

Department of **Auditing**



Corporate governance in accountancy

Only study guide for AUE2602

Semesters 1 & 2

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TOPIC 1

CORPORATE GOVERNANCE AND STATUTORY MATTERS

Topic overview

The aim of this topic is to explain and apply corporate governance in practical situations by referring to statutory matters regarding company directors as contained in the Companies Act, No 71 of 2008, as well as the provisions of the King IV Report and Code on Governance for South Africa.

This topic is divided into the following learning units:

Learning unit	Title
1.1	The background of corporate governance in South Africa
1.2	Statutory matters
1.2.1	Standards of directors' conduct – section 76
1.2.2	Liability of directors and prescribed officers – section 77
1.2.3	Indemnification and directors' insurance – section 78
1.2.4	Audit committees – section 94
1.3	The King IV Report on Governance for South Africa
1.3.1	Leadership, ethics and corporate citizenship
1.3.2	Strategy, performance and reporting
1.3.3	Governing structures and delegation
1.3.4	Risk governance
1.3.5	Technology and information governance
1.3.6	Compliance governance
1.3.7	Remuneration governance
1.3.8	Assurance
1.3.9	Stakeholder relationships
1.4	Corporate governance – international developments
1.4.1	Sarbanes-Oxley Act

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
1.1 The background of corporate governance in South Africa	<ul style="list-style-type: none">Briefly describe the background to corporate governance in South Africa.	1
1.2 Statutory matters	<ul style="list-style-type: none">Explain the requirements of sections 76 to 78 and 94 of the Companies Act, No 71 of 2008, regarding the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance and audit committees.	2
1.3 The King IV Report on Governance for South Africa	<ul style="list-style-type: none">Explain and apply the significant matters covered by the King IV Report.	2
1.4 Corporate governance – international developments	<ul style="list-style-type: none">Briefly describe the background of the Sarbanes-Oxley Act.	1

LEARNING UNIT 1.1

THE BACKGROUND OF CORPORATE GOVERNANCE IN SOUTH AFRICA

INTRODUCTION

Statements like the following have been made regarding corporate governance:

“The King Commission describes Corporate Governance simply as “the system by which companies are directed and controlled.” (King 1994)

“Governance is the process whereby people in power make decisions that create, destroy or maintain social systems.” (Ramos [sa])

“Corporate governance is not a matter of right or wrong – it is more nuanced than that.” (Myburgh [sa])

“Despite questions being raised about the standard of corporate governance in South Africa, 85% of respondents believed that it significantly influenced investor confidence towards a company and 68% believed it was an important contributor to an organisation's performance.” (Padayachy [sa])

In this learning unit you will learn about corporate governance in South Africa, with specific reference to the King IV Report on Governance.

King I, II and III had their foundation in ethical and effective leadership. King IV is also based on these foundations, but was drafted to make it more easily applicable to all organisations to include public and private, large and small, for-profit and for non-profit organisations (King IV: 2016:6).

STUDY

- The King IV Report (2016:3–7, 20–38) **(included in the Auditing: Legislation and Standards handbook)**.
- Jackson & Stent (2016:4/3–4/18)

ACTIVITY 1

Define good corporate governance and briefly explain in your own words why it is important to society that companies operate within a framework of good corporate governance.

FEEDBACK ON ACTIVITY 1

References: King IV Report (2016:20)
Jackson & Stent (2016:4/3) Introduction

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. Ethical and effective leadership should complement and reinforce each other.

How did you find this activity? If your answer (which you provided from your own understanding) did indeed capture the facts mentioned above, then you are ready to proceed to the next section of this unit. If, however, you notice that your answer did not fully capture the information provided in the guidelines above, then you need to go back to the discussion of the term “corporate governance”.

ACTIVITY 2

The basis of any “code” on corporate governance can be legislated (a set of rules), or voluntary (principles and practices) or a combination of both. The King IV Report identifies these two bases as “comply or else” or “comply or explain” and describes a further variation of the latter, i.e. “apply and explain” (Jackson & Stent, 2016:4/5).

Explain in your own words what the term “apply or explain” means. Do you think that this allows directors to avoid adhering to principles of good corporate governance?

FEEDBACK ON ACTIVITY 2

References: King IV Report (2016:7)
Jackson & Stent (2016:4/5)

“Apply and explain” means that principles are applied and practices are explained. As the King IV principles are fundamental to good governance, it is assumed that they will be applied. A narrative account that shows how the recommended practices have been implemented in order to achieve each of the principles, should be provided.

Directors can't avoid adhering to principles of good corporate governance, because there is a link between good governance and compliance with the law. The directors themselves have legal duties stipulated in the Companies Act, No 71 of 2008.

Note: The duties of directors as laid out by the Companies Act, No 71 of 2008 will be explained in more detail in learning unit 1.2.

How did you fare in this activity? It is very important for you to keep checking and comparing your answers with the guidelines provided. The format of learning in this module has been structured in an incremental manner, meaning you need to master certain basic concepts in order to be able to understand the logic of the content in subsequent topics and learning units.

Now that you are familiar with the manner in which you are encouraged to study, remember to always compare your answers with those provided after you attempted them on your own first.

SUMMARY

In this learning unit you learned what good corporate governance in South Africa means, with specific reference to the King IV Report and Code on Governance.

LEARNING UNIT 1.2

STATUTORY MATTERS

INTRODUCTION

“There is always a link between good governance and compliance with law. Good governance is not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law.”
(King [sa])

In the previous learning unit you learned what good corporate governance in South Africa means, with specific reference to the King IV Report and Code on Governance.

Some of you may already have studied sections of the Companies Act, No 71 of 2008. As **directors** play a very important role in corporate governance, we want to ensure that you have sufficient background knowledge of the sections of the Companies Act specifically dealing with directors.

In this learning unit, we will take the discussion further and introduce you to sections 76, 77, 78 and 94 of the Companies Act, which deal with the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance and audit committees.

Once you have acquired this knowledge you will study the King IV Report in learning unit 1.3.

1.2.1 STANDARDS OF DIRECTORS' CONDUCT – SECTION 76

This section describes certain duties of directors. Note these as you make your study notes and keep them in mind when attempting to answer the activities to follow.

STUDY

- Companies Act, No 71 of 2008: Section 76
- Jackson & Stent (2016:3/45–3/46)

1.2.2 LIABILITY OF DIRECTORS AND PRESCRIBED OFFICERS – SECTION 77

This section deals with instances where a director and prescribed officer may be held liable for losses suffered by the company.

STUDY

- Companies Act, No 71 of 2008: Section 77
- Jackson & Stent (2016:3/46–3/47)

1.2.3 INDEMNIFICATION AND DIRECTORS' INSURANCE – SECTION 78

As stated in Section 78(2), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, is **void** if it directly or indirectly seeks to relieve a director of any of that director's duties. Section 78 does, however, allow certain "protection" of directors through indemnification and directors' insurance.

STUDY

- Companies Act, No 71 of 2008: Section 78
- Jackson & Stent (2016:3/47–3/48)

ACTIVITY 1

The King IV Report sets out that the governing body should lead ethically and effectively. It states that members of the governing body should individually and collectively cultivate the following characteristics and exhibit them in their conduct: **Integrity, competence, responsibility, accountability, fairness and transparency.**

Briefly discuss how these values and duties tie up with sections 76 to 78 of the Companies Act.

FEEDBACK ON ACTIVITY 1

The principles highlighted above strongly relate to section 76, which states that a director should exercise his or her powers in **good faith**, in the **best interests of the company** and with **reasonable care, skill and diligence.**

The King IV ethical values of **responsibility, accountability and fairness** are clearly addressed in sections 77 to 78, where liability, indemnification and directors' insurance are described.

As mentioned in activity 2 of learning unit 1.1, there is a link between good governance and compliance with the law.

Did your answer include similar facts as included in the feedback? If you still feel uncertain and cannot generate similar facts on your own, we suggest that you go back to the beginning of learning unit 1.2 and revise the content thereof.

1.2.4 AUDIT COMMITTEES – SECTION 94

Section 94 states that a public company, state owned company or other company that is required by its Memorandum of Incorporation to have an audit committee, must elect an audit committee at each annual general meeting.

STUDY

- Companies Act, No 71 of 2008: Section 94
- Jackson & Stent (2016:3/53–3/54)

ACTIVITY 2

1. Briefly list the membership requirements for the audit committee according to section 94 by referring to what a member **must** and **must not** be.
2. Briefly describe the main duties of the audit committee according to section 94.

FEEDBACK ON ACTIVITY 2

You will note that in activities up to now, we have provided you with detailed answers of how you should approach the answers to the activities. Now that you know what is expected of you, we expect you to compile your answers from the various sources provided and indicated in this feedback section.

- The membership requirements for the audit committee in terms of section 94 are listed in Jackson & Stent (2016:3/53) and are not repeated here.
- The main duties of the audit committee in terms of section 94 are described in Jackson & Stent (2016:3/53–3/54) and are not repeated here.

Note that the requirements for audit committees according to the King IV Report are explained further in section 1.3.4 hereafter.

SUMMARY

In this learning unit you have studied sections 76, 77, 78 and 94 of the Companies Act, which deal with the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance and audit committees.

LEARNING UNIT 1.3

THE KING IV REPORT ON GOVERNANCE FOR SOUTH AFRICA

INTRODUCTION

King IV consists of a **Report on Governance**, which provides recommendations for best practice for each of the principles.

Although the King IV Report has adopted a voluntary basis for the application of the principles of good governance, application of these principles is compulsory for public companies listed on the JSE (previously the JSE Securities Exchange and the Johannesburg Stock Exchange).

Paragraph 8.63 of the JSE listing requirements state that issuers of annual financial statements or annual reports should disclose, amongst others, the following information (JSE listing requirements):

- (a)(i) a narrative statement of **how it has applied the principles set out in the King Code**, providing explanation(s) that enable(s) its shareholders to evaluate how the principles have been applied; and
- (a)(ii) a statement addressing **the extent of its application of the principles of the King Code and the reasons for each and every instance of non-application during the accounting period**. The statement must also specify whether or not the company has applied throughout the accounting period with all the provisions of the King Code and indicate for what part of the period any non-application occurred.

The following are significant matters covered by the King IV Report:

- 1.3.1 Leadership, ethics and corporate citizenship
- 1.3.2 Strategy, performance and reporting
- 1.3.3 Governance structures and delegation
- 1.3.4 The governance of risk
- 1.3.5 The governance of information technology
- 1.3.6 Compliance governance
- 1.3.7 The governance of remuneration
- 1.3.8 Assurance
- 1.3.9 The governance of stakeholder relationships

1.3.1 LEADERSHIP, ETHICS AND CORPORATE CITIZENSHIP

The King IV Report (2016:20) states that effective leadership is results-driven. It is about achieving strategic objectives and positive outcomes. Effective leadership includes an internal focus on effective and efficient execution.

STUDY

- King IV Report (2016:43–46)
- Jackson & Stent (2016:4/19–4/24)

ACTIVITY 1

Principle 1 states that the governing body should lead ethically and effectively. List the six ethical values which, in terms of King IV, are embodied in ethical leadership.

FEEDBACK ON ACTIVITY 1

Reference: King IV Report (2016:43-44)

The ethical values are listed in the reference above, and is not repeated here. Read through this section to obtain a better understanding of the ethical values and what it entails.

ACTIVITY 2

Principle 3 states that the governing body should ensure that the organisation is and is seen to be a responsible corporate citizen. Explain in your own words what it means to be a “responsible corporate citizen”.

FEEDBACK ON ACTIVITY 2

Reference: Jackson & Stent (2016:4/22)

The answer to the question is provided in the reference above, and is not repeated here.

1.3.2 STRATEGY, PERFORMANCE AND REPORTING

STUDY

- King IV Report (2016:47–48)
- Jackson & Stent (2016:4/24–4/26)

ACTIVITY 3

Discuss how frequently a company should report to its stakeholders and what information should be reported to them.

FEEDBACK ON ACTIVITY 3

Reference: Jackson & Stent (2016:4/25, 4/14–4/15)

The governing body should oversee that the organisation issues an integrated report at least annually. Reporting needs to be far more than the presentation of historical financial information as a set of annual financial statements. Information pertaining to the economic, social and environmental aspects must be included. The six capitals of the company should also be reported on: financial, manufactured, intellectual, human, natural and social and relationship capital.

1.3.3 GOVERNING STRUCTURES AND DELEGATION

As the governing body is responsible for the corporate governance of businesses, this is an important section of the King IV Report. Familiarise yourself with the different principles that apply to the governing body as stated in the King IV Report.

STUDY

- King IV Report (2016:49–60)
- Jackson & Stent (2016:4/26–4/40)

Section 66(1) of the Companies Act, No 71 of 2008 requires that the business and affairs of companies must be managed by or under the direction of a **board of directors** and section 84(4)(c) provides that every public company and state-owned company must in addition appoint an **audit committee**. The King IV Report also recommends that an audit committee should be appointed for companies other than public and state-owned companies.

Section 72 of the Companies Act, No 71 of 2008 allows the board of directors to appoint any number of **committees (sub committees)**, with the King IV Report and JSE listing requirements specifying at least a **remuneration committee** and, if required, a **nomination committee, a risk committee, as well as a social and ethics committee**.

As mentioned before, section 72 allows for **any number** of board committees to be appointed, depending on the requirements of the company.

Please take note of the tables below, which contain a summary of some of the recommended composition and functions of the governing body and its main board committees. (cf. the King IV Report 2016). The composition and functions of the audit committee will be explained further in section 1.3.4.

Governing body

Chairman	<ul style="list-style-type: none"> • Independent non-executive director (<i>principle 7.31</i>). • CEO of the company should not also fulfil the role of chair of the board (<i>principle 7.34</i>). • The role of the chair should be formalised (<i>principle 7.32–7.33</i>). • Every alternate year, the governing body should evaluate the performance of the chair to support continued improvement in his/her performance and effectiveness (<i>principle 9.73–9.74</i>).
Membership	<ul style="list-style-type: none"> • The governing body should attain the appropriate balance of knowledge, skills, experience, diversity and independence (<i>principle 7</i>). • The governing body should comprise a majority of non-executive members, most of whom should be independent (<i>principle 7.8</i>). • The governing body, through its nomination committee, should recommend the eligibility of prospective members (<i>principle 7.14–7.16</i>).
Members	<ul style="list-style-type: none"> • Minimum of two executive members: one should be the CEO and the other may be the chief finance officer or other executive as is appropriate (<i>principle 7.9</i>). • Periodic, staggered rotation of members should be established (<i>principle 7.12</i>).
Functions	<ul style="list-style-type: none"> • The board should have a charter setting out its role, responsibilities, membership requirements and procedural conduct (<i>principle 6.2</i>). The functions of the board are listed under principle 6.1 of the King IV Report.

Principle 8 states that the governing body should ensure that its arrangements for delegation within its own structures promote independent judgement, and assist with balance of power and the effective discharge of its duties. This means that the governing body may delegate some of its

responsibilities to various committees as needed to ensure the best interest of the organisations is achieved.

Audit committee

As mentioned in section 1.2.2 before, the Companies Act, No 71 of 2008: section 94 requires of a public or state owned company to appoint an audit committee as well as a board of directors. The King IV Report also recommends that an audit committee should be appointed for companies other than public and state-owned companies.

STUDY

- King IV Report (2016:55–56)
- Jackson & Stent (2016: 4/32–4/34)

The table below provides a summary of the composition and functions of an audit committee:

	Audit committee
Chairman	<ul style="list-style-type: none"> • Independent non-executive director (<i>principle 8.57</i>). • The chair of the board should not be the chair or member of the audit committee (<i>principle 7.36a</i>).
Membership	<ul style="list-style-type: none"> • All members should be independent non-executive directors (<i>principle 8.56</i>).
Members	<ul style="list-style-type: none"> • Minimum of three members (<i>principle 8.46</i>).
Meetings	<ul style="list-style-type: none"> • Should meet with internal and external auditors at least once a year without management being present (<i>principle 8.58</i>).
Functions	<ul style="list-style-type: none"> • Provide independent oversight of the effectiveness of the organisation's assurance functions and services, including combined assurances, external assurance service providers, internal audit and the finance function (<i>principle 8.51</i>). • Provide independent oversight of the integrity of the annual financial statements and other external reports issued by the organisation (<i>principle 8.51</i>). • May approve the annual financial statements (but the governing body remains ultimately accountable) (<i>principle 8.52</i>). • The governing body may delegate the risk governance to the audit committee (<i>principle 8.53</i>). • Oversee the management of financial and other risks that affect the integrity of external reports (<i>principle 8.54</i>).

ACTIVITY 4

The following is a summary of the composition and certain functions of the audit committee of Mineco Ltd, a JSE listed company in the South African mining sector.

Audit Committee

Violet Mguni	–	Operations director
William Smith	–	Government official (only attends board meetings)
Bob Cilliers	–	Finance director

The audit committee meets annually. The audit committee evaluates the board's performance. During the recent meeting of the audit committee, it was decided that Mineco Ltd would acquire shares in Africa Coal, a coal mining company listed on the JSE. A detailed analysis of the coal-mining sector supported this decision.

REQUIRED

Comment on the information presented in terms of the requirements of the King IV Report.

FEEDBACK ON ACTIVITY 4

Reference: King IV Report (2016:55–56)

1. In terms of the King IV Report, the audit committee should comprise of at least three members. Mineco Ltd has three members and complies with the King IV Report.
2. All members should be independent non-executive directors. Two members of the committee are not independent non-executive directors, as they are involved in the day-to-day running of the business.
3. The audit committee should meet annually with internal and external auditors respectively without management being present. As two of the members of the audit committee is part of the executive management, they do not comply with this recommendation.
4. The board should assume responsibility for the evaluation of its own performance. It is not the audit committee's responsibility to evaluate the board.
5. As part of risk management, the audit committee cannot make decisions on the acquisition of shares in Africa Coal. This should be the responsibility of the board (with the approval of shareholders).

