

Tutorial Letter 103/3/2016

CORPORATE GOVERNANCE IN ACCOUNTANCY

AUE2602

Semesters 1 & 2

Department of Auditing

IMPORTANT INFORMATION:

This tutorial letter contains the suggested solutions to questions included in tutorial letter 102.

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FEEDBACK ON SUPPLEMENTARY DO QUESTIONS

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Please note the mark allocation included in the suggested solutions is different than in graded questions but is similar to what can be expected in an exam.

Topic 1 Corporate governance and Statutory Matters

Feedback on supplementary Do questions on topic 1

QUESTION 2.14 IN GRADED QUESTIONS

33 marks

Reference: King III Report

1. In terms of Principle 2.1 the board should act as the focal point for and custodian of corporate governance. This principle is not being adhered to. By his own admission Hennie Meyer (the chairman) does not know too much about “that stuff” (corporate governance and King III). As chairman of a large company he should. He should also be providing leadership to the board and ensuring its role as the focal point of corporate governance. (1½)
2. It appears that the board has met only twice for the financial year end 2016. In terms of Principle 2.1 the board should meet preferably at least four times a year or as often as is required to fulfil its duties. (1½)
3. In terms of Principle 2.21 the board should be assisted by a competent company secretary. Victor Hatfield’s competency can be questioned due to the fact that the minutes of the meeting are poorly constructed and certain matters do not seem to have been dealt with e.g. confirmation of the prior meetings minutes, matters arising. (1½)
4. In terms of Principle 2.14 the directors should act in the best interests of the company. Whilst there is no problem with Bulle (Pty) Ltd extending a contract with a non-executive director it is poor corporate governance and a breach of the Companies Act 2008 (Sec 75) and common law for Akon Ndungane to have voted on the decision. He should have recused himself and not taken part in the consideration or approval of the contract. (1½)
5. In terms of sound corporate governance, reports and documentation for meetings should be given to directors well in advance so that they can properly prepare themselves to make sound decisions. A number of reports were tabled at the meeting and virtually no discussion appears to have ensued. (1½)
6. In terms of principle 2.16 the board of Bulle (Pty) Ltd should elect (have elected) a chairman who is an independent non-executive director which Hennie Meyer is not, therefore they do not comply with the requirements of the King III Report. (1½)

7. In terms of principle 2.16 the role of chairman should not be filled by the chief executive officer. In this instance Hennie Meyer fills both roles. They do not comply. (1½)
8. The deputy chairperson is also an executive director. This means that for any decisions for which the chairman is “conflicted” (not independent) there is no lead independent non-executive director to act as chairman. There are no independent directors. They do not comply. (1½)
9. In terms of principle 2.18, the board should comprise a balance of power with a majority of non-executive directors. There is no balance of power, executive directors are in the majority (five of eight directors). They do not comply. (1½)
10. In terms of principle 2.18 the majority of the non-executive directors should be independent. There are no independent non-executive directors
 - Akon Ndungane is in a business relationship with Bulle (Pty) Ltd (1½)
 - Barry Botha is the company’s major supplier and (1½)
 - Pieter Spies is a shareholder. (1½)

Therefore all of them have a relationship with the company which would be seen to interfere with their capacity to act independently. (1½)

11. The attendance of only one non-executive director at the meeting suggests that the other non-executive directors do not attach much importance to their roles. Attending two meetings is not very onerous and they have failed to fulfil their responsibilities. (1½)
12. Although it is positive that there is an audit committee, it is not properly constituted which reduces its effectiveness. All members should be independent non-executive directors – none of the members are
 - Barry Botha is non-executive but not independent (1½)
 - Wynand Nel is the chief financial officer (1½)
 - Hennie Adams is not a director – he is the internal audit manager (he should report functionally to the audit committee, not be part of it). (1½)
13. The audit committee should be chaired by an independent non-executive director – and definitely not the financial director, Wynand Nel. They do not comply. (1½)
14. With a financial director and internal audit manager on the committee, it would appear that collectively the audit committee has the necessary knowledge which is in line with the requirements of the King III Report. (1½)
15. The remuneration committee should consist of a majority of non-executive directors of which the majority should be independent. Neither of the members of this committee are independent non- executive directors. (1½)
16. The remuneration committee should be chaired by an independent non-executive director. Barry Botha is not an independent non-executive director. They do not comply. (1½)
17. Overall sound corporate governance and compliance with King III are severely lacking. As the only independent non-executive director, Mornè Olivier is unlikely to make much difference. (1½)

