

Department of **Auditing**



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**Corporate governance in accountancy**  
Only study guide for AUE2602

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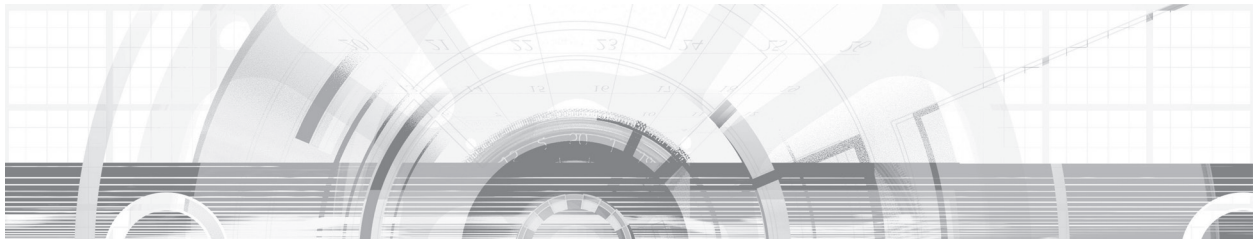
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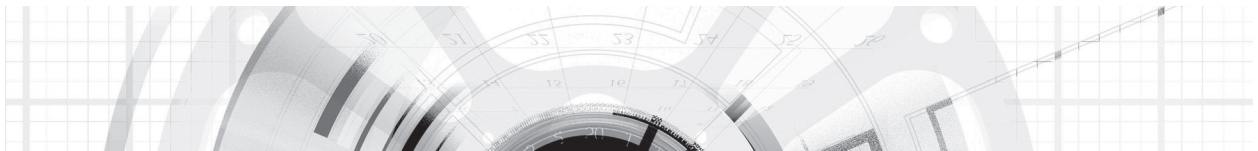
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# PREFACE

## 1 WELCOME

It is a great pleasure to welcome you to this module, **AUE2602: Corporate Governance in Accountancy**. This module deals with the underlying principles of corporate governance.

We urge you to read this preface thoroughly. It outlines the purpose of this module, gives the links with other auditing modules, explains our teaching strategy and provides useful hints that will help you to enjoy your learning experience. Refer back to it as often as you need to, since it will certainly make studying this module a lot easier.

We hope that you will find this module valuable in your study of auditing.

## 2 PURPOSE OF THE MODULE

The purpose of this module is to provide learners with knowledge and skills regarding the principles of corporate governance, statutory matters and internal controls in the business cycles.

Students credited with this module will be equipped with theoretical knowledge of corporate governance and will be able to identify and evaluate the efficiency of internal controls in different business cycles.

## 3 LINKS WITH OTHER MODULES

This module does not stand alone. It is an integral part of various degrees offered by UNISA.

The Department of Auditing offers various modules in the field of auditing, including the following Auditing 200 modules:

### **Auditing 200:**

AUE2601: Auditing Theory and Practice

AUE2602: Corporate Governance in Accountancy

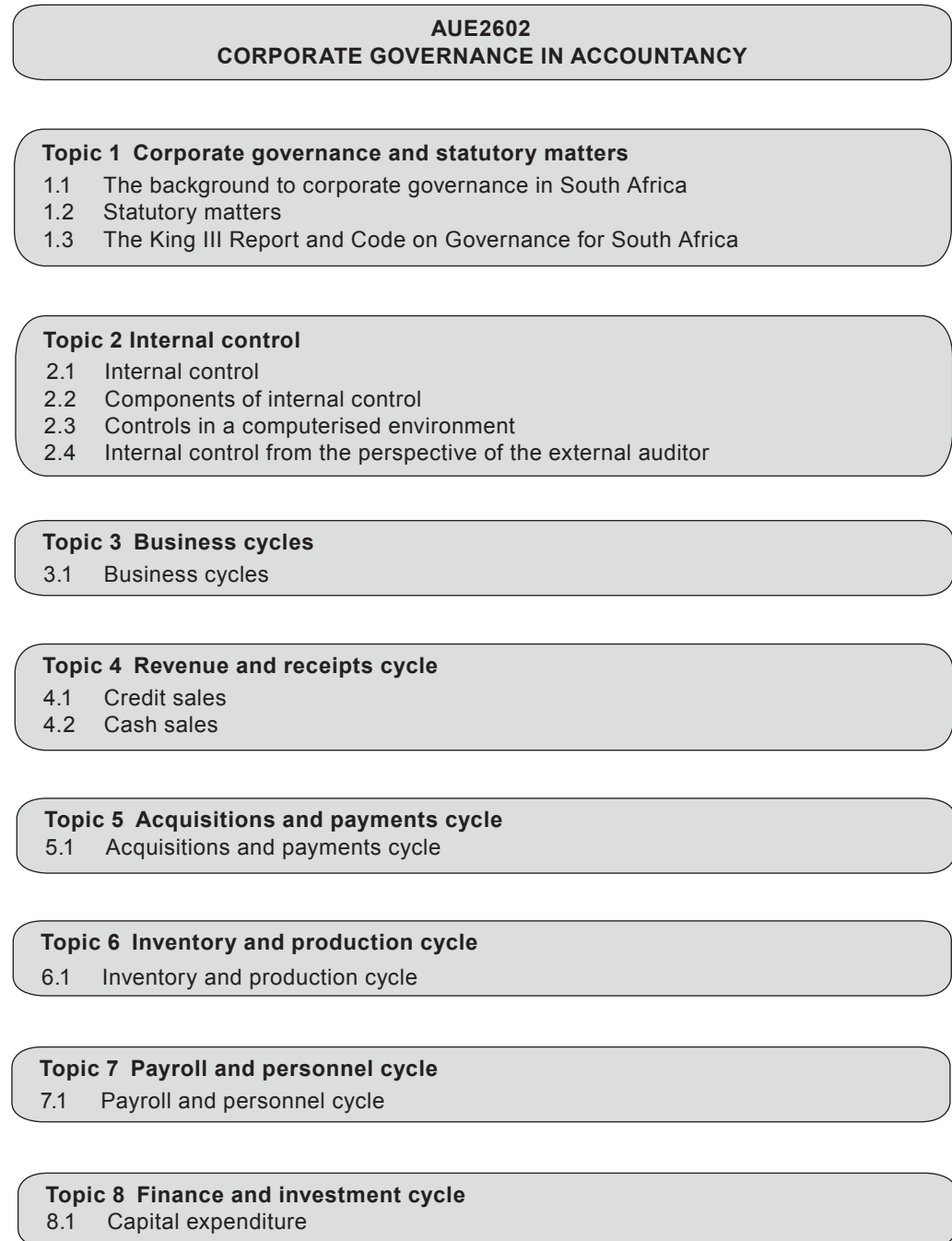
AUI2601: Internal Auditing: Theory and Principles

## 4 FRAMEWORK OF THE MODULE

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Diagram 1 below is a schematic representation of the content of this module.

**DIAGRAM 1**



## 5 THE TEACHING STRATEGY

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### 5.1 The study package

The study package that you will need to master this module consists of

- the prescribed **textbook(s)**
- the **study guide**, in which study material is grouped into topics with study units (the study guide serves as a key to the study material you have to study in the prescribed textbook(s) and also contains activities that will enable you to test your individual learning progress.)
- **questions and answers** which relate to the various study units (the questions and answers are made available in the form of tutorial letters.)
- **assignments**, which are contained in Tutorial Letter 101
- **tutorial letters**, which contain information to which we wish to draw your attention

### 5.2 Learning outcomes, assessment criteria and levels of mastery

We formulate the learning objectives for the various auditing modules to indicate exactly what will be expected of you in order to complete each module successfully.

For each topic in the study guide, we indicate learning outcomes that you should be able to achieve after studying a particular topic.

Assessment criteria are supplied in the study guide for each study unit and they indicate what you should be able to do after having studied the particular study unit. The formulated assessment criteria are based on various levels of mastery which you are required to achieve as you learn the study material. The required levels of mastery for this module vary from knowledge and comprehension to the application of knowledge under given circumstances. Integration as a further level of mastery only arises in the subsequent auditing modules and is not applicable to this module.

The first two levels as defined in the Education Requirements of the South African Institute of Chartered Accountants (SAICA) (2010:13–14) are requirements for the purposes of this module:

#### **Level 1: Basic**

At this level, the candidate is required to obtain a knowledge and understanding of the core/essence of the subject matter, which includes the fact that the subject matter exists and its significance, relevance and defining attributes.

#### **Level 2: Intermediate**

At this level, the candidate is required to obtain a detailed knowledge and understanding of the central ideas and issues that form the substance of the subject matter.

### **Level 3: Advanced**

At this level, the candidate is required to obtain a thorough knowledge and rigorous understanding of the subject matter. This level of knowledge and understanding extends beyond a sound understanding of central issues, to include complexities and unusual/exceptional aspects of the subject matter.

You will not be confronted with level 3 (advanced) material in this module. This is covered in your further auditing studies.

The level of knowledge and understanding that you will require for the various topics/study units covered in this study guide is indicated next to the learning outcome(s) formulated for each study unit of the topic.

Note the following points regarding the level of mastery indicated for the various learning outcomes for each study unit:

- The highest level of mastery that applies to a study unit is indicated. In other words, if a study unit is indicated as level 2 (intermediate) this implies that you should also be able to deal with the topic at level 1 (basic).
- Your mastery of the study material in terms of the specified learning outcomes will be tested in the final examination paper, which you will have to pass in order to complete the module successfully. Questions at both levels 1 and 2 will be included in the examination paper.

### **5.3 Study activities**

Numerous study activities and self-evaluation questions are included in each study unit to encourage your active participation in the learning process. These are a combination of reading, studying, doing and reflecting activities that are presented in a flexible manner throughout the study guide. They have been designed to enable you to absorb the knowledge content of the topic, to develop your understanding and to direct your thoughts.

This is a vital aspect of our learning approach because as you encounter these study activities and actually perform them, you will become directly involved in controlling the extent and quality of your learning experience. In short, how much and how well you learn will depend on the extent of your progress through the study activities, and the quality of your efforts.

### **5.4 Meaning of words**

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

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

An analysis of the action verbs contained in a question will

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

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




For the purposes of this module, the following meanings will be attached to the following action words:

Word	Meaning
Advise	Give advice to; express an expert opinion
Apply	Use in a practical manner; use as relevant or suitable
Calculate	Figure out; determine by a mathematical procedure
Clarify/demonstrate	This means expound; make the meaning clear; provide proof of; argue the truth of
Compare	Place side by side in order to observe similarities, relationships and differences
Complete	Finish; accomplish; supply whatever is missing
Define	Describe accurately; establish the exact meaning; explain the inherent meaning; make clear; give an account of the overall character
Describe	Give an account of the respective particulars or essential characteristics; outline clearly; give an accurate account
Determine	Establish; reach a conclusion or decision
Discuss	Examine; explain; examine by means of argument
Draft	Prepare a provisional outline
Examine	Inspect; investigate
Explain	Make clear or comprehensible; elucidate; give the meaning in detail
Identify	Establish through consideration; recognise; pick out
Illustrate	Explain; shed light on; use an example to elucidate something
Interpret	Explain the meaning of; explicate; construe; show the nature or essence
List	Note/specify matters or objects that are related to one another
Name/mention/state	Specify by name; give names, characteristics, items, elements or facts
Organise	Divide into classes or groups according to certain characteristics; place in a particular order

Word	Meaning
Prepare	Make ready in advance; finish; get something ready on the basis of previous study
Record	Put in writing; set down for reference and preservation
Substantiate	Supply reasons or facts; support a view or argument
Summarise	Give a brief account; briefly state the essence of a matter
Tabulate	Arrange in tabular form

## 5.5 Meaning of icons

The icons used in this study guide are listed below, together with an explanation of what they mean:

Icon	Description
	<b>Study.</b> This icon indicates which sections of the prescribed book or the study guide you need to study and internalise.
	<b>Read.</b> This icon will direct you to read certain sections of the prescribed book for background information.
	<b>Assessment.</b> This icon indicates that you are required to test your knowledge, understanding and application of the material you have just studied.

## 6 APPROACH TO YOUR STUDIES

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

### 6.1 Allocation of time for this module

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

We have provided the following breakdown of the estimated time required to work through the different topics contained in the study material, including the completion of assignment work. You can use it to compile your own study schedule for

this auditing module. Bear in mind that it is only a guideline. You may, however, find certain topics more difficult and therefore require more hours to master them.

<b>Topic</b>	<b>Minimum hours of study</b>
Preface	
1 Corporate governance and statutory matters	40
2 Internal control	15
3 Business cycles	1
4 Revenue and receipts cycle	10
5 Acquisitions and payments cycle	9
6 Inventory and production cycle	5
7 The payroll and personnel cycle	8
8 The finance and investment cycle	2
Completion of assignments	10
Revision for the examination	20
<b>Total time</b>	<b>120 hours</b>

## 6.2 Mastering the study material

Use the study guide to guide you through the study material. The prescribed textbook(s) contain the information you are required to master and remain the primary source(s) that you will need to study. Information, explanations and questions in the study guide, tutorial letters and assignments are included in order to make the information in the textbook(s) comprehensible to you and to give you an indication of how well you have mastered the study material.

Make use of the opportunities offered by the study guide. For example, use the margin in the study guide to make notes, and write down keywords and any problems that you have encountered. At the end of each study unit a page has been left for notes where you can jot down information which fits in with your particular study approach.

Particulars of the assignments that have to be completed for this module are contained in Tutorial Letter 101. Unisa publications contain information on administrative arrangements and the student support services offered. Make sure that you are familiar with all the information contained in these publications.

## 6.3 Self-study and self-evaluation

Since self-study and self-evaluation are key components of distance education, the study material contains various study activities that you are asked to do. Make the most of these opportunities to determine whether you have made sufficient progress to meet the assessment criteria in the various study units. Try to answer the questions contained in the activities, the question bank and the assignments independently, before looking at the suggested answers.

When you come across a subject-related problem in auditing, make a persistent effort to get to the bottom of the uncertainty or problem. If you persevere until you have solved the problem, you will find that you derive great satisfaction from

doing so. As indicated in Tutorial Letter 101 for each auditing module, the auditing lecturers responsible for the module are available to help you solve subject-related problems. Take note of other opportunities for active learning, as contained in Tutorial Letter 101 for each module and the Unisa publications, which may possibly meet your study needs.

## 7 WHAT YOU CAN EXPECT FROM UNISA

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You can expect us to do the following:

- We will provide you with up-to-date and relevant learning material.
- We will keep the learning material in line with the needs of industry and commerce by consulting regularly with the profession.
- We will assist you as students by giving you the opportunity to develop competencies and skills at a certain level. The outcomes correspond to the National Qualifications Framework (NQF) level 6. You will be assessed taking the level descriptors of the NQF into account.
- We will support you whenever you require assistance. You may contact your lecturers by making personal appointments; contact them by phone or via e-mail or the internet. We understand that studying through distance education is more challenging than attending a residential university.
- We will provide you with clear indications of what we expect from you in terms of your assessment.

## 8 FEEDBACK FROM STUDENTS

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

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

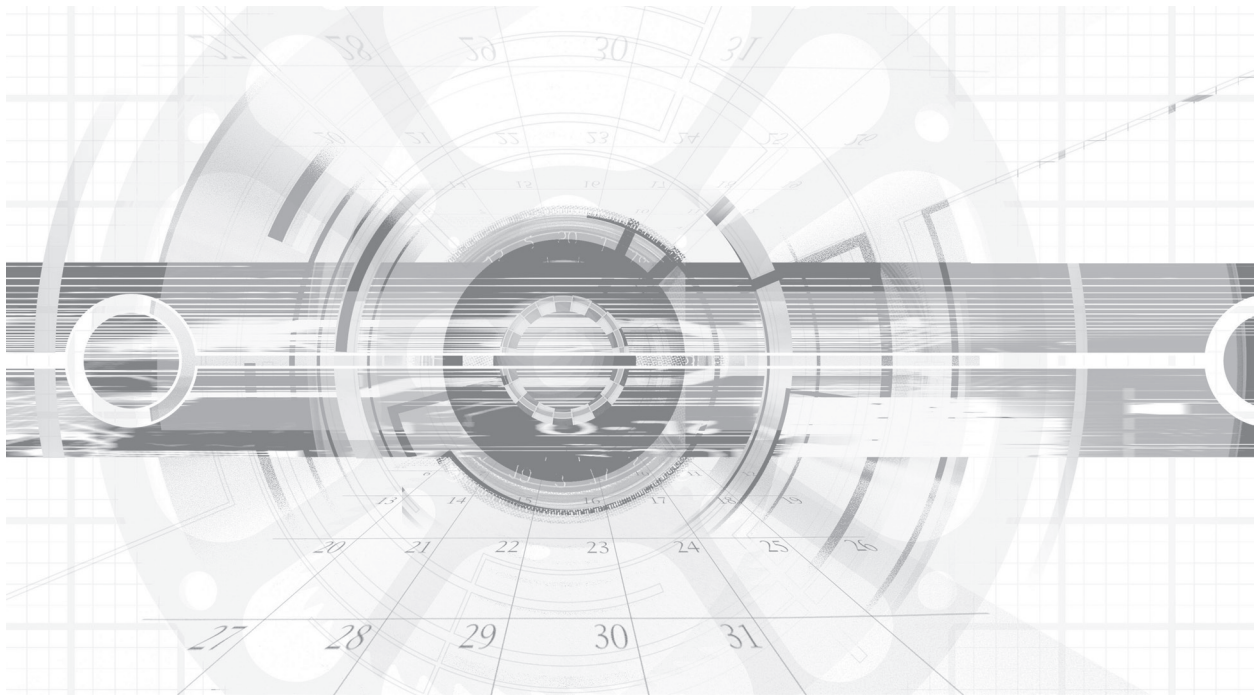
## 9 CONCLUSION

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

Best wishes

**YOUR LECTURERS FOR AUE2602**



# 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 2008, as well as the provisions of the King III Report and Code on Governance for South Africa.

