

ASPECTS OF INTERNAL CONTROLS AND CORPORATE GOVERNANCE-AUE2602

AUE2602 EXAM PACK

ASPECTS OF INTERNAL CONTROLS AND CORPORATE GOVERNANCE-AUE2602

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Question papers are attached on separate sheets, and some are also accessible on myunisa.

STUDY NOTES

Introduction

Students often ask where internal control and controls in a computerized environment fit into the audit process.

In terms of ISA 315 (par 5 and 6), auditors are required to perform **risk assessment procedures**. These procedures are performed to obtain an understanding of the entity and its environment (**including internal control**) sufficient to identify and assess risks of material misstatement, whether due to fraud or error.

- When the auditor identifies and assesses the risks of material misstatement, it should be done at:
 - (i) the financial statement level;
 - AND**
 - (ii) the assertion level for classes of transactions, account balances and disclosures.

This provides a basis for designing and performing further audit procedures.

ISA 315 (par 26) highlights the following for this purpose:

- identification of risks (through the process of obtaining an understanding of the entity and its

environment and by considering classes of transactions, account balances, and disclosures in the financial statements) **and identification of relevant controls** that relate to these identified risks **(covered specifically in this tutorial letter)**;

- assessing and evaluating these identified risks;
- relating the risks to what can go wrong at the assertion level; and
- considering the likelihood of material misstatement **(refer to Appendix 2 of ISA 315 for conditions and events that may indicate risks of material misstatement)**.

All of these procedures apply to both tutorial letters 103 and 104.

It is important to note that the understanding that the auditor has to obtain of the **entity and its environment** includes an understanding of the entity's **internal control**.

What is internal control?

ISA 315 (par 4) stipulates that it is

- **the process designed, implemented and maintained;**
- **by those charged with governance (refer to ISA 260 par 10 for definition), management and other personnel;**
- **to provide reasonable assurance about the achievement of an entity's objectives with regard to:**

reliability of financial reporting;

effectiveness and efficiency of operations; and

compliance with applicable laws and regulations.

ISA 315 (par 12) stipulates that the auditor **has to** obtain an understanding of internal control relevant to the audit.

Internal control is designed and implemented to address identified business risks that threaten the achievement of any of the above objectives.

When the auditor obtains an understanding of internal control, he/she has to (ISA 315 par 13):

- **evaluate the design of those controls.** Does a control (individually or in combination with others) **effectively** prevent, or detect and correct material misstatements?
- **determine whether these controls have been implemented.** It is no use having brilliant controls in theory if they are not implemented and used effectively by the entity.

Inquiry from the entity's personnel alone is not sufficient. Other procedures (e.g. observation, inspection, etc.) have to be performed in addition.

Internal control, according to ISA 315 (par 14-24), consists of the following components:

- **the control environment;**
- **the entity's risk assessment process;**
- **the information system (including the related business processes) relevant to financial reporting and communication;**

- **control activities relevant to the audit and**
- **monitoring of controls.**

Study these components from ISA 315. Also make use of ISA 315 Appendix 1 for further guidance on these components. Flag Appendix 1 of ISA 315 as it explains these components in detail and gives valuable examples to guide you in a test or the exam.

Also refer to Auditing Notes (chapter 7).

When the auditor obtains an understanding of the entity's control activities (a component of internal control), ISA 315 (par 21) stipulates that the auditor must obtain an understanding of how the entity responds to risks arising from IT (Information Technology), as the use of IT affects the way that control activities are implemented. From an audit perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective **general** and **application controls**. (Refer to ISA 315, par A103-A105.).

As you can see controls in an IT system (including general and application controls) form part of the entity's internal control.

As it is expected of the auditor to obtain an understanding of the entity's internal control (as per ISA 315 par 12) and how the entity responds to risks arising from IT (ISA 315 par 21), it is expected of the auditor to obtain an understanding of controls in an IT system (including general and application controls). Refer to section 9.3 where general and application controls are dealt with in detail.

These controls can be manual and/or automated controls. For both manual and automated controls you have to be comfortable with the theory on business cycles. Refer to chapters 10-14 of Auditing Notes.

It is important for you to familiarise yourself with ISA 315 par A59 to A66. These paragraphs deal with the characteristics of manual and automated elements of internal control.

In a completely manual system it may be easy to trace a transaction's path from initiation to its inclusion in the financial statements by following the flow of documentation. However, in computerised system environments, it may be more difficult to trace transaction flows through systems as these may not be visible. In some cases it may be impossible to obtain an understanding of the flow of transactions without the aid of sophisticated computer programs which map out the flow of data as it moves through the live processing phases of a computer system.

Business cycles can be described as the process of grouping together similar types of transactions or transaction processing systems.

Organisations would typically group their accounting transactions according to the following five common business cycles:

- the **acquisition and payments cycle**;
- the **payroll and personnel cycle**;
- the **inventory and production cycle**;
- the **revenue and receipts cycle**; and
- the **finance and investment cycle**.

Significant risks and significant deficiencies in internal control

ISA 315 par 27 requires the auditor to determine whether any of the risks identified are in his/her judgment, a **significant risk**.

What is a significant risk?

ISA 315 par 4 definition (e)

“

An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.”

What should the auditor consider when deciding if a risk is significant?

- Is the risk related to recent significant economic, accounting or other developments and, therefore, does it require specific attention?

- Is (are) the transaction(s) complex?
- Does the risk involve significant transactions with related parties?
- What is the degree of subjectivity in the measurement of financial information related to the risk?
- Does the risk involve significant transactions that are outside the normal course of business for the entity/or appear unusual?

Tests of controls

Auditors are required to perform tests of controls when the auditor's risk assessment includes an expectation that controls are operating effectively or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level (ISA 330 par 8).

The auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level, when an entity conducts its

business using **IT** and no physical documents are produced or maintained, other than through the IT system. **If so, the auditor should perform tests of relevant controls.**

Examination technique: internal control related questions

Internal control related questions are typically examined in the following ways (in tests and



examinations):

REQUIRED: weaknesses, risks and recommendations

- A question can either only require one of the above (e.g. only the weaknesses), or it can require a combination of two (e.g. weaknesses and risks), or even all three.
- When more than one of the above are required, present your answer in a **tabular format** (even if the question does not specifically require it). This will assist you in presenting your answer in a structured manner and it will make it easier for the marker.

For example:

Identify the weaknesses, potential risks/consequences of the weaknesses as well as your suggestions for improvement thereof relating to the revenue and receipts cycle.

Structure your answer in the form of a table, as illustrated below:

| Weakness | Potential risk/Consequences | Suggested improvement (recommendation) |
|-----------------|------------------------------------|---|
|-----------------|------------------------------------|---|

- When you are required to identify weaknesses in an internal control system, it is important to remember to:

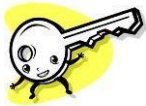
not only address those internal controls that are **performed incorrectly** (as indicated in the given scenario);

but also to address the **key internal controls** that should be performed but **are not mentioned** in the scenario.

Please note: These should still be relevant to what is given in the scenario

- addressing **internal controls** that you know should be performed but that are not specifically mentioned, the framework below should be used:

The following characteristics can be found in any good internal control system. They apply to all the business cycles. When you are answering a question relating to internal controls, always keep these internal controls in mind and apply them to the given scenario.



Always remember that you should only address those internal controls (from the framework) that are still relevant to the given scenario.

Framework for internal controls

Characteristics of good internal control.

- **Sound control environment** This overall control applies to all business cycles. It is a component of internal control (refer to ISA 315 par 14). Unless the scenario specifically deals with **concerns** regarding the directors' and/or managements' attitude and awareness to internal controls and their importance, this internal control should not be mentioned when you answer the question. Also refer to ISA 315 Appendix 1, par 2 a-g.
- **Competent, trustworthy personnel** The employees involved in the internal control system should be reliable, honest and competent (have the necessary knowledge, skills and experience). Only mention this internal control if the scenario specifically states something about personnel recruitment, personnel issues (relating to competence or trust) or other relevant personnel training or experience issues. Also refer to ISA 315 Appendix 1, par 2 g.
- **Segregation of duties** You need to be comfortable with the various functions performed in each business cycle and those functions that should be segregated between employees (i.e. that should not be performed by only one employee). Only mention this internal control if the scenario specifically mentions various functions/ duties (performed by one person) that are considered to be incompatible. Also refer to ISA 315 Appendix 1, par 9.
- **Isolation of responsibility** A signature on a document is an acknowledgement from an employee that he/she takes responsibility for the function/control being performed. This internal control should only be addressed when the scenario mentions that a particular document is not signed, or when various employees perform the same task (function) and responsibility should be isolated (e.g. six employees complete sales orders). Also refer to ISA 315 Appendix 1, par 9.
- **Access/custody controls** This internal control can easily be linked to access controls relating to general and application controls. Only address this control if the scenario mentions something about access related issues. Also refer to ISA 315 Appendix 1, par 9.

