Receiving customer orders function

We begin with the receiving of the customer orders function.

---

**DIAGRAM 20: SCHEMATIC REPRESENTATION OF THE FUNCTIONS IN THE ACCOUNTING SYSTEM FOR CREDIT SALES AND RECEIPT TRANSACTIONS**

*Jackson & Stent 2016:10/2–10/3*

<table>
<thead>
<tr>
<th>Function</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Order department</td>
<td>• Receiving customer orders</td>
</tr>
<tr>
<td>2. Credit Management</td>
<td>• Evaluating creditworthiness (Authorising the sale, granting or confirming credit)</td>
</tr>
<tr>
<td>3. Warehouse despatch</td>
<td>• Processing the order &lt;br&gt; • Despatch</td>
</tr>
<tr>
<td>4. Invoicing</td>
<td>• Notifying customer of the amounts owed for goods purchased</td>
</tr>
<tr>
<td>5. Recording the sales and raising the debtor</td>
<td>• Creating records of the sales that have been made as well as who owes the company money</td>
</tr>
<tr>
<td>6. Warehouse despatch</td>
<td>• Processing the order &lt;br&gt; • Despatch</td>
</tr>
<tr>
<td>7. Credit Management</td>
<td>• Collecting amounts owed</td>
</tr>
</tbody>
</table>

If you have difficulty in relating to the activities you can read the e description in Jackson & Stent (2016:10/3–10/5) for a more practical explanation.
Step 1: Identify the activities and purpose of the receiving of orders function

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/10) – Function column

ACTIVITY 20.2

Use the above study reference and complete the following sentences:

The objective of the order receiving function is to record ________________ and ________________ to fill them.

Persons receiving the order need to establish that the customer is a ________________ customer and that the details of the order are ________________ and ________________ in every respect.

Step 2: Identify the documents used in the order receiving function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

STUDY

Documents/records: Jackson & Stent (2016:10/10) – Documents/records column

Purpose of the document: Jackson & Stent (2016:10/6) – Documents used in the cycle

ACTIVITY 20.3

The documents used in the order receiving function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 20.3

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer order</td>
<td>Serves as the customer’s instruction as to what goods are required.</td>
</tr>
<tr>
<td>Internal sales order</td>
<td></td>
</tr>
<tr>
<td>Price list</td>
<td></td>
</tr>
</tbody>
</table>
Step 3: Identify the risks involved in the order receiving function

To complete the above step you are required to refer to the study reference below.

STUDY

Jackson & Stent (610/10) – Risks column

ACTIVITY 20.4

Use the above study reference and list three risks associated with the order receiving function.

SUGGESTED SOLUTION 20.4

(1) An order may be accepted from a non-account holder (no credit authorisation).
(2) ___________________________________________________________________
(3) ___________________________________________________________________

Now that we know what the risks are we can build in controls to mitigate the risks. This is the area that you as business owner, manager or auditor are interested in.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/10) – Control activities

ACTIVITY 20.5

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the order receiving function.

SUGGESTED SOLUTION 20.5

(1) Record all orders on sequentially numbered internal sales orders (ISOs).
(2) No orders to be accepted if the customer is not _________________________.
(3) Attach the customer order to the ________________________ and have a second staff member ________________________ detail.
(4) For phone orders, order clerk
   • request ________________________
   • request ________________________
   • confirm all order details.
(5) Order clerk to sign all ISOs to indicate performance of ____________________.
(6) On a regular basis, ISOs to be sequence checked (for ____________), and matched to delivery notes to identify ____________________.

DISCUSSION 20.1

**E-tutor assistance required**

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the receiving customer orders function.

Let's summarise. You know what the purpose of the order receiving function is, the documents they use, the risks involved and the control activities to mitigate the risks.

20.4.2  The sales authorisation function (credit management)

Remember we are dealing with credit sales. Cash sales would not be a problem in terms of collection because you sell and receive the money immediately (Jackson & Stent 2016:10/2). For credit sales, before a customer can open an account for credit a detailed credit check is performed. The customer’s credit history is checked based on the information in the credit application form (Jackson & Stent 2016:10/6). Credit bureaus have access to a person’s business’s history because today’s technology accesses many databases (Jackson & Stent 2016:10/11). With technology it is scary what one can establish with just a person’s identity number. Once you have a bad credit record, it is almost impossible to buy something on account (credit) like a car or house. Therefore, always pay your debts when they are due.

From your own business perspective, you don’t want customers that are unlikely to pay their debts.

**Step 1:** Identify the activities and purpose of the sales authorisation function

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:10/11) – Function column

**ACTIVITY 20.6**

Use the above study reference and complete the following sentences:

The objective of the sales authorisation function is to assess whether orders be ________________________________.
The intention is to determine whether the customer is ____________ and has not _________________.

**Step 2:** Identify the documents used in the sales authorisation function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:10/11) – **Documents/records column**

Purpose of the document: Jackson & Stent (2016:10/6) – **Documents used in the cycle**

**ACTIVITY 20.7**

The documents used in the sales authorisation function are listed in the table below. Use the above study reference to describe the purpose of each document.

**SUGGESTED SOLUTION 20.7:**

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit application</td>
<td>Filled in by the customer so that the customer’s credit can be established. Includes trades references, income and expenditure details, bankers, etc.</td>
</tr>
<tr>
<td>Debtors ledger</td>
<td>Transactions are recorded in the debtors ledger to establish current balance due by the customer.</td>
</tr>
</tbody>
</table>

**Step 3:** Identify the risks involved in the sales authorisation function

To achieve this step you are required to refer to the study reference below.

**STUDY**

Jackson & Stent (2016:10/11) – **Risks column**

**ACTIVITY 20.8**

Use the above study reference and list the risks associated with the sales authorisation function.
SUGGESTED SOLUTION 20.8

A sale will be made to a customer who is ___________________________
resulting in ___________________________

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/11) – Control activities

ACTIVITY 20.9

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the sales authorisation function.

SUGGESTED SOLUTION 20.9

(1) Before processing an order, checks should be carried out by the credit controller to establish:
   • ___________________________
   • ___________________________

(2) ISOs (picking slip) to be authorised by ___________________________ of the __________________________ before ___________________________.

(3) The credit application procedures must include:
   • banking details, trade references, income and expense details
   • The credit controller must follow up by ___________________________
   • ___________________________ must be set by the __________________________ and approved by the ___________________________.

DISCUSSION 20.2

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the sales authorisation function.

Let's summarise. You know what the purpose of the sales authorisation function is, the documents they use, the risks involved and the control activities to mitigate the risks.
20.5 THE WAREHOUSE/DESPATCH FUNCTION

In terms of Jackson & Stent (2016:10/3), the warehousing function is picking (gathering) the goods from the stores to fill the order and to despatch the goods to the customer. We will first deal with the warehouse function and then the despatch function.

20.5.1 The warehouse function

Step 1: Identify the activities and purpose of the warehouse function

To achieve this step you are required to refer to the study reference below and complete the activity.

ACTIVITY 20.10

Use the above study reference and complete the following sentences:

• The objective of the warehouse function is to fill orders ___________________________ and ___________________________ and to ensure that only ___________________________.

• This is a manual function of picking the goods from the ___________________________ using a signed copy of the ___________________________ and creating a ___________________________.

• Goods which cannot be picked because they are “_________________________” will be ___________________________ and a ___________________________ created.

Step 2: Identify the documents used in the warehouse function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

ACTIVITY 20.11

The documents used in the warehouse function are listed in the table below. Use the above study reference to describe the purpose of each document.
SUGGESTED SOLUTION 20.11

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Picking slip</td>
<td></td>
</tr>
<tr>
<td>Delivery note</td>
<td></td>
</tr>
<tr>
<td>Back order note</td>
<td></td>
</tr>
</tbody>
</table>

**Step 3:** Identify the risks involved in the warehouse function
To achieve this step you are required to refer to the study reference below.

**STUDY**

Jackson & Stent (2016:10/12) – Risks column

**ACTIVITY 20.12**

Use the above study reference and list the risks associated with the warehouse function.

SUGGESTED SOLUTION 20.12

1. Valid ISOs may not be acted upon.
2. Goods may be removed from inventory for ___________________.
3. ___________________ and ___________________ may be picked.
4. ___________________ and ___________________ delivery notes may be made out.
5. Out of stock items ___________________.
6. Customer not ___________________ resulting in loss ___________________.

**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks
To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:10/12) – Control activities

**ACTIVITY 20.13**

Use the above study reference to complete this activity.
Describe the control activities that can help mitigate the risks associated with the warehouse function.