Source: *Unisa – TOE412S/105/2011 – adapted*

Other board committees

	Remuneration committee	Nomination committee	Risk committee	Social and Ethics committee
Chair	<ul style="list-style-type: none"> Independent non- executive director. <i>(principle 8.67)</i> 	<ul style="list-style-type: none"> Not specified in King IV. <i>(principle 8.61)</i> 	<ul style="list-style-type: none"> Not specified in King IV. <i>(principle 8.64)</i> 	<ul style="list-style-type: none"> Not specified in King IV.
Member-ship	<ul style="list-style-type: none"> All should be non-executive of which majority should be independent. <i>(principle 8.66)</i> 	<ul style="list-style-type: none"> All should be non-executive of which majority should be independent. <i>(principle 8.61)</i> 	<ul style="list-style-type: none"> Executive and non-executive of which majority should be non-executive. <i>(principle 8.64)</i> 	<ul style="list-style-type: none"> Executive and non-executive of which majority should be non-executive. <i>(principle 8.70)</i>
Members	<ul style="list-style-type: none"> Minimum of three members. <i>(principle 8.46)</i> 	<ul style="list-style-type: none"> Minimum of three members. <i>(principle 8.46)</i> 	<ul style="list-style-type: none"> Minimum of three members. <i>(principle 8.46)</i> 	<ul style="list-style-type: none"> Minimum of three members. <i>(principle 8.46)</i>
Functions	<ul style="list-style-type: none"> Should assist the governing body in setting and administering remuneration policies. <i>(principle 8.65)</i> 	<ul style="list-style-type: none"> The process for nominating, electing and appointing members of the governing body. Succession planning iro governing body members. Evaluation of the performance of the governing body. <i>(principle 8.60)</i> 	<ul style="list-style-type: none"> Should consider the risk management policy and plan and monitor the risk management process. <i>(principle 8.62 and principle 11.6)</i> 	<ul style="list-style-type: none"> Oversight of, and reporting on organisational ethics, responsible corporate citizenship, sustainable development and stakeholder relationships. <i>(principle 8.68)</i>

The governing body may delegate its responsibilities to a committee or a member of the governing body, it does not constitute a discharge of the governing body's accountability *(principle 8.49)*. What this means is that even though the committees perform duties allocated to them by the governing body, the governing body remains ultimately responsible.

King IV moved away from recommending the minimum number of meetings the different committees should have per annum, and merely recommend that the number of meetings held during the reporting period and the attendance at those meetings, should be disclosed (*principle 8.50*).

ACTIVITY 5

The governing body should elect a chair who is an independent non-executive member. Explain what an **independent non-executive member** is.

FEEDBACK ON ACTIVITY 5

Reference: King IV Report (2016:51–52)
Jackson & Stent (2016: 4/29 Note a)

A **non-executive member** is not part of the executive team. A non-executive member will not participate in the day-to-day management of the organisation. The concept “**independent non-executive member**” is explained in detail in principle 8.28 of the King IV Report and is not repeated here.

In the exam you should be able to identify whether a member or director will be seen as independent based on the information that will be given in a scenario.

ACTIVITY 6

The collective responsibilities of management vest in the chief executive officer (CEO). List the CEO's **main functions**.

FEEDBACK ON ACTIVITY 6

Reference: King IV Report (2016:58), principle 10.77

The main functions of the CEO are set out in the King IV Report and are not repeated here.

ACTIVITY 7

Why should the CEO not fulfil the role of the chair of the governing body?

FEEDBACK ON ACTIVITY 7

Reference: King IV Report (2016:53) principle 7.31 and principle 7.34

- Given the strategic and operational role of the CEO, and to prevent too much power vesting in one person, this appointment should be separate from that of the chair of the governing body.
- The chair should be an independent non-executive member. The CEO is an executive director.

ACTIVITY 8

The governing body should delegate certain functions to well-structured committees. Are the chair of the governing body and the CEO allowed to be **members** of the following committees in terms of the principles of the King IV Report?

1. Audit committee
2. Remuneration committee
3. Nomination committee
4. Risk committee
5. Social and ethics committee

FEEDBACK ON ACTIVITY 8

Reference: King IV Report (2016:53–57)

Committee	Chair	CEO
Audit committee	No (<i>principle 7.36</i>)	No (<i>principle 8.56</i>)
Remuneration committee	Yes, but may not chair (<i>principle 7.36</i>)	No (<i>principle 8.66</i>)
Nomination committee	Yes, and may also chair (<i>principle 7.36</i>)	No (<i>principle 8.61</i>)
Risk committee	Yes, and may also chair (<i>principle 7.36</i>)	Yes King IV does not specifically state
Social and ethics committee	Yes, but may not chair (<i>principle 7.36</i>)	Yes King IV does not specifically state

ACTIVITY 9

Recently whilst scanning through the annual report of Stadium Ltd, a company listed on the JSE, you came across the company's schedule of directors and committees.

These appeared as follows:

1. Board of directors (Governing Body)

Chief executive officer	–	Donald Winthrop
Managing director – Administration	–	Charles Tree
Finance director	–	Monty Mann
Operations director	–	Christo Wells
Human resources director	–	Jerry German
Marketing director	–	Koos Katswinkel
Non-executive director	–	Caz Kallim
Independent non-executive director	–	Mary Maswai

The company has not appointed a chair. The most senior director who arrives at the directors' meeting acts as chair.

2. Committees

2.1 Nomination Committee	–	Donald Winthrop (chairman)
	–	Charles Tree

This committee makes recommendations to the shareholders regarding who should be appointed as directors. If the two directors on the committee disagree, Donald Winthrop has the casting vote.

2.2 Remuneration committee	–	Donald Winthrop (chair)
	–	Monty Mann
	–	Koos Katswinkel
2.3 Audit committee	–	Monty Mann (chair)
	–	Christo Wells
	–	Mitchell Street (Internal Audit manager)
	–	External Audit
	–	Fred Carver (finance manager)

All committees meet as and when required. The board meets every six months.

3. Risk committee

The risk committee was disbanded at the beginning of the year. The directors know the business and the risks involved.

REQUIRED

Comment on the information presented above in relation to the requirements of the King IV report.

FEEDBACK ON ACTIVITY 9

Stadium Ltd's adherence to the King IV Report appears to be less than adequate.

1. Board of Directors

Reference: King IV Report (2016:50–53)

- 1.1 The board does not contain a balance of executive and non-executive directors – six executive directors, one non-executive director and one independent non-executive director. Two non-executive directors, only one of which is independent, are hardly likely to bring any independent influence to the board (*principle 7.8*).
- 1.2 The company has no chair. King IV recommends that the governing body should elect a chair who is an independent, non-executive director (*principle 7.31*).
- 1.3 The board of directors is the most important component of corporate governance and important decisions must be taken at board meetings. This requires that the meetings be knowledgeably and efficiently run. This requires careful preparation for the meeting. At present this does not take place and the meeting is simply run by the most senior director who arrives at the meeting. This also suggests that not all directors arrive for meetings.

2. Board committees

Reference: King IV Report (2016:54–57)

Nominations Committee:

- 2.1 King IV recommends that a company such as Stadium Ltd should have a nominations committee (which may be called the directors' appointment committee) if the governing body deems it necessary and appropriate. All members of this committee should be non-executive members, with the majority being independent.
- 2.2 The recommendations for appointment of directors should be made by the Board as a whole and not a select committee. A nominations committee should merely assist in the process of nominating, electing and appointing members to the board.
- 2.3 The nominations committee does not adhere to the King IV recommendation of three members.

Remuneration Committee:

- 2.4 The remuneration committee should be chaired by an independent non-executive director. All members should be non-executive, of which the majority should be independent. At present this committee has no independent non-executive directors and no non-executive directors.
- 2.5 They do however have three members, as recommended by King IV.

Audit committee:

- 2.6 In terms of King IV, the audit committee should be chaired by an independent non-executive director, which Monty Mann is not, and it should be entirely made up of independent non-executive members, which it is not.
- 2.7 Neither Fred Carver, the finance manager, nor Mitchell Street, the internal audit manager, nor the external auditors should be audit committee members. These three should work closely with the committee at various times but they should not form part of the committee.

3. Risk committee

Reference: King IV Report (2016:57)

- 3.1 Risk is an ever present factor in any large company, and the nature of risks changes. It is unrealistic for Stadium Ltd to think otherwise and it is irresponsible to disband the risk committee because the directors “know the business and the risks involved”.
- 3.2 The risk committee duties could also have been delegated to the audit committee. If the governing body delegates risk governance to the audit committee, the audit committee should satisfy itself that it dedicates sufficient time to this responsibility.

4. General

- 4.1 On balance this company appears to be dominated by the CEO, Donald Winthrop.
- 4.2 King IV also recommend the appointment of a Social and Ethics Committee.

Source: *Graded Questions on Auditing 2015* (Gowar & Jackson 2014:29) – adapted.

1.3.4 RISK GOVERNANCE

According to the King IV Report (2016:61), the essential focus of the **governance** of risk is that “the governing body should govern risk in a way that supports the organization in setting and achieving its strategic objectives. Risk is positioned as a cornerstone of corporate governance and it is emphasized that it is the board’s responsibility to ensure that it is satisfied with the management of risk.

STUDY

- King IV Report (2016:61–62)
- Jackson & Stent (2016:4/40–4/43)

Who is responsible for what? The table below sets out the responsibilities for the governance of risk.

WHAT	WHO
Governance of risk	The governing body (<i>principle 11</i>).
Implement and execute the risk management plan	The governing body should delegate to management (<i>principle 11.5</i>).
Monitor the risk management process	The governing body, risk committee, audit committee (<i>principle 11.6</i>).
Performing an objective assessment of the effectiveness of risk management	Internal audit (<i>principle 15.59</i>).

ACTIVITY 10

List the functions that the governing body should implement that will result in effective risk management.

FEEDBACK ON ACTIVITY 10

Reference: King IV Report (2016:61)

The functions are listed under principle 11.6 in the King IV Report and is not repeated here.

1.3.5 TECHNOLOGY AND INFORMATION GOVERNANCE

The governance of information technology is dealt with in detail in the King IV Report.

STUDY

- King IV Report (2016:62–63)
- Jackson & Stent (2016:4/43–4/46)

ACTIVITY 11

Part 5.4 of the King IV Report deals with the governance of functional areas. Explain what should be achieved by technology and information management, under the control of the governing body.

FEEDBACK ON ACTIVITY 11

Reference: King IV Report (2016:62)

The role that information technology plays in the company's achievement of its strategic objectives explained under principle 12.13 in the King IV Report and is not repeated here.

1.3.6 COMPLIANCE GOVERNANCE

The governing body should ensure that the company complies with applicable laws, rules, codes and standards. The governing body should delegate the responsibility for implementation and execution of effective compliance governance to management. The governing body should monitor and oversee compliance. (King IV Report; 2016:63–64)

STUDY

- King IV Report (2016:63–64)
- Jackson & Stent (2016:4/46–4/47)

ACTIVITY 12

List what should be disclosed by the governing body in relation to compliance according to the King IV Report.

FEEDBACK ON ACTIVITY 12

Reference: King IV Report (2016:64)

The required disclosures are listed in the King IV Report under principle 13.23 – 25 and are not repeated here.

Note: The ultimate responsibility for complying with laws, rules, codes and standards lies with the governing body. The governing body's right to delegate the implementation of a compliance framework and process to management and to appoint a compliance officer falls within the framework of appointing board committees.

1.3.7 REMUNERATION GOVERNANCE

Principle 14 states that the governing body should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term.

STUDY

- King IV Report (2016:64–67)
- Jackson & Stent (2016:4/47–4/50)

ACTIVITY 13

Voting on remuneration policy is only applicable to companies. Discuss who may vote and approve the remuneration policy, as well as what should happen if the remuneration policy and/or the implementation thereof, was voted against by 25% or more of the voting rights exercised.

FEEDBACK ON ACTIVITY 13

Reference: King IV Report (2016:67)

Every year at the annual general meeting (AGM), the shareholders should vote on the remuneration policy and the implementation thereof. These votes are non-binding (Principle 14.37). If, however, the remuneration policy or implementation thereof, was voted against by 25% or more, the board should have measures in place for taking steps to engage with the shareholders to ascertain the reasons for the dissenting votes, and to appropriately address legitimate and reasonable objections and concerns raised (Principle 14.38).

1.3.8 ASSURANCE

STUDY

- King IV Report (2016:68–70)
- Jackson & Stent (2016:4/51–4/55)

ACTIVITY 14

Explain in your own words what the term “combined assurance model” means in the context of the King IV requirements.

FEEDBACK ON ACTIVITY 14

Reference: King IV Report (2016:10)

The definition is provided in the Glossary of the King IV Report, and is not repeated here.

ACTIVITY 15

According to principle 15.58a, internal audit should follow an approved risk-based internal audit plan. Explain in your own words what the term “risk-based audit plan” means in the context of the King IV requirements for internal audit.

FEEDBACK ON ACTIVITY 15

Reference: Jackson & Stent (2016:4/54–4/55)

The risk-based audit plan places emphasis on internal audit understanding the risks associated with the strategic direction of the company and determining whether internal controls, processes and procedures, adequately address these risks.

Internal auditor’s key responsibility is to the governing body through the audit committee. It assists the governing body by:

- Performing reviews of the organisation’s governance process including ethics
- Performing an objective assessment of the adequacy and effectiveness of risk management and internal controls
- Systematically analyzing and evaluating business processes and associated controls
- Providing a source of information regarding fraud, corruption, unethical behavior and irregularities.

ACTIVITY 16

Speed (Pty) Ltd, a large retailer of sporting goods with outlets in all major towns and cities in South Africa, has recently established an audit committee and internal audit department. The internal audit department is headed up by Josh Kronveld, a chartered accountant, and staffed by three suitably qualified internal auditors. The department reports to the audit committee. Josh Kronveld has received numerous requests for his department’s services, which are listed below:

1. The manager of the company's largest retail outlet requested that one of the internal auditors be seconded to the outlet for a period of three months, as the outlet’s accountant was to be away on maternity leave.
2. The finance director has requested internal audit to install the software for a new wage application, and control the conversion to the new system. Internal audit has the necessary expertise.
3. The warehousing manager has requested that internal audit evaluate the operational efficiency of the company's distribution system for the dispatch of goods from the central warehouse to the outlets.
4. The head office finance manager has requested internal audit to perform a surprise physical verification of the existence of fixed assets at two other

large retail outlets, e.g. shop fittings, tills, furniture, office equipment including computer hardware.

5. The finance director has requested that internal audit perform an in depth analysis of the monthly trading returns submitted by the outlets to head office.
6. The managing director has requested that Josh Kronveld make a presentation to the Board on the laws and regulations that govern the company and its operations, highlighting any areas where laws or regulations are not being complied with.
7. The external auditors have requested that the members of the internal audit department, attend the financial year-end inventory counts on their behalf, at four of the company's retail outlets. The external auditors will have their own teams at the other outlets.
8. The human resources manager has requested that Josh Kronveld be present at the annual wage negotiations to ensure that company policy and labour law requirements are adhered to.
9. The finance manager has requested that in future, Josh Kronveld authorize the write-off of bad debts at the end of each month after investigation of the debtors' circumstances.
10. The chairman of the social and ethics committee has asked Josh Kronveld if his three qualified internal auditors could assist the local community college by lecturing on the college's evening auditing courses.

REQUIRED

Indicate, giving reasons, how Josh Kronveld should respond to each of these requests.

FEEDBACK ON ACTIVITY 16

General: Josh Kronveld should inform all those seeking his department's services that he reports to the audit committee and any assignments undertaken will be discussed with it.

1. This request should be politely refused. Internal audit is essentially an independent monitoring and assurance function, reporting to the audit committee; it should neither perform any operational duties, nor supervise or direct staff not employed by internal audit. To fulfil the role of outlet accountant would result in both of the above. In addition the future relationship between the retail outlet and the internal audit department would not be independent.
2. This request should also be politely refused.
 - 2.1 As internal audit has the expertise, they may offer to evaluate the software and the conversion at any point in time and report their findings, but should not undertake operational responsibility for "installing" systems. (In effect, they should be part of the post-implementation review and probably should have been

involved in evaluating the suitability of the new wage application software.)

- 2.2 In future, internal audit may be called upon to give an independent assessment of the new application; they cannot also be the installers.
3. This is a perfectly valid request as it fits into the scope of internal audit's functions. These include performing assessments of internal control and evaluating business processes.
 - 3.1 Provided at least one member of the team understands the logistics of retail distribution, the assignment may be accepted.
4. As the verification is to be on a surprise basis it would appear that some kind of fraud or misappropriation of assets is suspected.
 - 4.1 If this is suspected, internal audit could justifiably be involved as one of its basic functions is to provide an independent source of information regarding instances of fraud, corruption etc, at the company.
 - 4.2 If this is just an arbitrary request from the finance manager (no suspicion of theft or fraud) Josh Kronveld should not involve his department as internal audit is not responsible for routine asset safeguarding procedures.
 - 4.3 Clearly this request is also not part of a planned internal audit risk evaluation relating to fixed assets.
5. Josh Kronveld will have to establish the intention of this request. If the finance director intends that this in-depth analysis becomes a regular monthly procedure, it becomes an operational duty and should not be taken on by internal audit.
 - 5.1 However, if this is in effect a once off evaluation of the trading data to evaluate its validity, accuracy and completeness, or for example to specifically identify fraudulent practice at an outlet(s), the assignment could be undertaken.
6. This is an acceptable request. Part of internal audit's scope of work should be to assist in the monitoring of the company's compliance with laws and regulations. This assignment requires internal audit to evaluate the company's responses to the risk of failing to comply with laws and regulations.
7. Co-operation between internal audit and external audit is to be encouraged and Josh Kronveld should make every attempt to accommodate the request.

8. It is questionable whether the presence of Josh Kronveld at these negotiations would be of any value. The human resources director should be fully familiar with company policy, and the adherence to labour law requirements is best left to the judgement of lawyers.
- 8.1 In addition, a (presumably) annual wage negotiation is really an operational activity in which Josh Kronveld should not be involved. Josh Kronveld should probably explain to the HR manager that he is not likely to add much value to the negotiations.
9. This request should be declined. Internal audit should not approve any accounting transactions. This is an operational activity. The only thing that internal audit could do, would be to monitor (from time to time) that the correct procedures (controls) are exercised in the writing off of bad debts particularly if there is a perceived risk that controls and procedures are not being followed.
10. This request should be accepted as a service to the local community. It will enhance the image of the company and make a positive contribution to the community which is one of the company's stakeholders.

Source: *Graded Questions on Auditing 2017* (Gowar & Jackson 2016:4039 – adapted)

1.3.9 STAKEHOLDER RELATIONSHIPS

The King IV Report emphasises a “stakeholder inclusive” approach to corporate governance.

STUDY

- King IV Report (2016:71–73)
- Jackson & Stent (2016:4/55–4/59)

ACTIVITY 17

- 1 Define the term “stakeholder” according to the King IV Report.
- 2 Do you regard yourself as a stakeholder of your local municipality? Do you think that they should adhere to the principles of the King IV Report with regard to stakeholder management? If so, how do your local municipality's operations affect you?

FEEDBACK ON ACTIVITY 17

Reference: King IV Report (2016:17)

1. The term “stakeholder” is defined in the King IV Report glossary (2016:17) and is not repeated here.
2. You are indeed a stakeholder of your local municipality, to which you pay rates and taxes every month. The Public Finance Management Act (PFMA) does not make the application of the King IV Report compulsory for government institutions, but the same principles of good corporate governance are embodied in the Act.