- **Source document designs** When documents (paper documents and/or electronic documents) are well designed, this can assist in achieving good internal control (e.g. preprinted, pre-numbered, multi-copied, logical, etc.).
Only address this control when the design of documents is questionable and can be improved.
Also refer to ISA 315 Appendix 1, par 9.

- **Comparison and reconciliation** These should preferably be independent of the functions and records which are being compared and reconciled.
The following is also very important to remember:

Reconciliations should be reviewed (authorised) by someone in a more senior position than the person preparing the reconciliation.

Reconciling items identified on the reconciliation, should be properly investigated.
Also refer to ISA 315 Appendix 1, par 9.

- What is the difference between identifying a **weakness** and describing the **risk**?

Weakness When identifying a weakness you merely state:

- whether an existing control is being performed incorrectly, and/or
- if an internal control (relevant to the scenario) is not being performed at all.

The question can also ask for **concerns** you have about a given scenario. Then you will also address the weaknesses.

Risk You might be asked to describe the risks in a given scenario. The risk is the **potential**

consequence of the weaknesses mentioned above. This is normally what management **and** we as auditors are concerned about, as the risk usually relates to the impact on the financial statements and/or the financial/reputational impact on the client's business.

- What about **recommendations**?

Remember to formulate your answer in accordance with the requirements of the question. If you are required to make recommendations (suggestions for improvements), make sure that you do not formulate your answer as weaknesses!

The recommendations that you make should be practical and preferably cost effective (from a

client's perspective).

If we take the weakness of: "no tests of creditworthiness carried out" (in the table with the example of weaknesses and risks above), what would appropriate recommendations be?

A credit limit should be determined for each new client after proper background checks have been carried out.

When the orders are received, the computer system or the sales clerk should check whether the credit limit has been exceeded and should then authorise the sale.

If the credit limit has been reached, the credit manager or other senior official should authorise the sale.

- A question can also require you to "evaluate the effectiveness of an internal control system". Here you will have to address **both** negative (weaknesses) as well as positive aspects of the controls being performed. An evaluation means that you compare the negative and the positive of a certain matter and conclude thereon.

controls that should be present or implemented

A question can require you to identify/list/describe the internal controls (both manual and automated) that should be present in a client's internal control system, or that should be implemented to ensure certain control objectives are met.

Don't confuse this with tests of controls. You should be comfortable with the various business cycles and the internal controls that should be performed in each cycle. You cannot describe controls that a client should have in place if you are not familiar with the controls in each cycle.

Refer to section 9.2.4.1 above for the framework for internal controls.

Examples: CONTROL

A reconciliation between deposits captured and bank statements should be performed by the accounting department.

This reconciliation should be reviewed by a senior official (manager).

Any security breaches must be logged and followed up by management.

As you can see you are **not testing** the control, but merely stating what the **control should be**.

General

- You have to determine exactly what a question requires you to do. Does the question only require you to look at a certain area of a transaction cycle? Does it require you to address only certain control objectives?

The golden rule is to limit your answer to what is required from you!

- Determine from whose point of view the question is asked (i.e. the external auditor, internal auditor or management). This could influence the way in which you formulate your answer.

General and application controls

As discussed in earlier, controls in a CIS environment include both **general** and **application** controls.

These controls can be both manual controls and controls designed and built into computer programs (automated procedures).

General controls

In terms of ISA 315 par A104, general IT-controls are policies and procedures that relate to many

applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments.

General controls comprise:

- (a) control environment and security policy;
- (b) organisational structure and personnel practices;
- (c) standards and standard operating procedures;
- (d) system development controls;

(e) programme change controls;

(f) continuity of operations;

(g) access controls; and

documentation

Application controls

As per ISA 315 par A105, application controls are manual or automated procedures that typically operate at a business process level and apply to the recording of transactions by individual applications.

Application controls relate to specific tasks performed by computerised information systems and can be preventative or detective in nature. Their function is to provide reasonable assurance that the initiation, recording, processing and reporting of financial data are properly performed. Application controls are categorised as ***“input”, “processing”, “master file maintenance”*** and ***“output”*** controls.

Application controls relate primarily to the occurrence, authorisation, accuracy and completeness of transactions within a specific application in an organisation. General controls, in turn, provide the standards and guidelines under which employees function in their work governing the functions of developing, maintaining and operating systems to process data.

Contained in chapters 10-13 of Audit Notes for South African students, are sections that discuss the computerisation of the particular cycle. It is crucial for you to study this

together with chapter 8 of Auditing Notes

REQUIRED

Describe the **automated (programmed) controls** that exist and/or should be implemented in the Gym2Earn application to ensure the **completeness** of the initial sign-up process. 25

How do you approach this question?

Break down and UNDERSTAND what is required!!!

- Describe the **AUTOMATED (PROGRAMMED) controls** that exist and/or should be implemented.

Do NOT address any manual controls (no marks). If the question only said describe controls,

then address both. Application controls can be both manual and automated.

- In the GYM2EARN application

- In other words ... APPLICATION controls

- To ensure the COMPLETENESS of ...

- Do NOT address the validity (occurrence and authorisation) and accuracy control objectives (no marks!).

- The initial sign-up process

- The question will never explicitly state that it is the INPUT phase of the process. You need to identify which phase it is.

The following are important examination techniques and should be considered when answering a similar question to those of application controls:

- Ask yourself the following questions:

Which phase of the process is being addressed, i.e. input, processing, output and/ or master file?

If it is input phase – who does the capturing? In this question the customer (gym member) does the capturing on-line, NOT an employee of the client.

Is the capturing being done in batches or on-line?

Are manual and/or computerised controls required?

- Be careful of the following: No marks are awarded for only saying “a sequence check should be performed”. On what? Why?

Do not address access controls & passwords if validity is not required.

Batch controls were not applicable. The gym member does not complete a source document!!

The COMPLETENESS control objective is concerned with ensuring that:

Data and transactions are not omitted (left out) or incomplete.

How does management ensure this?

- By implementing controls to make sure every single transaction (with all its data) is fully captured, processed and reported on. In other words SEQUENCE of data and/or transactions is critical.

What do we as auditors do?

- If we plan on placing reliance on these controls, we test them!

HOW TO EARN MARKS

COMPLETENESS – INPUT PHASE

SEQUENTIAL NUMBERING (of users) – should be implemented

SEQUENCE CHECKS: • When detecting gaps in sequence = completeness test.

SCREEN AID: • Screen formatted i.t.o. hardcopy document

Mandatory fields, sign-up cannot continue without (the terms and conditions and agreeing to fee)

Screen dialogue and prompts e.g. error message to the person doing the input (e.g. gym user).

MISSING DATA CHECKS: • Not quite the same as mandatory fields

EXEPTION REPORTS: • Mostly to senior employee or management (gym user will not see this)

Examination technique: General and Application controls

- First of all determine which transaction cycle (or part of it) is being addressed in the question (e.g. payroll cycle).
- Secondly determine which phase of the process in the transaction cycle is being addressed in the scenario. Does the scenario deal with the:

input phase;

processing phase;

output phase; and/or

master file maintenance phase?

E.g. Capturing employees' clock card hours onto the payroll system would fall into the input phase of the payroll transaction cycle.

- Thirdly determine which control objective(s) is/are being addressed. Does the question require you to address:

occurrence;

authorisation;

accuracy; and/or

completeness?

- **Example:**

List the controls that the management of company X should implement to ensure the accuracy and completeness of the capturing of clocked hours on the clock cards.

Where do you start?

1. Determine the transaction cycle (or part of it):

Payroll and personnel cycle.

2. Determine the phase of the process:

Input phase (capturing of clocked hours).