**SUGGESTED SOLUTION 20.13**

1. Picker to initial the picking slip for each item picked and [Blank] on the picking slip items that [Blank] (out of stock).
2. Supervisory checks should be carried out by the warehouse foreman to ensure that [Blank].
3. Warehouse clerk to do the following:
   - Check goods picked to [Blank].
   - Prepare [Blank] from picking slip.
   - Prepare [Blank] from picking slip and cross reference to the [Blank] to [Blank] the customer.
   - Send copy of the [Blank] to the [Blank].
4. The order clerk to follow up back orders [Blank] and [Blank].
5. Delivery notes and picking slips to be [Blank]. Unmatched picking slips [Blank].

**DISCUSSION 20.3**

**E-tutor assistance required**

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the warehouse function.

Let's summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

**20.5.2 The despatch function**

**Step 1:** Identify the activities and purpose of the despatch function

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:10/13) – Function column
ACTIVITY 20.14

Use the above study reference and complete the following sentences:

- To ensure that only goods supported by ____________ and accompanied by ____________ and ____________ delivery notes, are despatched.
- To ensure ____________ despatch of goods which have been to the ____________ customer.

Step 2: Identify the documents used in the despatch function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

STUDY

Documents/records: Jackson & Stent (2016:10/13) – Documents/records Column
Purpose of the document: Jackson & Stent (2016:10/6) – Documents used in the cycle

ACTIVITY 20.15

The documents used in despatch function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 20.15

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery note</td>
<td>To detail the ____________, description and ____________ of goods despatched to the customer and is ____________ by the customer to acknowledge receipt of the goods</td>
</tr>
<tr>
<td>List of deliveries</td>
<td>A list of deliveries contains a column for the delivery note and physical goods loaded onto the vehicle</td>
</tr>
</tbody>
</table>

Step 3: Identify the risks involved in the despatch function

To achieve this step you are required to refer to the study reference below.

STUDY

Jackson & Stent (2016:10/13) – Risks column
ACTIVITY 20.16

Use the above study reference and list the *risks* associated with the despatch function.

SUGGESTED SOLUTION 20.16

(1) Theft may be facilitated by ____________________________.

(2) Despatch errors may occur
   • ________________ or ________________ despatched
   • Goods delivered to ____________________________

(3) Customers may ________________ having received goods.

(4) Goods released from the warehouse are never ________________.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/13) – *Control activities*

ACTIVITY 20.17

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the despatch function.

SUGGESTED SOLUTION 20.17

(1) On receipt of the goods, picking slip and delivery notes from the warehouse, the despatch clerk should:
   • check ____________________________
   • sign ____________________________
   • retain two copies of the ____________________________

(2) The goods picked should be ____________________________.

(3) The despatch clerk should prepare a list of deliveries and the list should be matched to the delivery notes and the physical goods loaded to the vehicle.

(4) The delivery staff should supervise the ____________________________ of the truck and sign a copy of the ____________________________

(5) Gate control should check ____________________________.

(6) On delivery, the customer should ____________________________
DISCUSSION 20.4

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the despatch function.

Let's summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

20.6 SUMMARY AND SELF-ASSESSMENT

In this study unit we examined the ordering department and the warehouse/despatch function as part of the revenue and receipts cycle. We identified the objective, risks and control activities to mitigate risks within each function. We briefly introduced you to tests of controls.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 20.1</th>
<th>Activity 20.10</th>
<th>Reflection 20.1</th>
<th>Discussion 20.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 20.2</td>
<td>Activity 20.11</td>
<td>Reflection 20.2</td>
<td>Discussion 20.2</td>
</tr>
<tr>
<td>Activity 20.3</td>
<td>Activity 20.12</td>
<td></td>
<td>Discussion 20.3</td>
</tr>
<tr>
<td>Activity 20.4</td>
<td>Activity 20.13</td>
<td></td>
<td>Discussion 20.4</td>
</tr>
<tr>
<td>Activity 20.5</td>
<td>Activity 20.14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 20.6</td>
<td>Activity 20.15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 20.7</td>
<td>Activity 20.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 20.8</td>
<td>Activity 20.17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activity 20.9</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- explain the overall risk of the revenue and receipts cycle?
- identify the six functions within the revenue and receipts cycle?
- identify the activities and purpose of the ordering and warehouse/despatch functions?
- identify the documents involved in the ordering and warehouse/despatch functions?
- identify the risks involved in the ordering and warehouse/despatch functions?
- describe the controls to mitigate (reduce/prevent) the risks in the ordering and warehouse/despatch functions?

In the next study unit we are going to examine the invoicing and recording of sales functions.
INVOICING AND RECORDING OF SALES FUNCTIONS

IN THIS STUDY UNIT WE ARE GOING TO

• identify the activities and purpose of the invoicing and recording of sales functions
• identify the documents involved in the invoicing and recording of sales functions
• identify the risks involved in the invoicing and recording of sales functions
• describe the controls to mitigate (reduce/prevent) the risks in the invoicing and recording of sales functions

21.1 INTRODUCTION

In the previous study unit we learned how a customer’s order is recorded and approved. The picking slip was used to pick the goods from the stores and goods were despatched for delivery. In this study unit we will examine the invoicing and recording of sales functions. We are going to continue using the four steps to unpack each function.

21.2 THE INVOICING FUNCTION

According to Jackson & Stent (2016:10/3) the invoicing function involves notifying the customer of the amounts owed for goods purchased. The sooner a customer receives an invoice, the sooner the invoice can get paid.

Step 1: Identify the activities and purpose of the invoicing function

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/14) – Function column
TOPIC 7: THE REVENUE AND RECEIPTS CYCLE

ACTIVITY 21.1

Use the above study reference and complete the following sentences:

The invoicing function is to ______________ the customer ______________ of amounts due for goods supplied.

On return of the signed ______________ from the customer it should be ______________ with the ______________ and an ______________ should be generated.

Step 2: Identify the documents used in the invoicing function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

STUDY

Documents/records: Jackson & Stent (2016:10/14) – Documents/records Column

Purpose of the document: Jackson & Stent (2014:10/6 & 7) – Documents used in the cycle

ACTIVITY 21.2

The documents used in the invoicing function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 21.2:

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales invoice</td>
<td>Document sent to the customer to notify them of the _______ and _______ of the goods sold to them, the _______ of the sale, discounts and VAT</td>
</tr>
<tr>
<td>Price lists</td>
<td>Documents containing process and discounts of the company’s products</td>
</tr>
</tbody>
</table>

Step 3: Identify the risks involved in the invoicing function

To achieve this step you are required to refer to the study reference below.

STUDY

Jackson & Stent (2016:10/14) – Risks column
ACTIVITY 21.3

Use the above study reference and list the risks associated with the invoicing function.

SUGGESTED SOLUTION 21.3

(1) Goods despatched

(2) Invoices may be (__________________, ______________, ______________,
__________________, ______________, ______________).

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/14) – Control activities

ACTIVITY 21.4

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the invoicing function.

SUGGESTED SOLUTION 21.4

(1) A copy of the ISO should be held in __________ order in a temporary file in the invoicing section of the accounting department.

(2) As ______________ delivery notes are received they should be matched to their __________ and filed sequentially by ______________ number.

(3) On a frequent and regular basis, __________ remaining on the temporary file should be __________.

(4) The invoice clerk should:
   • compare details on the __________ and
   • check ______________ quoted to the customer, and entered on the __________, against official ________ and discount schedules
   • prepare ______________ and cross reference it to the __________

(5) Second employee to check and sign invoice after checking:
   • ______________, ______________
   • ______________, ______________
   • ______________, ______________
DISCUSSION 21.1

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the **invoicing function**.

Let’s summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

21.3 RECORDING OF SALES

According to Jackson & Stent (2016:10/3) the recording of sales and raising the debtor function involves creating the records of the sales that have been made as well as who owes the company money, i.e. debtors.

**Step 1:** Identify the activities and purpose of the recording of sales function

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:10/15) – **Function column**

**ACTIVITY 21.5**

Use the above study reference and complete the following sentences:

The purpose of this function is to _____________ and to _____________ the corresponding debtor _____________.

Invoices must be recorded _____________ and entered against the _____________ debtor in the debtors ledger. Total sales for the period must also be posted to the _____________ and _____________ in the general ledger.

**Step 2:** Identify the documents used in the recording of sales function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:10/15) – **Documents/records column**

Purpose of the document: Jackson & Stent (2014:10/6 & 7 and 10/5) – **Documents used in the cycle**
ACTIVITY 21.6

The documents used in the recording of sales function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 21.6

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invoice</td>
<td>Document sent to the customer to notify them of the _______ and _______ of the goods sold to them, the _______ of the sale, discounts and VAT</td>
</tr>
<tr>
<td>Sales journal</td>
<td>A record in which the invoices are written up</td>
</tr>
<tr>
<td>Debtors ledger</td>
<td>The individual invoices are to the relevant debtors account</td>
</tr>
<tr>
<td>General ledger</td>
<td>The total of the sales journal to the debtors control account in the general ledger</td>
</tr>
</tbody>
</table>

Step 3: Identify the risks involved in the recording of sales function

To achieve this step you are required to refer to the study reference below.