Sec 2 of the PFMA – The object of this Act is to secure transparency, accountability and sound management of the revenue, expenditure, assets and liabilities of the institutions to which this Act applies.

King IV included principles in the section “sector supplements” that applies specifically to municipalities.

Your local municipality's operations affect you in many ways, one of which is service delivery.

ACTIVITY 18

Treelines Ltd is a large forestry company which grows and harvests trees and transports them to its mills, where the timber is pulped (an operation which uses a great deal of water and produces unusable waste) for the manufacture of pulp-based products. Demand for pulp-based products is declining world-wide, but demand for other timber products is stable.

The company's forests are spread over numerous regions of the country and the majority are in remote areas. A key element of the location of forests for both re-planting and new forests is the level of local rainfall as forests are not irrigated.

Treelines Ltd employs a reasonably large work force at its forest locations, ranging from unskilled to skilled logging machine operators, all of whom are vital to the operation. It also has a large administrative, financial, marketing and support staff of mixed gender and race at its head office.

The board of Treelines Ltd follows sound corporate governance practices regarding the way it conducts its business and reports to its stakeholders. Integrated sustainability reporting and disclosure are regarded as important.

REQUIRED

Identify the main stakeholders, other than shareholders, with whom Treelines Ltd should be “building relationships and promoting respect” and indicate briefly for each why you consider them to be stakeholders.

FEEDBACK ON ACTIVITY 18

1. Treeline Ltd's main stakeholders are:

Reference: Jackson & Stent (2016:4/56–4/59)

- 1.1 **Suppliers** of goods and services without whom the company cannot operate effectively.
- 1.2 **Creditors** arising from the supply of goods, services and finance, for example loan providers. These parties are owed money and therefore have a direct stake in the company.
- 1.3 **Employees** at all levels and in all activities, skilled, unskilled and administrative.
- 1.4 **Government** and important parties in respect of other legislation, for example the granting of forestry licenses.
- 1.5 **External auditors** who require co-operation and respect to fulfil their function.
- 1.6 **Customers** who may range from individuals to large corporations to government. Customers are the lifeblood of the company.
- 1.7 **Industry at large** – Treelines Ltd does not operate within a vacuum. It is part of the greater economic community and the forestry/milling/pulp/paper industry specifically. Co-operation and participation are key to sustainability of the industry as a whole.
- 1.8 **Local communities** – Companies are part of a wider society and as in the case of Treelines Ltd, numerous local communities. The company depends on these communities and vice versa.
- 1.9 **Media** – Financial, industrial and human interest journalists write about the company and can enhance or damage a company's reputation and its image as a good corporate citizen.
- 1.10 **Regulators** – Treelines Ltd will probably be regulated by a number of bodies that require compliance with rules, regulations or a code, for example the Forest Stewardship Council regulations and code. A sound working relationship between the company and regulator must be cultivated.

Source: *Graded Questions on Auditing 2017 (Gowar & Jackson 2016:34)*

SUMMARY

In this learning unit we explained and applied the provisions of the King IV Report of Governance for South Africa.

LEARNING UNIT 1.4

CORPORATE GOVERNANCE – INTERNATIONAL DEVELOPMENTS

INTRODUCTION

The King IV Report and Code on governance as well as the Companies Act, No 71 of 2008 are providing rules, laws, principles and recommendations to companies in South Africa to ensure that they adhere to good corporate governance.

There are similar laws and codes governing the rest of the world. One of these is the Sarbanes-Oxley Act which we will be looking at in a bit more detail.

1.4.1 SARBANES-OXLEY ACT

The Sarbanes-Oxley Act (“SOX”) came into force in July 2002 and introduced major changes to the regulation of corporate governance and financial practice. It is named after US Senator Paul Sarbanes and US Representative Michael Oxley, who were its main architects, and it set a number of non-negotiable deadlines for compliance for all United States (US) public company boards, management and public accounting firms. (Wikipedia, [sa])

In the US, SOX is a great example of the “comply or else” principle, as it is legislated.

As a result of SOX, top management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the oversight role of boards of directors and the independence of the outside auditors who review the accuracy of corporate financial statements. (Wikipedia, [sa])

The bill, which contains eleven sections, was enacted as a reaction to a number of major corporate and accounting scandals, including Enron and Worldcom.

These sections of the bill covers responsibilities of a public corporation's board of directors, adds criminal penalties for certain misconduct, and required the Securities and Exchange Commission to create regulations to define how public corporations are to comply with the law. (Wikipedia, [sa])

In response to the perception that stricter financial governance laws are needed, SOX-type regulations were subsequently enacted in Canada (2002), Germany (2002), South Africa (2002), France (2003), Australia (2004), India (2005), Japan (2006), Italy (2006), Israel and Turkey. (Wikipedia, [sa])

Please follow the following link to a video of a summary of SOX.

[Sarbanes-Oxley Act Of 2002 – SOX - Video | Investopedia](#)

ACTIVITY 1

What is the main purpose of the Sarbanes-Oxley Act (“SOX”)?

FEEDBACK ON ACTIVITY 1

The main purpose of SOX is to protect shareholders from fraudulent representations in corporate financial statements. Investors need to know that the financial information they rely on is truthful, and that an independent third party has verified its accuracy.

SUMMARY

In this learning unit we described the background of the Sarbanes-Oxley Act as a regulatory measure of corporate governance internationally.

CONCLUSION

In this topic, **corporate governance and statutory matters**, we explained and applied corporate governance principles by referring to the background of corporate governance and statutory matters regarding company directors, as well as the provisions of the King Report on Governance. We also touched on the background and main purpose of the Sarbanes-Oxley Act.

In the next topic we will explain and apply the theory of internal control as an important aspect of corporate governance.

TOPIC 2

INTERNAL CONTROL

Topic overview

In the previous topic you learnt about **corporate governance and statutory matters**. The aim of this topic is to explain and apply the theory of internal control as an important aspect of corporate governance. It will be explained according to the objectives of internal control and the components of internal control in chapter 5 of Jackson & Stent. General and application controls in a computerised environment will also be explained and applied as part of control activities in chapter 8 of Jackson & Stent.

The need for the external auditor to obtain an understanding of a client's internal control in order to identify significant risks will also be explained.

This topic is divided into the following learning units:

Learning unit	Title
2.1	Internal control
2.1.1	Definition of internal control
2.1.2	Limitations of internal control
2.2	Components of internal control
2.2.1	Control environment
2.2.2	Risk assessment
2.2.3	Information system
2.2.4	Control activities
2.2.5	Monitoring of controls
2.3	Controls in a computerised environment
2.3.1	General controls
2.3.2	Application controls
2.4	Internal control from the perspective of the external auditor
2.4.1	Obtaining an understanding of internal control
2.4.2	Significant risks

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
2.1 Internal control	<ul style="list-style-type: none">• Define and explain internal control.• Explain the limitations of internal control.	2 2
2.2 Components of internal control	<ul style="list-style-type: none">• Describe, explain and apply the five components of internal control.	2
2.3 Controls in a computerised environment	<ul style="list-style-type: none">• Describe, explain and apply general controls in a computerised environment.	2
2.4 Internal control from the perspective of the external auditor	<ul style="list-style-type: none">• Explain and apply application controls in a computerised environment.• Explain the need for the external auditor to obtain an understanding of a client's internal control in order to identify significant risks.	2 2

LEARNING UNIT 2.1

INTERNAL CONTROL

INTRODUCTION

The importance of good corporate governance to a business and its stakeholders was explained in topic 1. Principle 15.40 state that the governing body should assume responsibility for assurance by setting the direction concerning the arrangements for assurance services and functions. The audit committee, if in place are responsible for overseeing that those arrangements are effective in achieving the objective of enabling an effective internal control environment.

2.1.1 DEFINITION OF INTERNAL CONTROL

As stated in Jackson & Stent (2016:5/3) internal control is designed to address and limit potential risks.

STUDY

- Jackson & Stent (2016:5/3–5/4), section 1

ACTIVITY 1

Name and explain six key characteristics of internal control that you have learnt.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:5/4), section 1.3

The characteristics of internal control are:

- Internal control is a process.
- Internal control is effected by people.
- Internal control is not the sole responsibility of management.
- Internal control is not static.
- Internal control is not fool proof.
- Internal control is not a case of a single control addressing a single risk.

From the above aspects of internal control it is clear that although the board of directors is responsible overall for the governance of risk, everyone in the business carries responsibility with regards to the implementation and execution of internal controls.

The board of directors has the overall responsibility and accountability. Management identify risks, design and implement policies and procedures to address risks, while the employees execute internal control procedures. Therefore, it is clear to see that success depends on all parties involved.

STUDY

- Jackson & Stent (2016:5/5), section 3

ISA 315.4(c) **defines internal control** as the **process** designed, implemented and maintained by **those charged with governance, management and other personnel** to provide **reasonable assurance** about the achievement of an **entity's objectives** with regard to ...

- the reliability of the entity's financial reporting;
- the effectiveness and efficiency of its operations; and
- its compliance with applicable laws and regulations.

2.1.2 LIMITATIONS OF INTERNAL CONTROL

Your prescribed textbook, Jackson & Stent (2016:5/4), correctly indicates that internal control does not provide absolute assurance that the risks, that threaten the achievement of the objectives of the business, will be adequately responded to. This is due to the inherent limitations of internal controls.

STUDY

- Jackson & Stent (2016:5/4–5/5), section 2

ACTIVITY 2

Management design an internal control system, which **theoretically** addresses risk. List six inherent limitations of internal control and provide an example of each.

FEEDBACK ON ACTIVITY 2

Reference: Jackson & Stent (2016:5/4–5/5)

The inherent limitations of internal control and examples thereof are explained in your textbook under section 2 and are not repeated here.

SUMMARY

In this learning unit we explained the definition and limitations of internal control. We also explained that internal control is a response to risk and that the entity's objectives are achieved by implementing **internal controls**.

LEARNING UNIT 2.2

COMPONENTS OF INTERNAL CONTROL

INTRODUCTION

Internal control consists of the following five components (Jackson & Stent 2016:5/5–5/6):

1. Control environment
2. Risk assessment
3. Information systems
4. Control activities
5. Monitoring of controls

Internal controls in a computerised environment are part of the system of internal control of an entity. It is important to keep this in mind when studying the components of internal control below. **General and application controls** in a computerised environment will be explained in detail in learning unit 2.3.

STUDY

- Jackson & Stent (2016:5/5–5/6), section 4
- Jackson & Stent (2016:8/4–8/6), section 2

The five components of internal control will now be explained in more detail.

2.2.1 CONTROL ENVIRONMENT

STUDY

- Jackson & Stent (2016:5/7–5/8), section 4.1

As stated in Jackson & Stent (2016:5/7) the control environment sets the tone of the entity and creates the atmosphere in which employees go about their duties. The desirable mind set is one of “**doing things the right way**”.

2.2.2 RISK ASSESSMENT

The King III Report (2009:76) states that the board should ensure that risk assessments are performed on a continual basis. It also states under principle 5.5 that information technology risks form an integral part of the company's risk management activities.

STUDY

- Jackson & Stent (2016:5/8–5/10), section 4.2

Risk assessment is important because internal controls are designed and implemented as a response to assessed risks. It is therefore critical that the risk assessment process is comprehensive, accurate, thorough and complete.

2.2.3 INFORMATION SYSTEM

Your prescribed textbook, Jackson & Stent (2016:5/10), explains the objective of the information system and its subpart, the accounting system, to produce information that is **valid** (the transactions and events underlying the information actually **occurred** and were **authorised**), **accurate** and **complete** and timeously produced.

STUDY

- Jackson & Stent (2016:5/10–5/12), section 4.3

2.2.4 CONTROL ACTIVITIES

The entity's objective relating to financial reporting to record and process only transactions (and events) which have occurred and pertains to the entity and which are recorded and processed accurately and completely can only be realised in the information system with the implementation of control activities. This will now be explained.

2.2.4.1 General principles

Control activities are the **actions** which are carried out to manage or reduce risks (Jackson & Stent 2016:5/12) and to achieve the entity's objectives of providing reliable financial reporting, have effective and efficient operations and to comply with the laws and regulations.

STUDY

- Jackson & Stent (2016:5/12–5/17), section 4.4

Note the following types of control activities:

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

Also note that the control activities can be **preventive**, **detective** or **corrective** in nature.

ACTIVITY 1

Twinkles Groceries (Pty) Ltd

Twinkles Groceries (Pty) Ltd (hereafter referred to as “Twinkles”) is a large local grocery store. At the start of a cashier’s shift, the cashier must use a username and password to log onto his/her till. If the cashier accidentally makes a mistake, for example, scan an item twice, he/she has to call the manager to authorise a correction. The manager will first ask what happened and determine if the information provided is true, before entering a password. When all the items have been scanned, the total amount due is automatically calculated and shown on the screen. At the door to the store, a security guard will check the customer’s bag of groceries against the customer’s till slip.

REQUIRED

Identify the internal controls implemented by Twinkles and link each of them to a type of control activity.

FEEDBACK ACTIVITY 1

No	Internal control	Type of control activity
1.	The cashier uses a username and password to gain access to the till.	Isolation of responsibilities (remember, there are normally more than one cashier), access controls
2.	A manager has to authorise any corrections of mistakes made.	Segregation of duties between the manager functions and the cashier duties, approval and authorisation
3.	The security guard checks the goods in the bag to the till slip.	Comparison and reconciliation

ACTIVITY 2

1. For each of the six types of control activities, give an example of **what could go wrong (risks)** in the absence of the control activity.
2. Clearly indicate the difference between **segregation of duties** and **isolation of responsibilities**.

FEEDBACK ON ACTIVITY 2

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

1. The following table provides a list of **possible things that could go wrong (risks)** in an accounting system for each of the types of control activities. This is based on the examples given in Jackson & Stent (2016:5/12–5/16).

Control activity	Things that could go wrong (risks)
Approval, authorisation	Credit sales could be made to customers who are not credit worthy and who cannot pay their accounts, if a credit sale is not approved by the credit controller first.
Segregation of duties	Goods purchased could be stolen if no segregation of duties exists between the authorisation of the order, the placing of an order and the issuing the goods received note, as the purchase clerk could order it for him/herself whilst letting the company pay.
Isolation of responsibility	An incorrect number of goods could be received if a supplier delivers goods to a company and the receiving clerk does not count the goods and sign the supplier's delivery note. The clerk could not be held responsible and the mistake could be repeated.
Access/ custody	Physical inventory could be stolen if not stored properly, for example if not protected by a security guard at the inventory warehouse entrance.
Comparison and reconciliation	The balance of the cash receipts and payments journal could be incorrect if it is not regularly compared and reconciled to the balance on the bank statement.
Performance reviews	An abnormal increase in transport costs due to fuel being stolen could go undetected due to management not comparing the actual cost figure to the budgeted transport cost.

Note that these risks are examples based on your study material and that there are many other possible solutions.

2. **Segregation of duties** is an internal control designed to reduce error and fraud by ensuring that at least two individuals are responsible for the separate parts of a task. For example, the sales order clerk will receive an order, but the sales manager has to authorise the sale before the clerk can process/record the order.

Isolation of responsibilities refers to the accountability of an employee for a specific task, and the acknowledgement by the employee for the performance of an internal control. This is normally done by signing. In other words, there could be more than one sales order clerk who takes orders. The signature can isolate who was responsible for a task (should a problem arise) and the employee acknowledges the performance of an internal control procedure. It could also signify the transfer of responsibility from one individual to the next in the task process.

2.2.5 MONITORING OF CONTROLS

As stated in Jackson & Stent (2016:5/17) the monitoring of controls involves the assessment of internal control performance over time. If controls are not monitored, the board or management will not know if the entity's financial reporting is reliable and whether the laws, regulations and company policies are being complied with.

STUDY

- Jackson & Stent (2016:5/17–5/18), section 4.5

ACTIVITY 3

Internal control

You have been assigned to the task of completing the firm's internal control questionnaire. The following policies and procedures implemented have been noted regarding the internal control of SoftWorld (Pty) Ltd.

- Regular meetings are held at divisional and departmental levels to consider the risks at specific levels within the organisation.
- Weekly reports on invoicing and debt collection are produced by the online system and are reviewed by management.
- When goods are delivered by a supplier, the receiving clerk counts the goods and then signs the delivery note as proof that he was responsible for receiving the delivery.
- From inspection of the minutes of the board of directors' meetings it appears as though all directors are involved in the decision-making process.
- Procedures are in place to resolve incorrect processing of transactions.
- The entity operates within specific operating guidelines and time is taken by management to create and implement systems and procedures.

REQUIRED

Based on the information given regarding the entity's internal control:

1. List the **five (5)** components of internal control.
2. For each of the policies and/or procedures described in (a) to (f) in the scenario, **identify** the relevant component of internal control it relates to.

FEEDBACK ON ACTIVITY 3

1 Components of internal control

Control environment

The entity's risk assessment process

The information system

Control activities

Monitoring of controls

2

Policies and /or procedures(a)–(f)	Component of internal control
a)	The entity's risk assessment process/control environment
b)	Monitoring of controls/control activities/control environment/the information system
c)	Control activities
d)	Control environment
e)	The entity's information system and related business processes/control environment
f)	Control environment

SUMMARY

In this learning unit we explained the five components of internal control.