QUESTION 2.17 IN GRADED QUESTIONS**18 marks****Reference:** King III Report

- a) The role of internal audit is to produce independent findings and conclusions on the following activities to assist the board in meeting their governance responsibilities.
- Review the company's governance processes (1½)
 - Perform an objective assessment of the adequacy and effectiveness of risk management and the internal control framework (1½)
 - Analyse and evaluate business processes and associated controls and (1½)
 - Provide a source of information on fraud, corruption, unethical behaviour, etc. (1½)

Internal audit will primarily take its instructions from the audit committee not from Kieran Skay, i.e. the chief audit officer will report to the audit committee. (1½)

- b)
1. Internal audit should NOT take on this responsibility. The bank reconciliation is a routine accounting procedure which is the responsibility of the accounting department. (1½)
 2. Internal audit could justifiably carry out this procedure as part of its assessment of the effectiveness of internal controls. It would be particularly appropriate as part of an exercise to assess whether the controls in place over the custodianship of cash at the manufacturing facilities are adequate to address the risks of misappropriation or misuse of cash resources (which are material). (1½)
 3. Internal audit should not be part of the monthly internal control routines. Internal audit may well attend and observe cycle counts and indeed perform a sample of test counts but this would be to evaluate the company's inventory controls as part of a risk based plan to assess the effectiveness of management's response to the risk of inventory loss. (1½)
 4. Internal audit should investigate suspected instances of fraud as they are perfectly placed to do so. They are independent, technically capable and should be familiar with all aspects of the business and the various risks it faces and therefore the ways in which fraud could be perpetrated. One of internal audits roles is to provide (be a source of) information regarding instances of fraud or alleged fraud to the board so that appropriate action can be taken. (1½)
 5. Internal audit should not be involved in "head hunting" as this is a human resource function which does not align with the role of internal audit in any way. (1½)
 6. Internal audit could certainly take responsibility for this review as part of its role is to systematically analyse and evaluate business processes and associated controls. This activity will usually have an element of compliance testing in it. (1½)
 7. Internal audit's primary functions (and the expertise of its members) are geared to assessment and evaluation of processes and controls. This is a function which internal audit could justifiably carry out. One of the major reasons that a company

sets up a complaints hotline is to monitor the internal control process. In this specific case, the contravention of company policies and procedures relating to the ordering/buying function, particularly those of an ethical nature e.g. suggesting the possibility of the suppliers paying a bribe “commission” or “fee” for placing the order with that supplier. Any instances of fraud, corruption or unethical behaviour should be investigated by internal audit (and others where necessary). (1½)

8. This is a perfectly acceptable function for the internal auditor to carry out. Although final responsibility for the integrated report lies with the Board the responsibility for overseeing integrated reporting and its integrity lies with the audit committee. (1½)

QUESTION 2.23 IN GRADED QUESTIONS

18 marks

Reference: King III Report

1. **Gambhir Gull:** Not eligible. As company secretary he may not be a director of JayB Ltd, which is a requirement to be elected to the audit committee. (2)
2. **Rod Dodger:** To be appointed to the audit committee, the individual concerned must be a director of JayB Ltd. He would therefore have to be appointed as a non-executive director. He appears to be independent and has the advantage of being a corporate law expert which would be useful (King III). (2)
3. **Karl Zeiss:** Although Karl Zeiss is a non-executive director (and presumably independent), King III recommends that the chairman of the board not be a member of the audit committee (principle 3.3) as to be a member and chairman of the board, would threaten his objectivity. He may be invited to attend audit committee meetings. (2)
4. **Terry Ticker:** He is not eligible for appointment for a number of reasons. To be on the audit committee he would need to be a director but as he is “the auditor” of JayB Ltd, he is disqualified from being a director. Furthermore, in terms of King III, he is not independent as he is in effect a professional adviser to the company and is therefore not appointable. (2)
5. **Aaron Khumalo:** He is not appointable as he is not a director. Even if he was appointed a director, he is still involved in the “day to day business” of JayB Ltd and therefore not independent or non-executive and therefore cannot be appointed despite the fact that he has the required financial knowledge. (2)
6. **Klark Gayble:** He is appointable as he is an independent non-executive director with the necessary financial expertise and experience. (2)
7. **Theuns Jordaan:** He is not a director of JayB Ltd so on this count, is not appointable. (2)