STUDY

Jackson & Stent (2016:10/15) – Risks column

ACTIVITY 21.7

Use the above study reference and list the risks associated with the despatch function.

SUGGESTED SOLUTION 21.7

(1) Invoices are omitted from the sales journal.
(2) 
(3) 
(4) 

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/15) – Control activities
TOPIC 7: THE REVENUE AND RECEIPTS CYCLE

ACTIVITY 21.8

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the recording of sales function.

SUGGESTED SOLUTION 21.8

(1) Invoices to be entered in the sales journal in numerical sequence
   •                                                                                     
   •                                                                                     .

(2) Control totals of a day's sales with the sales recorded in the sales journal (batch control system).

(3) Independent staff member to:
   •                                                                                     
   •                                                                                     
   •                                                                                     

(4) Reconciliation

DISCUSSION 21.2

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the recording of sales function.

Let's summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

21.4 SUMMARY AND SELF-ASSESSMENT

In this study unit we examined the invoicing and recording of sales functions as part of the revenue cycle. We identified the objective, risks and control activities to mitigate risks within each function.

Refer to your notes you made in your workbook after completing the following activities.
After having worked through the study unit and the study references are you able to:

- identify the activities and purpose of the invoicing and recording of sales functions?
- identify the documents involved in the invoicing and recording of sales functions?
- identify the risks involved in the invoicing and recording of sales functions?
- describe the controls to mitigate (reduce/prevent) the risks in the invoicing and recording of sales functions?

In the next study unit we are going to examine the credit management function and the recording of receipts function as part of the revenue and receipts cycle. We will also examine the bank reconciliation process.
STUDY UNIT 22

RECORDING OF RECEIPTS AND CREDIT MANAGEMENT FUNCTIONS

IN THIS STUDY UNIT WE ARE GOING TO

- identify the activities and purpose of the recording of receipts and credit management functions
- identify the documents involved in the recording of receipts and credit management functions
- identify the risks involved in the recording of receipts and credit management functions
- describe the controls to mitigate (reduce/prevent) the risks in the recording of receipts and credit management functions
- explain the concept behind the design of tests of controls

22.1 INTRODUCTION

In the previous study units we examined the receiving of the customer order, the sales authorisation, warehouse/despatch, invoicing and recording of sales. We finished with Study Unit 21, where amounts due by the debtor were recorded in the debtors ledger and debtors control account in the general ledger. In this study unit we are going to examine what happens when the debtor (the customer) pays their account or is slow to pay their account (credit management).

You are also going to be introduced to how auditors design test of controls.

22.2 THE FUNCTIONS OF THE ACCOUNTING SYSTEM FOR RECEIPTS

Refer to diagram 18 so that you can follow where we are in the cycle. The customer receives a debtor's statement with all of the month's invoices and based on the statement they make a payment. In the past cheques were used to pay accounts. Today most businesses make use of electronic fund transfers (EFTs). Therefore we are not going to examine receipts in the mail room for receiving cheques as explained in Jackson & Stent (2016:10/16). We will, however, examine the recording of EFTs.
22.2.1 Recording electronic fund transfers

With EFTs, funds are transferred from the customer’s bank account to the seller’s bank account through internet banking. With EFTs the payment from the debtor will appear directly on the bank statement as a credit. Therefore, numerous credit entries (deposits) will appear on the seller’s bank statement.

**Step 1: Identify the activities and purpose of the recording EFTs**

Numerous credit entries (deposits) will appear on the seller’s bank statement. These deposits need to be allocated to the correct debtor’s account. Therefore, it is very important that the customer uses the account reference on the debtor’s statement when making the EFT. The debtor will sometimes e-mail a remittance advice to assist the debtor’s clerk to allocate the payment. Once a deposit is identified on the bank statement a receipt must be created. The receipt is used to allocate the payment to the debtor’s account. The bank account must be reconciled to the bank statement before the end of the next working day.

The accounting system for receipts consists of the following activities and functions (Jackson & Stent 2014:10/5):

- Print and e-mail the debtor’s statements.
- Identify the EFTs (deposits) on the bank statement.
- Issue a receipt for the customer for the identified EFT.
- Write up the cash receipts journal.
- Allocate the receipt by crediting the debtor’s account in the debtor’s ledger.
- Reconcile the debtor’s ledger with the debtors control account.
- Reconcile the bank statement with the cash book (containing both cash receipts journal and cash payment journal).
- Follow up customer queries, unpaid invoices and unallocated receipts.
- Manage accounts not paid at month-end (credit management).

The purpose of this function is to promptly and accurately allocate payments to the debtors’ accounts.

**Step 2: Identify the documents used in the recording of receipts**

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Purpose of the document: Jackson & Stent (2016:10/5, 6 & 7) – **Documents used in the cycle**

**ACTIVITY 22.1**

The documents used in the warehouse function are listed in the table below. Use the above study reference to describe the purpose of each document.
SUGGESTED SOLUTION 22.1

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFT register</td>
<td>A list of the day’s payments deposited directly into the business’s bank account</td>
</tr>
<tr>
<td>EFT receipt</td>
<td>Records the details of the EFT payment from the EFT register</td>
</tr>
<tr>
<td>Cash receipts journal</td>
<td>The EFT receipts are recorded in CRJ</td>
</tr>
<tr>
<td>Debtors ledger</td>
<td>The individual receipts are transferred to the relevant debtor’s account</td>
</tr>
</tbody>
</table>

**Step 3: Identify the risks involved in the recording of receipts function**

The following risks are identified (Jackson & Stent 2016:10/17):

1. EFTs are not recorded timeously.
2. Recorded EFTs may be inaccurate, overstated, credited to the wrong debtor.

**Step 4: Describe the controls to mitigate (reduce/prevent) the risks**

The following controls are necessary to mitigate the risks involved with the recording of EFTs.

Reference: Jackson & Stent 2016:10/16–10/17

1. The EFT register and EFT receipts should subsequently be reconciled with the bank account by an independent supervisory employee.
2. The cash receipts journal should be written up on a daily basis by date and receipts number.
3. Supervisory staff should review the cash receipts journal for missing dates and gaps in sequence of receipts. They should also test posting to the debtors ledger.
4. The cash book containing the cash receipts journal and cash payments journal should be reconciled with the bank statement on a daily basis.
5. Queries from debtors should be investigated by an employee independent of debtors and banking.
6. Reconciliation of the debtors ledger to the debtors control account in the general ledger should be conducted on a regular basis by the financial accountant.

**DISCUSSION 22.1**

**E-tutor assistance required**

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the recording of receipts function.
Let's summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

### 22.3 THE CREDIT MANAGEMENT FUNCTION

Do you recall from Study Unit 20 that when an order was placed by a customer it had to be approved for credit before it could be processed? We are now going to examine the credit management function in more detail. The credit management function plays an important role in a business. The first role is not to allow credit to customers who will not be in a position to repay debts (Study Unit 20). The second role is to collect the money owing by the debtor as reflected on the debtor’s monthly statement as soon as possible (receipts). If debtors do not pay their accounts within the 30 day period, it will seriously affect the cash flow of your business. Remember, to make the sale you had to buy the goods (inventory) on credit. If you do not pay your creditors in time, they will withdraw your account facility. Where will you get the money to pay for stock? Therefore, paying businesses what is due to them within the 30 day credit period is essential for the sustainability of businesses.

**Step 1:** Identify the activities and purpose of the credit management function

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:10/19) – **Function column**

**ACTIVITY 22.2**

Use the above study reference and complete the following sentences:

The purpose of this function is to _______________ the _______________ from _______________ and to encourage debtors to _______________.

Credit management should also identify debtors to be _______________ and subsequently _______________ if necessary.

**Step 2:** Identify the documents used in the credit management function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:10/19) – **Documents/records column**

Purpose of the document: Jackson & Stent (2016:10/6) – **Documents used in the cycle**
ACTIVITY 22.3

The documents used in the credit management function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 22.3:

<table>
<thead>
<tr>
<th>Document/ Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly statements</td>
<td>A summary of all the ____________</td>
</tr>
<tr>
<td>Age analysis</td>
<td>A summary of debtors accounts setting out the age of the accounts e.g. current, 30 days, 60 days, 90 days and older.</td>
</tr>
<tr>
<td>Credit bureau information</td>
<td>A data basis collected by credit bureau that identifies businesses that are blacklisted, handed over for collection, etc.</td>
</tr>
</tbody>
</table>

Step 3: Identify the risks involved in the credit management function

To achieve this step you are required to refer to the study reference below.