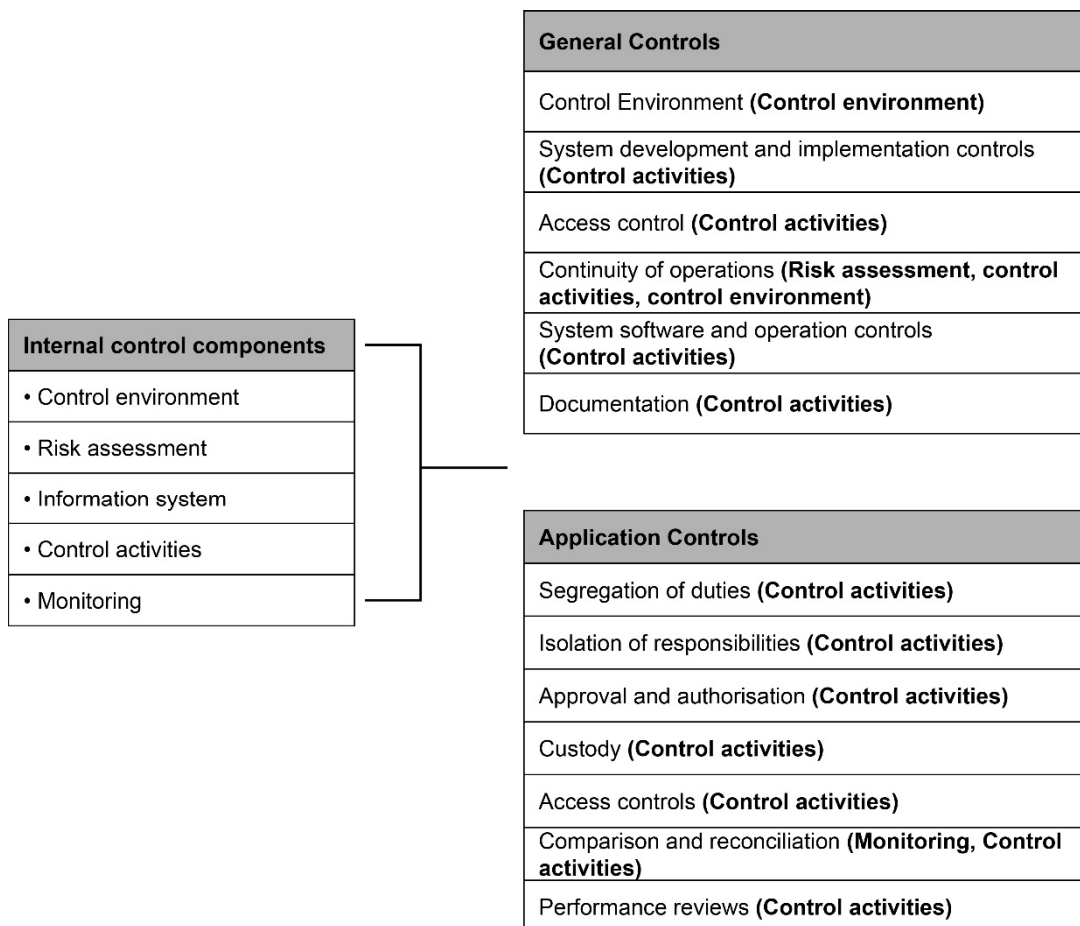
LEARNING UNIT 2.3

CONTROLS IN A COMPUTERISED ENVIRONMENT

INTRODUCTION

General and application controls in a computerised environment are an integral part of the total system of internal control of an entity and touch on all components of internal control.

The following diagrammatic representation of general and application controls illustrates that the general and application controls relate to all the components of internal control.



Diagrammatic representation of general and application controls

Although the information system component is not evident under general and application controls, the information system underlies internal controls in a computerised environment, as this is where the controls are implemented.

General and application controls can be **manual** (physical) or **computerised** (logical).

STUDY

- Jackson & Stent (2016:8/3–8/4)

General and application controls are discussed in more detail in the sections to follow.

2.3.1 GENERAL CONTROLS

General controls are defined as those controls which establish an **overall framework** of control for computer activities, and they span across all applications (Jackson & Stent 2016:8/7, section 1). General controls are of great importance. As general controls operate “around” the application controls, if your general controls are not adequate, the application controls might not be of much use.

Note the following:

- The term “computerised environment” refers to any particular and unique combination of hardware, software and personnel (Jackson & Stent 2016:8/3).

STUDY

- Jackson & Stent (2016:8/7–8/25)

ACTIVITY 1

Access controls in a computerised environment are important as the consequences of unauthorised access to a system can be disastrous for a company.

REQUIRED

1. Describe the **general physical access controls** that should be present to ensure proper internal control in a computerised environment.
2. Give examples of **preventative logical access controls** in a computerised environment.
3. Explain what controls over passwords as part of **logical access controls** entails.

FEEDBACK ON ACTIVITY 1

- Jackson & Stent (2016:8/17–8/20)
1. Interpret the question as follows:
 - It requires **general controls** (not application controls).
 - It requires **access controls**.
 - It requires only **physical** access controls (not logical access controls).

General physical access controls includes aspects such as:

- control over visitors from outside the company to the IT building, for example they should be escorted to the IT department
 - controlled access to company personnel other than IT personnel
 - physical entry to the data centre to be controlled, for example closed circuit televisions (CCTVs) at entrances
 - access control over remote workstations/terminals, for example terminals should be secured to desks
2. Apply the steps in 1. to interpret the question.

All **logical access** controls are preventative in nature and consist of the following:

- identification of users and computer resources
 - authentication of users and computer resources
 - authorisation of the levels of access to be granted
 - logging of access and access violations
 - access tables
3. Control over passwords is fundamental to successful, logical access controls. This is explained in your textbook under section 5.4 and is not repeated here.

2.3.2 APPLICATION CONTROLS

Jackson & Stent (2016:8/26) defines application controls as any control **within** an application which contributes to the accurate and complete recording and processing of transactions which have actually occurred, and have been authorised (**occurred**, **accurate** and **complete** information).

The stages through which a transaction flows through the system can be described as **input**, **processing** and **output** and application controls can be described in terms of these activities, e.g. an application control relating to **input**.

In addition to implementing controls over input, processing and output, controls must be implemented over **masterfiles**. A masterfile is a file which is used to store only standing information and balances, e.g. the debtors masterfile will contain the debtor's name, address, contact details, credit limit etc. The masterfile is a very important part of producing reliable information and must be strictly controlled.

The objective of controls in a computerised accounting environment is generally regarded as being centred around the occurrence, authorisation, accuracy and completeness of data and information processed by and stored on the computer.

Occurrence and authorisation are concerned with ensuring that transactions and data

- are not fictitious (they have occurred) or fraudulent in nature, and
- are in accordance with the activities of the business and have been properly authorised by management

Accuracy is concerned with minimising errors by ensuring data and transactions are correctly captured, processed and allocated.

Completeness is concerned with ensuring that data and transactions are not omitted or incomplete.

STUDY

- Jackson & Stent (2016:8/26–8/41), sections 1–4

ACTIVITY 2

The following control techniques and application controls, applicable to the **input stage** through which a transaction flows through the system, are mentioned in your textbook, Jackson & Stent (2016:8/27–8/40):

Access control

Authorisation

Batching

Screen aids and related features

Programme controls relating to input

Existence/validity checks

- Validation checks
- Matching checks
- Data approval/authorisation checks
- Reasonableness and limit checks
- Dependency checks
- Format checks
- Check digits
- Sequence checks

- Logs and reports
- Override reports
- Activity reports
- Access/access violation reports
- Audit trails

REQUIRED

Link the control techniques and application controls mentioned to the **objective of the control** being either occurrence and authorisation, completeness or accuracy.

FEEDBACK ON ACTIVITY 2

References: Jackson & Stent (2016:8/27–8/40), sections 1–4

Input controls

Occurrence and authorisation	Completeness	Accuracy
1. Access control 2. Authorisation 3. Batching 4. Existence/validity checks for example <ul style="list-style-type: none"> • Validation checks • Matching checks • Data approval/authorisation checks 5. Logs and reports for example <ul style="list-style-type: none"> • Override reports • Activity reports • Access/access violation reports 	1. Batching 2. Sequence tests 3. Logs and reports, for example: <ul style="list-style-type: none"> • audit trails 	1. Batching 2. Screen aids and related features, for example: <ul style="list-style-type: none"> • Minimum keying in of information • The screen should be formatted • Screen dialogue and prompts • Mandatory fields • Shading of fields 3. Reasonableness and limit tests 4. Dependency checks 5. Format checks, for example: <ul style="list-style-type: none"> • Alpha-numeric • Size checks • Mandatory field/missing data checks • Valid character and sign check 6. Check digits

Please remember that the suggested solution is only a **checklist** for study purposes. In tests and exams you should expand on the above, for example "The computer should perform a sequence test on invoice numbers and print an exception report if there are any outstanding invoices". This will be illustrated when applied to the various business cycles in the topics to follow.

Follow these steps:

1. Determine at which stage in the scenario a transaction flows through the system. Which of the following does the scenario deal with?
 - input phase
 - processing phase, and/or
 - output phase

2. Determine the objective of the control to be addressed. Which of the following does the question require you to address?
 - occurrence and authorisation
 - accuracy, and/or
 - completeness

ACTIVITY 3

Describe the application controls that the management of company X should implement to ensure the completeness of amendments to a masterfile in the computerised accounting system.

FEEDBACK ON ACTIVITY 3

Objective of the controls	Masterfile amendments
Completeness	<ol style="list-style-type: none"> 1. All amendments should be recorded on hardcopy masterfile amendment forms (MAF) (no verbal instructions). 2. MAFs should be pre-printed, sequenced and designed in terms of sound document design principles. 3. All masterfile amendments should be automatically logged by the computer on sequenced logs. 4. The MAFs themselves should be sequence checked against the log to confirm that all MAFs were entered.

SUMMARY

In this learning unit we explained general and application controls in a computerised environment as part of a system of internal control.

LEARNING UNIT 2.4

INTERNAL CONTROL FROM THE PERSPECTIVE OF THE EXTERNAL AUDITOR

INTRODUCTION

The external auditor obtains an understanding of a client's system of internal control as part of his/her external audit.

2.4.1 OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

Jackson & Stent (2016:7/14) states that an understanding of a client's internal control assists the auditor in identifying types of potential misstatement and factors that affect the **risks of material misstatement**, and in designing the nature, timing and extent of further audit procedures.

STUDY

- Jackson & Stent (2016:7/15–7/20)

2.4.2 SIGNIFICANT RISKS

Jackson & Stent (2016:7/21) defines significant risks as risks that require special audit consideration. Such risks relate to the auditor's risk of material misstatement. The auditor assesses risk so that he or she can determine the nature, timing and extent of further audit procedures.

STUDY

- Jackson & Stent (2016:7/21–7/22), sections 1–3

ACTIVITY 1

Name the six factors that the auditor should consider when assessing whether a risk is a significant risk.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:7/20)

The six factors that the auditor should consider when assessing whether a risk is a significant risk are explained in your textbook and are not repeated here.

SUMMARY

In this learning unit we explained the need for the external auditor to understand internal control in order to identify significant risks.

CONCLUSION

In this topic, **Internal control**, we explained and applied the theory of internal control according to the five components of internal control. We explained that internal control is designed to address and limit potential risks. Internal control from the perspective of the external auditor was also explained.

TOPIC 3

BUSINESS CYCLES

Topic overview

The aim of this topic is to explain the various business cycles as part of the accounting system over which internal controls are implemented. A condensed example of the financial statements of a trading company is provided to illustrate the main components of financial statements to which the transactions and balances relate in the business cycles.

This topic is divided into the following learning units:

Learning unit	Title
3.1	Business cycles
3.1.1	The accounting system and business cycles
3.1.2	Financial statements

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
3.1 Business cycles	<ul style="list-style-type: none"> Identify the different business cycles. 	1
	<ul style="list-style-type: none"> Relate the transactions and balances in the statement of financial position and statement of comprehensive income to the various business cycles. 	1

LEARNING UNIT 3.1

BUSINESS CYCLES

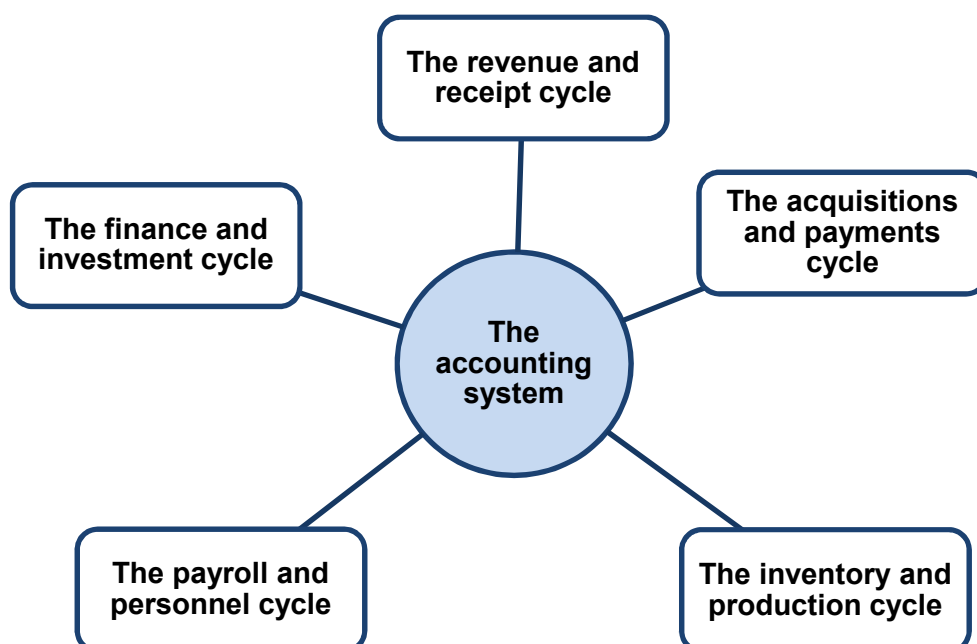
INTRODUCTION

In topic 2 we explained that management wants to achieve **reliable financial reporting** by ensuring that transactions which are initiated, recorded, processed and reported are **valid** (occurred and are authorised), **accurate** and **complete**. It is the **accounting system** which provides the foundation to achieve these objectives of internal financial control. In other words, internal control is designed and implemented over the accounting system.

3.1.1 THE ACCOUNTING SYSTEM AND BUSINESS CYCLES

Your textbook, Jackson & Stent (2016:5/12) describes an accounting system as a series or collection of tasks and records by means of which transactions are processed to create **financial records**. An accounting system identifies, assembles, analyses, calculates, classifies, records, summarises and reports transactions and other events. The major elements of the accounting system are **people**, who carry out **procedures**, for example write out a credit sales invoice, calculate a price, enter the invoice in a sales journal, et cetera, and **paper**, such as order forms, ledgers, lists, invoices, et cetera, which facilitates the initiation, execution and recording of the transaction.

DIAGRAM: Schematic representation of the five business cycles in relation to the accounting system



The functions and actions in the business cycles, as well as the control activities in each cycle, will be explained in detail in the topics to follow.

3.1.2 FINANCIAL STATEMENTS

As mentioned above, financial records relate to the business cycles. The financial records are summarised in a company's **financial statements**. In other words, the balances and totals of the transactions in the business cycles are reflected in the financial statements.

In your financial accounting courses, you may already have studied the drafting of company financial statements. To give you a complete picture, we have repeated a condensed example of the financial statements of a company which is trading as a commercial enterprise.

The purpose of the example is to indicate the transactions and balances in financial statements for the purpose of illustrating the business cycles. For the detailed financial statement and disclosure requirements, please refer to your financial accounting study material.

XY LTD

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1

	Notes	20X1 R'000	20X0 R'000
ASSETS			
Non-current assets			
Property, plant and equipment		16 069	14 696
		<u>16 069</u>	<u>14 696</u>
Current assets			
Inventories		192 085	149 002
Trade receivables		418 465	222 833
Cash and cash equivalents		–	1 465
		<u>610 550</u>	<u>373 300</u>
Total assets		626 619	387 996
EQUITY AND LIABILITIES			
Equity attributable to owners of the parent			
Share capital		147 834	147 834
Revaluation surplus		8 500	–
General reserve		5 000	2 000
Retained earnings		22 192	18 375
		<u>183 526</u>	<u>168 209</u>
Non-controlling interest		40 125	32 000
Total equity		<u>223 651</u>	<u>200 209</u>
Non-current liabilities			
Long-term borrowings		236 000	108 297
Deferred taxation		28 875	23 100
		<u>264 875</u>	<u>131 397</u>

Current liabilities			
Trade payables		35 990	20 145
Current portion of long-term borrowings		83 042	24 639
Shareholders for dividends		17 409	11 606
Bank overdraft		1 652	-
		<u>138 093</u>	<u>56 390</u>
Total liabilities		<u>402 968</u>	<u>187 787</u>
Total equity and liabilities		626 619	387 996

XY LTD

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	Notes	20X1 R'000	20X0 R'000
Revenue		1 287 052	902 052
Cost of sales		(1 098 187)	(819 939)
Gross profit		<u>188 865</u>	<u>82 113</u>
Distribution costs		(25 741)	(14 010)
Administrative expenses		(28 813)	(10 345)
Other expenses		(48 881)	(22 237)
Finance costs		(39 264)	(20 862)
Profit before tax		<u>46 166</u>	<u>14 659</u>
Income tax expense		(10 927)	(6 148)
Profit for the year		<u>35 239</u>	<u>8 511</u>
Other comprehensive income for the year after tax			
Revaluation surplus		10 625	-
Other comprehensive income for the year, net of tax		<u>10 625</u>	<u>-</u>
Total comprehensive income for the year		45 864	8 511
Profit attributable to:			
– Owners of the parent		28 039	1 711
– Non-controlling interest (given)		7 200	6 800
		<u>35 239</u>	<u>8 511</u>
Total comprehensive income attributable to:			
– Owners of the parent		36 539	1 711
– Non-controlling interest		9 325	6 800
		<u>45 864</u>	<u>8 511</u>

The following are components in the financial statements:

Statement of financial position: **Statement of comprehensive income:**

- | | |
|--|---|
| <ul style="list-style-type: none"> • property, plant and equipment • investments • loans granted • inventories | <ul style="list-style-type: none"> • revenue (credit and cash sales) • cost of sales (inventory) • purchases • distribution costs |
|--|---|

- trade receivables
- cash and cash equivalents
- share capital
- reserves
- retained earnings
- long-term borrowings
- trade payables
- administrative expenses
- other expenses
- finance costs
- other income

ACTIVITY 1

1. Identify the five business cycles which are generally applicable to commercial enterprises.
2. Based on the business cycles in an accounting system, identify the statement of financial position balances and statement of comprehensive income classes of transactions that relate to one another.

FEEDBACK ON ACTIVITY 1

1. The business cycles which are generally applicable to commercial enterprises are
 1. the revenue and receipts cycle
 2. the acquisitions and payments cycle
 3. the inventory and production cycle
 4. the payroll and personnel cycle
 5. the finance and investment cycle
2. The balances in the statement of financial position and the classes of transactions in the statement of comprehensive income that relate to the business cycles are:

Business cycle	Statement of financial position (account balances)	Statement of comprehensive income (classes of transactions)
Revenue and receipts cycle	<ul style="list-style-type: none"> • Accounts receivable • Cash and cash equivalents 	<ul style="list-style-type: none"> • Credit sales • Sales returns • Discount allowed • Credit losses • Interest received • Cash sales • All receipts (revenue and other)

Acquisitions and payments cycle	<ul style="list-style-type: none"> • Accounts payable 	<ul style="list-style-type: none"> • Credit purchases • Cash purchases • Purchase returns • Discount received • Interest on late payments • Expenses
Inventory and production cycle	<ul style="list-style-type: none"> • Inventory 	<ul style="list-style-type: none"> • Cost of sales
Payroll and personnel cycle	<ul style="list-style-type: none"> • Bank and cash • Accounts payable (accumulated leave, unclaimed wages, SARS, pension funds, medical aids and other) 	<ul style="list-style-type: none"> • Wages and salaries (net of employee deductions such as PAYE, UIF, SDL, pension fund, medical aid and other)
Finance and investment cycle	<ul style="list-style-type: none"> • Share capital • Reserves • Long-term loans • Property, plant and equipment • Investments 	<ul style="list-style-type: none"> • Dividends paid • Profit or loss (reserves) • Interest paid • Profit or loss on sale of asset • Profit or loss on investment

CONCLUSION

In this topic, **Business cycles**, we identified the various business cycles and explained what an accounting system entails. The balances in the statement of financial position and transactions in the statement of comprehensive income were related to the various business cycles.