**This topic is divided into the following study units:**

Study unit	Title	Page
<b>1.1</b>	<b>The background to corporate governance in South Africa</b>	3
<b>1.2</b>	<b>Statutory matters</b>	5
1.2.1	Standards of directors' conduct – section 76	5
1.2.2	Liability of directors and prescribed officers – section 77	5
1.2.3	Indemnification and directors' insurance – section 78	6
1.2.4	Audit committees – section 94	6
<b>1.3</b>	<b>The King III Report and Code on Governance for South Africa</b>	8

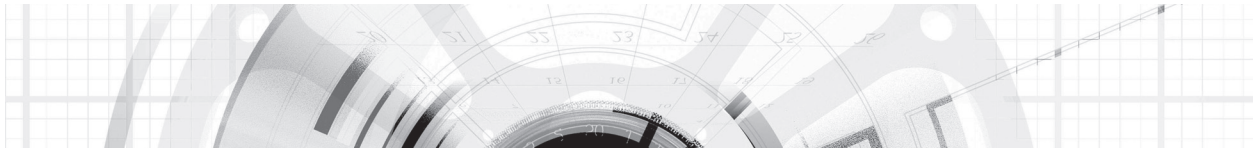
Study unit	Title	Page
1.3.1	Ethical leadership and corporate citizenship	9
1.3.2	Boards and directors	9
1.3.3	Audit committees	14
1.3.4	The governance of risk	16
1.3.5	The governance of information technology	17
1.3.6	Compliance with laws, rules, codes and standards	17
1.3.7	Internal audit	18
1.3.8	Governing stakeholder relationships	20
1.3.9	Integrated reporting and disclosure	21

### Textual amendments and additions

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

### Learning outcomes

Study unit	In this topic we focus on the following learning outcomes:	Level
1.1 The background to corporate governance in South Africa	<ul style="list-style-type: none"> <li>Briefly describe the background to corporate governance in South Africa.</li> </ul>	1
1.2 Statutory matters	<ul style="list-style-type: none"> <li>Explain the requirements of sections 76 to 78 and 94 of the Companies Act, 71 of 2008, regarding the standards of directors' conduct, liability of directors and prescribed officers, indemnification and director's insurance and audit committees.</li> </ul>	2
1.3 The King III Report and Code on Governance for South Africa	<ul style="list-style-type: none"> <li>Explain and apply the significant matters covered by King III.</li> </ul>	2



# STUDY UNIT 1.1

## THE BACKGROUND TO CORPORATE GOVERNANCE IN SOUTH AFRICA

### INTRODUCTION

Statements like the following often appear in the media:

***“Successful leaders in a turbulent world are bold, risk-taking visionaries:***

***They studied what worked, figured out why it worked, and then put ideas into effect”*** (*The Globe and Mail*, accessed at <http://www.ctv.ca>, 18 Oct 2011).

***“In South Africa we still have a chance to prevail – if we all play our part. He said there was an international consensus that out of every ten people, one would never be corrupt, one would easily be corrupt, and the rest would be swayed by pressure or temptation”*** (Corruption: SA at tipping point – *Fin24* 26 Oct 2010, accessed at <http://www.fin24.com>, 18 Oct 2011).

You may be wondering how the above quotes relate to corporate governance? In this study unit you will learn about corporate governance in South Africa, with specific reference to the King III Report and Code on Governance.

As stated in the King III Report (2009:12), the success of companies in the 21st century is bound up with three independent subsystems – the natural environment, the social and political system and the global economy.

The success of companies therefore depends not only on their profitability, but also on the **integration** of social, environmental and economic issues, which revolve around leadership, sustainability and corporate citizenship (cf the King III Report 2009:10–11).



### STUDY

The King III Report (2009:5–18) (included in the **SAICA Legislation Handbook**)

Jackson & Stent (2012:4/3–4/7), sections 1 to 6

Note that you should study the **King III Report** itself (included in the SAICA Legislation Handbook).

### ACTIVITY 1

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

### FEEDBACK ON ACTIVITY 1

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References: The King III Report (2009:6–14)  
Jackson & Stent (2012:4/3), introduction

Corporate governance is the system or process whereby companies are directed or controlled. It is about companies being good corporate citizens and all that this entails. Companies are an integral part of modern society and it therefore follows that healthy, honest, open, competently and responsibly controlled companies will improve the quality of modern society.

### ACTIVITY 2

---

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

### FEEDBACK ON ACTIVITY 2

---

References: The King III Report (2009:6–7)  
Jackson & Stent (2012:4/5)

“Apply or explain” means that King III follows a non-legislated approach, which allows companies to explain if they choose not to apply the principles of King III. They may make this choice if they believe that it would be in the best interests of their company.

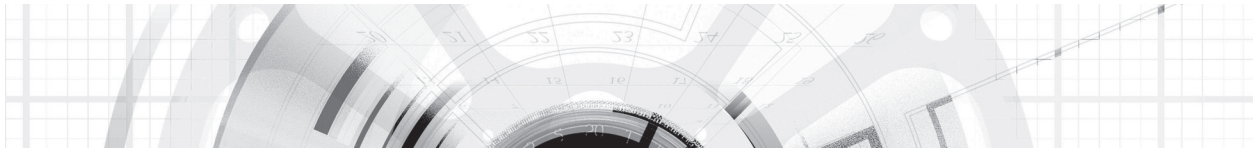
Directors can’t avoid adhering to the principles of good corporate governance, because there is a link between good governance and compliance with the law. The directors themselves have legal duties stipulated in the Companies Act 2008.

**Note:** The duties of directors as stipulated in the Companies Act 2008 will be explained in more detail in study unit 1.2.

## SUMMARY

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

The King III Report endeavoured to be at the forefront of governance internationally (King III Report 2009:5).



# STUDY 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.” Mervyn E King, SC, King Committee Chairman, 1 September 2009***

Some of you may already have studied sections of the Companies Act 71 of 2008. As **directors** play a very important role in corporate governance, we want to ensure that you have sufficient background knowledge of sections 76, 77, 78 and 94 of the Companies Act. These sections 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 III Report in study unit 1.3.

Note the following about the study information below:

 **SAICA Legislation Handbook, 2010/2011, Volume 1** – Where instructed below, ensure that you study the relevant sections in the **Companies Act 71 of 2008**.

### 1.2.1 STANDARDS OF DIRECTORS’ CONDUCT – SECTION 76

This section describes certain duties of directors.



#### STUDY

- The Companies Act 71 of 2008: section 76
- Jackson & Stent (2012:3/45–3/46)

### 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

- The Companies Act 71 of 2008: section 77
- Jackson & Stent (2012:3/46–3/47)

### 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

- The Companies Act 71 of 2008: section 78
- Jackson & Stent (2012:3/47)

### ACTIVITY 3

---

The King III Report (2009:21) sets out the board of directors' responsibility to provide effective leadership based on an ethical foundation. It states that the deliberations, decisions and actions of directors should be based on the four ethical values of **responsibility, accountability, fairness** and **transparency**. It also states that directors have five moral duties, namely **conscience, inclusivity, competence, commitment** and **courage**.

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

### FEEDBACK ON ACTIVITY 3

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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 III 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 above, there is a link between good governance and compliance with law.

### 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

- The Companies Act 71 of 2008: section 94
- Jackson & Stent (2012:3/52–3/53)

## ACTIVITY 4

---

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 4

---

- The membership requirements for the audit committee in terms of section 94 are listed in Jackson & Stent (2012:3/52) and are not repeated here.
- The main duties of the audit committee in terms of section 94 are described in Jackson & Stent (2012:3/52–3/53) and are not repeated here.

Note that the requirements for audit committees in terms of the King III Report are explained further in section 1.3.3 below.

## SUMMARY

In this study unit you 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.

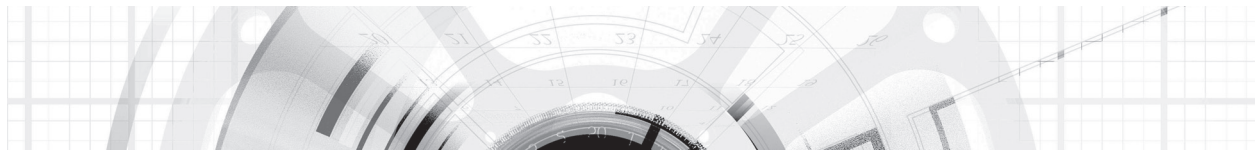


## SELF-ASSESSMENT

After having worked through the study unit and the references to the prescribed study material, see whether you can do the following:

1. Explain and apply section 76 of the Companies Act, which deals with the standards of directors' conduct.
2. Explain and apply section 77 of the Companies Act, which deals with the liability of directors and prescribed officers.
3. Explain and apply section 78 of the Companies Act, which deals with indemnification and directors' insurance.
4. Link sections 76, 77 and 78 of the Companies Act, which deal with the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance, to the principles of good corporate governance in King III.
5. Explain and apply section 94 of the Companies Act, which deals with audit committees.

Refer to additional questions about statutory matters in your study material if you are not sure that you can answer these self-assessment questions.



# STUDY UNIT 1.3

## THE KING III REPORT AND CODE ON GOVERNANCE FOR SOUTH AFRICA

### INTRODUCTION

King III consists of a **Code of Governance**, which deals with the principles, and a **Report on Governance**, which provides recommendations for best practice for each of the principles.

Although the King III 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 Johannesburg Stock Exchange (JSE).

Paragraph 8.63 of the JSE Listing Requirements states that issuers of financial reports should disclose, among others, the following information (JSE Listing Requirements 2011:165):

- (i) a narrative statement of **how it has applied the principles set out in the King Code**, providing an explanation or explanations enabling its shareholders to evaluate how the principles have been applied; and
- (ii) a statement dressing **the extent of the company's compliance with the King Code and the reasons for noncompliance** with any of the principles in the King Code, specifying whether the company has complied with all the provisions of the King Code throughout the accounting period, and indicating for what part of the period any noncompliance occurred.

**The following are significant matters covered by the King III Report:**

- 1.3.1 Ethical leadership and corporate citizenship
- 1.3.2 Boards and directors
- 1.3.3 Audit committees
- 1.3.4 The governance of risk
- 1.3.5 The governance of information technology
- 1.3.6 Compliance with laws, rules, codes and standards
- 1.3.7 Internal audit
- 1.3.8 Governing stakeholder relationships
- 1.3.9 Integrated reporting and disclosure

### 1.3.1 ETHICAL LEADERSHIP AND CORPORATE CITIZENSHIP

As stated in the King III Report (2009:20), responsible leadership is about effective responsible leadership, building sustainable businesses, reflecting on the role of business in society, doing business ethically, not compromising the natural environment and embracing a shared future.



#### STUDY

- The King III Report (2009:20–27)
- Jackson & Stent (2012:4/7–4/9) topic 1

#### ACTIVITY 5

---

List five **responsibilities of the board** with regard to ethical leadership and the corporate citizenship of a company.

#### FEEDBACK ON ACTIVITY 5

---

Reference: The King III Report (2009:20–21)

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

### 1.3.2 BOARDS AND DIRECTORS

As the board of directors is responsible for the corporate governance of businesses, this is an important section of the King III Report. Familiarise yourself with the different principles that apply to the boards and directors as stated in the King III Report.



#### STUDY

- The King III Report (2009:29–52)
- Jackson & Stent (2012:4/9–4/17) topic 2

Section 66(1) of the Companies Act 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 III 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 allows the board of directors to appoint any number of **committees (sub committees)**, with the King III Report and the JSE Listing Requirements specifying at least a **remuneration committee** and, if required, **nomination** and **risk committees**.

As mentioned above, section 72 allows for **any number** of board committees to be appointed, depending on the requirements of the company. The King III Report mentions the appointment of a social and ethics committee and governance, IT

steering and sustainability committees. These board committees constitute an important element of the governance process.

Please take note of the tables below, which contain a summary of the recommended composition and functions of the board of directors and its main board committees (cf the King III Code of Governance Principles 2009:21–31). The composition and functions of the audit committee will be explained in section 1.3.3 below.

## Board of directors

<b>Chairman</b>	<ul style="list-style-type: none"> <li>Independent non-executive director (<i>principle 2.16</i>).</li> <li>CEO of the company should not also fulfil the role of chairman of the board (<i>principle 2.16</i>).</li> <li>The role of the chairman should be formalised (<i>principle 2.16.5</i>).</li> <li>The chairman's ability to add value, and his performance against what is expected of his role and function, should be assessed every year (<i>principle 2.16.6</i>).</li> </ul>
<b>Membership</b>	<ul style="list-style-type: none"> <li>The board should comprise a balance of power, with a majority of non-executive directors. The majority of non-executive directors should be independent (<i>principle 2.18</i>).</li> <li>The board, through its nomination committee, should recommend the eligibility of prospective directors (<i>principle 2.18.7</i>).</li> </ul>
<b>Members</b>	<ul style="list-style-type: none"> <li>Minimum of two executive directors of which one should be the CEO and the other the director responsible for finance (<i>principle 2.18.5</i>).</li> <li>At least one-third of directors should rotate every year (<i>principle 2.18.6</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>Meet at least four times a year (<i>principle 2.1.2</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>The board should have a charter setting out its responsibilities. The functions of the board are listed under <i>principles 2.1 to 2.17</i> of the Code of Governance.</li> </ul>

## Board committees

	<b>Remuneration committee</b>	<b>Nomination committee</b>	<b>Risk committee</b>
<b>Chairman</b>	<ul style="list-style-type: none"> <li>Independent non-executive director (<i>principle 2.23</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Independent non-executive director (<i>principle 2.23</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Independent non-executive director (<i>principle 2.23</i>).</li> </ul>
<b>Membership</b>	<ul style="list-style-type: none"> <li>Majority should be non-executive directors of which majority should be independent (<i>principle 2.23.7</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Majority should be non-executive directors of which majority should be independent (<i>principle 2.23.7</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Executive and non-executive directors (<i>principle 4.3.2.2</i>).</li> </ul>

	Remuneration committee	Nomination committee	Risk committee
<b>Members</b>	<ul style="list-style-type: none"> <li>Not specified in King III.</li> </ul>	<ul style="list-style-type: none"> <li>Not specified in King III.</li> </ul>	<ul style="list-style-type: none"> <li>Minimum of three members (<i>principle 4.3.2.3</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>Not specified in King III.</li> </ul>	<ul style="list-style-type: none"> <li>Not specified in King III.</li> </ul>	<ul style="list-style-type: none"> <li>Meet at least twice a year (<i>principle 4.3.2.4</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>Should assist the board in setting and administering remuneration policies (<i>principle 2.25.2</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Should assist with the process of identifying suitable members of the board (<i>principle 2.19.1</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Should consider the risk management policy and plan and monitor the risk management process (<i>principle 4.3.2.1</i>).</li> </ul>

**Note:** The principles refer to the King III Code of Governance.

## ACTIVITY 6

The board should elect a chairman who is an independent non-executive director. Explain what an **independent non-executive** director is.

## FEEDBACK ON ACTIVITY 6

Reference: The King III Report (2009:38–39) point 65–67

The concept “independent non-executive director” is explained in detail in the King III Report and is not repeated here.

## ACTIVITY 7

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

## FEEDBACK ON ACTIVITY 7

Reference: The King III Report (2009:37–38) point 60

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

## ACTIVITY 8

Why should the CEO not fulfil the role of the chairman of the board?

## FEEDBACK ON ACTIVITY 8

---

Reference: The King III Report (2009:37) point 59

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 chairman of the board.

## ACTIVITY 9

---

The board should delegate certain functions to well-structured committees. Are the chairman of the board and the CEO allowed to be **members** of the following committees?

1. Audit committee
2. Remuneration committee
3. Nomination committee
4. Risk committee

## FEEDBACK ON ACTIVITY 9

---

Reference: The King III Report (2009:46)

Committee	Chairman	CEO
Audit committee	No	No
Remuneration committee	Yes	Yes
Nomination committee	Yes	Yes
Risk committee	Yes	Yes

## ACTIVITY 10

---

Recently, while skimming 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

Chief Executive Officer	– Donald Winthrop
Managing Director – Administration	– Charles Tree
Financial 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 chairman. The most senior director who arrives at the directors' meeting acts as chairman.

## 2. Committees

- 2.1 Directors' Appointment Committee – Donald Winthrop  
– 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  
– Monty Mann  
– Koos Katswinkel

- 2.3 Audit Committee – Monty Mann  
– Christo Wells  
– Mitchell Street (Internal Audit)  
– External Audit  
– Fred Carver

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 III Report.

## FEEDBACK ON ACTIVITY 10

---

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

### 1. Board of Directors

Reference: The King III Report (2009:34–40)

- 1.1 The company has no chairman. King III recommends that the board should elect a chairman who is an independent, non-executive director.
- 1.2 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 that 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.
- 1.3 The board should meet at least 4 times a year. At present the board only meets every six months.