8. **Jennifer Jacobs:** She would have to be appointed to the board as a director (non-executive). She probably does not have the necessary financial knowledge and experience requirements but is independent of JayB Ltd and could therefore serve as an independent non-executive director on the audit committee, provided the other members have the necessary skills (which it appears will be the case if Robbie Wessels remains and Klark Gayble and (possibly) Rod Dodger are appointed). (2)
9. **Rod Grind:** If a reasonable and informed third party would conclude that Rodds (Pty) Ltd (which is “related” to Rod Grind) is a material supplier to the extent that Rod Grind’s integrity, impartiality or objectivity might be compromised by his relationship to both companies, then he would be disqualified in terms of Sec 94(4)(b)(iii) and would not be regarded as an independent non-executive director in terms of King III and should therefore not be appointed. (2)

Comments:

Question 2.14

Both compliance and non-compliance should be covered in your answer.

Know and understand the principles of the King III Report to be able to apply your knowledge in practical scenarios. This is a very good question to test your knowledge on Corporate Governance and the King III Report. If you are able to do this question, you should not have a problem in the assignments and exams!

Organise your answers under relevant subheadings such as the board of directors, the various board committees and general remarks. This will assist you to present your answers logically and not leave out important information regarding the different aspects.

When answering a corporate governance and King III Report question always structure your comments to address the **theory**, **application of theory** and a **conclusion**.

Refer to the tables in learning units 1.3.2 and 1.3.3 of your MO001 which summarise important principles regarding the board of directors and board committees. It is still important to refer to the King III Report itself as well.

You are not required to include the specific reference to the principles of the King III Report as in the suggested solution, you only need to state what the principles are/require.

Question 2.17

You need to know and understand what the roles of an internal audit department is according to the King III Report to be able to apply it to a scenario and evaluate whether particular services or requests should be performed or accepted by an internal audit department.

Question 2.23

To be able to evaluate whether candidates are eligible to be appointed to an audit committee, you need to know the requirements per the King III Report.

Very important, remember that Corporate Governance accounts for only about **25%** of this module in the examination. As such you should manage your time well to ensure you study the topics to follow well.

Topic 2 Internal Control

Feedback on supplementary Do questions on topic 2

QUESTION NUMBER 4.19 IN GRADED QUESTIONS

27 marks

Reference: Jackson & Stent (2014: 5/7-5/17)

Nr.	Control environment/control activity	Category of control activity
1.	Control environment (1½)	
2.	Control activity (1½)	Access/custody control (physical control) (1½)
3.	Control activity (1½)	Access controls and segregation of duties (user profile) (1½)
4.	Control activity (1½)	Isolation of responsibility, segregation of duties and authorization (1½)
5.	Control environment (1½)	
6.	Control activity (1½)	Authorisation (1½)
7.	Control activity (1½)	Comparison and reconciliation (1½)
8.	Control activity (1½)	Custody control and segregation of duties (1½)
9.	Control activity (1½)	Comparison and reconciliation, segregation of duties and isolation of responsibility (1½)
10.	Control activity (1½)	Comparison/reconciliation and isolation of responsibility (1½)

Comments:

To be able to answer this question, you need to know the difference between the control environment and control activities as well as the different categories of control activities.