In the next topic we will explain and apply the revenue and receipts business cycle as well as the applicable internal controls in the cycle.

TOPIC 4

REVENUE AND RECEIPTS CYCLE

Topic overview

In business, **revenue** is income that arises in the course of ordinary activities of an entity, usually from the sale of goods and services to customers. Depending on the type of business activities, some companies receive revenue from fees, interest, dividends or royalties (see International Accounting Standard, IAS 18).

The revenue and receipts cycle includes the following transactions and balances:

Statement of financial position	Statement of comprehensive income
Accounts receivable	Credit sales (turnover) Sales returns Discount allowed Credit losses (bad debts) Interest received
Cash and cash equivalents	Cash sales (turnover) All receipts (revenue and other)

The focus in this topic is on a trading concern where revenue is earned through the buying and selling of goods and services, which can consist of credit sales and/or cash sales.

The aim of this topic is to explain and apply the actions, functions and documents in the revenue and receipts accounting cycle. The risks in this cycle will also be explained and internal controls applied to mitigate those risks, as well as internal control over revenue transactions in a computerised environment.

This topic is divided into the following learning units:

Learning unit	Title
4.1	Credit sales
4.1.1	Activities and functions in the cycle
4.1.2	Documents used in the cycle
4.1.3	Risks and internal control in the cycle
4.1.4	Computerisation of the cycle
4.2	Cash sales
4.2.1	Stages of a cash sale
4.2.2	Risks and internal control over a cash sale

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
4.1 Credit sales	<ul style="list-style-type: none"> Describe credit sales transactions by referring to the activities, functions and documents associated with these transactions. 	2
	<ul style="list-style-type: none"> Identify and explain the risks associated with credit sales transactions and explain and apply the internal controls that could be implemented to mitigate the risks. 	2
	<ul style="list-style-type: none"> Describe and apply internal control in a computerised environment to credit sales transactions. 	2
4.2 Cash sales	<ul style="list-style-type: none"> Describe cash sales transactions by referring to the activities, functions and documents associated with these transactions. 	2
	<ul style="list-style-type: none"> Identify and explain the risks associated with cash sales transactions. 	2
	<ul style="list-style-type: none"> Describe and apply the internal controls that could be implemented to mitigate the risks. 	2

LEARNING UNIT 4.1

CREDIT SALES

INTRODUCTION

Your prescribed textbook, Jackson & Stent (2016:10/2), explains revenue transactions and indicates that this cycle deals with the accounting system and related internal controls which are put in place to control the sale of the company's goods or services, and the collection of amounts owed in respect of those sales.

4.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

Although revenue and receipts systems can vary considerably, your textbook, Jackson & Stent (2016:10/2–10/5), describes a system for a business which has conventional revenue and receipt functions. Note that the functions in the credit sales cycle also include the collection of payments from accounts receivable (trade debtors).

STUDY

- Jackson & Stent (2016:10/2–10/7)

ACTIVITY 1

Rearrange the following functions in a credit sales transaction in the correct order and provide a brief explanation of each:

- 1 Invoicing
- 2 Credit management
- 3 Warehouse/despatch
- 4 Receiving and recording payment from debtors
- 5 Order department
- 6 Recording sales and raising the debtor

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:10/3–10/5; 10/8–10/9)

Note the logical flow of documents through the different functions for credit sale transactions in the flow charts on pages 10/8 to 10/9 of your prescribed textbook. The normal order of the functions in a credit sales transaction is:

1. Order department
2. Warehouse/despatch
3. Invoicing
4. Recording sales and raising the debtor
5. Receiving and recording payment from debtors
6. Credit management

4.1.2 DOCUMENTS USED IN THE CYCLE

STUDY

- Jackson & Stent (2016:10/6–10/7)

ACTIVITY 2

Match the documents explained in your textbook to the different functions in the revenue/receipts cycle mentioned in 2.1 above.

FEEDBACK ON ACTIVITY 2

Function	Document
Order department	Price lists Customer order Internal sales order
Warehouse/despatch	Picking slip Delivery note Back-order note
Invoicing	Invoice
Recording of sales and raising debtors	Statement Goods returned voucher Credit note
Receiving and recording payments from debtors	Remittance advice Remittance register Receipt Deposit slip
Credit management	Credit application form

ACTIVITY 3

The **Consumer Protection Act, 68 of 2008**, which came into effect on 1 April 2011, lays down in section 26(3) the following minimum requirements that should be stated on sales documentation:

1. the supplier's full name, or registered business name, and VAT registration number, if any

2. the address of the premises at which, or from which, the goods or services were supplied
3. the date on which the transaction occurred
4. a name or description of any goods or services supplied or to be supplied
5. the unit price of any particular goods or services supplied or to be supplied
6. the quantity of any particular goods or services supplied or to be supplied
7. the total price of the transaction, before any applicable taxes
8. the amount of any applicable taxes
9. the total price of the transaction, including any applicable taxes

REQUIRED

Indicate in which respects the following tax sales invoice does not meet the minimum requirements as stipulated in the Consumer Protection Act.

TAX INVOICE		INV
772		
COPRO LIMITED		Date: 31 August 20xx
To: Customer A PO Box A Durban 4001		
Description		Total
No XL001 Stapler		2 430.00
No 1185 Paper		49 200.00
No 2.1 pencils		2 100.00
Subtotal		53 730.00
VAT		7 522.22
Total		61 252.20

FEEDBACK ON ACTIVITY 3

The following information required by the Consumer Protection Act, 68 of 2008, is not indicated on the invoice:

1. the VAT registration number of Copro Ltd
2. the address of the premises of Copro Ltd
3. the unit price of the particular goods supplied
4. the quantity of the particular goods supplied

ACTIVITY 4

The following are examples of an order form, delivery note and tax invoice issued by company XY Ltd for commodities sold by the company:

SALES ORDER		OD 1028	
XY LIMITED PO Box X Pretoria 0001		Date: 30 May 20xx	
To: Customer Y PO Box Y Durban 4001 Account number: Y4458			
Description	Quantity	Unit price	Total
No XL001 Stapler	85	28.60	2 430.00
No 1185 Paper	400	123.00	49 200.00
No 2.1 Pencil	1000	2.10	2 100.00
		Subtotal	53 730.00
		VAT	7 522.20
		Total	61 252.20
		Authorised:	<i>Order Clerk</i>

DELIVERY NOTE		DN 532
XY LIMITED PO Box X Pretoria 0001		Date: 3 June 20xx
To: Customer Y PO Box Y Durban 4001		Deliver to: Customer Y: Warehouse C 55 1st Street Durban North 4001
Account number: Y4458		
Description	Quantity	
No XL001 Stapler	85	
No 1185 Paper	400	
No 2.1 Pencil	1000	
Goods received in good order by customer:		<i>Customer Y</i>
Date:		<i>3/06/20XX</i>

TAX INVOICE		INV 772	
XY LIMITED PO Box X Pretoria 0001		Date: 3 June 20xx	
To: Customer Y PO Box Y Durban 4001			
Account number: Y4458			
Description	Quantity	Unit price	Total
No XL001 Stapler	85	28.60	2 430.00
No 1185 Paper	400	123.00	49 200.00
No 2.1 Pencil	1000	2.10	2 100.00
		Subtotal	5 730.00
		VAT	7 522.20
		Total	61 252.20

REQUIRED

Indicate which of the information shown on the above documents demonstrates that the objective of control for financial reporting have been addressed.

FEEDBACK ON ACTIVITY 4

The following information on the order form, delivery note and tax invoice illustrates that the accounting system produces information which **occurred, is accurate** and **complete**.

Occurred:

1. The name and address of XY Ltd on the order form, delivery note and tax invoice.
2. A valid customer account number on the order form, delivery note and tax invoice.
3. The signature on the order form indicating that it was approved.
4. The customer signature on the delivery note indicating that the goods were received and accepted.
5. The existence of a corresponding order form and delivery note for the invoice.

Accurate:

1. The total amount (including VAT) of the credit sale on the invoice, which accurately corresponds with the sales order (to be recorded against the customer's account).
2. The credit sales amount and the VAT amount on the invoice which accurately correspond with the sales order (to be recorded against the sales revenue and VAT accounts).
3. The order form and delivery note items, quantities and amounts that correspond with the invoice.
4. The customer name and account number on the order form, delivery note and tax invoice.

Complete:

1. The date of the invoice to be recorded in the accurate period in the accounting records of XY Ltd.
2. The invoice number to be sequentially recorded in the accounting records of XY Ltd.

4.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

The functions that can be distinguished for credit sale transactions were explained in learning unit 4.1.1.

Risks associated with each of these functions are mentioned in your prescribed textbook; internal controls (control activities) that could be implemented to mitigate the risks are described as well.

STUDY

- Jackson & Stent (2016:10/10–10/19; 10/42–10/43)

ACTIVITY 5

Answer the following questions regarding the order department of a trading concern that sells goods on credit (credit sales):

1. Give a system description of the activities in the order department.
2. Name the documents usually encountered in an order department.
3. Explain the control risks that can exist in an order department.
4. Describe the internal controls (control activities) that can be implemented to mitigate the risks in an order department.

FEEDBACK ON ACTIVITY 5

1. System description of the activities in the order department

Refer to Jackson & Stent (2016:10/3–10/4) where the activities of the order department are presented.

2. Documents usually encountered in an order department

Refer to Jackson & Stent (2016:10/10) where the documents used in the order department are presented.

3. Explain the control risks that can exist in an order department.

Refer to Jackson & Stent (2016:10/10–10/11) where the control risks in an order department are described.

4. Internal controls (control activities) that can be implemented to mitigate the risks in an order department.

Refer to Jackson & Stent (2016:10/10–10/11) where the control activities for an order department are mentioned.

Note that you should limit your answer to the order department, which includes receiving customer orders and sales authorisation.

ACTIVITY 6

1. Describe the internal controls that can be implemented to minimise the following risks associated with credit sales transactions:
 - Goods may be removed from the inventory warehouse for fictitious/unauthorised sales.
 - Incorrect goods or quantities could be despatched.
 - Goods despatched may not be invoiced.
 - Invoices could be duplicated in the sales journal.
 - Payments received from customers may not be deposited in the bank due to theft or carelessness.

2. Name the internal control objective(s) for financial reporting affected by each of the risks mentioned in 1 above.

Present your answer in a tabular format.

FEEDBACK ON ACTIVITY 6

Reference: Jackson & Stent (2016:10/10–10/19)

Risk	1. Internal control	2. Assertion
Goods may be removed from the inventory warehouse for fictitious/unauthorised sales.	1. Supervisory checks should be carried out by the warehouse foreman to ensure that all goods picked are supported by signed picking slips.	Occurrence
Incorrect goods or quantities could be despatched.	1. On receipt of the goods, picking slip and delivery notes from the warehouse, the despatch clerk should check quantities and description of goods against the authorised picking slip and delivery note.	Occurrence for the incorrect goods Accuracy for the incorrect quantities
Goods despatched may not be invoiced.	1. The invoice clerk should prepare a numerically sequenced invoice and cross-reference it to the delivery note/customer order. 2. The file of delivery notes matched against sales invoices should be sequence-tested and gaps in sequence investigated.	Completeness

Invoices could be duplicated in the sales journal.	1. Prior to entry in the sales journal, invoices should be added to obtain a control total. This control total should then be compared to the total in the sales journal after entry of individual invoices.	Accuracy and occurrence
Payments received from customers may not be banked due to theft or carelessness.	<ol style="list-style-type: none"> 1. Post must be opened by two people. 2. All payments received in the post should be recorded in a remittance register and a prenumbered receipt should be made out for each payment received. 3. All amounts received should be banked daily. 4. The remittance register and receipts issued should be reconciled to bank deposits by an independent supervisory employee. 5. Bank deposits should be reviewed regularly and gaps in daily banking investigated by management. 	Completeness

4.1.4 COMPUTERISATION OF THE CYCLE

Your textbook, Jackson & Stent, describes an integrated manual and computerised credit sales system of telesales transactions that are entered and processed in real time.

STUDY

- Jackson & Stent (2016:10/20–10/39)

ACTIVITY 7

1. Describe the application controls that should be present in a computerised environment to ensure that only **authorised** amendments are made to the debtors' masterfile in a credit sales accounting system.

2. Mention things that could go wrong (risks) if no application controls exist over amendments to the debtors' masterfile, for each of the objectives of control.

FEEDBACK ON ACTIVITY 7

1. The application controls that should be present in a computerised environment to ensure that only authorised amendments are made to the debtors masterfile are described in Jackson & Stent (2016:10:23–10/25) and are not repeated here.
2. Things that could go wrong (risks) if no application controls exist over amendments to the debtors masterfile:

Reference: Jackson & Stent (2016:10/23–10/25)

Occurrence: Unauthorised and fraudulent amendments could be made to the detriment of the company, for example a debtor's credit limit could be increased, allowing the debtor credit facilities which he/she cannot pay within the allowed payment terms.

Accuracy: Incorrect amendments could be made to the debtors' masterfile, for example a change in a debtor's postal address could be recorded incorrectly, resulting in a debtor not receiving monthly statements and not paying his/her account (accuracy) or an incorrect change to a debtor's account number could result in incorrect postings (classification).

Completeness: Amendments to the debtors' masterfile could be incomplete, for example a new debtor is not loaded onto the debtors masterfile and his/her purchase order would not be accepted and processed (completeness) or amendments could be made in the incorrect period (cut-off).

ACTIVITY 8

1. Explain what the term "real time" means and what the effect on the application control of "batching" will be.
2. Describe the application controls that should be present to ensure that orders received from customers are **accurately** entered into the computerised credit sales system.

Use the framework described in learning units 2.3.1 and 2.3.2 in topic 2 to answer the question.

FEEDBACK ON ACTIVITY 8

1. “Real time”

Reference: Jackson & Stent (2016:8/34) section 3.1.3

This term means that transaction data are entered immediately online as each transaction occurs and relevant program checks take place as information is keyed in. This means that transactions are not batched before entering.

2. Application controls to ensure that orders received from customers are accurately entered into the computerised credit sales system.

Reference: Jackson & Stent (2016:10/26)

Internal control objective	Input	Processing	Output	Master file
Occurrence				
Accuracy	<ol style="list-style-type: none"> 1. Screen formatting: the screen will be formatted to look like a sales order document. 2. Minimum entry: for example entering the inventory item code, will bring up the description of the item being ordered and the price. 3. Mandatory fields: for example, to proceed with the order, a number must be entered in the quantity field and a customer order reference must be entered. 4. Alphanumeric check: for example, on the quantity field to check that no alphanumeric characters were entered. 5. Limit or reasonableness check: to ensure that reasonable quantities are entered, for example not 1 billion items, which is more than realistic production targets. 			

	<p>6. Screen prompts will require the order clerk to confirm details of order and important details.</p> <p>7. Fields on the “on screen sales order” which cannot be changed by the order clerk.</p> <p>8. The system will allocate a customer reference number to every sales order which is given to the customer at the time of placing the order in order for the customer to follow up on inaccurate information on the sales order.</p>			
Completeness				

Note that only application controls relevant to **input** and **accuracy** are included in the solution, as required. Remember to use this table to limit your answer to only the information required.

SUMMARY

In this learning unit we explained and applied the actions, functions and documents of credit sales transactions. The risks and internal control in credit sales were also explained and applied, as well as internal control over credit sales transactions in a computerised environment.

LEARNING UNIT 4.2

CASH SALES

INTRODUCTION

Cash sales transactions occur daily in many business entities. Cash transactions carry a high risk of fraud and theft, over which management should implement a strict system of internal control (Jackson & Stent 2016:10/2 & 10/40).

4.2.1 STAGES OF A CASH SALE

In a cash sales transaction, payment is received from the customer when the goods are supplied to the customer. In broad terms, a cash sale transaction follows the same process as a credit sales transaction.

STUDY

- Jackson & Stent (2016:10/40) section 9.2

4.2.2 RISKS AND INTERNAL CONTROL OVER A CASH SALE

As stated in Jackson & Stent (2016:10/40), the main risk associated with cash sales transactions is theft. This risk is increased in smaller businesses which do not always have the resources to implement the necessary internal controls.

STUDY

- Jackson & Stent (2016:10/40–10/42) sections 9.1 and 9.3

ACTIVITY 1

The following are a few things that can go wrong with cash sales transactions:

1. Cash sales could be recorded but the cash not deposited.
2. Cash could be received from customers but the cash sales transactions are not recorded.
3. Cash could be stolen after the cash register is “cashed up” for the day.
4. Customers could leave without paying for goods taken.
5. An armed robbery could take place, resulting in cash stolen from cash registers.

REQUIRED

Describe the internal controls that could be implemented to mitigate these risks.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:10/40–10/42) section 9.3

The internal controls that could be implemented to mitigate the risks mentioned are:

Things that can go wrong (Risk)	Internal control
1. Cash sales could be recorded but the cash not deposited in the cash register drawer.	The cash in the cash register should be reconciled to the total daily cash sales entered on the cash register till roll. The till roll in the cash register should not be alterable.
2. Cash could be received from customers, but the cash sales transaction not recorded.	Physical safeguards should be in place, for example signage encouraging customers to request a receipt. Cash receipts should be sequentially numbered.
3. Cash could be stolen after the cash register is “cashed up” for the day.	Whenever cash is transferred from the custody of one person to another, it should be counted, reconciled, documented and signed for by both parties in a safe location. Cash should not be allowed to accumulate and should be banked daily.
4. Customers could leave without paying for goods taken.	Physical safeguards should be in place, for example limited entry and exit points and security guards at the exit points requesting to sign off on cash sale receipts.
5. An armed robbery could take place, resulting in cash being stolen from cash registers.	Physical safeguards should be in place, for example security guards and surveillance cameras.

	Cash should not be allowed to accumulate and should be banked daily so that the minimum amount of cash is exposed to the risk of theft.
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SUMMARY

In this learning unit you learned about the stages of a cash sale transaction, as well as the risks associated with cash sales. The internal controls over cash sales transactions were also explained and applied.

CONCLUSION

In this topic, **Revenue and receipts cycle**, we explained and applied the activities, functions and documents in the revenue and receipts cycle. The risks and internal control in this cycle were also explained and applied, as well as internal control over credit sales transactions in a computerised environment.

In the next topic we will explain and apply the acquisitions and payments business cycle, as well as the applicable internal controls in the cycle.