## 2. Board committees

Reference: The King III Report (2009:40–52)

- 2.1 King III recommends that a company such as Stadium Ltd should have a nominations committee (which may be called the directors' appointment committee). This committee should be chaired by an independent non-executive director (for example the chairman of the board) and the majority of members should be non-executive directors, the majority of whom should be independent. At present Stadium Ltd doesn't have a chairman.
- 2.2 The recommendations for the appointment of directors should be made by the Board as a whole and not by a select committee. A nominations committee should merely assist in the process.
- 2.3 The remuneration committee should be chaired by an independent non-executive director and the majority of the members should be independent non-executive directors. At present this committee has no independent non-executive directors.
- 2.4 In terms of King III, the audit committee should be chaired by an independent non-executive director, which Monty Mann is not, and it should be made up of independent non-executive members, which it is not.
- 2.5 Neither Fred Carver, the financial manager, nor Mitchell Street, the internal audit manager, nor the external auditors should be committee members. These three should work closely with the committee at various times but they should not form part of the committee.
- 2.6 All committees should schedule meetings properly and should meet a stipulated minimum number of times, not just on a random "as and when" basis.

## 3. Risk committee

Reference: The King III Report (2009:46)

- 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".

## 4. General

- 4.1 On balance, this company appears to be dominated by the CEO, Donald Winthrop.

**Source:** *Graded Questions on Auditing 2012* (Gowar & Jackson 2012: 21) – adapted

### 1.3.3 AUDIT COMMITTEES

As mentioned in section 1.2.2 above, the Companies Act 71 of 2008: section 94 requires a public or state-owned company to appoint an audit committee as well as a board of directors. The King III Report also recommends that an audit committee should be appointed for companies other than public and state-owned companies.



## STUDY

- The King III Report (2009:56–68)
- Jackson & Stent (2012:4/17–4/21) topic 3

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

	Audit committee
<b>Chairman</b>	<ul style="list-style-type: none"> <li>• Independent non-executive director (<i>principle 3.3</i>).</li> <li>• The chairman of the board should not be the chairman or a member of the audit committee (<i>principle 3.2.3</i>).</li> </ul>
<b>Member-ship</b>	<ul style="list-style-type: none"> <li>• All members should be independent non-executive directors (<i>principle 3.2.1</i>).</li> </ul>
<b>Members</b>	<ul style="list-style-type: none"> <li>• Minimum of three members (<i>principle 3.2.2</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>• Meet at least twice a year (<i>principle 3.1.4</i>).</li> <li>• Should meet with internal and external auditors at least once a year without management being present (<i>principle 3.1.5</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>• Should oversee integrated reporting (<i>principle 3.4</i>).</li> <li>• Should ensure that a combined assurance model is applied (<i>principle 3.5</i>).</li> <li>• Should satisfy itself of the expertise, resources and experience of the company's finance function (<i>principle 3.6</i>).</li> <li>• Should oversee internal audit (<i>principle 3.7</i>).</li> <li>• Should be an integral component of the risk management process (<i>principle 3.8</i>).</li> <li>• Should recommend the appointment of the external auditor and oversee the external audit process (<i>principle 3.9</i>).</li> <li>• Should report to the board and shareholders on how it has discharged its duties (<i>principle 3.10</i>).</li> </ul>

## ACTIVITY 11

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	–	Financial 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 King III.

## FEEDBACK ON ACTIVITY 11

Reference: The King III Report (2009:56–59)

1. In terms of King III, the audit committee should comprise at least three members. Mineco Ltd has three members and complies with King III.
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 as often as necessary, but at least twice a year.
4. The board should be evaluated by the chairman or by an independent party, not by the audit committee.
5. In line with the requirements for risk management, the audit committee is not permitted to make decisions on the acquisition of shares in Africa Coal. This should be the responsibility of the board (with the approval of the shareholders).

Source: Unisa – TOE412S/105/2011 — adapted

### 1.3.4 THE GOVERNANCE OF RISK

According to the King III Report (2009:73), the essential focus of the **governance** of risk is that “the board should exercise leadership to prevent risk management from becoming a series of activities that are detached from the realities of the company’s business”. Risk is positioned as a cornerstone of corporate governance and it is emphasised that it is the board’s responsibility to ensure that it is satisfied with the management of risk.



#### STUDY

- Reference: The King III Report (2009:73–80)
- Jackson & Stent (2012:4/22–4/26) topic 4

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

WHAT	WHO
Governance of risk.	The board ( <i>principle 4.1</i> ).
Design, implementing and monitoring of the risk management plan.	The board should delegate to management ( <i>principle 4.4</i> ).
Monitoring the risk management process.	The board, risk committee, audit committee ( <i>principle 4.3.2.1</i> ).
Performing an objective assessment of the effectiveness of risk management.	Internal audit ( <i>principle 7.1.2.2</i> ).

**Note:** The term “principles” refers to the King III Report.

## ACTIVITY 12

---

Explain the responsibility of **management** and the **CEO** in the risk management process.

## FEEDBACK ON ACTIVITY 12

---

Reference: The King III Report (2009:75–76)

The responsibility of **management** and the **CEO** in the risk management process is explained under points 24 to 30 in the King III Report and is not repeated here.

### 1.3.5 THE GOVERNANCE OF INFORMATION TECHNOLOGY

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



#### STUDY

- The King III Report (2009:82–87)
- Jackson & Stent (2012:4/26–4/29) topic 5

## ACTIVITY 13

---

Chapter 4 of the King III Report on Governance deals with the governance of risk. Explain the role that information technology plays in the company's risk management.

## FEEDBACK ON ACTIVITY 13

---

Reference: The King III Report (2009:85, 87)

The role that information technology plays in the company's risk management is explained under points 5.5 and 5.7 in the King III Report and is not repeated here.

### 1.3.6 COMPLIANCE WITH LAWS, RULES, CODES AND STANDARDS

The board should ensure that the company complies with applicable laws, rules, codes and standards. The board should monitor this and disclose details in the integrated report (King III Report 2009:89).



#### STUDY

- The King III Report (2009:89–91)
- Jackson & Stent (2012:4/29–4/30) topic 6

## ACTIVITY 14

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Explain the main functions of the **board**, **management** and the **compliance officer** with regard to compliance with laws, rules, codes and standards.

## FEEDBACK ON ACTIVITY 14

---

Reference: The King III Report (2009:89–91)

The functions of the board, management and the compliance officer with regards to compliance with laws, rules, codes and standards, is explained in the King III Report, 2009: 89–91 and is not repeated here.

**Note:** The ultimate responsibility for complying with laws, rules, codes and standards lies with the board. The board'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, as explained in section 1.3.2 above.

### 1.3.7 INTERNAL AUDIT



#### STUDY

- The King III Report, 2009:93–98
- Jackson & Stent (2012: 4/30–4/32) topic 7

## ACTIVITY 15

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1. Explain in your own words what the term “risk-based audit approach” means in the context of the King III requirements for internal audit.

## FEEDBACK ON ACTIVITY 15

---

Reference: The King III Report (2009:94)

1. Risk-based internal auditing (RBIA) is the methodology which provides assurance that risks are being managed within the organisation's risk appetite (*Risk based internal auditing: three views on implementation* Griffiths 2006:1).

## ACTIVITY 16

---

Stapleking Ltd is a manufacturer and wholesaler of a wide range of fasteners, such as staples, tacks and drawing pins. Controls are sound and include an internal audit department which is staffed by competent internal auditors. Internal audit activities are scheduled at the start of each financial year, but during the year numerous requests are received from within the company for “internal audit” to carry out various assignments. The following requests have been received:

1. Lindsay Haffejee, the chief audit executive, has been asked by the human resources director to serve on a selection committee for the appointment of a new company secretary.

2. The financial director has asked the internal audit department to design and implement a costing system for a new type of product which is to be manufactured.
3. The information technology manager has asked internal audit to conduct a post-implementation review on a recently introduced telesales ordering system.
4. The warehouse manager has requested internal audit to perform an audit to determine whether the company is complying with all the necessary safety regulations, for example the fire protection and ventilation regulations.
5. The financial director has requested internal audit to schedule an investigation into the payroll and personnel cycle to determine whether there are fictitious employees on the payroll.
6. The production director has requested internal audit to conduct inventory cycle counts in the finished goods warehouse on an ongoing basis.
7. The external auditors have requested internal audit to assist them with the verification of the existence of plant and equipment at an interim audit.
8. The board of directors has requested internal audit to assist in identifying, evaluating and assessing significant organisational risks.

## **EQUIRED**

1. Indicate, giving reasons, how Lindsay Haffejee, as the chief audit executive, should respond to the above requests.

## **FEEDBACK ON ACTIVITY 16**

---

### **1. Feedback on Lindsay Haffejee's requests:**

Reference: The King III Report (2009:95–98)

- 1.1 This request could be accepted. The company secretary is an important appointment in respect of corporate governance. In a sense the company secretary is similar to internal audit in that both are “control mechanisms”.
- 1.2 This request should be refused. The design and installation of systems is an operational responsibility from which the internal audit department should be independent. Internal audit may review the proposed system and be part of the post-implementation review, but should not take responsibility for the system.
- 1.3 This request should be accepted. Part of internal audit's basic function is to perform objective assessments of the adequacy and effectiveness of risk management and internal controls and post-implementation reviews are part of this.
- 1.4 This assignment could be accepted. Although internal audit should follow a risk-based approach to the internal audit function, compliance audits (evaluating whether the company is complying with relevant laws and regulations) are part of what internal auditors do. Ensuring compliance with laws and regulations is part of risk management.
- 1.5 This assignment could be accepted. The board has direct responsibility for risk management, and for implementing and monitoring the controls which serve, inter alia, to safeguard the assets of the company (in this case, cash). Internal audit is one means which the directors use to obtain information relating to fraud and corruption.

- 1.6 This request should be refused. Inventory control is an operational activity and is the responsibility of the inventory controller/production department. Internal audit could be used to review and evaluate cycle counts from time to time.
- 1.7 This request could be accepted. External and internal audit should co-operate in this kind of exercise, which is, in effect, an independent verification procedure.
- 1.8 This request could be accepted, but internal audit must not assume the functions, systems and processes of risk management. In other words, internal audit must not become part of the operational internal controls. The intention is that internal audit should assist and support the board in fulfilling their responsibilities, one of which is to identify risk. This request is in line with the risk-based approach to internal audit.

**Source:** *Graded questions on auditing* (Gowar & Jackson 2012:25) – adapted

### 1.3.8 GOVERNING STAKEHOLDER RELATIONSHIPS

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



#### STUDY

- The King III Report (2009:100–106)
- Jackson & Stent (2012:4/32–4/37) topic 8

#### ACTIVITY 17

1. Define the term “stakeholder” according to King III.
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 III Report with regard to stakeholder management? If so, how do your local municipality’s operations affect you?

#### FEEDBACK ON ACTIVITY 17

Reference: The King III Report (2009:100)

1. The term “stakeholder” is defined in the King III Report under point 6 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 III Report compulsory for government institutions, but the same principles of good corporate governance are embodied in the Act.

**Sect 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.

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

### 1.3.9 INTEGRATED REPORTING AND DISCLOSURE STUDY



- The King III Report (2009:108–111)
- Jackson & Stent (2012: 4/38–39) topic 9

Note the following from the study information:

- King III's integrated reporting is often referred to as “triple bottom line” reporting.

■ **Triple bottom line** – A company should report on its performance with regard to **economic**, **social** and **environmental** issues.

#### 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 in the location of forests for both replanting and new forests is the level of local rainfall as forests are not irrigated.

Treelines Ltd employs a reasonably large workforce at its forest locations, ranging from unskilled workers 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.

#### YOU ARE REQUIRED TO:

1. Discuss how frequently a company like Treelines Ltd should report to its stakeholders on sustainability and other issues.
2. Identify the main stakeholders, other than shareholders, with whom Treelines Ltd should be “building relationships and promoting respect” and indicate briefly why you consider each of them to be stakeholders.

#### FEEDBACK ON ACTIVITY 18

1. Effective reporting should take place at least once a year, but there is no fixed number of times that it should take place. The objective is to keep all stakeholders informed in a manner that satisfies the needs of each stakeholder groupings.
2. Treeline Ltd's main stakeholders are:

Reference: The King III Report (2009:100)

- 2.1 **Suppliers** of goods and services without whom the company cannot operate effectively.
- 2.2 **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.
- 2.3 **Employees** at all levels and in all activities – skilled, unskilled and administrative.
- 2.4 **Government** and important parties in respect of other legislative matters, for example the granting of forestry licenses.
- 2.5 **External auditors** who require co-operation to fulfil their function.
- 2.6 **Customers**, who may range from individuals to large corporations to government and who are the lifeblood of the company.
- 2.7 **Industry at large** – Treelines Ltd does not operate in a vacuum. It is part of the broader economic community and the forestry/milling/pulp/paper industry specifically. Co-operation and participation are key to sustainability of the industry as a whole.
- 2.8 **Local communities** – Companies are part of the wider society and, as in the case of Treelines Ltd, of numerous local communities. The company depends on these communities and vice versa.
- 2.9 **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.
- 2.10 **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 the regulator must be cultivated.

**Source:** *Graded questions on auditing* (Gowar & Jackson 2012:27) – adapted

## SUMMARY

In this study unit we explained and applied the provisions of the King III Report and Code on Governance in South Africa.



## SELF-ASSESSMENT

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

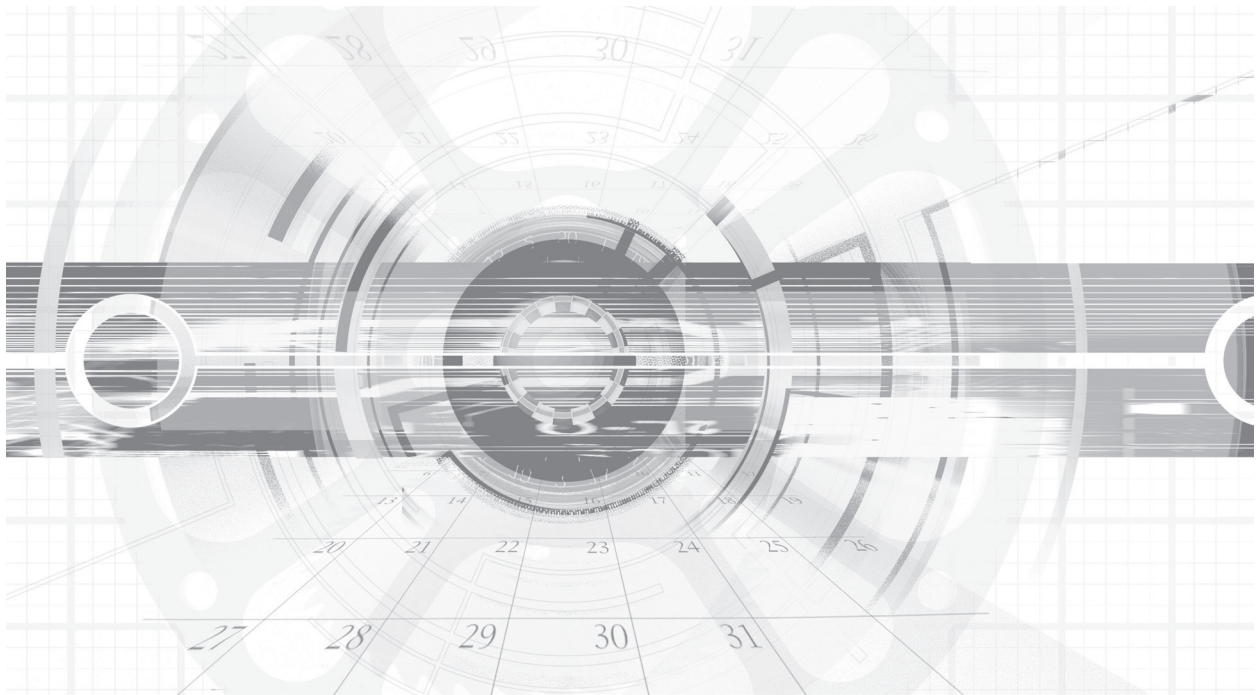
1. Explain and apply the nine significant matters covered by King III.

## 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 III Code on Governance.

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

The aim of this topic is to explain and apply the theory of internal control as an important aspect of corporate governance. Internal control will be explained on the basis of internal control objectives and the components of internal control. General and application controls in a computerised environment will also be explained and applied as part of control activities.

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 study units:**

Study unit	Title	Page
<b>2.1</b>	<b>Internal control</b>	27
2.1.1	Definition of internal control and internal control objectives	27
2.1.2	Limitations of internal control	29
<b>2.2</b>	<b>Components of internal control</b>	31
2.2.1	Control environment	31
2.2.2	Risk assessment	31
2.2.3	Information system	33

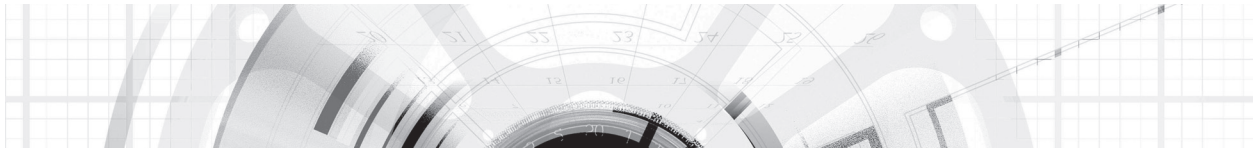
Study unit	Title	Page
2.2.4	Control activities	33
2.2.5	Monitoring of controls	36
<b>2.3</b>	<b>Controls in a computerised environment</b>	<b>37</b>
2.3.1	General controls	38
2.3.2	Application controls	39
<b>2.4</b>	<b>Internal control from the perspective of the external auditor</b>	<b>45</b>
2.4.1	Obtaining an understanding of internal control	45
2.4.2	Significant risks	45

### Textual amendments and additions

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

### Learning outcomes

Study unit	In this topic we focus on the following learning outcomes:	Level
2.1 Internal control	• Define and explain internal control and internal control objectives with reference to management assertions.	2
	• Relate internal control objectives for financial reporting to risks and internal controls.	2
	• Explain the limitations of internal control.	2
2.2 Components of internal control	• Describe, explain and apply the five components of internal control.	2
2.3 Controls in a computerised environment	• Describe and apply general controls in a computerised environment.	2
	• Describe and apply application controls in a computerised environment.	2
2.4 Internal control from the perspective of the external auditor	• Discuss the need for the external auditor to obtain an understanding of a client's internal control in order to identify significant risks.	2



# STUDY UNIT 2.1

## INTERNAL CONTROL

### INTRODUCTION

The importance of good corporate governance to a business and its stakeholders was explained in topic 1. As part of Principle 3.8, point 65.1, of the King III Report (2009:64), it is stated that **the audit committee should be responsible for overseeing financial risk management and controls and ensuring that the controls provide guidance that embeds internal financial control in the business processes and evolves to remain relevant over time.**

### 2.1.1 DEFINITION OF INTERNAL CONTROL AND INTERNAL CONTROL OBJECTIVES

As stated in Jackson & Stent (2012:5/3), internal control is designed to address and limit potential risks.