STUDY

Jackson & Stent (2016:10/19) – Risks column

ACTIVITY 22.4

Use the above study reference and list the risks associated with the credit management function.

SUGGESTED SOLUTION 22.4

The risks associated with the credit management function are:

1. Debtors do not ________________________________.
2. Debtors are ________________________________.
3. Debts are ________________________________.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:10/19) – Control activities
ACTIVITY 22.5

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the credit management function.

SUGGESTED SOLUTION 22.5

1. Credit application controls as discussed under sales authorisation apply.
2. 
3. 
4. 
5. 
6. 
7. 
8. 

DISCUSSION 22.2

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the credit management function.

Let's summarise. You know what the purpose of the warehouse function is, the documents they use, the risks involved and the control activities to mitigate the risks.

22.4 INTRODUCING THE FORMULATION OF TEST OF CONTROLS

In Study Unit 17 we indicated that the auditor performs tests of controls and substantive procedures. A test of control is simply identifying the controls like we did in step 4: Describe the controls to mitigate (reduce/prevent and then testing if those controls were implemented as designed. In other words, tests of controls describe instructions to audit personnel as contained in an audit programme on how the internal control measure in question should be evaluated. If there are no controls, then no tests of controls can be performed.

There are mainly four types of test of controls (Jackson & Stent 2016:5/26):

1. **Inspection**: Consists of examining the documents which provide the auditor with evidence as to whether a control procedure did occur. For example, the auditor would inspect the signature of the order clerk indicating the performance of control activities.
TOPIC 7: THE REVENUE AND RECEIPTS CYCLE

(2) **Reperformance:** This procedure involves the auditor’s repeating, either wholly or in part, the same control procedures that the client performed. For example, reperforming a creditor’s reconciliation performed by the client.

(3) **Enquiry:** Consists of seeking information from knowledgeable persons inside the entity. For example, enquire from management as to the procedures followed by ordering clerks to record phone orders.

(4) **Observation:** This might involve watching a client’s employee performing a control procedure. For example, the auditor would inspect the order recording process that all orders are on sequentially internal sales orders.

From the above methods you can gather that tests of controls are merely asserting whether or not the control activities that have been prescribed by management/owner have indeed been implemented by personnel.

You will not be required to formulate tests of controls in this module.

22.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we examined the function of the accounting system for recording receipts. We identified the objective, risks and control activities to mitigate risks for receipts.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 22.1</th>
<th>Discussion 22.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity 22.2</td>
<td>Discussion 22.2</td>
</tr>
<tr>
<td>Activity 22.3</td>
<td></td>
</tr>
<tr>
<td>Activity 22.4</td>
<td></td>
</tr>
<tr>
<td>Activity 22.5</td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to

- identify the activities and purpose of the recording of receipts and credit management functions?
- identify the documents involved in the recording of receipts and credit management functions?
- identify the risks involved in the recording of receipts and credit management functions?
- describe the controls to mitigate (reduce/prevent) the risks in the recording of receipts and credit management functions?
- explain the concept behind the design of tests of controls?

In the next topic we are going to examine the acquisitions and payments cycle.
TOPIC 8

The acquisitions and payments cycle

Study unit 23
The ordering and receiving of goods functions 157

Study unit 24
The recording of purchases and payment (preparation and actual payment) functions 167
TOPIC OVERVIEW

In Study Unit 19 we briefly looked at the acquisitions and payments cycle. In this topic we are going to examine the acquisitions and payments cycle in more detail. The topic will be split into two study units. The purpose of this topic is to introduce you the activities, documents, risks and controls for the acquisitions and payments cycle.

This topic is divided into the following study units:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>The ordering and receiving of goods functions</td>
<td>157</td>
</tr>
<tr>
<td>24</td>
<td>The recording of purchases and payment (preparation and actual payment) functions</td>
<td>167</td>
</tr>
</tbody>
</table>

Textual amendments and additions

Before you proceed with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions as indicated in the tutorial letter.
THE ORDERING AND RECEIVING OF GOODS FUNCTIONS

IN THIS STUDY UNIT WE ARE GOING TO

- explain the overall risk of the acquisitions and payments cycle
- identify the five functions within the acquisitions and payments cycle
- identify the activities and purpose of the ordering and receiving of goods functions
- identify the documents involved in the ordering and receiving of goods functions
- identify the risks involved in the ordering and receiving of goods functions
- describe the controls to mitigate (reduce/prevent) the risks in the ordering and receiving of goods functions

23.1 INTRODUCTION

In Study Unit 19 you were introduced to the five business cycles. In this topic comprising of two study units, we are going to examine the acquisitions and payments cycle.

We are going to follow the same structure (four steps) as for the previous business cycle that applies to all the cycles. This will make your learning easier. For an overview of how we are going to unpack the content, refer to Jackson & Stent and page through pages 11/9 to 11/13.

We are going to do the following:

**Step 1:** Identify the activities and purpose of each function.
**Step 2:** Identify the documents involved in each function and their purpose
**Step 3:** Identify the risks involved in each function.
**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks.
23.2 THE OVERALL RISK OF THE ACQUISITIONS AND PAYMENTS CYCLE

As explained Jackson & Stent (2016:11/2–11/3), the acquisitions and payment cycle deals with three major activities which are linked but which are also quite distinct, i.e. the:

- ordering and receiving of goods (or services) from suppliers (this study unit),
- recording of purchases (Study Unit 24) and
- payment of amounts due for the goods ordered and received (Study Unit 24).

Let us revert back to our business idea. In the previous topic your business sold goods on credit to your customers. Before you can sell the goods, you either have to buy goods or manufacture something from raw materials that you purchased from suppliers. In this module we focus only on retailing (buying and selling) and not on manufacturing. This study unit is all about the acquisitions cycle, i.e. buying goods.

According to Jackson & Stent (2016:11/2) the consequences of a poor acquisitions cycle will have a very negative effect on the business. If the correct products are not available, sales will be lost. It will not be long before the business gets a reputation for being unreliable and customers will go and buy their goods elsewhere. Purchasing the wrong goods that does not resell or buying goods of an inferior quality can result in losses. The aim with the acquisitions (purchasing) cycle is to buy the best quality goods at the best prices to be able to resell the goods at a profit.

Remember: under the Consumer Protection Act, 2008 customers have the right to goods that are free of any defects and of acceptable quality (http://www.gov.za/sites/www.gov.za/files/32186_467_0.pdf). Therefore, it is important to do your homework very carefully when ordering goods from your suppliers that you want to resell at a profit.

Another risk to be considered is that the cycle involves the outflow of funds from the business. Thus, the payment of fictitious creditors can be affected if inadequate controls are not implemented (Jackson & Stent 2016:11/2).

23.3 FUNCTIONS FOR CREDIT PURCHASES TRANSACTIONS

Refer to diagram 21 in Study Unit 19, which gives an overview of the credit purchases and payments cycle. The diagram serves as a map to help you find your way through this study unit.

Identifying and understanding the distinct functions in the accounting system for acquisitions and payments transactions is crucial for the identification of risks and designing controls. Therefore, study diagram 21 carefully and make sure that you can list and describe the various functions of this cycle.
STUDY UNIT 23: The ordering and receiving of goods functions

DIAGRAM 21 SCHEMATIC REPRESENTATION OF THE FUNCTIONS IN THE ACCOUNTING SYSTEM FOR CREDIT PURCHASES & PAYMENT CYCLE

1. Ordering of goods
   • Receiving the requisition
   • Processing the purchase order

2. Receiving of goods
   • Receiving the goods and
   • Acknowledge receipt of goods

3. Recording of purchases
   • Raise purchase in purchases journal & creditors

4. Payment preparation
   • Determining amount to be paid to creditors

5. Actual payment (Bank)
   • Preparing payment
   • Recording payment


If you have difficulty in relating to the activities you can read the description in Jackson & Stent (2016:11/3–11/5) for a more practical explanation.

REFLECTION 23.1

• Are you able to list the five functions of the acquisitions and payments cycle?
• Are you able to briefly describe the activity within each function?

23.4 ORDERING OF GOODS

Assume your business has a designated receiving section for the goods you ordered and a storeroom where inventory is stored. The storeman on his accounting system identifies that the stock level of an item is low and that this product must be ordered. The storeman issues a stock requisition note to the ordering department.

Step 1: Identify the activities and purpose of the ordering of goods function

The ordering department is essentially responsible for obtaining the correct type and quantity of goods at the best price and desired quality (Jackson & Stent 2016:11/3).