TOPIC 5

ACQUISITIONS AND PAYMENTS CYCLE

Topic overview

Goods, services and assets are acquired and paid for in order to continue with business activities that will generate revenue.

The acquisitions and payments cycle includes the following classes of transactions and balances:

Statement of financial position	Statement of comprehensive income
Accounts payable	Credit purchases Cash purchases Purchase returns Discount received Interest on late payments Expenses

The aim of this topic is to explain and apply the activities, functions and documents in the acquisitions and payments business cycle. The risks and internal control in this cycle will also be explained and applied, including internal control over acquisitions and payments transactions in a computerised environment.

This topic is divided into the following learning units:

Learning unit	Title
5.1	Acquisitions and payments cycle
5.1.1	Activities and functions in the cycle
5.1.2	Documents used in the cycle
5.1.3	Risks and internal control in the cycle
5.1.4	Computerisation of the cycle

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
5.1 Acquisitions and payments cycle	<ul style="list-style-type: none"> Describe acquisitions and payments transactions by explaining the activities, functions and documents associated with these transactions. 	2
	<ul style="list-style-type: none"> Identify, explain and evaluate the risks associated with acquisitions and payments transactions and describe and apply the internal controls that could be implemented to mitigate the risks in a non-computerised environment. 	2
	<ul style="list-style-type: none"> Describe and apply internal control in a computerised environment to acquisitions and payments transactions. 	2

LEARNING UNIT 5.1

ACQUISITIONS AND PAYMENTS CYCLE

INTRODUCTION

Jackson & Stent (2016:11/2) indicate expenditure transactions for different core business processes. As this module is concerned with a normal going concern, the two main activities for expenditure transactions are:

- the ordering and receiving of goods (or services) from suppliers
- the payment of amounts due for the goods ordered and received

5.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

The ordering and receiving of goods from customers and the payment of amounts due to creditors are also referred to as the purchases and payments cycle. The major balance produced by this cycle is accounts payable (including trade creditors).

STUDY

- Jackson & Stent (2016:11/2–11/5)

ACTIVITY 1

The following list identifies a number of the functions in a typical **trading company**:

1. Receiving of goods
2. Despatch
3. Payment preparation
4. Marketing
5. Production
6. Payment and recording of payment
7. Recording of purchases
8. Personnel
9. Ordering of goods
10. Wages

REQUIRED

1. Identify, in logical order, the functions that you would normally encounter in the **acquisition of and payment** for credit purchases in a company.
2. Briefly explain the main activities within the **payment preparation** function in this cycle.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:11/2–11/5)

1. The functions of the acquisition of and payment for credit purchases are:
 - Ordering of goods
 - Receiving of goods
 - Recording of purchases
 - Payment preparation
 - Payment and recording of the payment

Were you able to list these functions in logical order? Remember to think of practical experiences you encounter on a daily basis. This will make it easier to remember.

2. The main activities relevant to the **payment preparation** function are described in Jackson & Stent (2016:11/12) and are not repeated here.

5.1.2 DOCUMENTS USED IN THE CYCLE

STUDY

- Jackson & Stent (2016:11/5–11/6)

ACTIVITY 2

Match the documents explained in your textbook to the functions in the solution to activity 1.

FEEDBACK ON ACTIVITY 2

Function	Document
Ordering of goods	Requisitions Purchase order forms
Receiving of goods	Supplier's delivery note Goods received note
Recording of purchases	Purchase invoice Credit note
Payment preparation	Creditor's statement Cheque (payment) requisition
Payment and recording of the payment	Remittance advice Cheque or electronic payment Receipt

It is important to know which documents are used in the different functions and business cycles for you to be able to design internal controls appropriately. Note that various **logs and variance reports** exist that could be produced for any of the functions and at any stage in the acquisitions and payments cycle.

In addition to the above documents, **accounting records**, such as a purchase journal, creditors ledger, the general ledger (creditors control account), and a purchases returns and allowances journal are also used in the acquisitions and payments cycle. These records are normally maintained in the accounting department.

5.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

As stated in the introduction to this topic, the two main activities for expenditure transactions are ...

- the ordering and receiving of goods (or services) from suppliers
- the payment of amounts due for the goods ordered and received

The acquisition phase of the cycle attempts to ensure that the company orders and receives only those goods which it requires and that the goods are of a suitable quality and price. The second phase of the cycle attempts to ensure that only goods that have been validly ordered and received are paid for and that payment is authorised, accurate and timeous (Jackson & Stent 2016:11/2). Sound internal controls should be implemented to achieve this.

To derive the internal controls over payments and acquisitions per function and activity in the cycle, you need to apply the **control activities**. The other components of internal control in this cycle are explained separately in Jackson & Stent (2016:11/31).

STUDY

- Jackson & Stent (2016:11/9–11/13)
- Jackson & Stent (2016:11/31)

ACTIVITY 3

1. Give a system description of the functions, documents and internal controls that can be implemented in the **ordering** department of a going concern. Formulate your answer in the following tabular format:

Functions	Documents	Internal controls

FEEDBACK ON ACTIVITY 3

1. The functions, documents and internal controls that can be implemented in the **ordering** department of a going concern are:

Functions	Documents	Internal controls
1. Initiating orders	1. Requisition	<p>1.1 Before the order is placed, a supervisor/senior buyer should check the order against the requisition for accuracy and authorisation; and review the order for suitability of supplier, reasonableness of price and quantity, and nature of goods being ordered.</p> <p>1.2 The ordering department should file requisitions sequentially and should frequently review the files for requisitions which have not been cross-referenced to an order.</p>
2. Placing orders with suppliers	2. Purchase order form	2.1 Order clerks should not place an order without receiving an authorised requisition and should cross-reference the order to the requisition. Stores/production personnel should confirm that the goods are really needed.

		<p>2.2 The company should have an approved supplier list to which the buyer should refer when ordering.</p> <p>2.3 A copy of the order should be filed sequentially and the file should be sequence-checked and frequently cross-referenced to goods received notes.</p> <p>2.4 Blank order forms should be subject to sound stationery controls.</p>
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If you were able to perform this activity, you understand what internal controls relating to business cycles are all about. You should be able to perform this for each function in each business cycle.

ACTIVITY 4

Delmundo (Pty) Ltd is a small manufacturing company. The company's accounting functions are carried out by the accounting staff consisting of the accountant, Mary Roosevelt, and two clerical assistants, Stella Stirling and Dean Ramjan. The new owner of the business, John de Marzo, is concerned about a number of processes followed and, not having a business background, has asked you to review and report on certain of these processes. However, his immediate concern is the control over the payment of creditors. To gather first-hand knowledge of how the system currently works, John de Marzo himself compiled an accurate description of the system which he has given to you.

1. When an invoice is received from a supplier, it is promptly entered into the purchase journal by Stella Stirling and filed alphabetically by supplier name. When the supplier's monthly statement arrives, Stella Stirling agrees the invoices received to the statement. She also checks that any payments that were made to the supplier by Delmundo (Pty) Ltd are reflected on the statement.
2. If an invoice reflected on the statement has not been received, Stella Stirling highlights the invoice(s) and marks it "outstanding" on the statement. The full amount reflected on the statement is paid. When the outstanding invoice is received, it is filed with the statement to which it relates and the "outstanding" mark on the statement is crossed out and dated.
3. Using the statements, Stella Stirling then makes a list of all creditors and the amounts which they are to be paid. The list is passed to Mary Roosevelt, who writes out a cheque for each creditor under R5 000. All cheques are carefully written out and marked "not transferable". Mary Roosevelt signs each cheque and returns them with the list to Stella Stirling. Stella Stirling confirms the amounts of each cheque and that

there is a cheque for each creditor on the list under R5 000. Stella Stirling writes the cheque number next to each payment on the list and then mails the cheques to the creditors attached to a Delmundo (Pty) Ltd compliment slip. If the amount to be paid is more than R5 000, it is paid by EFT and not by cheque.

4. To pay creditors over R5 000, Mary Roosevelt accesses the electronic funds transfer facility on her computer and compiles a schedule of payments to be made by EFT to creditors. She obtains this information from the creditors list prepared by Stella Stirling. She carefully checks the details, namely the bank, branch code and account number of the creditor to be paid against a hard copy listing which she keeps for all creditors.
5. Stella Stirling passes the creditors list to Dean Ramjan, as he is solely responsible for the cash payments journal, namely writing it up, posting transactions to the general ledger and reconciling the cash receipts and payments journal to the bank statement monthly.

REQUIRED

Identify the weaknesses in the payments system described by John de Marzo. For each weakness you identify, explain briefly why you consider it to be a weakness (i.e. what can go wrong because of this weakness).

FEEDBACK ON ACTIVITY 4

- 1.1 The invoices received from suppliers are not matched to any other documents, namely the purchase order, supplier delivery note or goods received note. Delmundo (Pty) Ltd could be paying for goods which were never ordered or never received (delivered), and are incorrect in terms of description, quantity or price.
- 2.1 Before the invoice is paid, there is no check to confirm that the purchase is authorised (or even that the goods purchased are of a type used by Delmundo (Pty) Ltd). If nobody checks the above, the risk that employees might be purchasing goods for themselves and have the company pay is significantly increased.
- 2.2 The full amount as reflected on the statement is paid, even where no invoice has been received. Delmundo (Pty) Ltd may be paying for goods incorrectly charged to them.
- 2.3 No checks are carried out on the casts, extensions, calculations and VAT on the purchase invoice. This may result in inaccurate payments and under-recovery of VAT.
- 3.1 No creditors ledger appears to be kept. Creditors are paid on the strength of an external document (creditor statement) only. By having a creditors ledger, a more accurate record of purchases and payments is maintained. The creditors ledger can be reconciled monthly to the creditors statement and any differences and unusual items can be followed up before payment is made.

- 3.2 There is only one cheque signatory. Having only one cheque signatory provides inadequate security over the company's bank balance. As Mary Roosevelt has access to the cheque book and she is the sole signatory, she can write out a cheque to a fictitious creditor at any time.
- 3.3 Mary Roosevelt does not agree the amounts to be paid to creditors to any supporting documentation (for example approved creditors reconciliations). This increases the risk of invalid payments to creditors as Stella Stirling could add a fictitious creditor to the list from which Mary Roosevelt writes out cheques.
- 4.1 There is insufficient control over payments made by EFT. In effect, there is only one "signature" required to access the company's bank account and transfer funds.
- 4.2 EFTs are made without supporting documentation and can be made by Mary Roosevelt at any time and for any amount.
- 4.3 Nobody checks at any stage during the payment whether payments to creditors or others are valid.
- 5.1 No review of the cashbook is carried out by "management", for example the cash book is not reviewed for missing cheque numbers or unusual payments. With no independent review of Dean Ramjan's work, he has the opportunity to cover up misappropriation.
- 5.2 An almost total lack of involvement by senior personnel/management. With such a small staff, and a lack of basic controls, the senior management should be playing an active role – for example, acting as the second signatory on cheques and EFTs or reviewing supporting documentation. This lack of involvement weakens the control environment considerably and facilitates fraud and collusion.

Source: *Graded Questions on Auditing 2015* (Gowar & Jackson 2014:230–231) – adapted.

Note: The theory relating to this question can be found in Jackson and Stent (2016:11/12–11/13).

To be able to identify weaknesses in any business cycle, you need to know which internal controls should be implemented to mitigate the risks in a perfect control environment.

5.1.4 COMPUTERISATION OF THE CYCLE

Your textbook, Jackson & Stent, describes an integrated manual and computerised acquisitions and payments system of a going concern.

STUDY

- Jackson & Stent (2016:11/14–11/30)

ACTIVITY 5

Your textbook describes the application controls over masterfile amendments as mainly **preventative**, but supported by **detective** controls.

1. Explain in your own words why the creditors masterfile is central to the acquisition and payments system.
2. Explain in your own words what the term “preventative” means in this context.
3. Provide an example of a preventative application control.
4. Provide an example of a detective control.
5. Name a few logs and reports that are used as part of detective controls over masterfile amendments.
6. Describe the application controls that should be implemented to prevent and detect errors during amendments made to the creditors’ masterfile in a computerised environment.

FEEDBACK ON ACTIVITY 5

Reference: Jackson & Stent (2016:11/16–11/18)

1. The accurate and complete processing of authorised purchases and payments depends to a great extent on the integrity of the masterfile. The creditors’ masterfile will contain information relating to the suppliers of the company, the terms which affect payments, balances and the banking details required to make EFT payments to the creditors.
2. This means that application controls are implemented to **prevent** mistakes from happening in the first place.
3. Restrict write access to the creditors’ masterfile to a specific member of the section by the use of a user ID and passwords. This will **prevent/deter** unauthorised users from gaining access and making unauthorised amendments to the masterfile.
4. Each logged amendment should be checked to confirm that it is supported by a properly authorised masterfile amendment form (MAF). This will enable management to **detect** any unauthorised amendments to the masterfile.
5. The masterfile amendment log is the main log used when making amendments to the masterfile. Various other logs and reports issued in the course of the acquisitions and payments cycle could be used to detect errors during masterfile amendments, such as the masterfile access violation reports and creditors ledger exception reports, for example invalid account numbers.
6. The application controls that should be present to prevent and detect errors in amending the creditors masterfile in a computerised environment are described in Jackson & Stent (2016:11/16–11/18) and are not repeated here.

ACTIVITY 6

1. Provide five examples of things that can go wrong when creating a purchase order in a computerised environment.
2. Describe the application controls that should be present to ensure that purchase orders that are **created** and **sent** to suppliers in a **computerised environment** are authorised, accurate and complete.

FEEDBACK ON ACTIVITY 6

Reference: Jackson & Stent (2016:11/20–11/21)

3. Examples of things that could go wrong when creating a purchase order in a computerised environment:
 - Purchase orders could be made out for goods that are not sold by the company if an incorrect inventory item code is entered into the ordering system and the system accepts the inventory code without matching it to inventory codes in the masterfile.
 - Purchases could be made from unapproved suppliers if the system allows the order clerk to enter suppliers that are not approved (no verification checks).
 - Details pertaining to the order could possibly not be entered accurately and completely if the system does not perform programme checks, such as mandatory field checks.
 - An inappropriate quantity of goods could be ordered if the system does not perform programme checks, such as limit or reasonableness checks.
 - Goods ordered could possibly not agree with the purchase requisition report if the order clerk is not alerted by a screen message whenever the quantity of the purchase order does not agree with the purchase requisition report (reasonableness check).
4. The application controls that should be present to ensure that purchase orders that are **created** and **sent** to suppliers in a computerised environment are authorised, accurate and complete are described under points 3 and 4 in Jackson & Stent (2016:11/20–11/21) and are not repeated here.

ACTIVITY 7

1. Your textbook, Jackson & Stent (2016:11/24), explains that electronic funds transfer (EFT) is a fast and efficient method of making payments. Explain why the risk of fraudulent payments is very high if strict controls over EFT are not in place.

2. Describe the application controls that should be present to ensure sound control over the preparation and approval of the schedule of payments in a computerised environment.

FEEDBACK ON ACTIVITY 7

1. Theft of funds from the company's bank account can easily occur because EFTs are quick and efficient. Funds can be transferred to another bank account very quickly, if access can be gained to a company's internet bank account.
2. The application controls that should be present to ensure sound control over the preparation and approval of the schedule of payments in a computerised environment are described under point 3 in Jackson & Stent (2016:11/24–11/26) and are not repeated here.

Remember to limit your answer to the **preparation** and **approval** of the schedule of payments.

ACTIVITY 8

Answer the following questions regarding application controls over the bank account:

1. Why is it important to restrict access to the bank account in a computerised system?
2. Describe the access controls that should be implemented to ensure sound control over the bank account.
3. Provide a list of sound controls over passwords as part of access controls over the bank account.

FEEDBACK ON ACTIVITY 8

1. Restriction of access to the bank account

Reference: Jackson & Stent (2016:8/30–8/31), section 2.6

Violations of access to the bank account in a computerised system can have extremely serious consequences for the business. These include:

- Destruction of data: The internet bank account itself or account details could be deleted.
- “Theft” of data: Bank account details could be stolen and abused.
- Improper changes to data: Payment beneficiaries’ details could be changed in order to channel payments to unauthorised accounts.
- Recording of unauthorised or non-existent transactions: Unauthorised transfers of money could be done.

2. Access controls over the bank account

Reference: Jackson & Stent (2016:11/26), point 3

The access controls that should be implemented to ensure sound control over the bank account are:

- The terminal onto which the bank's software is loaded, should be in the creditors' section, and will usually be the terminal of the senior creditors' clerk.
- Access to the bank's site should be gained in the normal manner, but to access the company's bank account, the senior creditors' clerk should need to enter a PIN and password.
- If this identification and authentication procedure is successful, a menu of the functions available should be displayed, one of which will be "download bank statement".
- This function should be linked to the senior creditors' clerk's user profile to enable him/her to initiate the download.

3. Sound controls over passwords

Reference: Jackson & Stent (2016:8/20)

The strict control of passwords as part of access controls over the bank account is fundamental to successful, logical access controls. Sound controls over passwords are:

- Passwords to access the bank account should be unique to the senior creditors' clerk (group passwords should not be used).
- Passwords to access the bank account should consist of at least six characters, be random, not obvious, and be a mix of letters, numbers, upper/lower case and symbols.
- Passwords and user IDs for terminated or transferred senior creditors' clerks should be removed or disabled at the time of termination or transfer.
- Passwords to access the bank account should be changed regularly and the senior creditors' clerk should be forced by the system to change the password. (System sends the senior creditors' clerk a screen message to change the password and allows a limited number of attempts to enter the existing password. After this, access will not be granted until a new password has been registered.)
- The first time a new senior creditors' clerk accesses the bank account, he/she should be prompted to change the initial password.
- Passwords to access the bank account should not be displayed on PCs at any time, be printed on any bank statements or logged in bank transaction logs.
- Password files should be subject to strict access controls to protect them from unauthorised read and write access. Encryption of password files is essential.

- Passwords should be changed if confidentiality has been violated, or violation is expected.
- Passwords should not be obvious, for example birthdays, names, name backwards, or common words, and should not be the same as the user ID.
- The senior creditors' clerk should be prohibited from disclosing his/her passwords to others and subjected to disciplinary measures should he/she do so.
- Passwords to access the bank account should be changed if confidentiality has been violated, or violation is expected.
- Passwords to access the bank account should not be obvious, for example birthdays, names, name backwards, common words, and should not be the same as the senior creditors' clerk's user ID.

Note: Refer to chapter 8 of your prescribed textbook again if you need to remind yourself of the theory of the control of passwords.

CONCLUSION

In this topic, **Acquisitions and payments cycle**, we explained and applied the activities, functions and documents in the acquisitions and payments business cycle. The risks and internal controls in this cycle were also explained and applied, together with internal control over acquisitions and payments transactions in a computerised environment.