QUESTION 4.25 IN GRADED QUESTIONS**45 marks****Reference:** Jackson & Stent (2014: 8/26-8/38)

1. An application is a set of procedures and programmes designed to satisfy all users associated with a specific task, for example paying a salary, creating a sales invoice or placing an order. (1½)
2. The stages through which a transaction flows are described as input, processing and output. (1½)
3. One of the objectives of any business is to produce information (both financial and other) which is useful to users and reliable. (1½) If the information does not reflect these characteristics, the numerous business decisions and actions which are taken based on the information, will be poor and will ultimately result in losses to the business. (1½)

Controls which address (respond to) this risk will therefore need to be put in place in an attempt to ensure that ...

- transactions and data are not fictitious (occurrence) and are in accordance with the activities of the business and have been properly authorised by management (authorisation) (1½)
- transactions and data are correctly captured, processed and allocated with the minimum of error (accuracy) and that (1½)
- data and transactions are not omitted or incomplete (completeness). (1½)

4. True. (1½)

- 5.1 (i) When an individual wishes to gain access to the computer system, he must identify himself to the system by entering his user identification (user ID). This user ID will have been stored in a file on the system (under controlled conditions) when the employee was “registered” with the IT department. When the user ID is subsequently entered by the employee, the computer will compare it to the file of valid IDs and if there is a match, satisfactory identification of the user will have taken place. (1½)
 - (ii) However, the system now wants to authenticate the individual, i.e. obtain evidence that the user of the ID is the owner of the ID, e.g. by the entry of a unique password (again the system will compare the password entered by the user to a file of valid passwords – access table). A match to the file and the user ID proves that the user of the ID is also the owner of the ID. (1½)
 - (iii) Once the individual has been identified and authenticated successfully, the computer needs to authorise what access is given to the individual on a need to know/least privilege basis. The actual privileges etc, to which the individual has authorised access, will have been carefully worked out for each user and stored in the computer in access tables/user profiles. (1½)
- 5.2 (i) Requiring the individual to enter a unique password known only to himself. (1½)
 - (ii) Entering a piece of information which an unauthorised user would not know about the genuine user, e.g. his mother’s maiden name (more than one piece of information may need to be entered). In effect, this is a variation of the password principle. (1½)
 - (iii) Connecting a device to the computer (e.g. a dongle) through the USB port and entering a unique password at the same time. The device must be kept safe by the

individual and the password must be kept confidential. Password will not authenticate without the device and vice versa. (1½)

- (iv) Along the same lines as (iii) the user may have to enter a second unique “one-time” password which is sent to the individual’s cell phone or generated by a random number device given to the user. (1½)

5.3 This simply means that the user can read the contents of a file and write to that file as well, as opposed to only reading the file or having no access to the file at all. (1½)

6. No, logging in itself is not a control but it facilitates control. Unless the log is scrutinised/reviewed and problems followed up, no control is provided. (1½)

7.1 Passwords should :

- Consist of at least six characters and a mix of letters, numbers, upper/lower case and symbols. (1½)
- Be changed regularly and the system should force users to do so (screen message of pending expiry). (1½)
- Be terminated/disabled promptly when an individual leaves the organisation (immediately if the employee is dismissed). (1½)
- Not be displayed on the screen (e.g. when the password is being entered) or be included on any reports or logs. (1½)
- Not be obvious e.g. favourite soccer team, birthday, name backwards, etc. and should not be the same as the user ID. (1½)

7.2 Password files ...

- should be subject to strict access controls to protect them from unauthorised “read” or “write”. (1½)
- encrypted. (1½)

7.3 Employees should be subjected to disciplinary measures should they disclose their passwords. (1½)

7.4 The first time a new employee accesses the system he should be required by the system, to change his initial password. (1½)

8.1 Minimum keying in of information ...

- instead of keying in all the details about the debtor, e.g. name, address, contact details etc., the sales clerk would only need to key in the debtor’s account number. If it is a valid account number (per the debtors masterfile), all the relevant details about the debtor will appear in the appropriate fields on the on-screen invoice. (1½)
- the same principle could be applied by entering only the inventory item code for the goods required by the customer. The description and price of the goods would appear in the appropriate fields on the screen. (1½)

8.2 Mandatory field:

The “customer (debtor) order number” and “quantity fields” could be designated as mandatory. The sequence of keying in cannot continue until these fields are entered. (1½)

8.3 Screen dialogue and prompts:

These are simply messages which appear on the screen to prompt/remind the sales clerk to carry out a procedure, e.g. confirm and re-enter the customer’s order number or confirm

the delivery address. An un-entered mandatory field can also be conveyed to the sales clerk by screen message. (1½)

Comments:

This question covers many aspects covered in topic 2 and is a good question to do as part of your revision.