To achieve this step you are required to refer to the study reference below and complete the activity.
TOPIC 8: THE REVENUE AND RECEIPTS CYCLE

STUDY

Jackson & Stent (2016:11/9) – Function column

ACTIVITY 23.1

Use the above study reference and complete the following sentences:

The purpose of this function is to ___________ orders so that items/services re-
quired to maintain optimum conditions within the organisation, ___________.

This function is also responsible for placing ________________ with
supplier, having established that ____________, ______________,,
______________ and ___________, requirements have been satisfied.

Step 2: Identify the documents used in the ordering of goods function and their
purpose

To achieve this step you are required to refer to the two study references below
and complete the activity.

STUDY

Documents/records: Jackson & Stent (2016:11/9) – Documents/records column

Purpose of the document: Jackson & Stent (2016:11/5) – Documents used in
the cycle

ACTIVITY 23.2

The documents used in the ordering of goods function are listed in the table be-
low. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 23.2

<table>
<thead>
<tr>
<th>Document/ Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requisition</td>
<td>Used to convey to the _________ department that goods are ________________</td>
</tr>
</tbody>
</table>
| Purchase order form | Completed by the _________ department, record the _______ and _______ of
                         the goods to be purchased and are addressed to the ____________________________ |

Step 3: Identify the risks involved in the ordering of goods function

To complete the above step you are required to refer to the study reference below.
ACTIVITY 23.3

Use the above study reference and list three risks associated with the ordering of goods function.

SUGGESTED SOLUTION 23.3

(1) Ordering of __________ or __________, resulting in ______ and __________.

(2) Ordering __________ goods resulting in __________ to the company through fraud.

(3) Requisitions not __________ or orders not __________ or at all.

(4) Obtaining __________ goods.

(5) Paying unnecessarily __________ for goods.

(6) Orders placed with suppliers not __________ or not __________ filled.

(7) Order forms __________.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

ACTIVITY 23.4

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the ordering of goods function.

SUGGESTED SOLUTION 23.4

(1) The order clerks should not place an order without receiving an ______
• The order should cross-reference to the ________________________.

(2) Before the order is placed, a supervisor/senior buyer should
• check the order to the ______________ for ______________ and ________________________
  • review the order for ______________, reasonableness of ______________ and ______________, and the ________________________.
TOPIC 8: THE REVENUE AND RECEIPTS CYCLE

(3) The company should preferably have an ________________ to which the buyer should refer when ordering.
   • If the company does not have an approved supplier, the buyer should seek ________________ from a number of ________________ before ________________.
   • If the company does have an approved supplier, the buyer should contact the ________________ to confirm ________________ and ________________.

(4) The ordering department should file ________________ and should ________________ review the files for ________________.

(5) A copy of the order should be filed ________________ and the file should be ________________, and frequently cross-referenced to ________________, to confirm that ________________.

(6) Blank order forms should be subject to sound ________________.

DISCUSSION 23.1

E-Tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the ordering of goods function.

Let’s summarise. You should now know what the purpose of the order receiving function is, the documents they use, the risks involved and the control activities to mitigate the risks.

23.5 RECEIVING OF GOODS

The role of the receiving function is to accept goods from suppliers and acknowledge receipt thereof (Jackson & Stent 2016:11/10). Once you acknowledge receipt (ownership) you are legally obliged to pay for those goods. Therefore your business must only accept goods for which valid purchase orders have been placed.

**Step 1: Identify the activities and purpose of the receiving of goods function**

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:11/10) – Function column

**ACTIVITY 23.5**

Use the above study reference and complete the following sentences:
The purpose of the function is to _______ and _______ deliveries of orders from suppliers and to __________________________ (goods received note).

Prior to acceptance, _______ on _________, _________ and __________________________ of goods should be carried out.

**Step 2:** Identify the documents used in the receiving of goods function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

---

**STUDY**

Documents/records: Jackson & Stent (2016:11/10) – Documents/records column

Purpose of the document: Jackson & Stent (2016:11/5) – Documents used in the cycle

---

**ACTIVITY 23.6**

The documents used in the receiving of goods function are listed in the table below. Use the above study reference to describe the purpose of each document.

---

**SUGGESTED SOLUTION 23.6**

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplier delivery note</td>
<td>Made out by the supplier and _______ the goods which have been supplied. Cross-referenced to the purchasing company’s _______ and on delivery of the goods, will be _______ by the purchasing company to _______ receipts of the goods.</td>
</tr>
<tr>
<td>Goods received note (GRN)</td>
<td>Completed by the _______ company when the goods are _______ by the supplier. Records the _______ goods received and will be cross-referenced to the __________________________.</td>
</tr>
</tbody>
</table>

---

**Step 3:** Identify the risks involved in the receiving of goods function

To complete the above step you are required to refer to the study reference below.

---

**STUDY**

Jackson & Stent (2016:11/10) – Risks column
ACTIVITY 23.7
Use the above study reference and list four risks associated with the receiving of goods function.

SUGGESTED SOLUTION 23.7

(1) Acceptance of:
- __________________________ as full deliveries
- __________________________ and __________________________ items
- __________________________
- goods not of the required __________________________ or quality

(2) Goods received notes not made out __________________________ and ____________.

(3) No __________________________

(4) __________________________ by employees or outside parties.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks
To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:11/9) – Control activities

ACTIVITY 23.8
Use the above study reference to complete the following activity.

Describe the control activities that can help mitigate the risks associated with the receiving of goods function.

SUGGESTED SOLUTION 23.4

(1) The responsibility for receiving goods should be ______________ to a ______________ which should be physically secured and access controlled.

(2) On arrival of the delivery vehicle, goods should be offloaded in the presence of a goods receiving clerk who should do the following:
- Obtain the ______________ from the delivery personnel by referring to the order number thereon, and locate the ______________.
- Check the ______________ and ______________ of goods delivered against the order and customer ______________.
- Perform at least a superficial test of the ______________ of the goods delivered.
- Reject all ______________ and clearly ______________ rejections on both copies of the ______________.
- Accept goods short delivered but ______________ such goods clearly on the ______________ and ______________.
- Include on the ______________, only those goods which have been accepted.
• Ensure that the suppliers’ personnel sign both copies of the ________ including all ____________________.
• Sign the supplier ____________________.

(3) On transfer of the goods to the warehouse, the warehouse clerk should compare the ________ to the ________ and acknowledge receipt by signing the ________. Any discrepancies should be reported to the warehouse controller immediately.

DISCUSSION 23.2

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the receiving of goods function.

ACTIVITY 23.5

The following is an example of an order form issued by Sweetie Pie Bakery (Pty) Ltd (Sweetie Pie Bakery) for goods ordered by the company.

<table>
<thead>
<tr>
<th>Description</th>
<th>Code</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 x 1 kg bags of flour</td>
<td>FLO01</td>
<td>11</td>
</tr>
<tr>
<td>5 x 250 g of butter</td>
<td>BUT01</td>
<td>5</td>
</tr>
<tr>
<td>1000 packs of chocolate chips</td>
<td>CCH 01</td>
<td>1000</td>
</tr>
</tbody>
</table>

Authorised: __________
REQUIRED:
Identify and list the information that should be reflected on a purchase order that was not included in Sweetie Pie Bakery’s order.

SUGGESTED SOLUTION 23.5

Reference: Jackson & Stent (2016:11/3)

The following information should have been reflected on the purchase order but was not:

- The order form is not addressed to the supplier, as the name of the supplier is not included on the order form.
- The price of the goods to be purchased is not on the order form.
- The order form is not authorised/signed.
- The quantity of the bags of flour ordered was 12 kg and not 11 kg.

Let’s summarise. You should now know what the purpose of the receiving of goods function is, the documents they use, the risks involved and the control activities to mitigate the risks.

23.6 SUMMARY AND SELF-ASSESSMENT

In this study unit we examined ordering of goods and receiving of goods functions of the acquisitions and payments cycle. We identified the objective, risks and control activities to mitigate risks within each function.

Refer to your notes you made in your workbook after completing the following activities.

<table>
<thead>
<tr>
<th>Activity 23.1</th>
<th>Activity 23.2</th>
<th>Activity 23.3</th>
<th>Activity 23.4</th>
<th>Activity 23.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discussion 23.1</td>
<td>Discussion 23.2</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

After having worked through the study unit and the study references are you able to:

- explain the overall risk of the acquisitions and payments cycle?
- identify the five functions within the acquisitions and payments cycle?
- identify the activities and purpose of the ordering and receiving of goods functions?
- identify the documents involved in the ordering and receiving of goods functions?
- identify the risks involved in the ordering and receiving of goods functions?
- describe the controls to mitigate (reduce/prevent) the risks in the ordering and receiving of goods functions?