#### STUDY

Jackson & Stent (2012:5/3–5/4) section 1

#### ACTIVITY 1

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

#### FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2012:5/4) section 1.3

The characteristics are mentioned in your textbook and are not repeated here. Please refer to the textbook for the answer.

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 regard to the implementation and execution of internal controls.



## STUDY

Jackson & Stent (2012:5/5) section 3

Internal control can be defined 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
- its compliance with applicable laws and regulations

The aim of **reliable financial reporting** (the first objective above) is to enable management to ensure that transactions that are initiated, recorded, processed and reported are **valid** (occurred and have been authorised), **accurate** and **complete**. These are called **internal control objectives for financial reporting** and internal controls are implemented to help achieve these objectives.

Management **assertions** relate directly to the internal control objectives for financial reporting.



## STUDY

Jackson & Stent (2012:1/19–1/20) section 7

The following table illustrates the relation between internal control objectives and the assertions:

Internal control objectives	Assertions
Valid (occurred and authorised)	Occurrence Existence Rights and obligations
Accurate	Accuracy Classification Valuation and allocation
Complete	Completeness Cut-off

## ACTIVITY 2

1. Define what is meant by "assertions of management" in the financial statements.
2. Give another word for assertions.
3. What do the assertions of occurrence, accuracy and completeness mean?
4. Explain the link between the terms occurred and authorised and a valid transaction.

## FEEDBACK ON ACTIVITY 2

Reference Jackson & Stent (2012:1/21)

1. Assertions are in effect management's representations about the company's assets, equity, liabilities, transactions and events in the financial reports.

2. Another word for assertions is representations.
3. **Occurrence:** A transaction or event which has been recorded, took place and pertains to the entity.  
**Accuracy:** Amounts and other data relating to recorded transactions and events have been recorded appropriately.  
**Completeness:** All assets, liabilities, transactions or events which should have been recorded have been recorded.
4. A valid transaction implies that it has occurred, has been authorised and pertains to the entity.

## 2.1.2 LIMITATIONS OF INTERNAL CONTROL

Your prescribed textbook, Jackson & Stent (2012:5/4), 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.



### STUDY

Jackson & Stent (2012:5/4–5/5) section 2

### ACTIVITY 3

Management has designed an internal control system which **theoretically** addresses risk. Give an example of a control risk that may have increased as a result of the following limitation of internal control:

The possibility that procedures may have become inadequate owing to changes in business processes while controls have remained static.

### FEEDBACK ON ACTIVITY 3

Reference: Jackson & Stent (2012:5/5)

Example:

A company may experience such a steady increase in sales that the only way that its salesmen can keep up with the demand from customers is by ignoring certain controls.

Note that this is an example of controls that have remained static, while risks have changed. The King III Report (2009:73) states that the board should exercise leadership to prevent risk management from becoming a **series of activities that are detached from the realities** of the company's business, as illustrated here. This also reminds us that internal control is ultimately the responsibility of the board.

## SUMMARY

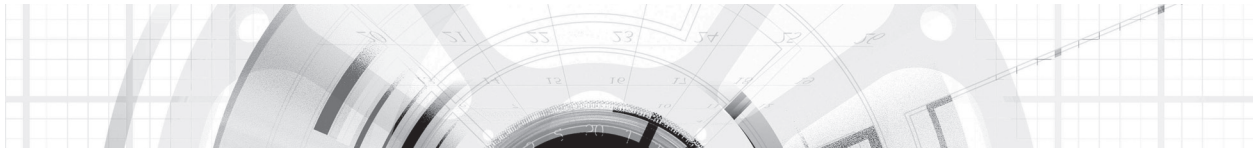
In this study unit we explained the definition and limitations of internal control. We also explained that internal control is a response to risk and that internal control objectives are achieved by implementing internal controls.



## SELF-ASSESSMENT

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

1. Explain and define internal control.
2. Explain the limitations of internal control.
3. Name and explain the internal control objectives in a financial context with reference to management assertions.
4. Illustrate the link between risks, internal controls and internal control objectives.



# STUDY UNIT 2.2

## COMPONENTS OF INTERNAL CONTROL

### INTRODUCTION

Internal control consists of the following five components (Jackson & Stent 2012:5/5):

- Control environment
- Risk assessment
- Information system
- Control activities
- 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 study unit 2.3.



#### STUDY

- Jackson & Stent (2012:5/5–5/6) section 4
- Jackson & Stent (2012:8/4–8/6) section 2

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

### 2.2.1 CONTROL ENVIRONMENT

As stated in Jackson & Stent (2012:5/7), the control environment sets the tone of the entity and creates the atmosphere in which employees go about their duties. The desirable mindset is one of **“doing things the right way”**.



#### STUDY

Jackson & Stent (2012:5/7–5/8) section 4.1

### 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.

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 should be comprehensive, accurate, thorough and complete (cf Jackson & Stent 2012:5/8–5/9).



## STUDY

Jackson & Stent (2012:5/8–5/10) section 4.2

## ACTIVITY 4

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1. Define the term “risk assessment” in the context of internal control.
2. What role do the internal control objectives of the entity play in the risk assessment process?
3. Explain financial reporting risk with reference to the internal control objectives for financial reporting, namely valid (occurred and authorised), accurate and complete.

## FEEDBACK ON ACTIVITY 4

---

Reference: Jackson & Stent (2012:5/8–5/9)

### 1. Risk assessment

The risk assessment process involves assessing the **likelihood** and frequency of risks identified and estimating the potential **impact** if the risk were to occur. This relates to the risk of failing to achieve the internal control **objectives** of the entity.

### 2. Role of internal control objectives in the risk assessment process

The internal control objectives of the entity should be defined so that the risks of failing to achieve the objectives can be properly identified, assessed and responded to. Objectives must be set for all departments and functions of the entity and the risks which threaten achievement of the objectives can then be identified, assessed and responded to.

Note how financial reporting risk relates to the objective of “reliable financial reporting”. If this is not clear to you, go back to 2.1.1, where the internal control objectives for financial reporting are explained.

### 3. Financial reporting risks

The risk that the entity has not achieved its objective of having an accounting system (part of the information system) which records and processes only transactions and events which have **occurred** and have been **authorised** (valid transactions) and which are recorded and processed **accurately** and **completely**.

### 2.2.3 INFORMATION SYSTEM

Your prescribed textbook, Jackson & Stent, (2012:5/10) explains an information system in terms of the procedures and records that form part of it and states that the objective of the information system is to produce information which is **valid** (occurred and authorised), **accurate** and **complete**. The internal control objectives for financial reporting were explained in 2.1.1 above. Note from the under-mentioned study reference how these objectives fit into the information system.



#### STUDY

Jackson & Stent (2012:5/10–5/12) section 4.3

#### ACTIVITY 5

Describe the procedures that normally form part of an entity's information system for financial reporting.

#### FEEDBACK ON ACTIVITY 5

Reference: Jackson & Stent (2012:5/10) section 4.3

The procedures established by the entity to:

- initiate, record, process and report transactions
- capture events and conditions other than transactions (such as depreciation)
- accumulate, record, process and summarise information for the preparation of the financial statements

Note that these procedures will usually take place in a combined manual and computerised environment.

### 2.2.4 CONTROL ACTIVITIES

The control objectives for financial reporting namely valid (occurred and authorised), accurate and complete can only be achieved in the information system with the implementation of control activities, which 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 2012:5/12) and to achieve the entity's internal control objectives.



#### STUDY

Jackson & Stent (2012:5/12–5/17) 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 6

1. For each of the six types of control activities mentioned above, give an example of **what could go wrong (risks)** in the absence of the control activity.
2. Use the solution for 1 above and state the related **internal control objective** for each of the risks identified. Give reasons for your answers.

## FEEDBACK ON ACTIVITY 6

Reference: Jackson & Stent (2012:5/12–5/16)

1. The following table provides a list of **possible things that could go wrong (risks)** in an accounting system for each of the control activities. This is based on the examples given in Jackson & Stent (2012:5/12–5/16).

Control activity	Things that could go wrong (risks)
Approval, authorisation	Credit sales could be made to customers who are not creditworthy and who cannot pay their account, 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, the placing of an order and the issuing of the goods received note, as the purchase clerk could order the goods for himself at the company's expense.
Isolation of responsibility	An incorrect number of goods could be received if a supplier delivers goods to a company and the receiving clerk did 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 with and reconciled to the balance on the bank statement.
Performance reviews	An abnormal increase in transport costs as a result of thefts of fuel could go undetected if management fails to compare the actual costs figure with the budgeted transport costs.

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

2. The following table provides the **internal control objectives** for financial reporting **at risk** for each of the things that could go wrong.

	Things that could go wrong	Internal control objective at risk
1.	Credit sales could be made to customers who are not creditworthy and who cannot pay their account, if a credit sale is not approved by the credit controller first.	Occurred and authorised are at risk as a sale could take place that was not valid.
2.	Goods purchased could be stolen if no segregation of duties exists between the authorisation, the placing of an order and the issuing of the goods received note, as the purchase clerk could order the goods for himself at the company's expense.	Occurrence is at risk as a purchase transaction that does not pertain to the entity has taken place.  Accuracy is also at risk as incorrect amounts and other data may be recorded. The inventory could be overstated by the stolen goods.
3.	An incorrect number of goods could be received if a supplier delivered goods to a company and the receiving clerk did not count the goods and sign the supplier's delivery note. The clerk could not be held responsible and the mistake could be repeated.	Validity, accuracy and completeness are at risk as goods could be over- or understated, depending on whether too many or too few items are received.
4.	Physical inventory could be stolen if not stored properly, for example if not protected by a security guard at the inventory warehouse entrance.	Accuracy is at risk as the inventory figure in the financial statements is incorrect and is overstated by the stolen inventory.
5.	The balance of the cash receipts and payments journal could be incorrect if it is not regularly compared with and reconciled to the balance on the bank statement.	Validity, accuracy and completeness are at risk if the cash receipts and payments journal balance is incorrect, depending on whether it is over- or understated.
6.	An abnormal increase in transport costs as a result of the theft of fuel could go undetected if management fails to compare the actual cost figure with the budgeted transport costs.	Validity (occurred and authorised) is at risk as purchase transactions take place for transport costs that do not pertain to the entity.

The purpose of this activity is to illustrate the application of the theory of control activities. Control activities will be applied in more depth to manual and computerised activities in the various business cycles in the topics that follow. The activities within the business cycles will also be explained in detail in the topics that follow.

### 2.2.4.2 General and application controls

As mentioned in 2.2.3 above, transactions usually take place in a combination of a manual and a computerised environment. So, it is fair to say that internal controls in a computerised environment are an integral part of the total system of internal control of an entity.

Although general and application controls are included in Jackson & Stent 2012:5/6 as part of control activities, strictly speaking, general and application controls go beyond the “control activities” component of the internal control process. To a certain extent they affect all the other components (cf Jackson & Stent 2012:5/17).

General and application controls will be dealt with in 2.3 below. When studying this section, you should note throughout how the general and application controls relate to the components of internal control.

### 2.2.5 MONITORING OF CONTROLS

As stated in Jackson & Stent (2012:5/17), the monitoring of controls involves the assessment of internal control performance over time.



#### STUDY

Jackson & Stent (2012:5/17–5/18) section 4.5

#### ACTIVITY 7

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Give five examples of different ways in which the monitoring of controls can take place.

#### FEEDBACK ON ACTIVITY 7

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Reference: Jackson & Stent (2012:5/17–5/18)

Refer to your textbook for examples of monitoring.

Note that monitoring is part of the **internal control system**, which is achieved by the **ongoing** assessment of internal control performance over time.

### SUMMARY

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

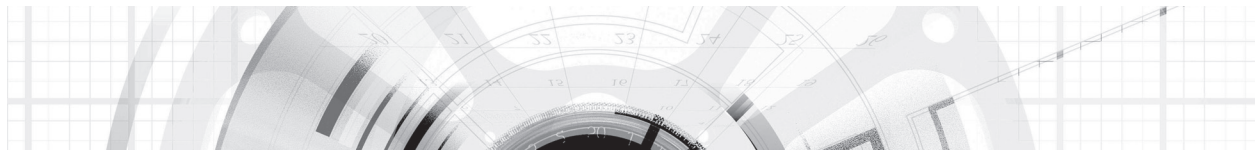


#### SELF-ASSESSMENT

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

1. Explain and apply the five components of internal control.

If you are not completely familiar with the application at this stage, you should not be concerned because further guidance will be given in later topics.



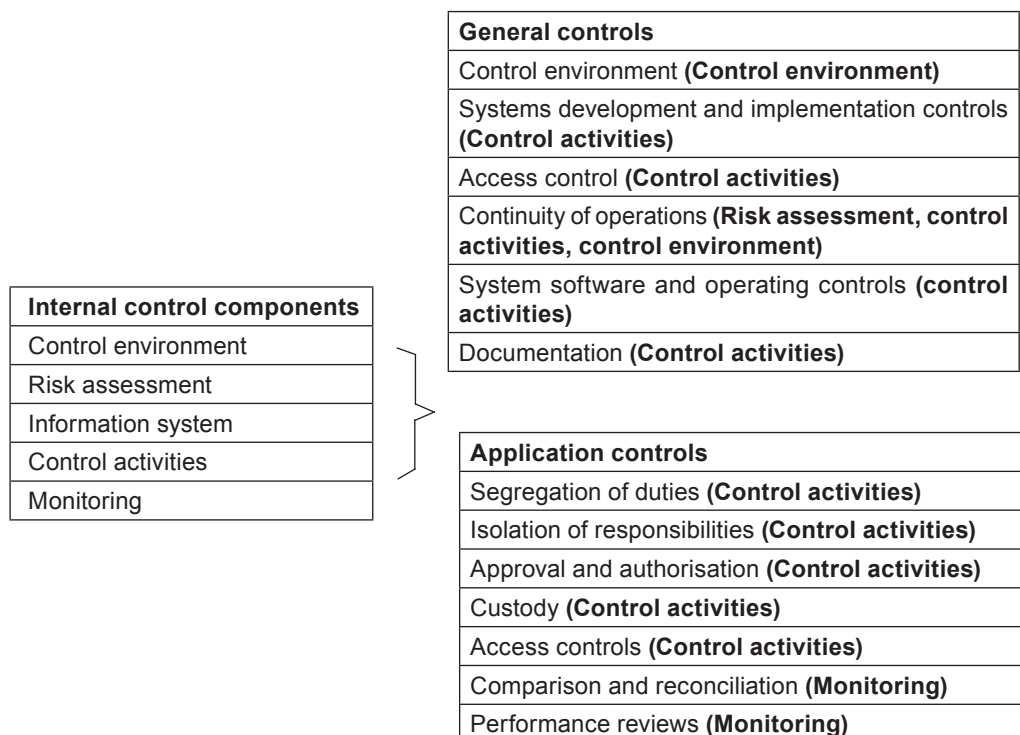
## STUDY UNIT 2.3

### 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 shows that the general and application controls relate to all the components of internal control.



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 are discussed in more detail below.

### 2.3.1 GENERAL CONTROLS

General controls are defined as those controls which establish an **overall framework** of control for computer activities (Jackson & Stent 2012:8/7).

Note the following:

The term “computerised environment” refers to any particular and unique combination of hardware, software and personnel (Jackson & Stent 2012:8/3).



#### STUDY

Jackson & Stent (2012:8/7–8/25)

Jackson & Stent (2012:8/7) categorise general controls as follows:

1. Control environment
2. Systems development and implementation controls
3. Access control
4. Continuity of operations
5. System software and operating controls
6. Documentation

---

#### ACTIVITY 8

Participation by those charged with governance is one of the characteristics of a good control environment. Explain who is responsible for governance and what participation entails in an Information Technology (IT) environment.

---

#### FEEDBACK ON ACTIVITY 8

Reference: Jackson & Stent (2012:8/8) section 3.3

The participation of the board in the IT control environment is explained in your textbook under section 3.3 and is not repeated here.

---

#### ACTIVITY 9

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 control over passwords as part of logical access controls, entails.

---

#### FEEDBACK ON ACTIVITY 9

Jackson & Stent (2012:8/17–8/21)

## 1. Interpret the question as follows:

- It requires **general controls** (not application controls).
- It requires **access controls** (component 3).
- It requires only **physical** access controls (not logical access controls).