3. Determine the control objectives:

Accuracy **and** completeness.

How would your table look?

Control objective

Input phase

Accuracy

Completeness

I.e. you will only address the input phase of the payroll cycle and the accuracy and completeness control objectives.

- Most marks in the test or exam will normally be allocated to the **input** and **processing** phases. Master file change controls are VERY popular and for relatively high mark allocations.
- When dealing with sequentially pre-numbered documents (hard-copy or electronic), one control objective is being addressed:

Completeness: To identify **missing** documents/transactions.

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These controls are embedded in computer programs Examples include:

Access controls on the computer, e.g. user names and passwords.

Programme checks, e.g. limit checks, range checks, size checks, etc.

Exception reports generated by the computer, etc.

Manual dependent

These manual controls are performed with the use or assistance of a computer.

Examples include:

A person using an exception report generated by the computer to follow-up on exceptions.

A person authorising someone.

Why does the auditor perform tests of controls?

Auditors are required to perform tests of controls when the auditor's risk assessment includes an expectation that controls are operating effectively or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level (ISA 330 par 8).

The auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level, when an entity conducts its business using Information Technology (**IT**) and no physical documents are produced or maintained, other than through the IT system. **If so, the auditor should perform tests of relevant controls.**

Tests on the operating effectiveness of controls are performed **only** on those controls that the auditor has determined are suitably designed to **prevent**, or **detect** and **correct**, a material misstatement at the assertion level. This includes obtaining audit evidence about how controls were applied at relevant times during the period under review, the consistency with which they were applied and by whom or by what means they were applied (ISA 330 par 10).

The auditor should perform tests of controls to obtain **sufficient appropriate** audit evidence that the controls were operating effectively at relevant times during the period under review.

The timing of tests of controls depends on the auditor's intended reliance on those controls (ISA 330 par 11). If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time. However, if the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls throughout that period.

It is a matter of the auditor's professional judgment, subject to the requirements of the ISA, whether a control (individually or in combination with others) is relevant to the auditor's considerations in assessing the risks of material misstatement as well as designing and performing further procedures in response to assessed risks. **Refer to ISA 315 par A68 for the factors relevant to the auditor's judgement about whether a control is relevant to the audit.**

How should a test of control be formulated?

A properly worded test of control should address the following:

HOW: This is the **verb** that describes the action to be performed. You will find these verbs (audit procedures) in ISA 500 par A14 to A25. Remember that the audit procedures mentioned in par A14 to A25 may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.

The following audit procedures will most likely be used when testing a control:

- **Inspection** A good example is the inspection of reconciliations for evidence of a signature as authorisation.

- **Observation** An example is when the auditor observes the

inventory count control activities. Another example is observing a person entering his/her user ID and password. This is not the best audit procedure as there are certain inherent limitations.

- **Reperformance** Reperforming the monthly bank reconciliation to confirm that the internal control of balancing the cash book and the balance per the bank statement has been properly carried out is an example.
- **Inquiry** On its own, inquiry is not considered to be sufficient and therefore can be used in addition to other audit procedures (mentioned above). An example is to inquire from the credit controller what functions each member of her department carries out and what control procedures are in place.

WHAT: Here you should make reference to the **source document** (e.g. the reconciliation on which the signature is made) and/or the **action (control)** being performed (e.g. the password being entered by the employee to gain access to the system).

WHY: This describes the **reason** for performing a test of control. Here you state the reason/objective of the procedures you are performing. What do you want to achieve through the specific test of control?

The following are examples of **well** worded tests of controls:

Example 1:

Inspect the clock card summary reconciliation for the manager's signature as evidence of approval.

- Inspect = **HOW** = verb = ISA 500 par A14
- Clock card summary reconciliation = **WHAT** = Source document
- For the manager's signature as evidence of approval = **WHY** = reason.

Example 2:

Inquire from management whether all employees should log into the system with a valid user identification number and password, to ensure that only authorised employees have access to the system. Inquire = **HOW** = verb = ISA 500 par A22

- All employees log into system with valid ID and password = **WHAT** = action Ensure only authorised employees have access = **WHY** = reason.

Examples of tests of controls questions

The business cycles that are dealt with in chapters 10-14 of Auditing Notes and tutorial letter 104 have not been covered in this tutorial letter again. You however, need to be comfortable

with all the business cycles and their respective controls as this tutorial letter will focus on the testing of these and other controls.

The same principle applies to chapters 8 and 9 of Auditing Notes where auditing in a computerised environment and advanced computerised environments are dealt with. You

need to be comfortable with all these controls (including general and application controls) in order for you to be able to test them in this tutorial letter.

The following question provides a good example of how proper tests of controls should be formulated. As you read through Annexure A, highlight controls that you identify that relate specifically to the sales system of HEAT.

You will find that the suggested solution indicates the HOW, WHAT and WHY of each test of control to assist you with your examination technique.

GOVERNANCE IN SOUTH AFRICA

As a member of society many individuals are somehow linked in some way or another to companies. You may be a shareholder, who is interested in maximising your return on an investment; a supplier who requires that your account be paid promptly in order for you to continue to sell your products to the company; an employee who might look for fair terms of employment or you may form part of the general public concerned about pollution control in your neighbourhood, if you live near an oil refinery. This challenge was articulated by Sir Adrian Cadbury, author of the Cadbury Report in the United Kingdom as follows:

"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and commercial goals ... the aim is to align as nearly as possible the interests of individuals, corporations and society."

(Source: Adapted from Jackson & Stent, seventh edition, Auditing notes for South African students.)

Applicable Text

Auditing Notes, Chapters 3 to 4.

SAICA Legislation Handbook 2012/2013, Volume 3.

We recommend that you study Corporate Governance directly from the SAICA handbook as this is a book you will be able to take in with you when sitting for a test or exam as per Open Book Policy.

At this point you are probably wondering:

What is meant by "Corporate Governance?" Corporate Governance is defined as a system whereby entities are managed and controlled.

To which entities does the King III Code of Governance Principles apply?

King III applies to all entities regardless of their manner and form of in-corporation. Obviously the size and complexity of the entity will determine the extent to which the entity applies the Code, e.g. a large listed company will have different governance structures to a small business, but the basic principles of good governance apply to all.

Note that companies listed on the Johannesburg Stock Exchange Limited (JSE) are required to report in their annual report on how they applied the principles set out in King III. If these principles are not applied, an explanation must be provided.

Where can I find out more on the King III Code of Governance Principles?

The King III Code is included in the *SAICA Legislation Handbook Volume 3*. This is very good news for you as a student because, according to the open-book policy as prescribed by SAICA this is one of the books that you may take into the test and examination venue. This might make it easier to perform well in a question on corporate governance. However, keep in mind that the level of application may be enhanced due to King III being open-book. It is therefore important that you know your way around King III.

The following list indicates the significant matters covered by King III and the sections where you can find these in the *SAICA Legislation Handbook, 2013/2014, Volume 3*. The King committee issued a Code of Governance and a Report. The Code of Governance Principles, which lists the principles, are included on pages 18 to 49 of the King Code of Governance for South Africa 2009. The Report, which provides recommendations of best practice for each of these principles, is included on pages 19 to 111 of the King Report on Governance for South Africa 2009. Please familiarise yourself with these sections before test 1 and the year-end examination.

The following are significant matters covered by King III:

1. Ethical leadership and corporate citizenship (*section 1*)
2. Board and directors (*section 2*)
3. Audit committees (*section 3*)
4. The governance of risk (*Section 4*)
5. The governance of information technology (*section 5*)

6. Compliance with laws, rules, codes and standards (*section 6*)
7. Internal audit (*section 7*)
8. Governing stakeholder relationships (*section 8*)
9. Integrated reporting and disclosure (*section 9*)

In the next few pages we will highlight some of the significant matters covered by King III and give you guidance on how to approach a question on King III. It is your own responsibility to work through the whole document and familiarise yourself with the rest of the King III Code.

1. Board of directors

*The board of directors is a very important section of King III. Please familiarise yourself with the **composition** of the board as well as the **roles and functions** of the board. The table below is a summary of the composition of the board.*

Composition of the board

Board of directors

Chairman Independent non-executive director (*principle 2.16*).

CEO of the company should not also fulfil the role of chairman of the board (*principle 2.16*).