In the next study unit we will examine the recording of purchases and payment (preparation and actual payment) functions.
THE RECORDING OF PURCHASES AND PAYMENT (PREPARATION AND ACTUAL PAYMENT) FUNCTIONS

IN THIS STUDY UNIT WE ARE GOING TO

- identify the activities and purpose of the recording of purchases and payment functions
- identify the documents involved in the recording of purchases and payment functions
- identify the risks involved in the recording of purchases and payment functions
- describe the controls to mitigate (reduce/prevent) the risks in the recording of purchases and payment functions

24.1 INTRODUCTION

Let us recap: the goods have been ordered and received. The next step is to record the transaction. According to Jackson & Stent (2016/11/3) the recording of the transaction function entails raising the purchases in the purchases journal and the corresponding liability (creditor) in the accounting records. The payment preparation function is responsible for determining the amount to be paid to the creditor. Payment preparation involves the inspection of documents to determine that the purchase was valid. Once the payment has been approved the actual payment takes place.

24.2 RECORDING OF PURCHASES

Step 1: Identify the activities and purpose of the recording of purchases function

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:11/11) – Function column
ACTIVITY 24.1

Use the above study reference and complete the following sentences:

The purpose of this function is to ______________ the purchase and corresponding ______________ in the accounting records.

The recording of ______________ purchases and trade liabilities should be carried out by the (_________________) ______________ so that controls are not ________________.

**Step 2:** Identify the documents used in the recording of purchases function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:11/11) – **Documents/records column**

Purpose of the document: Jackson & Stent (2016:11/5) – **Documents used in the cycle**

ACTIVITY 24.2

The documents used in the recording of purchases function are listed in the table below. Use the above study reference to describe the purpose of each document.

**SUGGESTED SOLUTION 24.2**

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase invoice</td>
<td>The document is sent by the ________________ __________________________ and VAT.</td>
</tr>
<tr>
<td>Credit note</td>
<td>This is a supplier document which records any ________________ to the purchasing company’s account other than payment for damaged or unwanted goods.</td>
</tr>
<tr>
<td>Creditors statement</td>
<td>Produced by the ________________ on a ________ basis. This document summarises the ________________ between the ________________ and ________________ company for the month.</td>
</tr>
<tr>
<td>Purchases journal</td>
<td>A record in which all purchased are recorded in terms of the order, supplier delivery note and GRN.</td>
</tr>
<tr>
<td>Creditors ledger</td>
<td>The individual purchases are allocated to the relevant creditor’s account in the creditors ledger.</td>
</tr>
<tr>
<td>General ledger</td>
<td>The total of the purchases journal are allocated to the creditors control account in the general ledger</td>
</tr>
</tbody>
</table>
Step 3: Identify the risks involved in the recording of purchases function
To complete the above step you are required to refer to the study reference below.

STUDY


ACTIVITY 24.3

Use the above study reference and list three risks associated with the recording of purchases function.

SUGGESTED SOLUTION 24.3

1. The recording of ________ amounts arising from ________ invoices
   • ________, ________, and type not as ________ or ________
   • ________ of goods not as ________
   • ________ errors e.g. ________, ________, VAT.

2. The raising of ________ purchases/creditors by the ________ of ________ which are for goods ________ received or ________ by the company.

3. Delays, ________, and ________ errors when entering details into accounting records resulting in ________ problems and failure to make use of favourable ________ terms (discounts).

Step 4: Describe the controls to mitigate (reduce/prevent) the risks
To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:11/11) – Control activities

ACTIVITY 24.4

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the recording of purchases function.

SUGGESTED SOLUTION 24.4

(1) The purchases invoices received from the suppliers should be 1.1 matched to the corresponding ________ and ________ for ________, and ________ of goods
TOPIC 8: THE REVENUE AND RECEIPTS CYCLE

• _________________ prices and _________________

1.2 R_________ to confirm that amounts on the invoice have been _________________ to the correct accounts e.g. _________________, consumables, stationery.

(2) When a requisition is made out to initiate an order, the _________________ to which the purchase must be _________________ in the _________________ should be selected from the “official list of accounts” and entered onto the _________________ and then transferred to the _________________. (If this is not done, _________________.)

(3) All _________________, _________________ and _________________ on the invoice should be _________________.

(4) A specific employee should be designated the responsibility of ensuring, by scrutiny of _________________ of _________________ and _________________ in the pending file, that purchases are _________________ and _________________ recorded in the _________________ and correctly posted to the _________________.

DISCUSSION 24.1

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the recording of purchases function.

Let’s summarise. You now should know what the purpose of the recording of purchases function is, the documents they use, the risks involved and the control activities to mitigate the risks.

24.3 PAYMENT PREPERATION

Step 1: Identify the activities and purpose of the payment preparation function

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:11/12) – Function column

ACTIVITY 24.5

Use the above study reference and complete the following sentences:

The role of this function is to ensure that only _________________ creditors are _________________ and that they are paid the _________________, on _________________. The function will produce and EFT requisition.
The EFT requisition will initiate the preparation of the EFT on the online bank account.

**Step 2:** Identify the documents used in the payment preparation function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:11/12) – **Documents/records column**

Purpose of the document: Jackson & Stent (2016:11/5) – **Documents used in the cycle**

**ACTIVITY 24.6**

The documents used in the payment preparation purchases function are listed in the table below. Use the above study reference to describe the purpose of each document.

Note: Cheque payments are replaced by Electronic Fund Transfers (EFTs).

**SUGGESTED SOLUTION 24.6**

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remittance advice</td>
<td>A document prepared by the purchasing company sent to the supplier containing a breakdown of the invoices are paid with the EFT.</td>
</tr>
<tr>
<td>EFT requisition</td>
<td>A form completed by the creditors section of the purchasing company requesting that an EFT be made to a particular creditor.</td>
</tr>
</tbody>
</table>

**Step 3:** Identify the risks involved in the payment preparation function

To complete the above step you are required to refer to the study reference below.

**STUDY**

Jackson & Stent (2016:11/12) – **Risks column**

**ACTIVITY 24.7**

Use the above study reference and list three risks associated with the payment preparation function.
TOPIC 8: THE REVENUE AND RECEIPTS CYCLE

SUGGESTED SOLUTION 24.7

(1) Payment to ________________________________
(2) Payment of ________________________________
(3) U ________________________________ payments
(4) D ________________________________ lost to late payments

Step 4: Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:11/12) – Control activities

ACTIVITY 24.8

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the payment preparation function.

SUGGESTED SOLUTION 24.8

(1) The monthly creditors statement sent by the supplier should be ________ to the supporting documentation, e.g. ___________, ___________ etc, and the creditors clerk should ensure that the ________ were subjected to ________ controls before being ________.
(2) The __________ creditor’s accounts in the __________ should be ________ with the monthly __________ sent by the suppliers.
(3) A creditors clerk should identify those creditors who must be paid at end to comply with the ________, and to ensure that __________ available for early ________, are ________.
(4) EFT requisitions (cheques) should be ________ and unused requisitions subject to sound ________.
(5) EFT requisitions (cheques) should include details of the EFT being requested and should be ________ by the preparer of the requisition.
(6) The EFT requisitions (cheques) and ________ documentation should be presented for signatories of approval.

DISCUSSION 24.2

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.
Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the payment preparation function.

Let’s summarise. You know what the purpose of the order receiving function is, the documents they use, the risks involved and the control activities to mitigate the risks.

24.4 ACTUAL PAYMENT AND RECORDING
Note: instead of paying with a cheque we are nowadays paying by EFT.

Step 1: Identify the activities and purpose of the actual payment and recording function
To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY
Jackson & Stent (2016:11/13) – Function column

ACTIVITY 24.9
Use the above study reference and complete the following sentences:
The purpose of this function is to produce a ________________________________ and authorised EFT and to ________________________________ all EFT payments ________________________________ and ________________________________ in the ________________________________ records.

Step 2: Identify the documents used in the actual payment and recording function and their purpose
To achieve this step you are required to refer to the two study references below and complete the activity.

STUDY
Documents/records: Jackson & Stent (2016:11/13) – Documents/records column
Purpose of the document: Jackson & Stent (2016:11/5) – Documents used in the cycle

ACTIVITY 24.10
The documents used in the actual payment and recording function are listed in the table below. Use the above study reference to describe the purpose of each document.
TOPIC 8: THE REVENUE AND RECEIPTS CYCLE

SUGGESTED SOLUTION 24.10

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFT</td>
<td>This is an electronic online bank payment that replaces cheques.</td>
</tr>
<tr>
<td>Bank statement</td>
<td>Statements received from the bank. The bank statement shows payments (debits), receipts (credits) and bank charges.</td>
</tr>
<tr>
<td>Cash payments journal (CPJ)</td>
<td>A record in which all payments are recorded</td>
</tr>
<tr>
<td>Creditors ledger</td>
<td>A record in which the individual payments are allocated to the relevant creditors account in the creditors ledger</td>
</tr>
<tr>
<td>General ledger</td>
<td>The total of the CPJ are allocated to the creditors control account (debit) and bank account (credit).</td>
</tr>
</tbody>
</table>

**Step 3:** Identify the risks involved in the actual payment and recording function

To complete the above step you are required to refer to the study reference below.