General physical access controls include 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 TVs 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. Controls 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 (2012:8/27) define 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 (**valid**, **accurate** and **complete** information).

Note the following:

- In other words, application controls are the **activities** within an **application** carried out to ensure that the **internal control objectives** are achieved.
- An **application** is a set of procedures and programmes designed to satisfy all users associated with a specific task, such as the payroll cycle (Jackson & Stent 2012:8/27).



### STUDY

Jackson & Stent (2012:8/26–8/41) sections 1–4

### ACTIVITY 10

The following control techniques and application controls, described according to the stages a transaction passes through as it flows through the system, are mentioned in your textbook:

**Input:**

- \* Access control
- \* Authorisation
- Batching
- Screen aids and related features
- Programme controls – Input
- Existence/validity checks
  - Reasonableness and limit checks
  - Dependency checks
  - Format checks
  - Check digits
  - Sequence checks
- Logs and reports
- \* Training
- \* Extraction from masterfiles

**Processing:**

- \* Version control
- Programme controls – Processing
  - Programme edit checks
  - Programme reconciliation checks
  - Logs and reports
- \* Identifying and resubmitting errors

**Output:**

- Controls over distribution
- User controls
- Logs and reports

**Masterfile:**

- Record amendments on masterfile amendment form (MAF)
- Authorise MAF
- Enter authorised amendments onto system
- Review amendments

- \* Note that additional controls have been included in this list that are not explained in your textbook. They are relevant application controls and you are expected to study them.

**REQUIRED**

Link the control techniques and application controls mentioned above to the internal control objectives of valid (occurred and authorised), complete and accurate.

**FEEDBACK ON ACTIVITY 10**

Jackson & Stent (2012:8/27–8/40) sections 1–4

**Input controls**

<b>Valid (Occurred and Authorised)</b>	<b>Complete</b>	<b>Accurate</b>
<ol style="list-style-type: none"> <li>Access control</li> <li>Authorisation</li> <li>Batching</li> <li>Existence/validity checks <ul style="list-style-type: none"> <li>Validation checks</li> <li>Matching checks</li> <li>Data approval/authorisation checks</li> </ul> </li> <li>Logs and reports <ul style="list-style-type: none"> <li>Override reports</li> <li>Activity reports</li> <li>Access/access violation reports</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>Batching</li> <li>Sequence tests</li> <li>Logs and reports <ul style="list-style-type: none"> <li>audit trails</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>Batching</li> <li>Screen aids and related features <ul style="list-style-type: none"> <li>Minimum keying in of information</li> <li>Screen should be formatted</li> <li>Screen dialogue and prompts</li> <li>Mandatory fields</li> <li>Shading of fields</li> </ul> </li> <li>Reasonableness and limit tests</li> <li>Dependency checks</li> <li>Format checks <ul style="list-style-type: none"> <li>Alpha-numeric</li> <li>Size checks</li> <li>Mandatory field/missing data checks</li> <li>Valid character and sign check</li> </ul> </li> <li>Check digits</li> <li>Training</li> <li>Extraction from masterfiles</li> </ol>

**Processing controls**

<b>Valid (Occurred and Authorised)</b>	<b>Complete</b>	<b>Accurate</b>
<ol style="list-style-type: none"> <li>Version control</li> <li>Programme reconciliation checks <ul style="list-style-type: none"> <li>Valid operation code (assess control during processing)</li> </ul> </li> <li>Logs and reports <ul style="list-style-type: none"> <li>Override reports</li> <li>Activity reports</li> <li>Access/access violation reports</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>Programme edit checks <ul style="list-style-type: none"> <li>Sequence test</li> <li>Matching</li> </ul> </li> <li>Programme reconciliation checks <ul style="list-style-type: none"> <li>Control totals</li> <li>Run-to-run totals</li> </ul> </li> <li>Logs and reports <ul style="list-style-type: none"> <li>Audit trails</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>Programme edit checks <ul style="list-style-type: none"> <li>Arithmetic</li> <li>Reasonableness/consistency/ range tests</li> <li>Limit test</li> <li>Accuracy test</li> </ul> </li> <li>Programme reconciliation checks <ul style="list-style-type: none"> <li>Parity checks</li> <li>Echo check</li> <li>Equipment check</li> </ul> </li> <li>Identifying and resubmitting errors</li> </ol>

## Output controls

Valid (Occurred and Authorised)	Complete	Accurate
1. Controls over distribution 2. User controls <ul style="list-style-type: none"> <li>Review of output for reasonableness</li> </ul> 3. Logs and reports <ul style="list-style-type: none"> <li>Exception reports</li> </ul>	1. User controls <ul style="list-style-type: none"> <li>Numerical sequence check</li> <li>Reconciliation of input to output</li> <li>Review of output for reasonableness</li> </ul>	1. User controls <ul style="list-style-type: none"> <li>Reconciliation of input to output</li> <li>Review of output for reasonableness</li> <li>Review and follow-up of exception reports</li> </ul>

## Masterfile controls

Valid (Occurred and Authorised)	Complete	Accurate
1. Authorise MAF 2. Enter authorised amendments onto system <ul style="list-style-type: none"> <li>Write access controls (ID and passwords)</li> </ul> 3. Review amendments <ul style="list-style-type: none"> <li>Amendments supported by MAF</li> </ul>	1. Record amendments on MAF 2. Enter authorised amendments onto system <ul style="list-style-type: none"> <li>Amendments logged on sequenced logs</li> </ul> 3. Review amendments <ul style="list-style-type: none"> <li>MAFs sequence checked against the logs</li> </ul>	1. Enter authorised amendments onto system <ul style="list-style-type: none"> <li>Screen aids (Minimum keying in of information, screen formatting, automatically generated accounts)</li> <li>Programme checks (Verification/ matching, alpha-numeric, range and limit/data approval, field size and mandatory/ missing data, dependency check)</li> </ul> 2. Review amendments <ul style="list-style-type: none"> <li>Numbers and amounts etc.</li> </ul>

Please remember that the above is only a **checklist** for study purposes. In tests and exams you must expand on the above. For example you could answer as follows: "The computer must 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.

The above summary could also be arranged in the format below. You may find this helpful when answering questions on application controls.

Internal control objective	Input	Processing	Output	Masterfile
Valid (Occurred and Authorised)				
Complete				
Accuracy				

Follow these steps:

1. Determine which of the stages a transaction passes through as it flows through the system is being addressed in the scenario. Does the scenario deal with the:
  - input phase,
  - processing phase,
  - output phase, and/or
  - masterfile maintenance?
2. Determine which control objectives are being addressed. Does the question require you to address:
  - valid (occurred and authorised),
  - complete, and/or
  - accurate?

### ACTIVITY 11

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 11

**Apply the steps discussed above to the question.**

1. Determine the business cycle:
  - In this instance the question does not specify which cycle. Generic controls over any masterfile amendments are requested.
2. Determine the phase of the transaction process:
  - Masterfile amendments.
3. Determine the control objectives:
  - Completeness.

**How would your table look?**

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

Note: The purpose of this activity is to illustrate the steps you should follow when answering a question. The control components in a computerised environment for the various business cycles will be explained in the topics that follow.

## SUMMARY

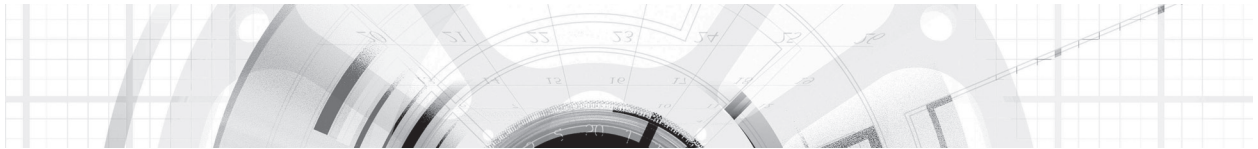
In this study unit we explained general and application controls in a computerised environment as part of a system of internal control.



## SELF-ASSESSMENT

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

1. Explain and apply general controls in a computerised environment.
2. Explain and apply application controls in a computerised environment.



## STUDY 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 (2012:7/14) state 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 (2012:7/14–7/18)

#### 2.4.2 SIGNIFICANT RISKS

Jackson & Stent (2012:7/19) define 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 (2012:7/19–7/20) sections 1–3

#### ACTIVITY 12

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

## FEEDBACK ON ACTIVITY 12

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Reference: Jackson & Stent (2012:7/19)

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



## SELF-ASSESSMENT

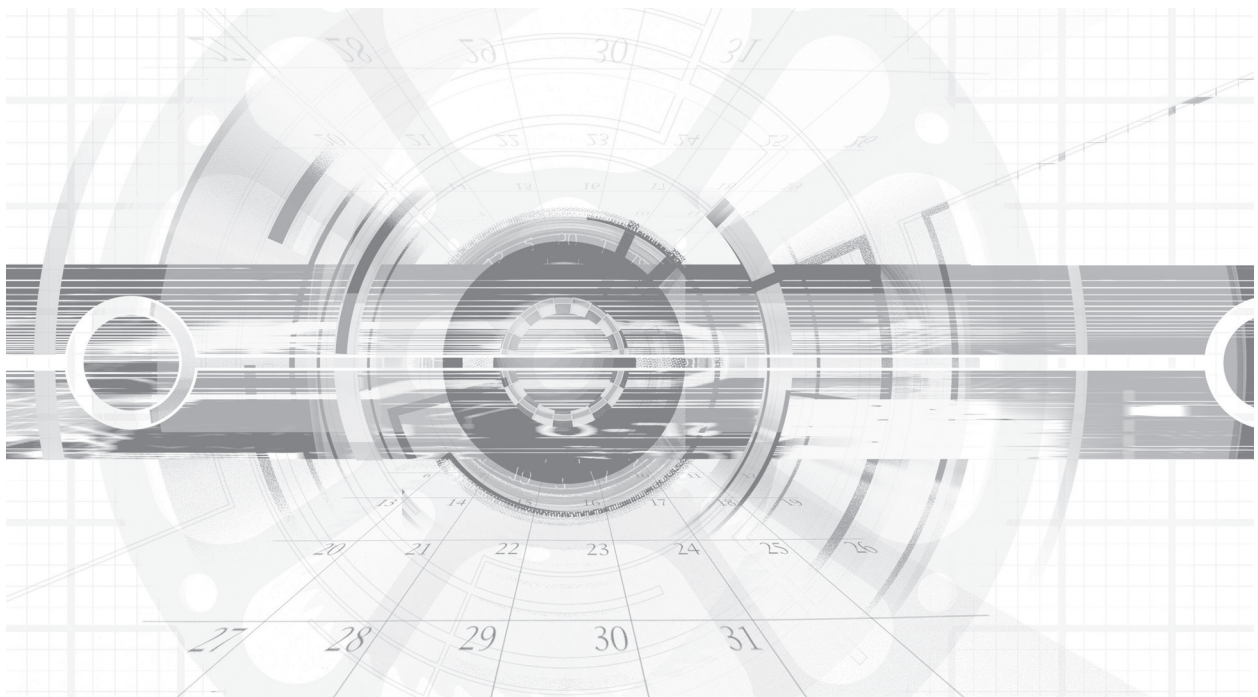
After having worked through the study unit and the references to the prescribed study material, see whether you are able to do the following:

1. Describe the need for the external auditor to obtain an understanding of a client's internal control.

## 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 a response to risk and that certain internal control objectives are achieved by means of internal control. Internal control from the perspective of the external auditor was also explained.

In the next topic we will explain and apply the various business cycles as part of the accounting system over which internal controls are implemented.



# 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 study units:**

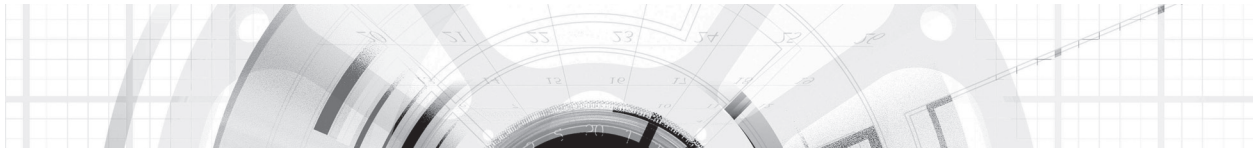
Study unit	Title	Page
<b>3.1</b>	<b>Business cycles</b>	49
3.1.1	The accounting system and business cycles	49
3.1.2	Financial statements	49

### Textual amendments and additions

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

### Learning outcomes

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



# STUDY 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 have been authorised), **accurate** and **complete**. It is the **accounting system** which provides the foundation for achieving 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, (2012:5/12) describes an accounting system as a series or collection of tasks and records by 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; etc, and **paper** such as order forms, ledgers, lists, invoices etc, which facilitate the initiation, execution and recording of the transaction.

The accounting system consists of various business cycles, namely:

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

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
<b>ASSETS</b>			
<b>Non-current assets</b>			
Property, plant and equipment		16 069	14 696
		16 069	14 696
<b>Current assets</b>			
Inventories		192 085	149 002
Trade receivables		418 465	222 833
Cash and cash equivalents		—	1 465
		610 550	373 300
<b>Total assets</b>		<b>626 619</b>	<b>387 996</b>
<b>EQUITY AND LIABILITIES</b>			
<b>Equity attributable to owners of the parent</b>			
Share capital		147 834	147 834
Revaluation surplus		8 500	—
General reserve		5 000	2 000
Retained earnings		22 192	18 375
		183 526	168 209
<b>Non-controlling interest</b>		40 125	32 000
<b>Total equity</b>		223 651	200 209
<b>Non-current liabilities</b>			108 297
Long-term borrowings		236 000	23 100
Deferred taxation		28 875	131 397
		264 875	
<b>Current liabilities</b>			
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	—
		138 093	56 390
<b>Total liabilities</b>		402 968	187 787
<b>Total equity and liabilities</b>		<b>626 619</b>	<b>387 996</b>

## 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		188 865	82 113
Distribution costs		(25 741)	(14 010)
Administrative expenses		(28 813)	(10 345)
Other expenses		(48 881)	(22 237)
Finance costs		(39 264)	(20 862)
<b>Profit before tax</b>		46 166	14 659
Income tax expense		(10 927)	(6 148)
<b>Profit for the year</b>		35 239	8 511
<b>Other comprehensive income for the year after tax</b>			
Revaluation surplus		10 625	–
Other comprehensive income for the year, net of tax		10 625	–
<b>Total comprehensive income for the year</b>		<b>45 864</b>	<b>8 511</b>
Profit attributable to:			
– Owners of the parent		28 039	1 711
– Non-controlling interest (given)		7 200	6 800
		35 239	8 511
Total comprehensive income attributable to:			
– Owners of the parent		36 539	1 711
– Non-controlling interest		9 325	6 800
		45 864	8 511

The following are components in the financial statements:

## Statement of financial position:

- property, plant and equipment
- investments
- loans granted
- inventories
- trade receivables
- cash and cash equivalents
- share capital
- reserves
- retained earnings
- long-term borrowings
- trade payables

## Statement of comprehensive income:

- revenue (credit and cash sales)
- cost of sales (inventory)
- purchases
- distribution costs
- 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 the financial position and the classes of transactions in the statement of comprehensive income that relate to the business cycles are:

<b>Business cycle</b>	<b>Statement of financial position (account balances)</b>	<b>Statement of comprehensive income (classes of transactions)</b>
Revenue and receipts cycle	<ul style="list-style-type: none"> <li>• Accounts receivable</li> <li>• Cash and cash equivalents</li> </ul>	<ul style="list-style-type: none"> <li>• Credit sales</li> <li>• Sales returns</li> <li>• Discount allowed</li> <li>• Credit losses</li> <li>• Interest received</li> <li>• Cash sales</li> <li>• All receipts (revenue and other)</li> </ul>
Acquisitions and payments cycle	<ul style="list-style-type: none"> <li>• Accounts payable</li> </ul>	<ul style="list-style-type: none"> <li>• Credit purchases</li> <li>• Cash purchases</li> <li>• Purchase returns</li> <li>• Discount received</li> <li>• Interest on late payments</li> <li>• Expenses</li> </ul>
Inventory and production cycle	<ul style="list-style-type: none"> <li>• Inventory</li> </ul>	<ul style="list-style-type: none"> <li>• Cost of sales</li> </ul>
Payroll and personnel cycle	<ul style="list-style-type: none"> <li>• Bank and cash</li> <li>• Accounts payable (Accumulated leave, unclaimed wages, SARS, pension funds, medical aids and other)</li> </ul>	Wages and salaries (net of employee deductions such as PAYE, UIF, SDL, pension fund, medical aid and other)

<b>Business cycle</b>	<b>Statement of financial position (account balances)</b>	<b>Statement of comprehensive income (classes of transactions)</b>
Finance and investment cycle	<ul style="list-style-type: none"> <li>• Share capital</li> <li>• Reserves</li> <li>• Long-term loans</li> <li>• Property, plant and equipment</li> <li>• Investments</li> </ul>	<ul style="list-style-type: none"> <li>• Dividends paid</li> <li>• Profit or loss (reserves)</li> <li>• Interest paid</li> <li>• Profit or loss on sale of asset</li> <li>• Profit or loss on investment</li> </ul>

## SUMMARY

In this study unit we identified the different business cycles and explained the accounting system over which internal controls are implemented. The transactions and balances in the statement of financial position and statement of comprehensive income were also related to the various business cycles.