Membership The board should comprise a balance of power, with a majority of non- executive directors. The majority of non-executive directors should be independent (*principle 2.18*).

Members Minimum of two executive directors of which one should be the CEO and the other the

director responsible for finance (*principle 2.18.5*).

Meetings Meet at least four times a year (*principle 2.1.2*).

What is an independent non-executive director? (Principle 2.18 (par 67), King Report)

A director who:

- is not a representative of a shareholder who has the ability to control or significantly influence management;
- does not have a direct or indirect interest in the company which is material to the director or the company (a holding of 5% or more is considered material);
- has not been employed by the company in any executive capacity for the preceding three financial years;
- is not a member of the immediate family of an individual who is, or has been during the previous three financial years, employed by the company in an executive capacity;
- is not a professional advisor to the company;
- is free from any business or other relationship which could be seen to interfere materially with the individual's capacity to act independently; and
- does not receive remuneration contingent upon the performance of the company.

Why is it important to know these principles?

In a question you may be asked to comment on the composition of the board or a board committee. If you are familiar with the principles, it will be easy for you to formulate your answer. Please refer to the questions that are included

under 2.1 of Part B of this tutorial letter for examples of the type of questions that you can expect.

2. Board committees

What is a board committee? A board committee is a group of people appointed by the board of directors to assist the board in meeting its responsibilities in respect of a particular activity

or function. The King III report states that public and state-owned companies must appoint an audit committee. All other companies should establish an audit committee and define its composition, purpose and duties in the memorandum of incorporation. Companies should at a minimum establish **remuneration, nomination** and **risk** committee (*principles 2.23.4 to 2.23.6*).

The following table sets out the composition of the different committees:

Some students get confused with the concept of independence and the concept of being a member of one of the board committees.

*Board committees, other than the risk committee, should only comprise members of the board and should have a majority of non-executive directors, with the exception of the audit committee which should only comprise of independent, non-executive directors. The majority of the non-executive directors serving on these committees should be **independent**. You are therefore first and foremost a director of the company who is appointed to serve on one or more of the committees of the board, for example the audit committee. A non-executive director's **independence** is determined by the characteristics set out on page 27 of this tutorial letter and a not by the fact that he/she serves on a board committee.*

3. Governance of risk

Risk management is the practice of identifying and analysing the risk associated with the business and, where appropriate, taking adequate steps to manage the risks by either eliminating the risk or mitigating the risk. Risk management is about looking after the interests of all “**stakeholders**”, not just the **shareholders**. Remember that all companies, small, medium and large have stakeholders, e.g. suppliers, customers, providers of finance and employees.

Who is responsible for what?

WHAT

Governance of risk.

Design, implement and monitor the risk management plan.

Monitor risk management process.

Perform an objective assessment of the effectiveness of risk management.

WHO

The board (*principle 4.1*).

The board should delegate to management

The board, risk committee, audit committee (*principle 4.3.2.1*).

Internal audit (*principle 7.1.2.2*).

4. Governance of Information Technology

Please refer to *Tutorial letter 104* for a detailed discussion on Governance of Information Technology. This topic will not be assessed in test 1, but may be assessed in test 2 and the examination.

5. Internal audit

Remember:

Always keep your ISA in mind when answering a question on corporate governance dealing with internal audit. The table below illustrates how ISA 610- "Using the work of internal auditors" can be linked to King III.

6. Sustainability, integrated reporting and disclosure

King III calls for entities to issue an integrated report on an annual basis (*principle 9.1.3*). This report also falls within the JSE listing requirements, as listed companies have to produce an integrated report for their financial years starting on or after 1 March 2010.

Sustainability reporting and disclosure (by means of an integrated report) is said to give the —bigger picture of a company. The integrated report needs to incorporate strategy and financial performance with risks and opportunities as well as environmental, social and economic challenges. In other words, the integrated report communicates to the stakeholders

of the company the key issues affecting the company and the effect the company's operations have had on the economic, social and environmental well-being of the community, both positive and negative.

The King III report states that sustainability reporting and disclosure should be integrated with the company's financial reporting (*principle 9.2*). The annual financial statements should therefore be included in the integrated report, and the board should include a commentary on the company's financial results.

Sustainability reporting and disclosure should be independently assured (*principle 9.3*). It is the responsibility of the audit committee to oversee the assurance of the integrated report. In terms of principle 9.3 of the King Report (paragraph 18), two standards are used as guidance when providing assurance on the integrated report: AccountAbility's AA 1000 Assurance Standard (AA1000AS) and the International Accounting and Auditing Standards Board's International

Standard on Assurance Engagements (ISAE 3000). Please go and have a look at these two documents, you can find them here:

- **ISAE3000:** Volume 2 of the SAICA Handbook
- **AA1000AS:** <http://www.accountability.org/standards/aa1000as/index.html>

The above standards are however not examinable at CTA and ITC.

Please refer to the following links on the internet for examples of integrated reports:

http://suninternational.investoreports.com/sun_ar_2012/

http://www.woolworthsholdings.co.za/downloads/2012/2012_integrated_report.pdf
http://www.murrob.com/fin_annual_reports.asp

7. The link between governance principles and law

The King Code on Corporate Governance is often linked with Companies Act 2008 and Ethics questions. Use the explanation below and table on pages 54 to 55 as a quick reference when answering integrated questions on King III and the Companies Act 2008.

The governance of corporations can be on a statutory basis, or based on a code of principles and practices, or a combination of both. Certain countries, for example the United States of America (USA), have chosen to codify governance in an act (Sarbanes Oxley Act (SOX)). This is known as the —comply or else governance framework which implies legal sanctions for noncompliance.

King III has opted for an —apply or explain governance framework. The —apply or explain governance framework means that the board of directors, in its collective decision making, could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interest of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of good corporate governance principles of fairness, accountability, responsibility and transparency. Explaining how the principles and recommendations were applied or, if not applied, the reasons for not applying will result in compliance.

The —apply or explain basis does not mean that corporate governance and the law can be separated. Corporate Governance and the law are intertwined. The —apply or explain basis does not allow directors to break the law and then justify doing so by claiming it was in the best interest of the company. For example the Companies Act of 2008 requires that public and stateowned companies must be audited and that they must appoint audit committees. The directors can't decide not to have an audit because it is inconvenient or costs too much.

Keep this in mind for the exam!!!

- Please note that when a question refers to the term —Corporate Governance , it implies that you have to consider the King III Report and Code. In addition you may need to consider Corporate Governance issues arising from other sources e.g. Companies Act, Insider Trading act, business ethics, etc.

- Corporate Governance is very topical and will therefore be examined on a regular basis.
- As mentioned earlier in this Tutorial letter, you have the King III document at your disposal when writing a test or exam, so make sure you are familiar with the content of the document to enable you to find the relevant sections without wasting too much time.
- Corporate Governance can be integrated with more than one topic. In preparing for tests and exams, always envision how the aspects from King III can be linked to other topics within Auditing (especially with the Companies Act) as well as your other subjects.

- Apply good exam technique by reading carefully what is required of you. If you are required to identify instances of **non-application** of King III, do not waste time by mentioning instances where the entity in question applied King III (which is a common mistake that students make).
- It is very important that you do not make assumptions from the facts given to you, except when you are instructed to do so. For example if the minutes of one specific board meeting have been provided in the scenario without clearly stating that that was the only meeting held during the year, then you cannot assume that the entity did not comply with King III by not having four board meetings a year. By making these assumptions you are wasting valuable time by writing down information that you will not be awarded marks.
- As with any of the other topics in Auditing, the best way to study this section on Corporate Governance is to establish a good theoretical basis and then to attempt as many questions as possible.

1. KING III REPORT AND CODE ON GOVERNANCE FOR SOUTH AFRICA

Introduction

As a member of society many individuals are somehow linked in some way or another to companies. You may be a shareholder, who is interested in maximising your return on an investment; a supplier who requires that your account be paid promptly in order for you to continue to sell your products to the company; an employee who might look for fair terms of employment or you may form part of the general public concerned about pollution control in your neighbourhood, if you live near an oil refinery. This challenge was articulated by Sir Adrian Cadbury, author of the Cadbury Report in the United Kingdom as follows:

"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and commercial goals ... the aim is to align as nearly as possible the interests of individuals, corporations and society."