QUESTION 4.27 (A) IN GRADED QUESTIONS

12 marks

Reference: Jackson & Stent (2014: 8/34-8/38)

1. Alpha-numeric check (one of a number of format checks). (1½)
2. Validation check (also referred to as an existence check). (1½)
3. Check digit. (1½)
4. Data approval/authorisation check. (1½)
5. Sequence test – processing (a programme edit check). (1½)
6. Size checks (one of a number of format checks). (1½)
7. Reconciliation check – control totals (in this case, a record count). (1½)
8. Limit check. (1½)

Comments:

You need to understand what the objective of each of the programme controls is to be able to identify and describe the control to mitigate a specific risk in a given scenario.

Topic 4 Revenue and Receipts Cycle

Feedback on supplementary Do questions on topic 4

QUESTION NUMBER 8.2 IN GRADED QUESTIONS

22½ marks

Reference: Jackson & Stent (2014: 10/2-10/5)

1. Credit management. (1½)
2. Order Department (receiving customer orders and sales authorization). (1½)
3. Warehousing. (1½)

4. Despatch. (1½)
5. Despatch. (1½)
6. Credit management. (1½)
7. Despatch. (1½)
8. Recording of Sales. (1½)
9. Invoicing. (1½)
10. Mailroom receipting/cashier. (1½)
11. Goods returned function. (1½)
12. Ordering department (or warehousing). (1½)
13. Credit management. (1½)
14. Invoicing. (1½)
15. Warehousing. (1½)

Comments:

To answer the question you should know the functions and control measures that normally takes place in the revenue and receipts business cycle as described in your text book Jackson & Stent (2014: 10/2-10/5; 10/10-10/19).

QUESTION 8.9 (A) IN GRADED QUESTIONS

30 marks

Reference: Jackson & Stent (2014: 10/10-10/19)

Weakness 1: Internal Sales Orders are **not** made out for all orders received. (1½)

Explanation 1: There should be an **internal** (sequenced) document which **initiates** all transactions. This provides the order department with “authority” to process, and provides a means of following up queries. (1½)

Weakness 2: Internal Sales Orders are not sequenced. (1½)

Explanation 2: As ISOs are not sequentially numbered, it makes it impossible to sequence test the documents for the purposes of

- identifying missing ISOs (1½)
- confirming that all orders have been processed and (1½)
- following up on queries. (1½)

Weakness 3: There are inadequate controls to prevent sales being made to non-account holders e.g. no second staff member or supervisory check. (1½)

Explanation 3: The order clerk has a list of account holders but there are no second or supervisory checks to ensure that this control is carried out **prior** to the sale being processed. (1½)

Weakness 4: Inadequate credit management controls are in place;

- inadequate information is gathered when an application for credit is made by a prospective customer. (1½)
- credit terms and limits are not set. (1½)

Explanation 4: The decision to grant credit is made on the strength of two trade references given by the prospective customer. The prospective customer is unlikely to give poor trade references, so further information (preferably from an **independent** source e.g. credit bureau) must be gathered before credit is extended so as to establish the likelihood that the prospective customer **will pay**. (1½) Even though a prospective customer appears creditworthy, the granting of unlimited credit terms will result in abuse by customers (they are getting free financing) and significantly increase the risk of losses from bad debts. (1½)

Weakness 5: There is inadequate documentation for the picking of goods. (1½)

Explanation 5: Customers' orders, original and faxed, as well as ISOs are used for picking; to assist in goods being **accurately** picked both in terms of quantity and description, a standardized, preprinted, properly designed, sequenced document should be used (can be an adapted copy of the ISO). (1½) Inaccurate picking can result in increased returns of goods, incorrect invoicing and customer dissatisfaction. (1½)

Weakness 6: No documentation remains in the order department. (1½)

Explanation 6: As the order clerk sends all ISOs, customer orders (original and faxed) to the warehouse department, she has no means of following up queries or determining whether orders have been duplicated e.g. a phone order also sent through the post. (1½) This will result in duplicated picking and invoicing (and customer dissatisfaction).