In the next topic we will explain and apply the inventory and production business cycle, together with the applicable internal controls in the cycle.

TOPIC 6

INVENTORY AND PRODUCTION CYCLE

Topic overview

Inventories encompass **goods purchased and held for resale** including, merchandise purchased by a retailer and held for resale. Inventories also encompass **finished goods produced, or work in progress** and include **materials and supplies awaiting use in the production process** (see International Accounting Standard [IAS] 2).

The inventory and production cycle includes the following classes of transactions and account balances:

Statement of financial position	Statement of comprehensive income
Inventory	Cost of sales

The aim of this topic is to explain the activities, functions and documents in the inventory and production business cycle and to apply these to practical situations. The risks relating to this cycle and the internal controls to mitigate those risks, including internal controls over inventory and production transactions in a computerised environment, will be applied and explained. Basic inventory valuation concepts will also be described and explained.

This topic is divided into the following learning units:

Learning unit	Title
6.1	Inventory and production cycle
6.1.1	Activities and functions in the cycle
6.1.2	Documents used in the cycle
6.1.3	Risks and internal control in warehousing
6.1.4	Risks and internal control in production
6.1.5	Inventory counts
6.1.6	Computerisation of the cycle
6.1.7	Inventory valuation concepts

LEARNING OUTCOMES

Learning unit	In this topic we focus on the following learning outcomes:	Level
6.1 Inventory and production cycle	<ul style="list-style-type: none"> Describe the activities and functions and allocate the documents associated with inventory and production. 	2
	<ul style="list-style-type: none"> Identify and explain the risks associated with warehousing and describe and apply the internal controls that could be implemented to mitigate these risks. 	2
	<ul style="list-style-type: none"> Identify and explain the risks associated with production and describe and apply the internal controls that could be implemented to mitigate these risks. 	2
	<ul style="list-style-type: none"> Explain and apply inventory counts as part of control activities over inventory and production. 	2
	<ul style="list-style-type: none"> Describe and apply internal control in a computerised environment to inventory and production transactions. 	2
	<ul style="list-style-type: none"> List basic inventory valuation concepts. 	1

LEARNING UNIT 6.1

INVENTORY AND PRODUCTION CYCLE

INTRODUCTION

Your prescribed textbook, Jackson & Stent (2016:12/2), describes the inventory and production cycle as the heart of the business and explains that this cycle mainly deals with:

- the **custody and safekeeping** of inventory in whatever form, for example goods held for resale or manufacture, and finished goods
- the **recording of costs** where a production/manufacturing process occurs

6.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

Inventory is the major component in the calculation of cost of sales, gross profit and net profit of a trading concern (Jackson & Stent 2016:12/2). The inventory balance is usually also a material current asset on the statement of financial position in the company's financial statements.

STUDY

- Jackson & Stent (2016:12/2–12/4)

ACTIVITY 1

Jackson & Stent (2016:12/2) describes inventory and production as an internal cycle. Represent this on a diagram that shows the interface of the inventory and production cycle with the acquisitions cycle and the revenue cycle.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:12/3–12/4)

The diagram on page 12/4 of Jackson & Stent demonstrates that goods received from suppliers follow one of two paths, namely, to the raw materials and components store, on to production and into the finished goods warehouse, **or** direct to the “goods for resale” warehouse. The diagram is not repeated here.

6.1.2 DOCUMENTS USED IN THE CYCLE

STUDY

- Jackson & Stent (2016:12/4–12/5)

ACTIVITY 2

Allocate the documents explained in your textbook to the **warehousing** or **production** phase of the inventory and production cycle.

FEEDBACK ON ACTIVITY 2

Warehousing	Production
<ul style="list-style-type: none">• Goods received note• Picking slip and delivery notes	<ul style="list-style-type: none">• Materials (components) requisition, materials (components) issue note• Manufacturing or production schedules• Job cards• Production report• Costing schedule• Transfer to finished goods note

The inventory sheet, inventory tag and inventory adjustment form are used during an inventory count and do not fit into the warehousing or production phases. The inventory count will be explained later in this study unit.

6.1.3 RISKS AND INTERNAL CONTROL IN WAREHOUSING

Jackson & Stent (2016:12/3) describe two major risks associated with inventory warehousing, namely risks associated with the **physical transfer of inventory** and the **protection of inventory** from damage, loss and theft. These and other risks, as well as internal controls (control activities) to mitigate the risks, will now be explained.

STUDY

- Jackson & Stent (2016:12/6–12/7)

ACTIVITY 3

1. Describe the internal controls that can be implemented to mitigate the risks associated with the physical **transfer** of inventory in a warehouse.

2. Describe the internal controls that can be implemented to mitigate the risks associated with the **protection** of inventory against damage, theft and loss in a warehouse. Distinguish between **preventative** and **detective** controls in your answer.

FEEDBACK ON ACTIVITY 3

Reference: Jackson & Stent (2016:12/6–12/7)

1. The internal controls that can be implemented to mitigate the risks associated with the physical transfer of inventory in a warehouse are explained in Jackson & Stent (2016:12/6) and are not repeated here.
2. Physical controls over inventory in warehouses are **preventative controls**, in other words preventing damage, theft and loss from occurring in the first place. Comparison and reconciliation are **detective controls** that will pick up on damage, theft and loss that have already occurred by comparing physical inventory with theoretical inventory in the accounting records.

Refer to Jackson & Stent (2016:12/7) where internal controls to control damage, theft and loss of inventory in warehouses are explained.

6.1.4 RISKS AND INTERNAL CONTROL IN PRODUCTION

As with inventory warehousing, internal controls must also be implemented over **production inventory** to protect it from damage, loss and theft; internal controls to mitigate additional risks associated with the **planning, control and costs of manufacturing** should also be implemented (Jackson & Stent 2016:12/3–12/4).

STUDY

- Jackson & Stent (2016:12/8–12/10)
- Jackson & Stent (2016:12/20–12/22) – fraud in the cycle

ACTIVITY 4

Production of inventory can only commence after the production manager has authorised the job cards.

1. What details must the job cards contain and what procedures are performed by the production manager before a job card is authorised?
2. Describe the internal controls which should be present to ensure sound control over job orders.

FEEDBACK ON ACTIVITY 4

Reference: Jackson & Stent (2016:12/8–12/9)

1. The costing schedule should be transferred to job cards and the job cards should:
 - be sequenced and dated
 - contain a list of materials to be used, for example the description and quantity of materials
 - be cross-referenced to customer orders/quotes
 - be cross-referenced to a materials requisition and materials issue note
 - be cross-referenced to the daily production schedule, after which the production manager will review and authorise the job cards
2. Internal controls to ensure sound control over **job orders** are explained in Jackson & Stent (2016:12/8–12/9) and are not repeated here.

6.1.5 INVENTORY COUNTS

According to Jackson & Stent (2016:12/11), inventory counts are one of the most common control activities whereby actual inventory on hand is compared with theoretical inventory in accounting records.

The responsibility for carrying out inventory counts rests with management, since it is management's responsibility to ensure that the inventory figure in the financial statements is valid (exists), accurate and complete.

STUDY

- Jackson & Stent (2016:12/11–12/13)

Similar methods of counting and sound controls are used for both cycle counts (which take place on an ongoing basis) and year-end counts (annual counts).

ACTIVITY 5

Reference: Jackson & Stent (2016:12/12–12/13)

1. Which basic principles must be adhered to **before** conducting the actual inventory count in order to ensure a successful count?
2. List the procedures that should be followed by the counting team when conducting an inventory count.

FEEDBACK ON ACTIVITY 5

1. In order to ensure a successful inventory count, the following must be adhered to:

- proper and timeous planning and preparation
- standard stationery design principles and controls
- written count information and instructions to all members involved in the count

Note: The above principles are explained in further detail in Jackson & Stent (2016:12/12).

2. The procedures that should be followed by the counting team when conducting an inventory count are listed in Jackson & Stent (2016:12/12–12/13) and are not repeated here.

6.1.6 COMPUTERISATION OF THE CYCLE

The inventory masterfile is central in a computerised inventory and production cycle, since it contains the theoretical inventory figure which ideally should agree with the physical inventory on hand (Jackson & Stent 2016:12/13).

STUDY

- Jackson & Stent (2016:12/13), section 9

Access controls in a computerised environment are key to ensuring that unauthorised masterfile amendments are not made to disguise damage, loss or theft of physical inventory. Refer to the relevant activities in topics 3, 5 and 6 where access controls were dealt with extensively.

6.1.7 INVENTORY VALUATION CONCEPTS

The generally accepted basis for the valuation of inventory is the **lower of cost and net realisable value**. It is important that inventory should be valued accurately as the internal control objectives of validity, accuracy and completeness may be at risk if the inventory in the financial records is either over - or undervalued.

STUDY

- Jackson & Stent (2016:12/18–12/20), section 3

ACTIVITY 6

1. At what value should inventory be presented in the financial records of a company?
2. What does the term “net realisable value” mean?
3. What should the cost price of inventory consist of?
4. Which of the following costs should be excluded when valuing inventory:
 - delivery costs
 - administrative costs
 - commission paid on goods sold
 - wages paid to production staff
 - production material lost during a fire in the production plant
5. Name the three cost formulas permitted by International Accounting Standard (IAS) 2.

FEEDBACK ON ACTIVITY 6

Reference: Jackson & Stent (2016:12/18–12/19)

1. Inventory should be valued at the lower of cost and net realisable value.
2. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.
3. The cost of inventory should consist of:
 - all costs of purchase, including import duties and transport costs incurred in the acquisition of materials and goods for resale
 - conversion costs, for example direct labour and production overheads
 - costs incurred in bringing the inventory to its present location and condition, for example costs incurred in designing a product for a specific customer
4. The costs mentioned should be treated as follows:
 - delivery costs: included (transport costs incurred in the acquisition and costs incurred in bringing the inventory to its present location)
 - administrative costs: excluded
 - commission paid on goods sold: excluded (selling costs)
 - wages paid to production staff: included (fixed and variable production overheads)
 - production material lost during a fire in the production plant: excluded (abnormal amounts of wasted material)
5. The three cost formulas permitted by IAS 2 are **specific identification**, **weighted average** and **FIFO**. These cost formulas are explained in more detail in Jackson & Stent (2016:12/19–12/20).

CONCLUSION

In this topic, **Inventory and production cycle**, we explained and applied the activities, functions and documents in the inventory and production cycle. The risks and internal controls relevant to this cycle were explained and applied, as well as internal control over inventory and production transactions in a computerised environment. Inventory valuation concepts were also described and explained.

In the next topic we will explain and apply the payroll and personnel business cycle as well as the applicable internal controls in the cycle.

TOPIC 7

PAYROLL AND PERSONNEL CYCLE

Topic overview

With human resources and payroll departments under more pressure than ever before, a modern automated payroll solution is essential for any business. Yet many organisations are still using manual processes that can't keep pace with the demands of today's workforce and the fast-changing legal and tax environment (Fin week, 2015).

Two main types of transactions are processed through the payroll and personnel cycle, namely:

- payment to employees for services rendered (salaries and wages)
- accrual and payment of payroll-related liabilities (employee deductions such as taxes, pension fund and medical aid)

The payroll and personnel cycle includes the following classes of transactions and account balances:

Statement of financial position	Statement of comprehensive income
Bank and cash Accounts payable [accumulated leave, unclaimed wages, South African Revenue Services (SARS) liability, pension funds liability, medical aids liability and other]	Wages and salaries [net of employee deductions such as pay as you earn (PAYE), unemployment insurance fund (UIF), skills development levy (SDL), pension fund, medical aid and other]

The aim of this topic is to explain the activities, functions and documents in the payroll and personnel business cycle and to apply these in practical scenarios. The risks in this cycle will be explained and internal controls applied to mitigate those risks, as well as internal control over payroll and personnel transactions in a computerised environment.

This topic is divided into the following learning units:

Learning unit	Title
7.1	Payroll and personnel cycle
7.1.1	Activities and functions in the cycle
7.1.2	Documents used in the cycle
7.1.3	Risks and internal control in the cycle
7.1.4	Computerisation of the cycle

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
7.1 Payroll and personnel cycle	• Describe payroll and personnel transactions by explaining the activities, functions and documents associated with these transactions.	2
	• Identify, explain and evaluate the risks associated with payroll and personnel transactions and describe and apply the internal controls that could be implemented to mitigate the risks in a non-computerised environment.	2
	• Describe and apply internal control in a computerised environment to payroll and personnel transactions.	2

LEARNING UNIT 7.1

PAYROLL AND PERSONNEL CYCLE

INTRODUCTION

Jackson & Stent (2016:13/2) explains that the payment of salaries and wages is an integral part of any business which results in an outflow of funds.

7.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

The most obvious difference between a salary and wage system is that salary systems do not have a timekeeping function; a salary is a set monthly amount regardless of the hours worked by the employee (Jackson & Stent 2016:13/29).

STUDY

- Jackson & Stent (2016:13/2–13/5)

Note the following about the study material above:

Sections 4 and 5 in Jackson & Stent (2016:13/3–13/5) describe a **wage system**. Apart from time keeping and the difference in payment methods (salaries are generally paid by electronic funds transfer (EFT) and wages in cash), these functions are in general also relevant for a salary system.

STUDY

- Jackson & Stent (2016:13/29–13/30)

ACTIVITY 1

1. Explain why the payroll and personnel cycle could be especially susceptible to fraud.
2. Explain what practical arrangement companies can make with employees to avoid the risk of fraud.
3. Describe the timekeeping, payroll preparation and payout functions relevant to a **wage system** in the payroll and personnel cycle.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:13/3–13/5)

1. Companies who pay wages in cash are susceptible to fraud due to the high risk of theft of large amounts of cash.
2. To protect the company from this risk, as well as for the personal safety of employees, a company could pay wages via electronic funds transfer (EFT) directly into employees' bank accounts.
3. The timekeeping, payroll preparation and payout functions relevant to a wage system, are described in section 5 of Jackson & Stent (2016:13/4–13/5) and are not repeated here.

Note: Study section 1 of Jackson & Stent (2016:13/2) again if the differences between a wage and a salary system are unclear to you.

7.1.2 DOCUMENTS USED IN THE CYCLE

STUDY

- Jackson & Stent (2016:13/5–13/6), section 6

ACTIVITY 2

The following documents or records are found in most businesses. Some are applicable to the payroll system and some are not.

1. Cash receipt
2. Payroll amendment form
3. Clock card
4. Deduction tables
5. Employment contract
6. Unclaimed wages register
7. Payslips
8. Internal purchase order
9. Payroll (wage journal)
10. Purchase journal

REQUIRED

1. State which of the above documents or records will be found in the payroll cycle.
2. State the order in which the documents will normally occur in the payroll cycle, indicating in which function within the payroll cycle they will be used.

FEEDBACK ON ACTIVITY 2

Reference: Jackson & Stent (2016:13/5–13/6)

1. The following documents will be found in the payroll cycle:
 - 1.1 Payroll amendment form
 - 1.2 Clock card
 - 1.3 Deduction tables
 - 1.4 Employment contract
 - 1.5 Unclaimed wages register
 - 1.6 Payslips
 - 1.7 Payroll (wage journal)

Note: The cash receipt is applicable to the revenue and receipts cycle, and the internal purchase order and purchase journal are used in the acquisitions and payments cycle.

As previously stated you need to know which documents are used in the different functions and business cycles for you to be able to design internal controls appropriately.

2. The correct order in which the documents will be found and the functions within which they will be used are:
 - 2.1 Employment contract – personnel (human resources)
 - 2.2 Payroll amendment form – personnel (human resources)
 - 2.3 Clock card – timekeeping and payroll preparation
 - 2.4 Deduction tables – payroll preparation
 - 2.5 Unclaimed wages register – payment preparation and payout
 - 2.6 Payslips – Payment preparation and payout
 - 2.7 Payroll (wage journal) – deductions: payment and recording

Note that these functions are described in more detail in Jackson & Stent (2016:13/4–13/5)

7.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

Internal control procedures, the practices and guidelines a business follows to protect its resources, are especially important when recording, preparing and distributing the payroll. Having proper procedures in place protects the company's assets by reducing the risk of fraud and eliminating errors (Benge, [sa]).

STUDY

- Jackson & Stent (2016:13/9–13/13)

Note the following about the study material above:

The **payment** of **salaries** and the appropriate internal controls for this function are not specifically discussed in the textbook. In this regard you should remember that salaries are paid either by cheque or by EFT. The normal internal controls for cheque payments therefore apply to the payment of salaries. Internal controls over EFT payments in a computerised environment will be explained and applied in section 7.1.4.

To see whether you can identify the relevant internal controls over a wage payout, do the following activity:

ACTIVITY 3

Steelworks Ltd employs 1 000 workers who receive a weekly cash wage. You are requested to assist management in implementing **internal controls over the preparation and payout of wages**. Management is satisfied that there is sufficient internal control over the clocking of hours worked by employees and the calculation and recording of the wages payable.

FEEDBACK ON ACTIVITY 3

Internal controls over the preparation and payout of wages are explained in detail in Jackson & Stent (2016:13/12) and are not repeated here.

Note: Keep in mind that these internal controls are aimed at **mitigating the risks** associated with the **preparation** and **payout** of wages. The main risks identified in your prescribed textbook are:

1. Errors or theft of cash during:
 - drawing of cash
 - making up of wage packets
 - the payout [Risks addressed in points 1 to 6 of the control procedures in Jackson & Stent (2016:13/12).]
2. Misappropriation of unclaimed wages [Risk addressed in points 7 to 11 of the control procedures in Jackson & Stent (2016:13/12)].

ACTIVITY 4

C-Ment Ltd manufactures cement blocks and pavers. The company was started some years ago and has grown steadily to the extent that it currently employs 120 semi-skilled workers.