**STUDY**

Jackson & Stent (2016:11/13) – **Risks column**

**ACTIVITY 24.11**

Use the above study reference and list three risks associated with the actual payment and recording function.

**SUGGESTED SOLUTION 24.11**

1. EFTs may be incorrectly issued (e.g. wrong beneficiary, amount).
2. I________________________ payments may be made (e.g. ________________, ________________).
3. Payments may be recorded _______________(______________) or may be intentionally _______________ to hide ________________.

**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:11/13) – **Control activities**
ACTIVITY 24.12

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the actual payment and recording function.

SUGGESTED SOLUTION 24.12

Note: Cheques are replaced by EFTs therefore the suggested solution for the actual payment will differ from Jackson & Stent (points 1 to 7 and 11). However, the recording section is in terms of the study reference (points 8 to 10).

(1) There must be authorised access control processes to perform the EFT payment.
(2) All EFT requisitions should be marked paid and recorded in numerical sequence in CPJ (point 8).
(3) The ________ should be reviewed regularly by management for missing EFT requisition numbers and __________ payments. (point 9)
(4) Reconciliation of the ___________ to the ___________ should be performed and __________ monthly, by employees who are __________ of the banking functions, and creditors department. (point 10)

DISCUSSION 24.3

E-tutor assistance required

Consider the following question and post your thoughts about it on the discussion forum provided for the purpose. If you do not post your own idea, you have to respond constructively to a post by another student.

Consider the risks (step 3) and discuss whether or not the control activities (step 4) are appropriate to mitigate the risks for the actual payment and recording function.

Let’s summarise. You now should know what the purpose of the payment preparation function is, the documents they use, the risks involved and the control activities to mitigate the risks.

24.5 SUMMARY AND SELF-ASSESSMENT

In this study unit we examined the recording of purchases, payment preparation and the actual payment functions of the acquisitions and payments cycle. We identified the objective, risks and control activities to mitigate risks within each function.

Refer to your notes you made in your workbook after completing the following activities.
After having worked through the study unit and the study references are you able to:

- identify the activities and purpose of the recording of purchase and payment functions?
- identify the documents involved in the recording of purchase and payment functions?
- identify the risks involved in the recording of purchase and payment functions?
- describe the controls to mitigate (reduce/prevent) the risks in the recording of purchase and payment functions?

In the next topic we are going to examine the reconciliation of the bank account.
TOPIC 9

The bank account: receipts and payments

Study unit 25

The steps in performing a bank reconciliation 179
TOPIC OVERVIEW

In topic 7 we examined the risks and controls for receipts as part of the revenue receipts cycle and in topic 8, the payments as part of the acquisition and payment cycle. Both receipts and payments form part of the bank account. In this topic we are going to explain the steps to be followed in performing a bank reconciliation.

This topic is divided into the following study units:

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<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>The steps in performing a bank reconciliation</td>
<td>179</td>
</tr>
</tbody>
</table>
THE STEPS IN PERFORMING A BANK RECONCILIATION

IN THIS STUDY UNIT WE ARE GOING TO

• identify the objectives (assertions) for a bank reconciliation
• identify the documents/records used in a bank reconciliation
• describe the steps in performing a bank reconciliation

25.1 INTRODUCTION

Refer to diagram 17 in topic 6. Transactions revolve around the bank account. You have learned in topic 7 that EFTs received from customers will need to be deposited into the bank account (see Jackson & Stent 2016:10/5). In topic 8 you learned that creditors (credit purchases) are paid via EFTs from the bank account (see Jackson & Stent 2016:11/4). The transactions that relate to the bank account therefore form part of the revenue and receipts cycle and the purchases and payments cycle. In order to check the actual balance of the cash receipts and payments journal (cash book), it will be necessary to check both the receipts and the payments against the bank statement.

25.2 OBJECTIVE OF THE BANK RECONCILIATION

In terms of Jackson & Stent (2016:10/71) reperforming a bank reconciliation is a substantive procedure for the assertions of rights, existence and completeness, and valuation. Although substantive procedures are not examined in this module you must be able to prepare a bank reconciliation for the auditors to perform their substantive procedures.

The objective of preparing a bank reconciliation is to prove the above assertions. When a bank reconciliation is carried out, amounts deposited and paid out as shown in the cash receipts and payments journal are agreed with the particulars shown on the bank statement(s).
25.3 DOCUMENTS REQUIRED FOR THE BANK RECONCILIATION

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank statement</td>
<td>Supplied by the bank. The bank statement has an opening balance (beginning of the month), a list of all the debits and credits transacted during the month, and a closing balance (end of the month).</td>
</tr>
<tr>
<td>Cash receipts and payments journal (cash book)</td>
<td>A book of prime entry maintained by the business accounting all receipts (Study Unit 21) and payments (Study Unit 24).</td>
</tr>
<tr>
<td>General ledger</td>
<td>The balance of the cash book is reflected in the bank account in the general ledger.</td>
</tr>
</tbody>
</table>

25.4 THE STEPS IN PERFORMING A BANK RECONCILIATION

**ACTIVITY 25.1**

You are the bookkeeper of Mpo (Pty) Ltd. One way of reducing risk in bank transactions is to perform regular bank reconciliations. You are going to perform the bank reconciliation for the month ended 28 February 20XX.

You have the following records:
- Bank statements for 1 to 28 February 20XX
- The bank reconciliation for the previous month 31 December 20XX
- The cash receipts and payments journal (cash book)

**REQUIRED**

Describe the steps that you will follow to perform the bank reconciliation on 28 February 20XX.

**SUGGESTED SOLUTION 25.1**

Reference: Jackson & Stent (2016:10/5) section 5.5
Jackson & Stent (2016:11/4–11/5) – from section 5.5
Jackson & Stent (2016:10/71–10/72)

1. Obtain the previous month's reconciliation (December 20XX).
2. Obtain the cash book and balance for the month under review (28 February 20XX).
3. Obtain the bank statements for the month under review (1–28 February 20XX).
4. Agree the previous month's reconciliation with the opening balance of the cash book and bank statements.
5. Tick off the month's bank statements with the cash book and the reconciling items of the previous month's reconciliation.
6. Identify the reconciling items:
• Outstanding payments not yet reflected on the bank statement
• Outstanding deposits not yet reflected on the bank statement
• Bank charges on the bank statement not yet reflected on the cash book.

(7) Make the necessary adjustments to the cashbooks e.g. entering the bank charges not yet reflected on the cash book.

(8) Compile the reconciliation by setting it out as follows:
• Balance per cashbook
• Add: Outstanding payments
• Deduct: Outstanding deposits
• Balance per bank statement

ACTIVITY 25.2

How is it possible for a year-end bank reconciliation to include a number of EFTs as reconciling items?

SUGGESTED SOLUTION 25.2

Reference: Jackson & Stent (2016:10/70)

This will happen where the company prepares the EFTs, enters them in the cash book, but does not “release” the payments until after year-end. As the EFT has not been processed by the bank at year-end, the cash book and bank account balances will not agree.

25.5 SUMMARY AND CONCLUSION

In this study unit we examined the bank reconciliation.

Refer to your notes you made in your workbook after completing the following activities.

Activity 25.1
Activity 25.2

After having worked through the study unit and the study references are you able to:
• identify the objectives (assertions) for a bank reconciliation?
• identify the documents/records used in a bank reconciliation?
• describe the steps in performing a bank reconciliation?
TOPIC 10

Payroll and personnel cycle

Study unit 26

Personnel and payroll preparation 185
TOPIC 10: PAYROLL AND PERSONNEL CYCLE

TOPIC OVERVIEW

In this topic we are going to examine the payroll and personnel cycle – in particular, salaries. The payment of salaries is an integral part of any business and therefore it is important to prevent the potential significant misappropriation of funds (Jackson & Stent 2016:13/2).