(Source: Adapted from Jackson & Stent, seventh edition, Auditing notes for South African students.)

Applicable Text

Auditing Notes, Chapters 3 to 4.

SAICA Legislation Handbook 2012/2013, Volume 3.

We recommend that you study Corporate Governance directly from the SAICA handbook as this is a book you will be able to take in with you when sitting for a test or exam as per Open Book Policy.

At this point you are probably wondering:

What is meant by "Corporate Governance?" Corporate Governance is defined as a system whereby entities are managed and controlled.

To which entities does the King III Code of Governance Principles apply?

King III applies to all entities regardless of their manner and form of in-incorporation. Obviously the size and complexity of the entity will determine the extent to which the entity applies the Code, e.g. a large listed company will have different governance structures to a small business, but the basic principles of good governance apply to all.

Note that companies listed on the Johannesburg Stock Exchange Limited (JSE) are required to report in their annual report on how they applied the principles set out in King III. If these principles are not applied, an explanation must be provided.

Where can I find out more on the King III Code of Governance Principles?

The King III Code is included in the *SAICA Legislation Handbook Volume 3*. This is very good news for you as a student because, according to the open-book policy as prescribed by SAICA this is one of the books that you may take into the test and examination venue. This might make it easier to perform well in a question on corporate governance. However, keep in mind that the level of application may be enhanced due to King III being open-book. It is therefore important that you know your way around King III.

The following list indicates the significant matters covered by King III and the sections where you can find these in the SAICA Legislation Handbook, 2013/2014, Volume 3. The King committee issued a Code of Governance and a Report. The Code of Governance Principles, which lists the principles, are included on pages 18 to 49 of the King Code of Governance for South Africa 2009. The Report, which provides recommendations of best practice for each of these principles, is included on pages 19 to 111 of the King Report on Governance for South Africa 2009. Please familiarise yourself with these sections before test 1 and the year-end examination.

The following are significant matters covered by King III:

1. Ethical leadership and corporate citizenship (*section 1*)

2. Board and directors (*section 2*)
3. Audit committees (*section 3*)
4. The governance of risk (*Section 4*)
5. The governance of information technology (*section 5*)
6. Compliance with laws, rules, codes and standards (*section 6*)
7. Internal audit (*section 7*)
8. Governing stakeholder relationships (*section 8*)
9. Integrated reporting and disclosure (*section 9*)

In the next few pages we will highlight some of the significant matters covered by King III and give you guidance on how to approach a question on King III. It is your own responsibility to work through the whole document and familiarize yourself with the rest of the King III Code.

May/June 2013

QUESTION 1

50 MARKS

1.1 The requirements of sound corporate governance pertaining to the board of directors and board committees

25 marks

Reference: The King III Report (2009:29-75)

1. Board of directors: composition and appointments

1. M Lebete, the chairman of the board, is not an independent non-executive director (Principle 2.16). (1½)
2. S Gouws, the chief executive officer (CEO), is not the chairman of the board, which is in **accordance** with the Principle 2.16. (1½)
3. The board should comprise a balance of power with a majority of non-executive directors who should be independent. The board has only one independent non-executive director and does **not** comply with principle 2.18. (1½)
4. At least a chief executive director and finance director should be appointed to the board (Principle 2.18, point 73). Minetech does not currently have a financial director acting on the board (for the past six months). (1½)
5. Appointments to the board should be a matter for the board as a whole, assisted by the nominations committee (principle 2.19, point 80), and **not** the CEO, S Gouws, alone (financial director appointment). (1½)

Limited to 4 valid answers

2. Board of directors: meetings

1. Non-executive directors should ensure that they have the time required to attend properly to their duties (principle 2.19, point 83). L Pretorius, the independent non-executive director, does **not** meet this requirement. (1½)
2. Minetech's board meets only twice a year, and **not** 4 times a year as required by principle 2.1 point 1. (1½)

Limited to 2 valid answers

3. Audit committee: composition and appointments

1. All members should be independent non-executive directors (Principle 3.2 point

- 9). Minetech does **not** comply as only L Pretorius is an independent non-executive director. (1½)
2. The audit committee is not independent if two thirds of membership, which includes the chairman (influential), are **not** independent non-executive directors (Principle 3.2). (1½)
 3. Minetech **complies** with principle 3.2 point 10 with its minimum of three members. (1½)
 4. Audit committee members should be suitably skilled and experienced (Principle 3.2 and point 12). Minetech does **comply** with this requirement as L Pretorius is a CA(SA) and A Peters an IT specialist who knows computerised accounting systems well. (1½)

Limited to 3 valid answers

4. Audit committee: meetings

1. Minetech **complies** with principle 3.1 point 7's requirements to meet at least twice a year. (1½)
2. Minetech **complies** with principle 3.1 point 8's requirements to meet with internal audit at least once a year. (1½)
3. Minetech does **not** comply with principle 3.1 point 8's requirements to meet with internal and external audit at least once a year. (1½)
4. Minetech does **not** comply with principle 3.1 point 8's requirements to meet with internal and external audit without management being present (with reference to M Lebete and A Peters who are also part of management). (1½)

Limited to 3 valid answers

5. Risk committee: composition and appointments

1. The chairman, M Lebete, should not chair the risk committee but may be a member of it (Principle 2.16, point 45.4). Minetech does **not** comply with this requirement as M Lebete is also the chairman of the risk committee. (1½)
2. The risk committee has only two members and does **not** comply with the requirements of principle 4.3 point 21 of three members. (1½)
3. The risk committee has executive and non-executive directors as members, which **complies** with principle 4.3 point 20. (1½)
4. Principle 4.3 point 20 requires members of the risk committee to have, as a

whole, adequate risks management skills and experience. H Ally, the risk director, should have the necessary skills and experience and **complies** with the principle. (1½)

Limited to 2 valid answers

6. General remarks

1. The board has a company secretary in **accordance** with principle 2.21 point 95. (1½)
2. The board should appoint audit-, risk-, remuneration- and nomination committees (Principle 2.23, point 129-130). Minetech does not have remuneration and nomination committees. (1½)
3. Risk is an ever present factor in any large company, and risks change. It is unrealistic for Minetech Ltd to think otherwise and the theft committed by the financial director is an example of a current financial threat faced by the company. Mineco did **not** comply with principles of good governance of risk (principle 4.1) (1½)
4. Overall, the board of directors and board committees do **not** meet the King III Report's requirements for good corporate governance. (1½)

Limited to 2 valid answers

7. Presentation

Presentation of answer under sub-headings provided in paper. (2)

(1½ for each valid point compliance or non-compliance to the max. of 25 marks, available 36 marks)

Comments to markers:

- **Students are required to comment on both compliance and non-compliance.**
- **Students only have to identify compliance / non-compliance with brief explanations; and not also the King III principle or requirement. The memorandum includes these for reference purposes.**

- should be locked and secured to the desk. (1½)
- placed where they are visible and not near a window. (1½)
- offices should be locked at night and at weekends. (1½)
- Data cables should be protected to prevent tapping as a means of access to the system. (1½)

(1½ for each valid point to the max. of 15 marks, available 31.5 marks)

1.3 Password control to prevent unauthorised access to the company's bank account 10 marks

Reference: - Jackson and Stent (2012: 8/20)

1. Passwords should be unique to each individual. (1½)
2. Passwords should consist of at least six characters, be random not obvious, and a mix of letters, numbers, upper/lower case and symbols. (1½)
3. Passwords/user-ID's for terminated or transferred personnel should be removed/disabled at the time of termination or transfer. (1½)
4. Passwords should be changed regularly and users should be forced by the system, to change their password. (1½)
5. The first time a new employee accesses the system, he/she should be prompted to change his initial password. (1½)
6. Passwords should not be displayed on PCs at any time, be printed on any reports or logged in transaction logs. (1½)
7. Password files should be subject to strict access controls to protect them from unauthorised read and write access. (1½)
8. Personnel should be prohibited from disclosing their passwords to others and subjected to disciplinary measures should they do so. (1½)
9. Passwords should be changed if confidentiality has been violated, or violation is expected. (1½)
10. Passwords should not be obvious, e.g. birthdays, names and name backwards. (1½)
11. Two passwords from two separate personnel should be required to gain access to the bank account. (1½)
12. The passwords should only be valid and accepted by the system during business hours of the company. (1½)
13. Failed password login attempts should be logged and investigated. (1½)