Weakness 7: There is no supervisory check on goods picked. (1½)

Explanation 7: As no supervisory check is carried out, the risk that items ordered will be picked incorrectly (quantity and description) resulting in incorrect invoices etc, is increased (1½) and an increased opportunity for theft by pickers is presented. (Note: simply instructing pickers to pick carefully does not mean that they will do so!) (1½)

Weakness 8: The control environment at Gone Fishing (Pty) Ltd is weak. (1½)

Explanation 8: It is evident from the responses (taken collectively) that there is a lack of management control e.g. supervisory checks. Management does not seem to be "control orientated" and employees will soon pick this up. (1½)

Comments:

This question asked you to identify and explain weaknesses. The question did not ask for internal controls that should be implemented.

Remember to READ your questions carefully. We've found that a big problem during exams and assignments is that students do not read the "required" carefully and therefore answer incorrectly and/or spend precious time answering what was not asked.

You would also have noticed that the weaknesses identified, are not just a "memory dump" from the theory, but theory applied to this specific scenario. This will become more and more important for you to be able to do as you continue your studies in auditing.

The explanation part of this question ensures that you understand the theory and are able to apply it in a practical situation.

Topic 5 Acquisitions and Payments Cycle

Feedback on supplementary Do questions on topic 5

QUESTION 10.7 IN GRADED QUESTIONS

36 marks

Reference: Jackson & Stent (2014: 5/15 & 11/9 – 11/13)

Question 1 - sequencing

- 1.1 Numerical sequencing is very important as it provides each document with a unique number which identifies the specific document. (1½)
- 1.2 The number also enables the document to be cross-referenced to other documents in the cycle e.g. a purchase order and a goods received note. (1½)
- 1.3 The numerical sequence also enables employees (and auditors) to "sequence test" documents to identify any **missing** documents. (1½)

Question 4 – stationery controls

- 2.1 All blank documents should be kept under lock and key. (1½)
- 2.2 Access to the documents (the key) should be restricted to a responsible staff member. (1½)
- 2.3 Requests for the issue of documents should be recorded on a requisition signed by the head (senior member) of the section/department requesting the documents. (1½)
- 2.4 On issue, the number sequence of the documents being issued and a description e.g. purchase orders 1050 to 1999, should be entered in a stationery register. (1½)
- 2.5 The register should be signed by the stationery custodian and the recipient. (1½)
- 2.6 On a (reasonably) regular basis, blank documents on hand should be reconciled with the stationery register by an independent employee. (1½)

- 2.7** Orders placed with the printers of the company's documentation should be authorised by senior personnel (two) and the printer should be informed that no printing of Perky Pets (Pty) Ltd's stationery should be done without an authorised order, under any circumstances. (1½)

Question 6 – preset levels

- 3.1** Preset levels are theoretical and are based on a number of factors, e.g. lead times, demand, etc. (1½)
- 3.2** The factors used to calculate them can change e.g. demand for a product may have significantly reduced since the levels were set. To avoid overstocking (or understocking!) the most current information should be obtained. Preset levels are only indicators. (1½)

Question 8 – purchase order

- 4.1** The receiving department is sent a copy of the order so that ...
- * they can prepare to receive the delivery (1½)
 - * they can determine that the delivery results from an authorised order and thus can be accepted. (1½)
 - * they can compare what is being delivered to what was ordered (quantity and description), thus identifying any over/under or incorrect goods deliveries. (1½)
- 4.2** The creditors department is sent a copy of the order so that they can match the supplier invoice, GRN to the original order **before** payment to the creditor is authorised. This assists in preventing invalid payments. (1½)
- 4.3** With regard to filing the purchase order in alphabetic order, this may assist with some queries, but it would not enable important sequence controls such as identifying missing orders, to take place. In this instance it is far more useful to work with a numerical sequence. (1½)
- 4.4** Most queries will be linked to the unique document number, so it is far quicker to locate the order documents if they are filed in numerical sequence. (1½)