## SELF-ASSESSMENT

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

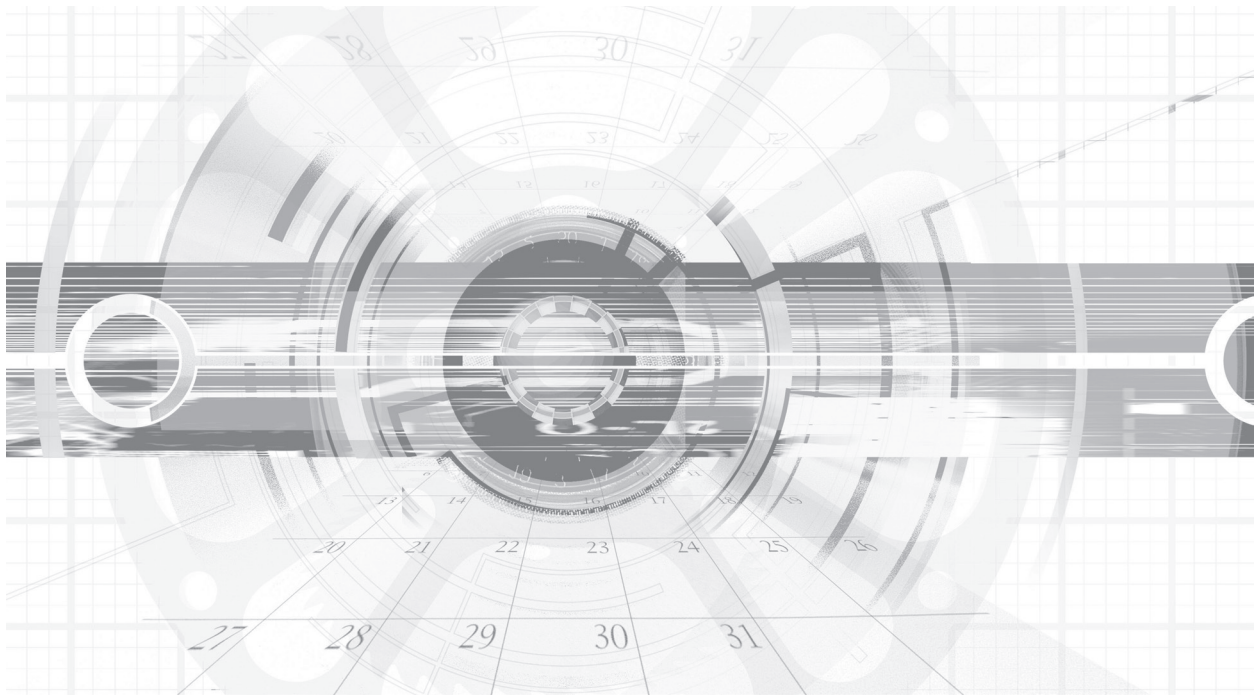
1. Identify the different business cycles.
2. Explain what an accounting system entails.
3. Relate the transactions and balances in the statement of financial position and the statement of comprehensive income to the various business cycles.

## 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 the 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 classes of transactions and account 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 may consist of credit sales and / or cash sales.

The aim of this topic is to explain and apply the activities, functions and documents in the revenue and receipts business 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 study units:**

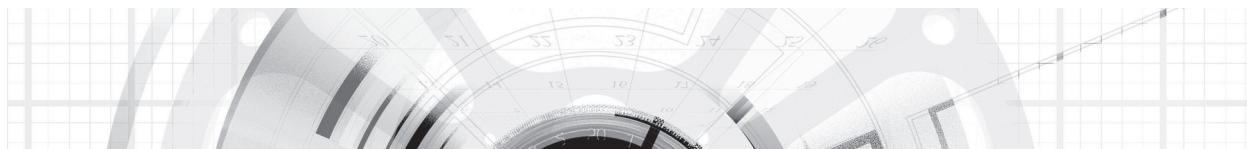
Study unit	Title	Page
<b>4.1</b>	<b>Credit sales</b>	57
4.1.1	Activities and functions in the cycle	57
4.1.2	Documents used in the cycle	58
4.1.3	Risks and internal control in the cycle	62
4.1.4	Computerisation of the cycle	65
<b>4.2</b>	<b>Cash sales</b>	70
4.2.1	Stages of a cash sale	70
4.2.2	Risks and internal control over a cash sale	70

### Textual amendments and additions

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

### Learning outcomes

Study unit	In this topic we focus on the following learning outcomes:	Level
4.1 Credit sales	• Describe credit sales transactions by explaining the activities, functions and documents associated with these transactions.	2
	• Identify and explain the risks associated with credit sales transactions and describe and apply the internal controls that could be implemented to mitigate the risks.	2
	• Describe and apply internal control over credit sales transactions in a computerised environment.	2
4.2 Cash sales	• Describe cash sales transactions by explaining the activities, functions and documents associated with these transactions.	2
	• Identify and explain the risks associated with cash sales transactions.	2
	• Describe and apply the internal controls that could be implemented to mitigate the risks.	2



# STUDY UNIT 4.1

## CREDIT SALES

### INTRODUCTION

Your prescribed textbook, Jackson & Stent (2012:10/2), explains revenue transactions and indicates that this cycle deals with the business 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 (2012:10/2–10/5), describes a system for a business which has conventional revenue and receipt functions. Note that the functions in the credit sales cycle include the collection of payments from accounts receivable (trade debtors).



#### STUDY

Jackson & Stent (2012:10/2–10/7)

#### 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 (2012:10/3–10/5)

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 (2012:10/6–10/7)

##### 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 Back-order note
Warehouse/despatch	Picking slip Delivery 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, No. 68 of 2008** which came into effect on 1 April 2011, specifies 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; and
9. the total price of the transaction, including any applicable taxes.

### REQUIRED

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

<b>TAX INVOICE</b>		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	522.22	
<b>Total</b>	<b>61 252.20</b>	

### 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

5. the amount of any applicable taxes
6. the total price of the transaction, including any applicable taxes

#### 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.

<b>SALES ORDER</b>		OD 1028	
XY LIMITED Po Box X Pretoria 0001			
		Date: 30 May 20xx	
To: Customer Y Po Box Y Durban 4001 Account number: Y4458			
<b>Description</b>	<b>Quantity</b>	<b>Unit price</b>	<b>Total</b>
No XL001 Stapler	85	28.60	2 430.00
No 1185 Paper	400	123.00	49 200.00
No 2.1 Pencil	1 000	2.10	2 100.00
		Subtotal	730.00
		VAT	7 522.20
		<b>Total</b>	<b>61 252.20</b>
		Authorised:	<i>Order Clerk</i>

<b>DELIVERY NOTE</b>		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 1 <sup>st</sup> Street 55 Durban North 4001													
Account number: Y4458														
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 70%;">Description</th> <th style="width: 30%;">Quantity</th> </tr> </thead> <tbody> <tr> <td>No XL001 Stapler</td> <td style="text-align: right;">85</td> </tr> <tr> <td>No 1185 Paper</td> <td style="text-align: right;">400</td> </tr> <tr> <td>No 2.1 Pencil</td> <td style="text-align: right;">1 000</td> </tr> <tr> <td colspan="2">           Goods received in good order by customer:            Date:         </td> </tr> <tr> <td colspan="2" style="text-align: right;"> <i>Customer Y</i>            3/06/20XX         </td> </tr> </tbody> </table>			Description	Quantity	No XL001 Stapler	85	No 1185 Paper	400	No 2.1 Pencil	1 000	Goods received in good order by customer: Date:		<i>Customer Y</i> 3/06/20XX	
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## REQUIRED

Indicate which of the information shown on the above documents demonstrates that the internal control objectives 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 is **valid (occurred and authorised), accurate and complete**.

### **Valid (occurred and authorised):**

1. The name and address of XY Ltd appear 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, which indicates that it was approved.
4. The customer signature on the delivery note, which indicates 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 agrees to 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 agrees to the sales order (to be recorded against the sales revenue and VAT accounts).
3. The order form and delivery note item descriptions, quantities and amounts that agree to the invoice.
4. The correct 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 correct 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 study 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 (2012:10/10–10/19)

### 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 could exist in an order department.
4. Describe the internal controls (control activities) that could 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 (2012:10/3–10/4), where the activities in the order department are described.
2. Documents usually encountered in an order department.  
Refer to Jackson & Stent (2012:10/10) where the documents used in the order department are described.
3. Control risks that could exist in an order department  
Refer to Jackson & Stent (2012:10/10–10/11), where the control risks in an order department are described.
4. Internal controls (control activities) that could be implemented to mitigate the risks in an order department  
Refer to Jackson & Stent (2012:10/10–10/11), where the control activities for an order department are listed.

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 banked, owing 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 (2012:10/10–10/19)

<b>Risk</b>	<b>1. Internal control</b>	<b>2. Control objective</b>
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.	Validity (occurred and authorised)
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 descriptions of goods against the authorised picking slip and delivery note.	Validity (occurred and authorised) 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 validity (occurred and authorised)
Payments received from customers may not be banked, owing to theft or carelessness.	1. Post must be opened by two people. 2. All payments received in the post should be recorded in a remittance register and a pre-numbered receipt should be made out for each payment received. 3. All amounts received should be banked daily.	Completeness

Risk	1. Internal control	2. Control objective
	<p>4. The remittance register and receipts issued should be reconciled to bank deposits by an independent supervisory employee.</p> <p>5. Bank deposits should be reviewed regularly and gaps in daily banking, investigated by management.</p>	

#### 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 (2012:10/20–10/39)

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

#### FEEDBACK ON ACTIVITY 7

1. The application controls that should be present in a computerised environment to ensure that only authorised amendments are made are described in Jackson & Stent (2012:10:23–10/25) and will not be repeated here.
2. Things that could go wrong (risks) if no application controls exist over amendments to the debtors' masterfile:

Reference: Jackson & Stent (2012:10/23–10/25)

**Validity (occurred and authorised):** Unauthorised and fraudulent amendments could be made, to the detriment of the company. For example, a debtor's credit limit could be increased, thereby allowing the debtor credit facilities which he or 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 the debtor's not receiving monthly statements and not paying his or 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 might not have been loaded onto the debtors' masterfile so that his or 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 study 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 (2012:8/34) section 3.1.3

This term means that transaction data are entered immediately online as each transaction occurs and relevant programme 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 in the computerised credit sales system.

Reference: Jackson & Stent (2012:10/30)

Internal control objective	Input	Processing	Output	Master-file
Validity (Occurred/ Authorised)				
Accuracy	<ol style="list-style-type: none"> <li>1. <b>Screen formatting:</b> the screen will be formatted to look like a sales order document.</li> <li>2. <b>Minimum entry:</b> for example entering the inventory item code will bring up the description of the item being ordered and the price.</li> <li>3. <b>Mandatory fields:</b> for example, to progress with the order a number must be entered in the quantity field and a customer order reference must be entered.</li> </ol>			

Internal control objective	Input	Processing	Output	Master-file
	<p>4. <b>Alphanumeric check:</b> for example on the quantity field to check that no alphanumeric characters have been entered.</p> <p>5. <b>Limit/or reasonableness check,</b> to ensure that reasonable quantities are entered. For example, not 1 billion items, because this would exceed realistic production targets.</p> <p>6. <b>Screen prompts</b> will require the order clerk to confirm details of the order and important particulars.</p> <p>7. <b>Fields on the “on screen sales order”</b> which cannot be changed by the order clerk.</p> <p>8. The system will allocate a <b>customer reference number</b> to every sales order. This number is given to the customer when the order is placed, to allow 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 the information you were required to give.

## ACTIVITY 9

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

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

## FEEDBACK ON ACTIVITY 9

1. Restriction of access to a bank account

Reference: Jackson & Stent (2012:8/30–8/31) section 2.6

Access violations 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 a bank account

Reference: Jackson & Stent (2012:10/33) point 1

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

- The terminal onto which the bank’s software is loaded should be in the debtors’ section, usually the terminal of the senior debtors’ clerk.
- Access to the bank’s site should be gained in the normal manner, but to access the company’s bank account, the senior debtors’ clerk should be required to enter a PIN and a 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 debtors’ clerk’s user profile to enable him or her to initiate the download.

## 3. Good password controls

Reference: Jackson & Stent (2012:8/20)

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

- Passwords to access the bank account should be unique to the senior debtors’ clerk and 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 characters and symbols.
- Passwords and user IDs for terminated or transferred senior debtors’ 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 debtors’ clerk should be forced by the system to change the password.
- The first time a new senior debtors’ clerk accesses the bank account, he or she should be prompted to change the initial password.
- Passwords to access the bank account should not be displayed on screens 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.
- The senior debtors' clerk should be prohibited from disclosing his or her passwords to others and subjected to disciplinary measures should he or she do so.
- Passwords to access the bank account should be changed if confidentiality has been violated, or violation is suspected.
- Passwords to access the bank account should not be obvious for example birthdays, names, names spelt backwards or common words and should not be the same as the senior debtors' clerk's user ID.

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

## SUMMARY

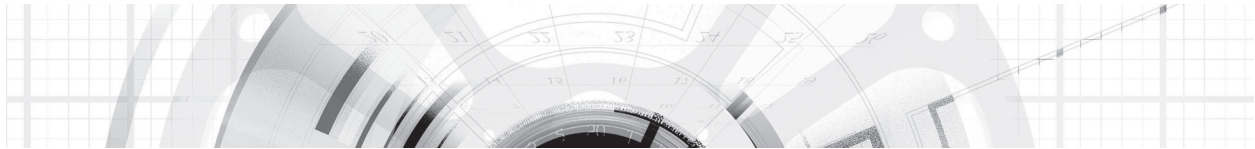
In this study unit we explained and applied the activities, functions and documents relating to credit sales transactions. The risks and internal control in credit sales were also explained and applied, as well as internal control over credit sales transactions in a computerised environment.



## SELF-ASSESSMENT

After having worked through the study unit and the references to the prescribed study material, determine if you are able to answer the following required:

1. Explain the activities and functions relevant to credit sales transactions.
2. Describe the documents used in credit sales transactions.
3. Explain and apply risks and internal controls over credit sales transactions in both a computerised and a noncomputerised environment.



## STUDY 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 (see Jackson & Stent 2012:10/2 & 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 (2012:10/40) section 9.2

#### 4.2.2 RISKS AND INTERNAL CONTROL OVER A CASH SALE

As stated in Jackson & Stent (2012:10/40), 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 (2012:10/40–10/42) section 9.1 and 9.3

#### ACTIVITY 10

The following are a few of the things that can go wrong (riks) with cash sales transactions:

1. Cash sales could be recorded without the cash being put in the cash register drawer.
2. Cash could be received from customers without the cash sales transactions being recorded.
3. Cash could be stolen after the cash register has been “cashed up” for the day.

4. Customers could leave without paying for goods that they have taken.
5. An armed robbery could take place, resulting in cash being stolen from cash registers.

## REQUIRED

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

## FEEDBACK ON ACTIVITY 10

Reference: Jackson & Stent (2012:10/40–10/42) section 9.3

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

Things that can go wrong	Internal control
1. Cash sales could be recorded without the cash being put in the cash register drawer.	The cash in the cash register should be reconciled with the total daily cash sales entered on the cash register roll.  The cash register roll should not be alterable.
2. Cash could be received from customers without the cash sales transaction being 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 has been “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 that they have taken.	Physical safeguards should be in place. For example, there should be limited entry and exit points with security guards at the exit points to sign off the 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.

### 4.2.3 SUMMARY

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



### SELF-ASSESSMENT

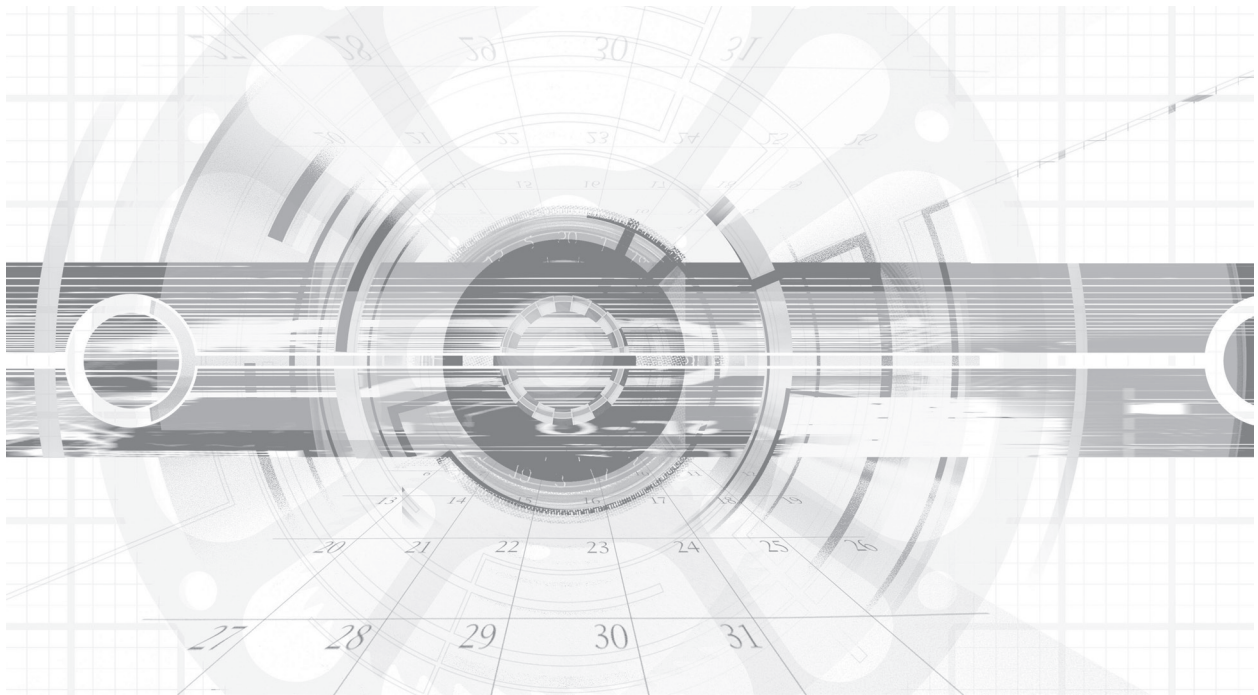
After having worked through the study unit and the references to the prescribed study material, see if you can do the following:

1. Describe the stages of a cash sales transaction.
2. Explain the main risks associated with cash sales transactions.
3. Explain and apply internal controls over cash sales transactions.