(1½ for each valid point to the max. of 10 marks, available 18 marks)

2.1 Internal controls over the ordering of goods in a manual system 15 marks

Reference: - Jackson & Stent (2010: 11/9)

Risk 1

1. Order clerks should not place an order without receiving an authorised requisition. (1½)
2. The order should be cross referenced to the requisition. (1½)
3. Prior to the requisition being made out, stores/production personnel should confirm that the goods are really needed. (1½)

Risk 2

1. Before the order is placed, a supervisor/senior buyer should:
 - check the order to the requisition for accuracy and authority; (1½)
 - review the order for suitability of supplier, reasonableness of price and quantity, and nature of goods being ordered. (1½)
2. Segregation of duties should exist between the ordering and authorisation duties. (1½)

Risk 3

1. The company should preferably have an approved supplier list to which the buyer should refer when ordering. (1½)

Risk 4

1. Before a supplier is approved, senior personnel should carefully evaluate the pricing of products of the company. (1½)
2. The suppliers masterfile could include a price list of goods normally/contracted to be purchased from the supplier. (1½)
3. If goods need to be purchased from a supplier other than the usual approved suppliers, or goods not included in the above price list, a quotation should be obtained for goods to be ordered. (1½)

Risk 5

1. Before a supplier is approved, senior personnel should carefully evaluate the reputation of the supplier with regards to reliability. (1½)
-

2. Even when ordering from an approved supplier, the buyer should contact the supplier to confirm availability and delivery dates. (1½)
3. The ordering department should file requisitions sequentially by department and should frequently review the files for requisitions which have not been cross referenced to an order. (purchase requisitions cross referenced to purchase orders) (1½).
4. A copy of the order should be filed sequentially. (1½)
5. The file should be sequenced checked and frequently cross referenced to goods received notes, to confirm that goods ordered have been received. (copies of orders cross referenced to goods received notes)(1½)
6. Alternatively the pending file of purchase order forms in the receiving bay can be reviewed for orders which are long outstanding. (1½)

Risk 6

1. Blank order forms should be subject to sound stationery controls. (1½)

(1½ for each valid internal control to the max. of 15 marks, available 18 marks)

2.2. Application controls over the suppliers (creditors) masterfile in a computerised environment 15 marks

Reference: - Jackson & Stent (2012: 11/17 – 11/18)

1. All amendments to be recorded on hardcopy masterfile amendment forms (MAFs). (1½)
2. MAFs to be pre-printed, sequenced and designed in terms of sound document design principles. (1½)
3. The MAFs should be signed by two senior personnel after they have agreed the details of the amendment to the supporting documentation. (1½)
4. Restrict write access to the creditors masterfile to a specific member of the section by the use of user ID and passwords. (1½)
5. All masterfile amendments should be automatically logged by the computer on sequenced logs and there should be no write access to the logs. (1½)
6. To enhance the accuracy and completeness of the keying in of masterfile amendments and to detect invalid conditions, screen aids and programme checks can be implemented:

screen aids and related features:

- Minimum keying in of information. (1½)
- Screen formatting, screen looks like MAF, screen dialogue. (1½)
- The account number for a new supplier should be generated by the system. (1½)

programme checks:

- Verification/matching checks to validate a creditors account number against the creditors masterfile. (1½)
 - Alpha numeric checks. (1½)
 - Data approval check(1½) (for example they must enter either 30 days or 60 days in the payment terms field, not say, 120 days)
 - Mandatory/missing data checks (1½) (for example credit limit and terms must be entered)
 - Sequence check on MAFs entered. (1½)
7. The logs should be reviewed regularly by a senior staff member and the sequence of the logs themselves should be checked for any missing logs. (1½)
 8. Each logged amendment should be checked to confirm that it is supported by a properly authorised MAF and that the details are correct (1½).
 9. The MAFs themselves should be sequence checked against the log to confirm that all MAFs were entered(1½).

(1½ for each valid control to the max. of 15 marks, available 24 marks)

2.3 Procedures to follow when conducting an physical year-end inventory count **20 marks**

Reference: - Jackson & Stent (2012: 12/12-12/13)

1. The count staff should be divided into teams of two, with one member of the team being completely independent of all aspects of inventory. (1½)
2. All teams should be given a floor plan of the warehouse which should clearly demarcate the inventory locations for which they are to be held accountable. (1½)
3. All inventory should be counted twice. One of the following methods can be adopted:
 - One member of a team counts and the other records, swapping roles thereafter and performing a second count in the same section to which

are accounted for. (1½)

13. Count teams will only be formally dismissed once the count is complete and all queries have been attended to. (1½)

(1½ for each valid count procedure to the max. of 20 marks, available 27 marks)

OCTOBER / NOVEMBER 2014

Board of Directors should be chaired by independent persons.

- Mr. Wonka is not an independent person he is both CEO and Chairperson.
- He is 2year old thus does not qualify to seat in the Board.
- Mr. Ompa qualifies to be an independent Director because he is independent director because he is Independent in state of mind note interest noted.

Company Secretary

- The Board should appoint and remove company secretary not only HR responsibility.
- The Board should empower individual to fulfill duties.

Audit Committee

- Should meet at least meet as but at least twice a year.
- Chairman of the committee should be independent.
- Should meet at least once with external auditors.
- Should have independent members.

Enumeration Committee

- Should have an Independent Executive Director to chair it.
- Companies should adopt enumeration policies dignified with strategies / assist in setting policies.
- Should address Bonus payout, severe benefits and share based and other long term schemes.

2.1. Designing of stock count street.

- Obtain resources such as labour or anything useful.
- Date and time when the counting to be done.
- Method of counting to be used.
- Supervision will and as a controller.
- Drafting of warehouse floorplan to identify count areas for count terms.
- Identifying location to be covered.
- Identifying or consider the use of exports.

Design of Stationery

- Inventory Sheet, printed numerically, sequentially designs of the document.
- Inventory adjustment forms.
- Inventory tags to design.

Written Instructions (Stent) 12/12 (page)

- The identification of count terms and responsibilities of each member of the team.
- Identification of slow moving or damaged inventory as well as consignment.
- Controls over issues to return of inventory sheet to the count controller.
- Procedure to be adopted if problems arise during count controller.
- Detailed instruction concerning dates.

Internals control (Recommendation)

- Surveillance camera to be in place.
- Security guards to be at the entrance and exit gates always (24 hours).
- There should lockable facilities.
- Insure the manufacturing equipment with insurance companies.

- Access control at entry zone of the manufacturing plant.
 - ✓ Password
 - ✓ User ID

- Access to manufacturing plant to be granted to employee only.
- Put alarm system and scanner on exit gates.

- Asset register to be updated and reconcile from time to time.

3.1. Receiving Goods Risks

- Incorrect quantity received by the receiving clerk.
- Goods received which are of different colour with the once ordred.
- Receiving Clerk may steal some of the goods received.

- Receiving damaged goods and fail to notice them thus leading losses.

Controls on Receiving Goods

- Cross reference the quantity received with the order invoice.
- Inspect whether or not are damaged good if any follow and don't sign up for them.
- Surveillance be put in a place in receiving areas.
- Signing and acknowledgement of receipt of goods.
- Attach customer order and internal sales order.
- Confirm all details delivered including address etc.

3.3. Internal control limitation

Explanation

| | |
|---|--|
| (b) The tendency for internal control to be directed at routine transaction than non – routine. | Non Routine transaction likely to make mistakes because non – familiarity. |
| (c) Potential human error due to careless | Errors often occur due to distractions or judgment. |
| (d) Abuse of responsibility by employee | Management or employee to vested to commit crime or fraud. |
| (e) Circumvention of internal control | Employee and management may agree to over note the system. |
| (f) Abuse of the system due to changes in constitution. | Unable to control the system in place. |

MAY/JUNE 2014 EXAM PACK

1. The Board should elect a chairman of the board who is independent non – executive director.

- The CEO of the company should not also fulfil the role of chairman of the board.
- The member of the board should elect a chairman on Annual basis who is not part of the business.
- Appointment of chairman, who is not independent, should be justified in the integrated report.

(b) Board of Director meeting should meet at least four times per year.

(c) Risk committee composition – The Board should appoint a committee responsible for risk.