This topic is divided into the following study unit:

<table>
<thead>
<tr>
<th>Study unit</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>26</td>
<td>Personnel and payroll preparation</td>
<td>185</td>
</tr>
</tbody>
</table>
STUDY UNIT 26

PERSONNEL AND PAYROLL PREPARATION

IN THIS STUDY UNIT WE ARE GOING TO

• explain the overall risk of the payroll and personnel cycle
• identify the activities and purpose of the personnel and payroll preparation functions
• identify the documents involved in the personnel and payroll preparation functions
• identify the risks involved in the personnel and payroll preparation functions
• describe the controls to mitigate (reduce/prevent) the risks in the personnel and payroll preparation functions

26.1 INTRODUCTION

In this study unit we will focus on salaries (not wages). According to Jackson & Stent (2016/13/2) salaries are expressed as a fixed monthly amount, whereas wages are calculated based on the hours worked by an employee. Furthermore, salaries are paid by a direct transfer into the employee’s bank account.

This study unit will focus on two payroll functions, namely personnel (human resources) and payroll preparation.

26.2 THE OVERALL OBJECTIVE OF THE PAYROLL AND PERSONNEL CYCLE

The objective of the payroll and personnel cycle is to avoid payments to fictitious employees and to comply with the legal requirements e.g. income tax deductions, dismissals, etc. (Jackson & Stent 2016:13/3)

We are going to examine the personnel (human resources), payroll preparation and pay out and deductions functions.

We are going to follow a certain structure (four steps) that we can apply to all the cycles. This will make your learning easier. For an overview of how we are going to unpack the content, refer to Jackson & Stent and page through pages 13/9 and 13/11. We will be excluding the aspects relating to wages.
We are going to do the following:

**Step 1:** Identify the activities and purpose of each function.

**Step 2:** Identify the documents involved in each function and their purpose.

**Step 3:** Identify the risks involved in each function.

**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks.

### 26.3 THE PERSONNEL (HUMAN RESOURCES)

**Step 1:** Identify the activities and purpose of the personnel (human resources) function

To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**

Jackson & Stent (2016:13/9) – **Function column**

**ACTIVITY 26.1**

Use the above study reference and complete the following sentences:

The purpose of this function is to assist with all personnel matters so as to ensure ________________ from the workforce, by controlling:

- ________________
- ________________
- ________________
- ________________
- ________________

and to maintain ________________, _______________ and _______________ records for all employees.

**Step 2:** Identify the documents used in the personnel (human resources) function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

**STUDY**

Documents/records: Jackson & Stent (2016:13/9) – **Documents/records column**

Purpose of the document: Jackson & Stent (2016:13/5) – **Documents used in the cycle**

**ACTIVITY 26.2**

The documents used in the payroll function are listed in the table below. Use the above study reference to describe the purpose of each document.
SUGGESTED SOLUTION 26.2

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll amendment form</td>
<td>This document is used to ______________ and changes made in the employer register which will affect the workforce, e.g. ______________, ______________, promotions and changes to pay rates.</td>
</tr>
<tr>
<td>(PAF)</td>
<td></td>
</tr>
<tr>
<td>Employee's file</td>
<td>Formal terms and conditions of employment are kept in the employee file.</td>
</tr>
<tr>
<td>List of employees/</td>
<td>This is a list (register) of ______________ employees and their ______________, necessary for calculating salaries provided by personnel.</td>
</tr>
<tr>
<td>employee register</td>
<td></td>
</tr>
</tbody>
</table>

**Step 3:** Identify the risks involved the personnel (human resources) function.
To complete the above step you are required to refer to the study reference below.

**STUDY**
Jackson & Stent (2016:13/9) – **Risks column**

**ACTIVITY 26.3**
Use the above study reference and list the risks associated with the personnel (human resources) function.

**SUGGESTED SOLUTION 26.3**

1. Recruiting/retaining ______________ or ______________ employees.
2. I ______________ dismissal procedures.
3. U ______________ amendments to employee records
   • f ______________
   • u ______________
4. I ______________ or ______________ records.

**Step 4:** Describe the controls to mitigate (reduce/prevent) the risks
To achieve this step you are required to refer to the study reference below and complete the activity.

**STUDY**
Jackson & Stent (2016:13/9) – **Control activities**
ACTIVITY 26.4

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the personnel (human resources) function.

SUGGESTED SOLUTION 26.4

(1) All _________ for _________ or _________ of employees should originate from the section making the request and should be in _________ and a _________ provided.

(2) Requests should be signed by the _________ and _________ by the section manager after reference to the _________. Specifications of the position and _________ required will be agreed by the _________ and the _________ department.

(3) Changes to pay _________, _________ to higher employment grades and any other changes in _________, should be decided upon by the personnel committee after
  • due _________ with _________ parties
  • consideration of relevant _________ and _________

(4) Such changes should be _________ and _________ by the authorising body.

(5) All of the above amendments should be _________ committed to sequenced _________ (PAFs) which should be _________ to _________ documentation and _________ by a _________ member of the personnel section.
  • From time to time the file of _________s should be _________ for _________ and _________ in _________.

(6) Sound personnel practices should be followed to obtain _________, _________ personnel by performing interviews, background checks, etc.

(7) A file should be kept for each employee and should include the following:
  • _________
  • _________
  • _________
  • _________

26.4 PAYROLL PREPARATION

Step 1: Identify the activities and purpose of the payroll preparation function

To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:13/11)
The activity texts have been adjusted to only address salaries (wages are excluded in this module).

ACTIVITY 26.5

Use the above study reference and complete the following sentences:

The purpose of this function is to _______________ gross salaries and make _______________ from employees which must be subsequently _______________, to arrive at net salaries i.e. create a payroll.

The employee’s authorised salary scale should be used. The appropriate deductions e.g. PAYE, must be extracted from authorised up to date tax tables.

Step 2: Identify the documents used in the payroll preparation function and their purpose

To achieve this step you are required to refer to the two study references below and complete the activity.

STUDY

Documents/records: Jackson & Stent (2016:13/11) – Documents/records column

Purpose of the document: Jackson & Stent (2016:13/5) – Documents used in the cycle

ACTIVITY 26.6

The documents used in the ordering of goods function are listed in the table below. Use the above study reference to describe the purpose of each document.

SUGGESTED SOLUTION 26.6

<table>
<thead>
<tr>
<th>Document/Records</th>
<th>The purpose of the document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction tables</td>
<td>These are schedules or returns for deductions provided by entities e.g. PAYE tables provided by SARS.</td>
</tr>
<tr>
<td>Updated list of employees</td>
<td>The updated list. Refer to activity 26.2 for the description.</td>
</tr>
<tr>
<td>Payroll journal</td>
<td>This journal is a spreadsheet which lists employees’, their work section, their gross pay, deductions, and net pay.</td>
</tr>
<tr>
<td>Salary advice</td>
<td>Notifies the employees of how their remuneration is made up.</td>
</tr>
</tbody>
</table>

Step 3: Identify the risks involved the payroll preparation function.

To complete the above step you are required to refer to the study reference below.
STUDY

Jackson & Stent (2016:13/11) – Risks column

ACTIVITY 26.7

Use the above study reference and list the risks associated with the payroll preparation function.

SUGGESTED SOLUTION 26.7

(1) Inclusion of ________________ employees.
(2) Use of ________________ or ________________ salary rates or deduction tables.
(3) ________________ and ________________ errors.

Step 4: Describe the controls to mitigate (reduce/prevent) the risks
To achieve this step you are required to refer to the study reference below and complete the activity.

STUDY

Jackson & Stent (2016:13/11) – Control activities

ACTIVITY 26.8

Use the above study reference to complete this activity.

Describe the control activities that can help mitigate the risks associated with the payroll preparation function.

SUGGESTED SOLUTION 26.8

(1) The salary clerk should prepare the payroll, salary advices and a reconciliation of the difference between the prior month’s salaries and the current period’s salaries for the number of employees and amounts for net wages and deductions.
(2) A supervisor should authorise the above payroll preparation.
(3) The head of payroll preparation should review and sign the payroll and monthly reconciliation and verify amendments to the authorised PAFs and vice versa.
(4) The salary advices should be prepared and the EFT schedule should be authorised and presented for payment.
26.5 SUMMARY AND CONCLUSION

In this study unit we examined two payroll functions, namely personnel (human resources) and payroll preparation.

Refer to your notes you made in your workbook after completing the following activities.

| Activity 26.1 | Activity 26.2 | Activity 26.3 | Activity 26.4 | Activity 26.5 | Activity 26.6 | Activity 26.7 | Activity 26.8 |

After having worked through the study unit and the study references are you able to:

- explain the overall risk of the payroll and personnel cycle?
- identify the activities and purpose of the personnel and payroll preparation functions?
- identify the documents involved in the personnel and payroll preparation functions?
- identify the risks involved in the personnel and payroll preparation functions?
- describe the controls to mitigate (reduce/prevent) the risks in the personnel and payroll preparation functions?