### 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 account 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 controls 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 study units:**

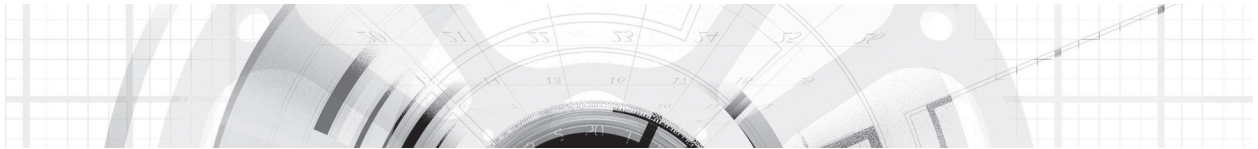
Study unit	Title	Page
<b>5.1</b>	<b>Acquisitions and payments cycle</b>	<b>75</b>
5.1.1	Activities and functions in the cycle	75
5.1.2	Documents used in the cycle	76
5.1.3	Risks and internal control in the cycle	77
5.1.4	Computerisation of the cycle	80

**Textual amendments and additions**

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

**Learning outcomes**

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



# STUDY UNIT 5.1

## ACQUISITIONS AND PAYMENTS CYCLE

### INTRODUCTION

Jackson & Stent (2012:11/2), indicate expenditure transactions for different core business processes. As this module is concerned with a normal trading concern, the two main activities for expenditure transactions are:

- the ordering and receiving of goods (or services) from suppliers, and
- 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 customers 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 (2012:11/2–11/5)

### 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 (2012:11/2–11/5)

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
2. The main activities relevant to the **payment preparation** function are described in Jackson & Stent (2012:11/14) and are not repeated here.

## 5.1.2 DOCUMENTS USED IN THE CYCLE



### STUDY

Jackson & Stent (2012:11/5–11/6)

## ACTIVITY 2

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

## FEEDBACK ON ACTIVITY 2

Function	Document
Ordering of goods	Requisitions Purchase order forms
Receiving of goods	Suppliers' delivery note Goods received note
Recording of purchases	Purchase invoice Credit note
Payment preparation	Creditors' statements Cheque (payment) requisitions
Payment and recording of payment	Remittance advice Cheque or electronic payment Receipt

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, and
- the payment of amounts due for the goods ordered and received.

The main internal control objectives associated with these activities are 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 2012:11/2). Sound internal controls should be implemented to achieve these objectives.

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 (2012:11/31).



#### STUDY

Jackson & Stent (2012:11/5–11/13)

Jackson & Stent (2012:11/31)

#### ACTIVITY 3

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

Functions	Documents	Internal controls

2. Which internal control objective is **most** at risk in the ordering department?

#### FEEDBACK ON ACTIVITY 3

1. The functions, documents and internal controls that can be implemented in the **ordering** department of a trading 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 to the requisition for accuracy and authority, 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	<p>2.1 Order clerks should not place an order without receiving an authorised requisition and should cross-reference the order to the requisition prior to the requisition. Stores/production personnel should confirm that the goods are really needed.</p> <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>

2. **Validity** (occurred and authorised) is most at risk as purchase orders that are not authorised could be completed and incorrect quantities or unnecessary goods could be ordered (Jackson & Stent (2012:11/9). More risks associated with purchase orders will be explained in activity 6 below.

#### ACTIVITY 4

The following is a description of the payments system of Delmundo (Pty) Ltd, a small manufacturing company. The company's accounting functions are carried out by the accounting staff, which consists of the accountant, Mary Roosevelt, and two clerical assistants, Stella Stirling and Dean Ramjan.

1. When an invoice is received from a supplier it is promptly written into the purchase journal by Stella Stirling and filed alphabetically by supplier name. When the suppliers' 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 (them) “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 who is owed less than R5 000. All cheques are carefully written out and marked “not transferable”. Mary Roosevelt signs each cheque and returns the cheques with the list to Stella Stirling. Stella Stirling confirms the amounts of each cheque and verifies that there is a cheque for each creditor on the list who is owed less than R5 000. Stella Stirling writes the cheque number next to each payment on the list and then mails the cheques, which she attaches to a Delmundo (Pty) Ltd compliment slip, to the creditors. If the amount to be paid is more than R5 000, it is paid by electronic funds transfer (EFT) and not by cheque.
4. To pay creditors over R5 000, Mary Roosevelt accesses the EFT 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. He writes it up, posts transactions to the general ledger and reconciles the cash receipts and payments journal to the bank statement monthly.

## REQUIRED

Identify the weaknesses in the payments system described above. For each weakness you identify, explain briefly why you consider it to be a weakness.

## FEEDBACK ON ACTIVITY 4

Reference: Jackson & Stent (2012:11/12–11/13)

- 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 the goods could also be incorrect in terms of description, quantity or price.
- 2.1 Before the invoice is paid there is no check to confirm that the purchase has been authorised. If nobody checks the above, the risk that employees are purchasing goods for themselves at the expense of the company 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 statements) only. The keeping of a creditors' ledger makes it possible to maintain a more accurate record of purchases and payments.
- 3.2 There is only one cheque signatory. 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 only one "signature" is required to 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 Almost total lack of involvement on the part of 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 EFT or reviewing supporting documentation. The lack of this involvement weakens the control environment considerably and facilitates fraud and collusion.

**Source:** *Graded questions on auditing* (2012:232) – adapted

#### 5.1.4 COMPUTERISATION OF THE CYCLE

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



##### STUDY

Jackson & Stent (2012:11/14–11/30)

##### ACTIVITY 5

Your textbook describes the application controls over masterfile amendments as mainly **preventative**, 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

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Reference: Jackson & Stent (2012:11/16–11/18)

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 that affect payments, balances and the banking details required to make EFT payments to 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 means of a user ID and passwords. This will **prevent/deter** unauthorised users from gaining access and making 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 (2012:11/16–11/18) and are not repeated here.

Note: Application controls for the following activities should be included in your answer:

- Application controls over the recording of masterfile amendments on masterfile amendment forms (preventative)
- Application controls over the authorisation of amendments to the masterfile (preventative)
- Application controls over the entry of amendments onto the system (preventative – for example access controls and screen aids and detective – for example programme checks)
- Application controls over the review of masterfile amendments (detective)

## ACTIVITY 6

---

1. Provide five examples of things that could go wrong when creating a purchase order in a computerised environment, based on the activity in Jackson & Stent (2012:11/20).
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 valid (occurred and authorised), accurate and complete.

## FEEDBACK ON ACTIVITY 6

---

Reference: Jackson & Stent (2012:11/20–11/21)

1. 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 order 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 who 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).

**Note:** As explained in activity 3 above, the internal control objective of validity (occurred/authorised) is most at risk when creating a purchase order.

2. The application controls that should be present to ensure that the purchase orders that are **created** and **sent** to suppliers in a computerised environment are valid (occurred/authorised), accurate and complete are described under points 3 and 4 in Jackson & Stent (2012:11/20–11/21) and are not repeated here.

**Note:** The activities under ***creating a purchase order*** and ***authorising and sending the purchase orders*** relate to the ***placing of orders***, as illustrated above.

## ACTIVITY 7

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1. Your textbook, Jackson & Stent (2012:11/24), 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 good 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.

**Note:** Access controls for a company's bank account have been explained in detail in activity 9 of topic 4 and are not repeated here. Refer to

topic 4 again if you need to refresh your memory on access controls over a bank account.

2. The application controls that should be present to ensure good control over the preparation and approval of the schedule of payments in a computerised environment are described under point 3 in Jackson & Stent (2012:11/24–11/26) and are not repeated here. Remember to limit your answer to the **preparation** and **approval** of the schedule of payments.

## SUMMARY

In this study unit we explained and applied the activities, functions and documents that relate to acquisitions and payments transactions. The risks and internal controls in acquisitions and payments were also explained and applied, together with internal control over acquisitions and payments transactions in a computerised environment.

Note that the ordering and receiving of goods (or services) from suppliers include all goods and services associated with a normal business operation. Costs associated with the manufacture of inventory as well as salaries and wages will be explained in more depth in the topics that follow.



## SELF-ASSESSMENT

After having worked through the study unit and the references to the prescribed study material, see whether you can do the following:

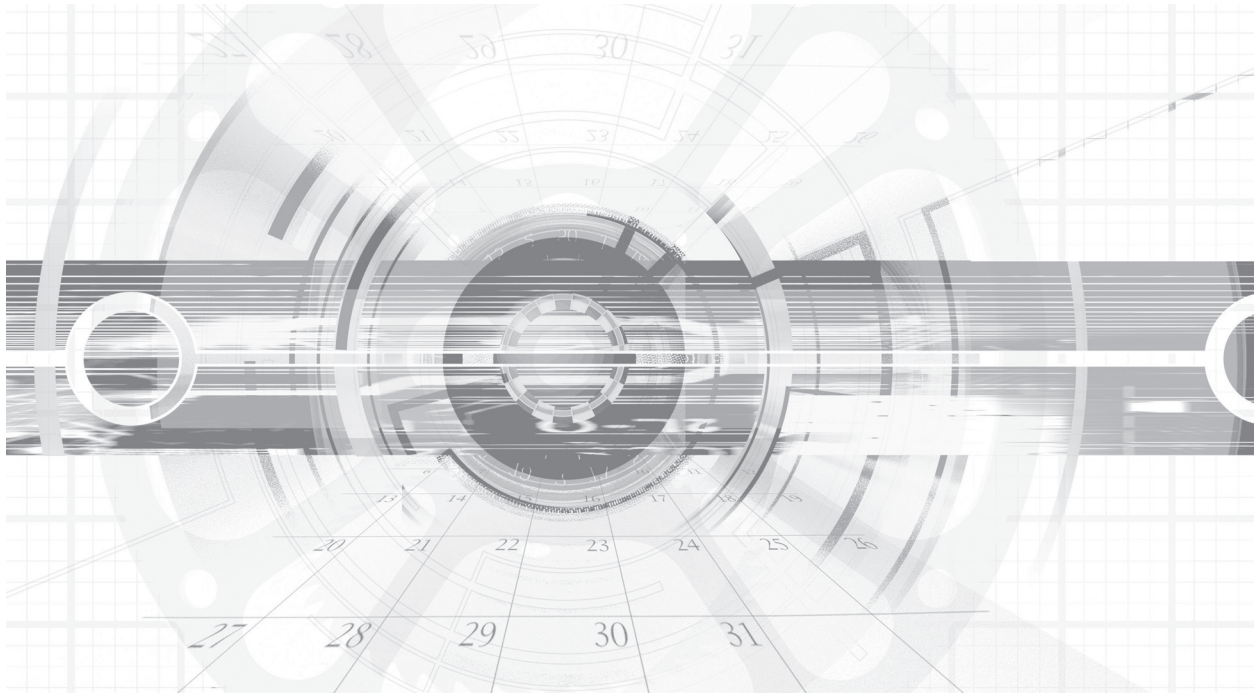
1. Explain the activities and functions relating to acquisitions and payments transactions.
2. Describe the documents used in acquisitions and payments transactions.
3. Explain and apply risks and internal controls related to acquisitions and payments transactions.
4. Explain and apply the risks and internal controls over acquisitions and payments transactions in a computerised environment.

## 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**, such as 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 study units:**

Study unit	Title	Page
<b>6.1</b>	<b>Inventory and production cycle</b>	<b>87</b>
6.1.1	Activities and functions in the cycle	87
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**Textual amendments and additions**

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

**Learning outcomes**

Study unit	In this topic we focus on the following learning outcomes:	Level
6.1 Inventory and production cycle	• Describe the activities and functions and allocate the documents associated with inventory and production.	2
	• Identify and explain the risks associated with warehousing and describe and apply the internal controls that could be implemented to mitigate these risks.	2
	• Identify and explain the risks associated with production and describe and apply the internal controls that could be implemented to mitigate these risks.	2
	• Explain and apply inventory counts as part of control activities over inventory and production.	2
	• Describe and apply internal control in a computerised environment to inventory and production transactions.	2
	• List basic inventory valuation concepts.	1



# STUDY UNIT 6.1

## INVENTORY AND PRODUCTION CYCLE

### INTRODUCTION

Your prescribed textbook, Jackson & Stent (2012:12/2), 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, and
- 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 (see Jackson & Stent 2012:12/2). The inventory balance is usually also a material current asset in the statement of financial position in the company's financial statements.



#### STUDY

Jackson & Stent (2012:12/2–12/4)

#### ACTIVITY 1

---

Jackson & Stent (2012:12/2) describe 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 (2012:12/3–12/4)

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 (2012:12/4–12/5)

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

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 (2012:12/3) describes 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 (2012:12/6–12/7)

### 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

---

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 (2012:12/6) and are not repeated here.
2. Physical controls over inventory in warehouses are **preventative controls**, in other words controls that prevent 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 (2012:12/7), 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 (cf Jackson & Stent (2012:12/3–12/4)).



#### STUDY

Jackson & Stent (2012:12/8–12/10)

Jackson & Stent (2012:12/20–12/22) – 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 good control over job orders.

### FEEDBACK ON ACTIVITY 4

---

Reference: Jackson & Stent (2012:12/8–12/9)

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 good control over **job orders** are explained in Jackson & Stent (2012:12/8–12/9) and are not repeated here.

### 6.1.5 INVENTORY COUNTS

According to Jackson & Stent (2012:12/11), 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 (2012:12/11–12/13)

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

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

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

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 (2012:12/12) .

2. The procedures that should be followed by the counting team when conducting an inventory count are listed in Jackson & Stent (2012:12/12–12/13) and are also 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 (cf Jackson & Stent 2012:12/13).



#### STUDY

Jackson & Stent (2012:12/13), section 9.

Access controls in a computerised environment are key to ensuring that unauthorised masterfile amendments are not done 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 (2012:12/18–12/20), 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 (2012:12/18–12/19)

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 be made up of:
  - all purchase costs, 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 (2012:12/19–12/20).

## SUMMARY

In this study unit we explained and applied the activities, functions and documents pertaining to inventory and production transactions. The risks and internal controls in inventory warehousing and production were explained and applied, as were inventory counts as part of control activities in a system of internal control. Internal control over inventory and production transactions in a computerised environment was explained, with specific reference to the inventory masterfile. Inventory valuation concepts were also described and explained.



## SELF-ASSESSMENT

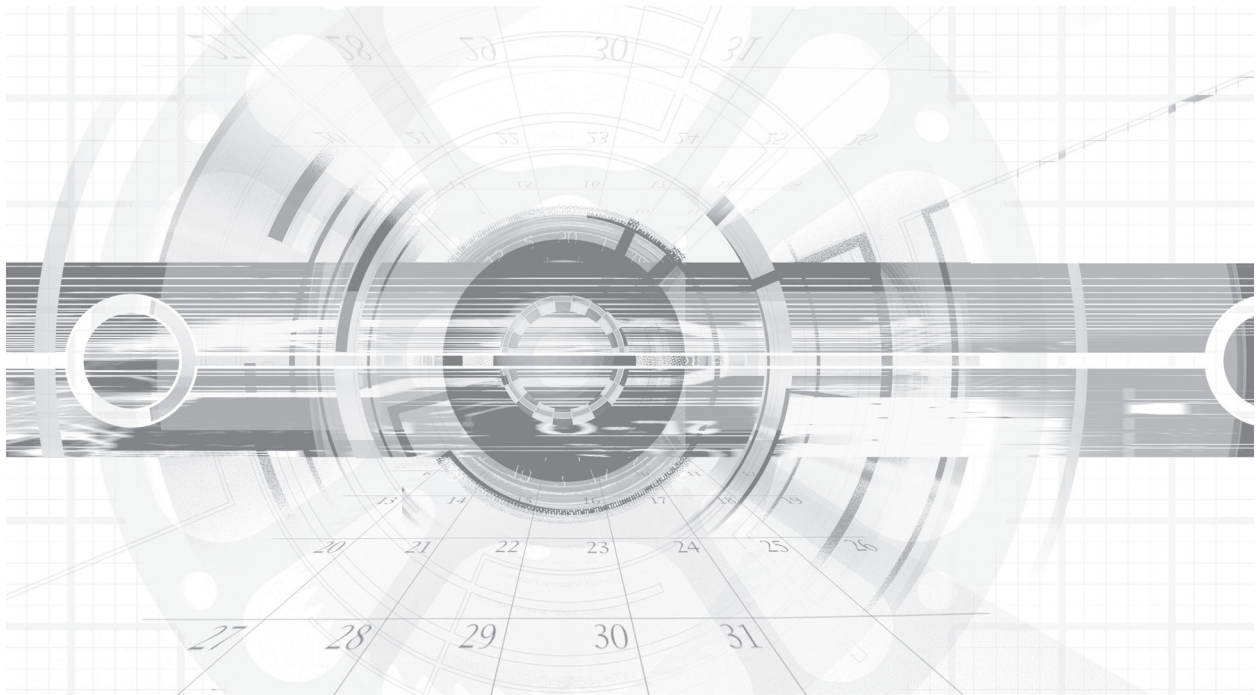
After having worked through the study unit and the references to the prescribed study material, see whether you are able to do the following:

1. Explain the activities and functions relevant to inventory and production transactions.
2. Describe the documents used in inventory and production transactions.
3. Explain and apply risks and internal controls relating to inventory warehousing and production transactions in both a computerised and a noncomputerised environment.
4. Describe and explain inventory valuation concepts.