- Risk committee has its executive and executive members of senior management and independent risk management expert. (Minimum 3 members).

(d) The board should have a majority of non-executive directors and few executive directors.

The board should have independent chairman to cheer the meeting.

Audit Committee

(a) The board should ensure that the company has an effective and independent committee.

(b) The audit committee should have at least 3 members.

(c) The audit committee should meet as often as necessary to fulfil its function but at least twice a year and at least once in a year to meet external auditors.

(d) Function of audit committee

- ✓ Should have regard to all factors and risk that may impact on integrity of the integrated report.

- ✓ Audit committee should review and comment on financial statements included in the integrated report.
- ✓ Audit committee should review the disclosure of sustainability issues in the integrated report.
- ✓ Should engage external auditors to provide assurance on financial information.

Risk

2.1. Inclusion of payment fictions employees.

- Use of incorrect or authorized pay rate, hours or deduction tables.
- Cast and calculation error pertaining wages calculation.
- Error of theft when collecting wages.

2.2. Internal Controls

- Unclaimed wage envelope should be returned to the cashier or paymaster who should record unclaimed wages.
- The cashier should sign payroll record to acknowledge receipt of the unclaimed wages.
- The pay pedants may not be realized to other parties for example a family member.
- When wages unclaimed – Employee should bring identification details e.g. ID cards.
- Employees should sign wages to acknowledge receipts.
- Unclaimed wages should be cutinized periodically by senior management.

The pay packet should not be released to other parties for example family member.

2.3. Masterfile control (Master Amended File)

- All amendments should be recorded on a hard copy.\
- MAF should be preprinted, sequenced and designed in terms of should document principles.
- MAF should be
 - ✓ Signed by the senior employee after they agreed on details of amendment.
 - ✓ Cross referenced to the supporting documentation.

- MAF location should be locked.
- Restrict write access to the employee Masterfile to a specific member of the personnel.
- MAF should be granted to the financial manager.
- MAFile should be occurred by less privilege.

Control over passwords

3.1. Passwords should be unique to each individual groups. Password should not be used.

- Password should consist of at least six characters, obvious password.
- Password/ user ID for terminated or transferred personnel should be removed.
- Password should be changed regularly by users.
- Its first time new employee access the system he/she should be prompted to change his/ her initial password.
- Password not to be displayed on the PC at any time.
- Password files should be subject to strict access controls to protect them from unauthorized access.
- Personnel should be prohibited from disclosing passwords to others.
- Password should be changed confidentially and no to be obvious. E.g. birthdays.

3.2. Automatic account lock out in the event of an access violation.

- Time out facilities which automatically log out users from the system if a for period of 3 minutes without activity.
- Encryption of confidential information.
- Sensitive functions and facilitates can be afforded extra protection.
- Once off passwords can be given to supplement existing user ID and password.

3.3. Internal Control to manage debtors

- The should credit application must be submitted for background check.
- All details should be followed with bureax such as Credit secure.
- The company should have guidelines for
 - ✓ The credit terms

- The cash receipts journal should be written up on daily basis by date and receipt number.
- Supervisor should review the cash receipts journal for missing dates.
- Cash book should be reconciled to the Bank Statement.

- Queries from debtors should be investigated by an employee independent of debtor and Banking.

- Reconciliation of debtors ledger to debtor Control account.

3.4. Refer to Jackson and Stent page 11/5 - 11/6

4.1. Option minutes from management regarding approval of purchase of vehicles.

- Obtain manager representation letter regarding the purchase of vehicle.
- Inspect the Bank Statement and agree with the purchase Invoice for vehicle.
- Regulate the purchase price
- Quantity x Price per vehicle
- Inspect the title deeds to confirm the ownership of the vehicles.
- Agree the opening balance of the asset to the prior year balance.
- Inspect the asset to confirm if they were addition during the year.

4.2. Obtain the Bank Statement to confirm the loan money was deposited.

- Inspect the minute to confirm whether management approved.
- Obtain bank agreements with the LOC limited to confirm existence of loan.
- Inspect the statement of Comprehensive confirm interest was charged.

May 2014 References

May/June 2014 Exam Memo references

QUESTION 1

1.1: Requirements of sound corporate governance

a) Board of Directors: composition and appointments

Refer to King III Report Principle 2.16, 2.18, 2.19 point 80 and principle 2.21 point 95

(maximum 6 marks/4 comments)

b) Board of Directors: Meetings

Refer to King III Report Principle 2.1 point 1

(maximum 1.5 marks/1 comment)

c) Risk Committee: composition and appointments

Refer to King III Report Principle 4.3 point 21, principle 2.23 and principle 4.3 point 20

(maximum 3 marks/2 comments)

d) General remarks

Refer to King III Report Principle 1.1, principle 2.21 point 97, principle 2.21 point 98, principle 2.23 point 129-130, principle 4.1 point 129-130, principle 4.1

(maximum 6 marks/4 comments)

Remember to add the following remark to conclude on overall compliance/non compliance.

“Overall, the board of directors and board committees do not meet the King III Report’s requirements for good corporate governance and any recommendations that are not applied should be explained by them.”

1 Presentation mark was awarded if your question was structured under the headings provided in the question.

Remember to answer all corporate governance questions by stating the theory, application and conclusion to ensure you receive maximum allocated marks for each statement.

1.2: Audit Committee requirements per King III Report

Refer to Study guide, Study Unit 1.3.3: Audit Committees table on page 15 (English) and page 16 (Afrikaans)

Comment: Students did fairly well in this question. They only struggled with the functions. Please make sure you know the difference in the functions of the audit committee and the internal auditors.

Question 2

2.1: Four risks which a company might face relating to its workforce

Refer to Jackson & Stent page 13/2 -13/6

Also refer to Tutorial letter 102/2014 Topic 7 Question 9.8 (1) and Tutorial letter 103/2014 for the solution.

Common mistakes: Students who did their Tutorial letter 102 questions did well with this question. However, a lot of students did not read the question carefully. The question asked for risks with regards to the workforce. The risks with the wage preparations and payout were not relevant. Again, read your question carefully.

2.2: Internal controls over unclaimed wages

Refer to Jackson & Stent page 13/5 and 13/12

Comment: Students did fairly well in this question. Some students did however not limit their answer to only the controls of **unclaimed** wages, and wasted time.

Remember: When you prepare an internal control answer, include **who, what, on what and why** as far as possible. If you only write “the document must be signed” you’ll receive zero marks, as I could sign my pink post it, which will not prove anything. Rather say: “The section head (**who**) must sign (**what**) the payroll (**on what**) to acknowledge receipt of the paypackets. (**why**)”

2.3: Controls which should be carried out when employee details are updated in the employees’ master file

Refer to Jackson & Stent page 13/16-13/18

Comment: Masterfiles are pretty much the same for all the cycles, the only differences are the people (**who**) and the documents (**on what**).

Question 3

3.1: Controls over passwords

Refer to Jackson & Stent page 8/20

Comment: Students did fairly well in this question, as it is a straight forward theory question.

3.2: Four supplementary access controls to protect the accounting system

Refer to Jackson & Stent page 8/22

Also refer to Tutorial letter 102/2014 Topic 2 Question 4.29 (d) and Tutorial letter 103 for the solution.

Common mistakes: The question asked for access controls to protect the **accounting system**. In the question, it was stated that the accounting system was uploaded on the LAN. Therefore, even though the question did not specifically state “application” access controls, it is clear that application controls was asked for. You should remember to read your question with the scenario in mind. We did allocate marks to students who gave physical (general) access controls, but only when they clearly linked it to the accounting system, or the LAN.

3.3: Internal controls that management can implement in the ‘recording of receipts’

Refer to Jackson & Stent page 10/17

Common mistakes: Students either did very well in this question, or failed it. The question asked for the internal controls when “RECORDING” receipts, not the internal controls when they received the cash payments. Again, I stress this, [read the question!](#) We as lecturers were also very surprised that students did not do well in this question, as it was one of the assignment 2 questions; the solution was available in tutorial letter 202. When we say, do questions, we also mean you should mark yourself with the solution / text book, to ensure you’re on the right track.

3.4: Match the documents to the different functions in the acquisitions and payments cycle.