Internal controls have not kept up with the growth of the business and you have been asked to evaluate the current wage system. You have obtained the following information:

1. The manufacturing yard is enclosed by a large security wall. The only access to the yard is through the gate used by vehicles that deliver raw materials and collect finished products. Workers enter and exit through this gate. There is a small gate hut manned by a security guard.
2. On arriving at or leaving work, employees tick off their names on a "daily time list" entering their time of arrival or departure in the space provided. A large clock is located in the gate hut.
3. The company's administration functions, such as sales and accounting, are located in a small office block next to the manufacturing yard. The accounting section is staffed by a senior accountant, Zeb Matabane, and three clerical assistants. One of the clerical assistants, Milly Moss, is responsible for the wage function which operates as follows:
 - 3.1 Each working day after close of business she collects the daily time lists from the gate hut and replaces them with new lists for the following day. The completed daily time lists are filed in date order in a lever arch file. She also maintains a simple hard copy employee's file for each employee.
 - 3.2 The wage week runs from Thursday morning to Wednesday afternoon. On Thursday mornings Milly Moss calculates the total hours worked by each employee for the week (both normal and overtime) and enters the totals against each employee's name, on a weekly "hours summary list". She then accesses the wage application on her computer and selects the "enter hours module". She then captures the hours for each employee, entering the employee's staff number and hours worked from the weekly "hours summary lists".
 - 3.3 Once each employee's hours worked have been entered, Milly Moss selects the "prepare payroll" module to start processing the wages and producing the payroll. The payroll reflects employee number, name, section, gross wages, deductions and net pay. It also has a space in which the employee signs on receiving his or her pay.
 - 3.4 Once the payroll has been produced, Milly Moss gives it to Mo Hiten, the cash payment journal clerk, who prepares a cheque for the net amount of the pay (as well as cheques for the amounts to be paid over to SARS for PAYE, UIF etc). Mo Hiten takes the cheques to Zeb Matabane who signs them.
 - 3.5 The cheque for the net wages and the wage packets is then delivered to WageMaster (Pty) Ltd, a security company which cashes the cheque and makes up the wage packets from the details on the packets. Milly Moss prepares a register which reflects the cheque number, amount and number of paypackets to be collected by WageMaster (Pty) Ltd. This register is signed by a WageMaster (Pty) Ltd employee.

- 3.6 On Friday morning WageMaster (Pty) Ltd returns the made-up wage packets to Milly Moss who agrees the number of paypackets to the register and signs the security company's delivery note.
- 3.7 The wage payout takes place at 3 pm on Fridays. At 1 pm Milly Moss leaves the wage packets and a copy of the payroll at the gate hut for collection by the supervisor. The supervisor conducts his or her own payout. He or she hands the paypacket to the employee, who must show his or her staff identity card and sign the payroll next to his or her name.
- 3.8 Any unclaimed wages are marked as such by the supervisor on the payroll. The unclaimed wages are taken home by the supervisor (all administration office employees finish work at 1 pm on Fridays) and handed to Milly Moss on Monday morning. She agrees the packets she has been given to the payroll and puts the packets in the safe. When the employee returns to work he or she must collect their wage packet from Milly Moss (staff identity card must be produced) and sign the payroll.

REQUIRED:

1. **Identify** and **explain** the weaknesses in C-Ment Ltd's wage system based on the information given.

FEEDBACK ON ACTIVITY 4

Reference: Jackson & Stent (2016:13/9–13/13)

Identification and explanation of weakness in the system of internal control over the current wage system of C-Ment Ltd:

Points 1–2:

Weakness: Controls over timekeeping are inadequate.

Explanation:

- There is no reliable timekeeping mechanism/clocking system, making it virtually impossible to prevent invalid hours being “clocked”.
- Workers record their own times of arrival and departure and could thus create fictitious hours.
- As the entry and exit take place through a generally used gate and are unsupervised, workers can again create fictitious hours.
- Workers could tick off the names of fellow workers who are not actually at work.
- Workers could sign in but not actually go to work and return to sign out.
- “Clocking” documentation controls are poor as there is no documentation (clock card or similar) which records the time of exit and entry of each employee independently and in permanent form.
- The clipboard bearing the daily time sheets is left unattended in the gate hut and could be lost, or tampered with, for example hours could be altered.

Point 3

Weakness: There is no separate personnel (human resources) function to ensure optimum efficiency in controlling the workforce.

Explanation:

- A company with a workforce of 120 requires the employment of the necessary skills in the business to deal with recruitments, dismissals, wage negotiations and labour problems in accordance with sound labour practices, and to maintain accurate and complete employee records.

Points 3.2–3.3

Weakness: Controls over the calculation of hours worked and entry into the computer are inadequate, which may result in errors in the amounts paid to employees.

Explanation:

- Nobody checks and authorises Milly Moss's calculation of the hours worked per the time lists, and mistakes could therefore go unnoticed.
- The supervisors do not confirm that overtime hours are valid at any stage.
- No batching system of any kind seems to be used to enhance the accuracy and completeness of entry into the computer, for example no pre-entry and post-entry control totals are calculated.
- There is no review of the payroll by an independent employee (for example one of the other administration clerks) to verify that the correct hours (normal and overtime) and wage rates have been used.

Points 3.1–3.8

Weakness: Milly Moss is responsible for incompatible functions (i.e. there is not appropriate segregation of duties):

- She initiates and controls the daily timesheets.
- She calculates and enters the hours worked.
- She creates the payroll.
- She has access to the made up wage packets.

Explanation:

This will enable her to steal money from the company by

- invalidly increasing the hours worked (for example adding overtime) for certain employees, or
- invalidly increasing the wage rates for certain employees

Points 3.4–3.5

Weakness: There are inadequate authorisation controls over the cheque for net wages.

Explanation:

- Zeb Matabane does not check and initial the supporting documentation, for example the payroll.
- No week-to-week reconciliation is provided to explain any fluctuations in the wages.
- There is only one signatory to the cheque which increases the risk of errors or fraud going undetected.

Point 3.7

Weakness: The supervisor and Milly Moss do not meet to effect the safe transfer of the wage packets. The wage packets are nobody's direct responsibility for a period of time and are left in an unsecure place.

Explanation:

- The supervisors do not check the wage packets they are taking responsibility for and acknowledge that they have done so by signing the payroll. Wage packets could be lost or stolen and nobody would be accountable.

Point 3.7

Weakness: Payouts are conducted by the supervisor without a second official being present.

Explanation:

- This facilitates fraud by a supervisor, particularly where the supervisor has created a fictitious employee by having a “dummy workman added” and recording hours for the dummy workman (easily done as time sheets are freely available in the gate hut). The supervisor would simply take the fictitious employee's packet and sign the payroll.

Point 3.8

Weakness: Unclaimed wage packets are taken home by the supervisor and only handed to Milly Moss on Monday morning.

Explanation:

- Unclaimed wage packets should be stored in a safe and should not be taken off the premises as this increase the risk of theft and or loss.

To be able to identify weaknesses in any business cycle, you need to know which internal controls should be implemented to mitigate the risks in a perfect control environment.

7.1.4 COMPUTERISATION OF THE CYCLE

A company's payroll system will be a combination of manual and computerised functions and most companies make use of the packaged payroll software that has been developed to meet the needs of the company (Jackson & Stent 2016:13/16).

STUDY

- Jackson & Stent (2016:13/14–13/28)

ACTIVITY 5

In section 7.1.3 we explained why internal controls over **timekeeping** in a wage system are very important. This was also illustrated by the weaknesses in the wages system of C-Ment Ltd in activity 4.

REQUIRED:

1. Explain what the term “biometric data” means in a computerised clocking system.
2. Describe the advantages of biometric data over an identification card or a clock card.
3. Describe the application controls that could be implemented to ensure good control over **timekeeping** in a computerised wages system.
4. Describe the application controls that could be implemented to **approve** the hours that were captured during electronic timekeeping before payroll preparation can commence.
5. Describe the application controls that could be implemented over **entering additional earnings and deductions** during the payroll preparation phase in a computerised wages system.

FEEDBACK ON ACTIVITY 5

Reference: Jackson & Stent (2016:13/19–13/21)

1. The most common example of biometric data is an employee's fingerprint. In a system where the identification of employees to be controlled by biometric data, a finger print is stored on the system so that when the employee places his finger on the scanner, it has a set of prints against which to “match” the finger print.
2. Biometric data overcomes the weaknesses of an identification card or clock card system where an employee can swipe the card on behalf of another employee and thereby create fictitious hours worked.
3. The application controls that could be implemented to ensure good control over timekeeping in a computerised wages system are described

in Jackson & Stent (2016:13/19–13/20) under the activities of **1) storing biometric data on the system; 2) employee identification and recording of hours worked; and 3) reviewing employee attendance.**

Note that the application controls over activities 1 and 2 are mainly access controls which are preventative in nature, whilst controls over activity 3 are detective controls such as reports produced on absent employees, late arrivals and unexplained exits from the work place.

4. Once timekeeping has been performed, the hours that were electronically captured must first be approved by the foreman **before** payroll preparation can commence.

The application controls over the **approval of hours worked** are explained in Jackson & Stent (2016:13/21) and are not repeated here.

5. Point 1.3 in Jackson & Stent (2016:13/21) explains that alterations may be necessary to the hours initially recorded during electronic timekeeping. The payroll clerk responsible for preparing the payroll will be responsible for entering these alterations made by the foreman. The application controls over **entering additional earnings and deductions** are described in Jackson & Stent (2016:13/21–13/22) and are not repeated here.

CONCLUSION

In this learning unit we explained and applied the activities, functions and documents of payroll and personnel transactions. The risks and internal control in the payroll and personnel cycle were explained and applied, as well as internal control over payroll and personnel transactions in a computerised environment.

In the next topic we will explain and apply capital expenditure in the finance and investment business cycle, as well as the applicable internal controls in the cycle.

TOPIC 8

FINANCE AND INVESTMENT CYCLE

Topic overview

Investing and financing activities consist of transactions that relate to the acquisition of the **non-current assets (fixed assets)** which are required to manage the activities of the enterprise. The financing activities include funds obtained from borrowing, finance leases and operating leases.

The finance and investment cycle includes the following classes of transactions and account balances:

Statement of financial position	Statement of comprehensive income
Share capital	Dividends paid
Reserves	Profit or loss (reserves)
Long term loans	Interest paid
Property, plant and equipment	Profit/loss on sale of asset
Investments	Profit or loss on investment

The aim of this topic is to explain **capital expenditure** in the finance and investment business cycle by referring to the characteristics of **fixed asset acquisition** transactions. The risks associated with the acquisition of fixed assets will be explained and internal controls applied to mitigate those risks.

This topic is divided into the following learning units:

Learning unit	Title
8.1	Capital expenditure
8.1.1	Characteristics of capital expenditure
8.1.2	Risks and internal control for capital expenditure

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
8.1 Capital expenditure	<ul style="list-style-type: none">• Describe, explain and evaluate capital expenditure as part of the finance and investment cycle by referring to the characteristics of fixed asset acquisition transactions.	2
	<ul style="list-style-type: none">• Identify and explain the risks associated with fixed asset acquisitions and describe and apply the internal controls that could be implemented to mitigate the risks.	2

LEARNING UNIT 8.1

CAPITAL EXPENDITURE

INTRODUCTION

Jackson & Stent (2016:14/2) explains that this cycle essentially deals with the transactions which a company enters into to raise **finance**, for example by borrowing money from a bank or investment company, as well as with the **investments** the company makes, whether it be in property, plant and equipment, or by making long-term loans or investing surplus funds.

8.1.1 CHARACTERISTICS OF CAPITAL EXPENDITURE

We explain **capital expenditure** in the finance and investment cycle with reference to the **acquisition of fixed assets** and the obtaining of finance by means of **long-term loans**.

STUDY

- Jackson & Stent (2016:14/2)

Risks and internal controls in the cycle are now explained.

8.1.2 RISKS AND INTERNAL CONTROL FOR CAPITAL EXPENDITURE

Compensating controls over capital expenditure transactions entail **planning, authorisation, implementation and review and approval** (Jackson & Stent (2016:14/3).

STUDY

- Jackson & Stent (2016:14/3–14/4)
- Jackson & Stent (2016:14/4–14/5) – The Finance and Investment Cycle at Proride (Pty) Ltd

ACTIVITY 1

1. Explain what the term “non-routine transactions” means.
2. How do internal controls over “non-routine transactions” differ from the internal controls over routine transactions explained in the previous topics in this study guide?

3. Describe the major risks for capital expenditure with reference to the internal control objectives.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2016:14/2)

1. **Non-routine transactions** such as fixed asset acquisitions do not usually occur every day and the number and frequency of transactions are considerably less than for example sales, purchases, salaries and wages. The size of transactions is usually significant (the amounts are large) and these transactions are frequently subject to legal and regulatory requirements.
2. Because of the characteristic mentioned in 1, transactions in this cycle are not subject to the routine everyday controls relating to transactions. Internal controls over non-routine transactions such as finance and investment transactions are still based on the five components of internal control (as explained in topic 2), but “**compensating controls**” would be implemented.
3. The major risks for capital expenditure with reference to the internal control objectives are explained in section 2.6 in Jackson & Stent (2016:14/2) and are not repeated here.

Note: The main risks explained under section 2.6 in Jackson & Stent (2016:14/2) are associated with the finance and investment cycle as a whole, but take note that these risks are also specifically applicable to **capital expenditure** in the cycle.

ACTIVITY 2

You have recently been appointed as the internal auditor of North Shore (Pty) Ltd, a large shipping company in Port Elizabeth. Your first assignment was to evaluate the company's accounting systems and related internal controls. The company is divided into five sections, each of which has its own section accountant who is responsible for producing monthly accounts and ensuring that sectional financial matters run smoothly. While reviewing the financial records of the warehousing section you were surprised to see that considerable capital expenditure had been incurred just before the financial year-end (30 June). You found that the same expenditure had been incurred in the other four sections of the company and on visiting the various sections (in July), you noticed a fair amount of equipment still in boxes and not in use. Deciding to follow this up, you approached Andy Bell, the most senior sectional accountant, and asked for an explanation of how the system for capital expenditure operated. He responded as follows:

1. Each sectional accountant is responsible for capital expenditure for his/her section.
2. A budget is prepared in the office of the financial director. Budgeting figures are calculated by increasing the previous year's budget by the

average consumer price index for the year. Sectional accountants are notified as to what their section can spend on the purchase of capital items.

3. However, if sections do not spend their capital budget in any financial year, that section's budget is reduced for the following year. As you can see, we all try to avoid a cut in our budget by making sure we spend our budget before the end of the financial year.
4. If a staff member in the section requires equipment, for example in my warehouse section the foreman may decide he needs a new forklift, he e-mails my assistant with the precise details of what is required as well as the name of a supplier. None of the equipment used by North Shore Ltd is particularly complicated, so this method works fine.
5. My assistant then completes a pre-printed, numerically sequenced, multi-copied order form, which the sectional accountant signs before sending the top copy to the supplier. The second copy of the order is sent to the central creditors department for payment, along with the supplier delivery note. The third copy is left in the order book and used by the assistant to write up the new equipment in the assets register.
6. The supplier delivers the equipment to the section and my assistant signs the supplier delivery note after agreeing the items to the supplier delivery note. The assistant retains a signed copy of the supplier delivery note, which is sent to the creditors department as described in point 5 above.

REQUIRED

Identify and **describe** the **weaknesses** in the system of investing in capital equipment at North Shore (Pty) Ltd, based on the information given **and** to **recommend improvements** to address the weaknesses you have identified.

Do not concern yourself with payments to creditors.

Structure your answer in the tabular format given below:

Weakness	Explanation and improvement

FEEDBACK ON ACTIVITY 2

Weakness	Explanation and improvement
1. The acquisition (investment in) fixed assets is not planned . <ul style="list-style-type: none"> • There is no evaluation of whether the items purchased by the five sectional accountants are required. 	<ul style="list-style-type: none"> • The company should appoint a fixed asset committee consisting of senior experienced management which to take responsibility for evaluating the need for the purchase and evaluating how capital expenditure will be financed. • All requests for fixed assets from

<ul style="list-style-type: none"> Any member of the section can request equipment without providing proper motivation. 	<p>sections must be fully motivated.</p> <ul style="list-style-type: none"> The fixed asset committee should be responsible for preparing an annual capital expenditure budget.
<p>2. The budgeting process is totally ineffective.</p> <ul style="list-style-type: none"> Simply increasing the prior year budget by an index has resulted in sections being allocated money which they do not require and which will be wasted. This weakness is compounded by the fact that sections are “punished” for not spending their allocation by having their budgets reduced. 	<ul style="list-style-type: none"> A proper budgeting system for capital expenditure should be put in place: Each section should carefully evaluate their actual capital expenditure needs (and planned disposals) for the upcoming year. The budget should not be based on adjusted figures for the previous year. The sectional budgets should be submitted to the fixed asset committee for their approval, which should only be given after careful consideration of the motivation. There should be ongoing comparison of actual capital expenditure with budgeted expenditure.
<p>3. There is inadequate authorisation of capital expenditure.</p> <ul style="list-style-type: none"> Sectional accountants have complete authority to purchase equipment provided they have not exceeded the budget. In effect the sectional accountants can make a purchase and authorise it, which shows a lack of division of duties. As there appears to be no reconciliation or follow-up of items actually purchased, this lack of division of duties becomes more serious. 	<ul style="list-style-type: none"> The fixed asset committee should approve the budget, which will then become the fundamental authorising document. See point 4.
<p>4. The controls over the requisitioning and ordering and receipt of capital expenditure items are inadequate.</p> <ul style="list-style-type: none"> No properly designed, pre-printed, sequenced (and authorised) requisition form is presented to support the purchase request (e-mail is sent). The order is placed by the 	<ul style="list-style-type: none"> A properly designed (two part) pre-printed, sequenced, capital expenditure requisition must be prepared and signed by a senior person in the section requiring the item, for example the warehouse manager requiring a new fork lift. This requisition should be submitted to the sectional accountant, who should authorise the requisition (sign) after confirming that the request complies

<p>assistant to the sectional accountant (not the buying department), without any follow up with the supplier as to availability and price and alternative suppliers.</p> <ul style="list-style-type: none"> • Items purchased should not be delivered to the individual sections as this weakens division of duties. 	<p>with the capital expenditure budget.</p> <ul style="list-style-type: none"> • A copy of the requisition should be sent to the company's buying department, and the second copy filed in numerical sequence. • The order department should <ul style="list-style-type: none"> – confirm that the goods requisition appear on the capital budget – check with the preferred supplier as to availability, current price and delivery particulars – make out and sign a three-part pre-printed, sequenced (capital expenditure) order • Items purchased should be delivered to North Shore Ltd's receiving department, where a pre-printed, sequenced, three-part "capital item goods received note" should be made out after the items delivered have been checked to the supplier delivery note.
<p>5. There is a serious lack of division of duties in respect of the assistant to the sectional accountant. This person</p> <ul style="list-style-type: none"> • places the order (on the strength of an e-mail) • receives the goods • "authorises" payment (by sending the unchecked documentation to creditors) • writes up the records (fixed asset register) 	<ul style="list-style-type: none"> • On receipt of the item, a responsible official in the section should check the item delivered against the original requisition and the "capital item goods received notes", before signing them. • Once the above procedures are complete, the assistant to the sectional accountant can write up the sectional fixed asset register.

Source: *Graded Questions on Auditing 2015* (Gowar & Jackson 2014:269) – adapted.

CONCLUSION

In this topic, **Finance and investment cycle**, we explained the business cycle by referring to capital expenditure and the characteristics of asset acquisition transactions. The risks and internal control related to fixed asset acquisition transactions were also explained and applied.