## 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

Compensation and related employee benefit costs represent major expenses for most businesses. Because of the routine nature of these transactions, a company's payroll is normally maintained on an IT system (Eilifsen, Messier, Glover, Douglas & Prawitt 2010:410).

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	Wages and salaries (net of employee deductions such as PAYE, UIF, SDL, pension fund, medical aid and other)
Accounts payable (accumulated leave, unclaimed wages, SARS, pension funds, medical aids 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 are 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 study units:**

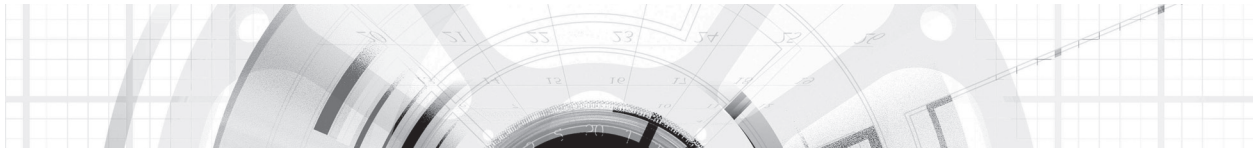
Study unit	Title	Page
<b>7.1</b>	<b>Payroll and personnel cycle</b>	95
7.1.1	Activities and functions in the cycle	95
7.1.2	Documents used in the cycle	96
7.1.3	Risks and internal control in the cycle	97
7.1.4	Computerisation of the cycle	102

### Textual amendments and additions

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

### Learning outcomes

Study unit	In this topic we focus on the following learning outcomes:	Level
7.1 Payroll and personnel cycle	<ul style="list-style-type: none"> <li>Describe payroll and personnel transactions by explaining the activities and functions and allocating the documents associated with these transactions.</li> </ul>	2
	<ul style="list-style-type: none"> <li>Identify and explain 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 noncomputerised environment.</li> </ul>	2
	<ul style="list-style-type: none"> <li>Describe and apply internal control in a computerised environment to payroll and personnel transactions.</li> </ul>	2



# STUDY UNIT 7.1

## PAYROLL AND PERSONNEL CYCLE

### INTRODUCTION

Jackson & Stent (2012:13/2) explains that the payment of salaries and wages is an integral part of any business and one which results in an outflow of funds.

#### 7.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

The most obvious difference between a salary system and a 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 2012:13/29).



#### STUDY

Jackson & Stent (2012:13/2–13/5)

#### Note the following about the study material above:

Sections 4 and 5 in Jackson & Stent (2012:13/3–13/5) describe a **wage system**. Apart from timekeeping and the difference in payment methods (salaries are generally paid by EFT and wages in cash), these functions are generally also relevant to a salary system.



#### STUDY

Jackson & Stent (2012:13/29), section 9

#### ACTIVITY 1

1. Explain why the payroll and personnel cycle could be especially susceptible to fraud.
2. What practical arrangement can companies 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 (2012:13/3–13/5)

1. Companies that pay wages in cash are susceptible to fraud owing to the high risk of theft of large amounts of cash.
2. To protect the company from this risk, as well as to safeguard the personal safety of employees, a company could pay wages via 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 (2012:13/4–13/5) and are not repeated here.

**Note:** Study section 1 of Jackson & Stent (2012:13/2) again if the differences between a wage system and a salary system are unclear to you.

### 7.1.2 DOCUMENTS USED IN THE CYCLE STUDY



Jackson & Stent (2012:13/5–13/6)

## 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. Income tax deduction tables
3. Clock card
4. Cash book
5. Employment contract
6. Unclaimed wages register
7. Cheque requisition
8. Internal purchase order
9. General ledger
10. Purchase journal

## REQUIRED

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

## FEEDBACK ON ACTIVITY 2

---

Reference: Jackson & Stent (2012:13/5–13/6)

1. The following documents will be found in the payroll cycle:
  - 1.1 Income tax tables

- 1.2 Clock card
- 1.3 Cash book
- 1.4 Employment contract
- 1.5 Unclaimed wages register
- 1.6 Cheque requisition
- 1.7 General ledger

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

- 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 Clock card – timekeeping
  - 2.3 Income tax deduction tables – Payroll preparations
  - 2.4 Cheque requisition – Payroll preparations
  - 2.5 Unclaimed wages register – Payout
  - 2.6 Cash payments journal – Recording
  - 2.7 General ledger – Recording

Note that these functions are described in more detail in Jackson & Stent (2012:13/4–13/5).

**Source:** *Graded questions on auditing 2012:* (Gowar & Jackson 2011:169–170) – adapted

### 7.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

Because salaries and wages represent major expenses, companies tend to have strong internal controls over payroll and personnel activities (Eilifsen, Messier, Glover, Douglas & Prawitt 2010:410).



#### STUDY

Jackson & Stent (2012:13/9–13/13)

#### 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 (2012:13/12) 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 the theft of cash during
  - the drawing of cash,
  - the making up of wage packets, and
  - at the payout (risks addressed in points 1 to 6 of the control procedures in Jackson & Stent 2012:13/12).
2. Misappropriation of unclaimed wages (risk addressed in points 7 to 11 of the control procedures in Jackson & Stent 2012:13/12).

### ACTIVITY 4

---

C-Ment Ltd manufactures cement blocks and pavers. The company was started some years ago and has grown steadily so 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 administrative 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 after 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 Mata-bane, 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 wage packets to the register and signs the security company's delivery note.
- 3.7 The wage payout takes place at 3 pm on Fridays. At 1pm 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 administrative 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 the 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 above.

### FEEDBACK ON ACTIVITY 4

Reference: Jackson & Stent (2012:13/6–13/13)

Identification and explanation of weaknesses 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 entry and exit take place through a gate in general use and are unsupervised, workers have another opportunity to 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 a 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 valid, 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 according to 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:

- 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 makes it possible for 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, such as 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.

## 7.1.4 COMPUTERISATION OF THE CYCLE

A company's payroll system is 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 2012:13/16).



### STUDY

Jackson & Stent (2012:13/14–13/28)

### ACTIVITY 5

---

In section 7.1.3 above 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 above.

### REQUIRED:

1. Explain what the term “biometric data” means in a computerised clocking system.
2. What are 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

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Reference: Jackson & Stent (2012:13/19–13/21)

1. The most common example of biometric data is an employee's fingerprint. In a system where the identification of employees is controlled by biometric data, a finger print is stored on the system so that when the employee places a 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 (2012:13/19–13/20) 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, whereas controls over activity 3) are detective controls such as reports produced on absent employees, late arrivals and unexplained exits from the workplace.

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 (2012:13/21) and are not repeated here.

5. Point 1.3 in Jackson & Stent (2012:13/21) 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 (2012:13/21–13/22) and are not repeated here.

## SUMMARY

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



## SELF-ASSESSMENT

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

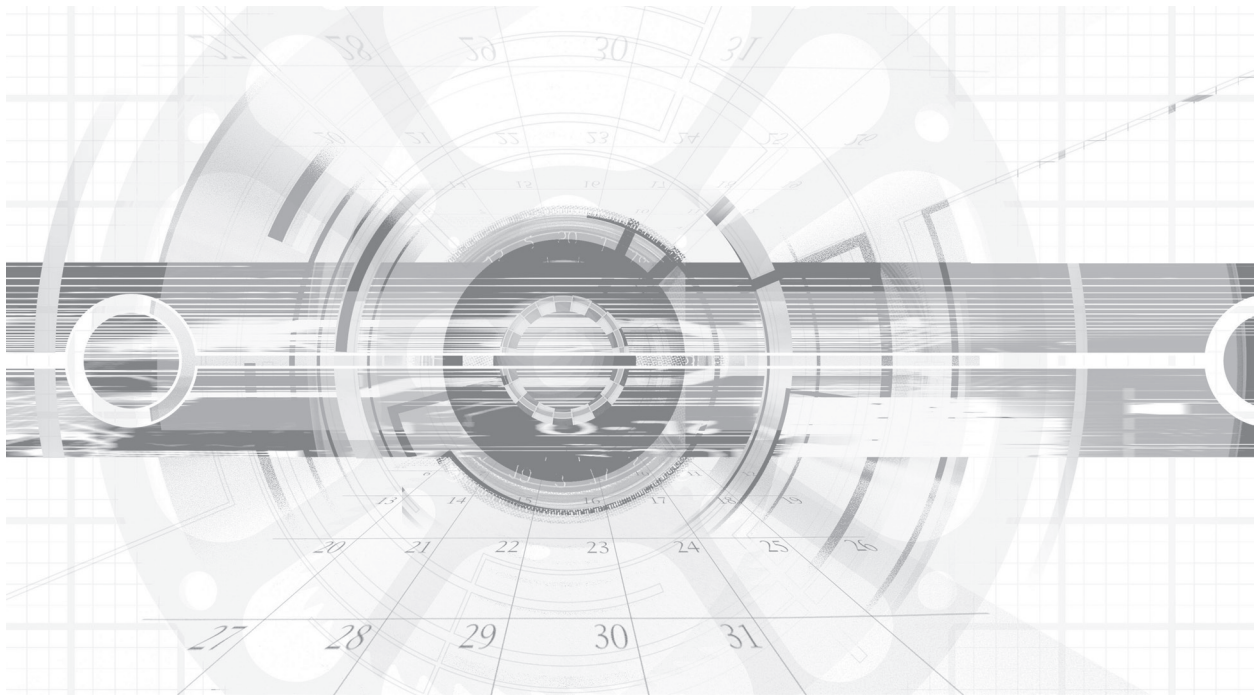
1. Explain the activities and functions relevant to payroll and personnel transactions.
2. Describe the documents used in payroll and personnel transactions.
3. Explain and apply risks and internal controls related to payroll and personnel transactions in a noncomputerised environment.
4. Explain and apply risks and internal controls related to payroll and personnel transactions in a computerised environment.

## CONCLUSION

In this topic, **Payroll and Personnel Cycle**, we explained and applied the activities, functions and documents in the payroll and personnel cycle. The risks and internal control in this 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
<b>Property, plant and equipment</b>	<b>Profit/loss on sale of asset</b>
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 study units:**

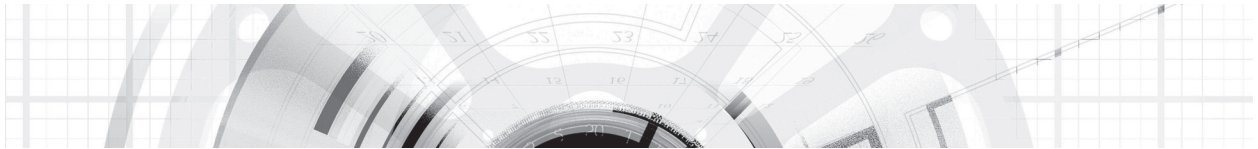
Study unit	Title	Page
<b>8.1</b>	<b>Capital expenditure</b>	107
8.1.1	Characteristics of capital expenditure	107
8.1.2	Risks and internal control over capital expenditure	107

**Textual amendments and additions**

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

**Learning outcomes**

Study unit	In this topic we focus on the following learning outcomes:	Level
8.1 Capital expenditure	<ul style="list-style-type: none"> <li>Describe and explain capital expenditure as part of the finance and investment cycle by referring to the characteristics of fixed asset acquisition transactions.</li> </ul>	2
	<ul style="list-style-type: none"> <li>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.</li> </ul>	2



# STUDY UNIT 8.1

## CAPITAL EXPENDITURE

### INTRODUCTION

Jackson & Stent (2012:14/2) 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 in property, plant and equipment, or by making long-term loans or investing surplus funds.

#### 8.1.1 CHARACTERISTICS OF CAPITAL EXPENDITURE

We will 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 (2012:14/2)

Risks and internal controls in the cycle will now be 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 (2012:14/3).



#### STUDY

Jackson & Stent (2012:14/3–14/4)

Jackson & Stent (2012:14/4–14/5) – The Finance and Investment Cycle at Proride (Pty) Ltd

## ACTIVITY 1

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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

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Reference: Jackson & Stent (2012:14/2)

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 above, transactions in this cycle are not subject to the routine everyday controls relating to transactions. Internal controls over nonroutine 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 internal control objectives are explained in section 2.6 in Jackson & Stent (2012:14/2) and are not repeated here.

**Note:** The main risks explained under section 2.6 in Jackson & Stent (2012:14/2) 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

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You have recently been appointed as the internal auditor of North Shore 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 con-

sumer 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 emails 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 Ltd, based on the information given above and **recommend improvements** to address the weaknesses you have identified.

Do not concern yourself with payments to creditors.

Write 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 <b>planned</b> . <ul style="list-style-type: none"> <li>• There is no evaluation of whether the items purchased by the five sectional accountants are required.</li> <li>• Any member of the section can request equipment without providing proper motivation.</li> </ul>	<ul style="list-style-type: none"> <li>• The company should appoint a fixed asset committee consisting of senior experienced management to take responsibility for evaluating the need for the purchase and evaluating how capital expenditure will be financed.</li> <li>• All requests for fixed assets from sections must be fully motivated.</li> <li>• The fixed asset committee should be responsible for preparing an annual capital expenditure budget (see below).</li> </ul>

Weakness	Explanation and improvement
<p>2. The budgeting process is totally ineffective.</p> <ul style="list-style-type: none"> <li>Simply increasing the prior year's budget by an index has resulted in sections being allocated money which they do not require and which will be wasted.</li> <li>This weakness is compounded by the fact that sections are "punished" for not spending their allocation by having their budgets reduced.</li> </ul>	<ul style="list-style-type: none"> <li>A proper budgeting system for capital expenditure should be put in place:</li> <li>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.</li> <li>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.</li> <li>There should be ongoing comparison of actual capital expenditure with budgeted expenditure.</li> </ul>
<p>3. There is inadequate authorisation of capital expenditure.</p> <ul style="list-style-type: none"> <li>Sectional accountants have complete authority to purchase equipment provided they have not exceeded the budget.</li> <li>In effect, the sectional accountants can make a purchase and authorise it. This amounts to a lack of division of duties.</li> <li>As there appears to be no reconciliation or follow-up of items actually purchased, this lack of division of duties becomes more serious.</li> </ul>	<ul style="list-style-type: none"> <li>The fixed asset committee should approve the budget, which will then become the fundamental authorising document.</li> <li>See points below (4).</li> </ul>
<p>4. The controls over the requisitioning and ordering and receipt of capital expenditure items are inadequate.</p> <ul style="list-style-type: none"> <li>No properly designed, pre-printed, sequenced (and authorised) requisition form is presented to support the purchase request (email is sent).</li> <li>The order is placed by the assistant to the sectional accountant (not the buying department), without any follow-up with the supplier as to availability and price and alternative suppliers.</li> <li>Items purchased should not be delivered to the individual sections as this weakens division of duties</li> </ul>	<ul style="list-style-type: none"> <li>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.</li> <li>This requisition should be submitted to the sectional accountant, who should authorise the requisition (sign) after confirming that the request complies with the capital expenditure budget.</li> <li>A copy of the requisition should be sent to the company's buying department, and the second copy filed in numerical sequence.</li> <li>The order department should: <ul style="list-style-type: none"> <li>confirm that the goods requisitioned appear on the capital budget, and if so</li> </ul> </li> </ul>

Weakness	Explanation and improvement
.	<ul style="list-style-type: none"> <li>— check with the preferred supplier as to availability, current price and delivery particulars, and</li> <li>— make out and sign a three-part pre-printed, sequenced (capital expenditure) order.</li> </ul> <ul style="list-style-type: none"> <li>• 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.</li> </ul>
<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"> <li>• places the order (on the strength of an email)</li> <li>• receives the goods</li> <li>• "authorises" payment (by sending the unchecked documentation to creditors)</li> <li>• writes up the records (fixed asset register)</li> </ul>	<ul style="list-style-type: none"> <li>• 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.</li> <li>• Once the above procedures are complete, the assistant to the sectional accountant can write up the sectional fixed asset register.</li> </ul>

**Source:** *Graded questions on auditing* (2012:281) – adapted

## SUMMARY

In this study unit we explained capital expenditure with reference to the characteristics of fixed asset acquisition transactions. The risks associated with fixed asset acquisitions were explained and internal controls applied to mitigate those risks.



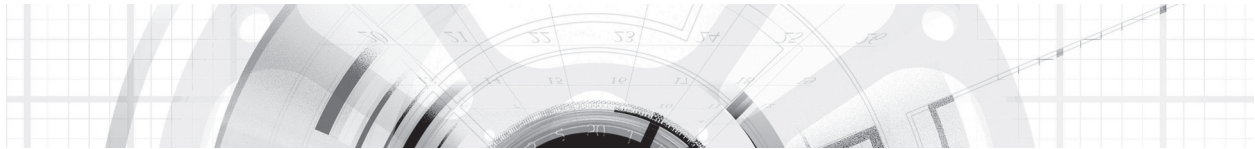
## SELF-ASSESSMENT

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

1. Explain capital expenditure by referring to the characteristics of fixed asset acquisition transactions.
2. Explain and apply risks and internal controls related to fixed asset acquisition transactions.

## CONCLUSION

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



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