Refer to Jackson & Stent page 11/5 -11/6 and 11/9-11/13

Exam Paper

QUESTION 2

15 Marks

Internal controls that can be implemented over the safeguarding of equipment acquired in the current year

Reference: Jackson & Stent (2012: 14/3; 14/21 – 14/26)

1. All new equipment needs to be recorded in the fixed assets register. Details such as the description, registration number, make and model need to be recorded. (1½)
2. The initial cost amount and all subsequent accumulated depreciation needs to be recorded in the fixed assets register and regularly reconciled to the amount recorded in the general ledger. (1½)
3. The doors of the warehouse where all the equipment is housed should be locked and a key or swipe card (or biometrics) should be required to open the doors. (1½)
4. There should be minimum entry and exit points at the warehouse where the equipment is housed. (1½)
5. Only authorised employees should be allowed access to the warehouse where equipment is kept. (1½)
6. Security checks should be performed on any visitors' identity and the purpose of the visit, by a security guard at the gate of the warehouse. (1½)
7. The user's arrival and departure should be logged in a visitors register and an identification card provided. (1½)
8. The visitors should be escorted to the warehouse where the equipment is kept by a security guard. (1½)
9. Surveillance cameras or video recording should be installed at the warehouse and should record all movement. (1½)
10. Insurance should be taken out on all new assets acquired to reduce loss. (1½)

(1½ for each internal control to the max. of 15 marks)

Comment

Internal controls over the safe guarding of equipment are physical control activities. Control activities are one of five components of internal control and are implemented as a response to risks. In this question, the risk that equipment may be stolen was addressed. It is therefore important that you are able to identify risks in a business cycle in order for you to understand and apply internal control in the cycle.

QUESTION 3

10 Marks

Internal controls that should be implemented over unclaimed wages

References: Jackson & Stent (2010: 13/5; 13/12)

1. Unclaimed wage envelopes should be returned to the cashier or paymaster, who should record these in an unclaimed wages register and safeguard these. (1½)
2. The cashier or paymaster should sign the payroll record to acknowledge receipt of the unclaimed wages identified. (1½)
3. The pay-packets may not be released to other parties, for example a family member, unless the employee has given written permission. (1½)

4. **Audit committee: meetings**

1. Minetech **complies** with principle 3.1 point 7's requirements to **meet at least twice a year**. (1½)
2. Minetech **complies** with principle 3.1 point 8's requirements to meet with **internal audit** at least once a year. (1½)
3. Minetech does **not** comply with principle 3.1 point 8's requirements to meet with **internal and external audit** at least once a year. (1½)
4. Minetech does **not** comply with principle 3.1 point 8's requirements to meet with internal and external audit **without management** being present (with reference to M Lebete and A Peters who are also part of management). (1½)

Limited to 3 valid answers

5. **Risk committee: composition and appointments**

1. The chairman, M Lebete, should not chair the risk committee but may be a member of it (Principle 2.16, point 45.4). Minetech does **not** comply with this requirement as M Lebete is **also the chairman of the risk committee**. (1½)
2. The risk committee **has only two members** and does **not** comply with the requirements of principle 4.3 point 21 of three members. (1½)
3. The risk committee has **executive and non-executive directors** as members, which **complies** with principle 4.3 point 20. (1½)
4. Principle 4.3 point 20 requires members of the risk committee to have, as a whole, **adequate risks management skills and experience**. H Ally, the risk director, should have the necessary skills and experience and **complies** with the principle. (1½)

Limited to 2 valid answers

6. **General remarks**

1. The board has a **company secretary** in **accordance** with principle 2.21 point 95. (1½)
2. The board should appoint audit-, risk-, remuneration- and nomination committees (Principle 2.23, point 129-130). Minetech do not comply as they **do not have remuneration and nomination committees**. (1½)
3. Risk is an ever present factor in any large company, and **risks change**. It is unrealistic for Minetech Ltd to think otherwise and the theft committed by the financial director is an example of a current financial threat faced by the company. Minetech did **not** comply with principles of good governance of risk (principle 4.1) (1½)
4. Overall, the board of directors and board committees do **not** meet the King III Report's requirements for good corporate governance. (1½)

Limited to 2 valid answers

7. **Presentation**

Presentation of answer under sub-headings provided in paper. (2)

(1½ for each valid point compliance or non-compliance to the max. of 25 marks, available 36 marks)

Comments

- You were required to comment on **both compliance and non-compliance**.
- You only need to **identify compliance / non-compliance with brief explanations**; and not also the specific King III principle. The memorandum includes these for reference purposes.

- 1.2 **General physical access controls to prevent access to the computer onto which the company's bank account software is loaded**

15 Marks

Reference: Jackson and Stent (2012: 8/17-8/18)

13. The inventory controller should **check that this procedure has been carried out**(1½) and should **sequence test the inventory sheets** to ensure that all sheets are accounted for. (1½)
14. Count teams will only be **formally dismissed** once the count is complete and all queries have been attended to. (1½)
(1½ for each valid count procedure to the max. of 20 marks, available 27 marks)

Comments

Performing the actual physical count was asked. Also remember to study the processes that occur before the count, regarding the planning and preparation, the design of stationery, and the written instructions (Jackson & Stent (2012:12/12)).

Oct/Nov 2013 Exam Memo references

Question 1

1.1: Requirements of sound corporate governance

Refer to King III Report Principle 2.16, principle 2.18 point 73, principle 2.19 point 80, principle 2.18, principle 2.21 point 98, principle 2.1 point 1, principle 2.23 point 129-130, principle 2.21 point 95

Remember to add the following remark to conclude on overall compliance/non compliance.

“Overall, the board of directors and board committees do not meet the King III Report’s requirements for good corporate governance and any recommendations that are not applied should be explained by them.”

Remember to answer all corporate governance questions by stating the theory, application and conclusion to ensure you receive maximum allocated marks for each statement.

1.2: Functions of internal audit

Refer to King III Report pages 95/98

1.5 marks were awarded if your question was structured under the headings provided in the question. This is easy marks – if you receive 48.5% for your exam and did not present the answer in the format asked for, you’ll kick yourself.

Common mistakes: Students got confused with the functions of the internal auditors and the audit committee.

Remember: The audit committee is the “link between” the external auditors, internal auditors and the board of directors, whereas your internal audit committee would test whether the internal controls that was implemented were effective and if the employees comply with it. Therefore, the functions of the audit committee and the internal auditors are vastly different.

1.3: Internal controls over wage packet preparation and payout of wages

Refer to Jackson & Stent page 13/12

Comment: Students did fairly well in this question, as it is a straight forward theory question.

Remember: When you prepare an internal control answer, include **who, what, on what and why** as far as possible. If you only write “the document must be signed” you’ll receive zero marks, as I could sign my pink post it, which will not prove anything. Rather say: “The section head (**who**) must sign (**what**) the payroll (**on what**) to acknowledge receipt of the paypackets. (**why**)”

1.4: Alternative means of payment of wages

Refer to Jackson & Stent page 13/24 and Study Guide, Study Unit 7.1.1 Activity 1 Question 2

1.5: An example and advantage of biometric data in time keeping

Refer to Jackson & Stent page 13/19

Question 2

2.1: Weaknesses in system of internal controls over credit sales transactions

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|------------|-------------------------------------|
| Function 1 | Refer to Jackson & Stent page 10/10 |
| Function 2 | Refer to Jackson & Stent page 10/11 |
| Function 3 | Refer to Jackson & Stent page 10/12 |
| Function 4 | Refer to Jackson & Stent page 10/13 |
| Function 5 | Refer to Jackson & Stent page 10/14 |
| Function 6 | Refer to Jackson & Stent page 10/15 |

Common mistakes: Students overall did not do well in this question. Most students provided us with risks or internal controls, and consequently received no marks.

Remember: Please refer to the document “Weakness, risks and internal controls” for the difference between these activities.

2 marks awarded for correct formulation and presentation. This is easy marks – if you receive 48% for your exam and did not present the answer in the format asked for, you’ll kick yourself.

2.2: Controls over the debtor’s master file to ensure only authorized amendments are entered

Refer to Jackson & Stent page 10/23- 10/25

Important: regarding the screen aids and programme controls, give an example/explanation to show you know what it means for example: Screen formatting: the screen should be laid out like to hard copy master file amendment form (MAF)

Comment: Masterfiles are pretty much the same for all the cycles, the only differences are the people (who) and the documents (on what).