Question 11 – senior buyer authorisation

- 5.1** The intention of this control is to reduce the risk of ...
- * invalid orders being placed e.g. the buying clerk purchasing goods for himself. (1½)
 - * inaccurate or incomplete orders being placed e.g. incorrect descriptions or incorrect item codes being used or quantities being omitted. (1½)
 - * incorrect prices being entered (agreed to) on the purchase order and (1½)
 - * orders being placed with non-approved suppliers e.g. the buying clerk placing orders with his friend's business (at an inflated cost). (1½)
- 5.2** It is partially an example of isolation of responsibility – when the senior buyer signs the purchase order, he/she becomes accountable for the placing of the order, and any errors or irregularities can be traced back to him. (1½)
- 5.3** It is primarily an example of division of duties i.e. between “authorizing” the transaction and “executing” it. (1½)

Question 13 – goods received note

- 6.1 Firstly, it is important to have an internally generated document to provide an audit trail for every purchase transaction. (1½)
- 6.2 The goods received note records what was actually received, which is not necessarily what is on the supplier delivery note. (1½)
- 6.3 The GRN enables accurate perpetual inventory records to be maintained. (1½)
- 6.4 It also provides the creditors department with a document to reconcile what was actually received from the supplier, with the suppliers invoice before payment is authorised. (1½)
- 6.5 Suppliers delivery notes obviously come from different suppliers so will have different number sequences. Creating an internal sequenced document (GRN) provides the benefits of sequence testing. (1½)

Question 15 – transfer to stores

- 7.1 Deliveries from suppliers should be moved from the receiving area (bay) into the custody of the warehouse as promptly as possible to minimize the risk of theft (or damage) to these goods, e.g. goods could be sent out on another supplier's truck (theft by collusion). (1½)
- 7.2 The transfer of the goods to the warehouse is in effect a transfer of the custody of an asset. (1½)
- 7.3 Therefore the recipient in stores should check what he is accepting **before** signing the GRN, because by signing the GRN, he acknowledges the transfer of the responsibility for the goods to the warehouse and hence that "warehouse" is accountable for the goods. (1½)

Question 18 – purchase invoices

- 8.1 The purchase invoice will be matched to the purchase order, goods received note, supplier delivery note. (1½)
- 8.2 The creditors section will match ...
 - * supplier name, document numbers (1½)
 - * quantity and description of goods (1½)
 - * prices and discounts (1½)
 - * per the purchase invoice to the supporting documentation.
- 8.3 In addition, the creditors section will ...
 - * confirm that the amounts on the invoice have been allocated to the correct ledger account e.g. consumables, stationery. (1½)
 - * test all casts, VAT calculations etc. (1½)

Question 22 – signing powers

- 9.1 It is not really an isolation of responsibility control although the signature does make the signee accountable. (1½)

- 9.2** The two signature control is primarily an access/custody control designed to protect a company asset i.e. the company's bank account. (1½)
- 9.3** It may be easier to have six authorised signatories (two to sign) but it significantly increases the risk of cheque fraud, as access to the bank account is given to more individuals. (1½)
- 9.4** In addition, where there is no common signatory, supporting documentation could be presented to two different sets of signatories, to fraudulently have the same amount paid twice. (1½)

Comments:

To answer the question you should know the controls that should be implemented in the purchases and payments business cycle to address the risks normally associated with these functions.

QUESTION 10.9 IN GRADED QUESTIONS

30 marks

Reference: Jackson & Stent (2014: 11/9 – 11/13)

a) Risks in the ordering of goods function

If a company does not implement sound control procedures over its ordering of goods function, the following risks may arise:

- Incorrect goods may be ordered (quantity or type). (1½)
- Goods of inferior quality, resulting in obsolescence, sales returns, etc, may be ordered. (1½)
- Unnecessary goods may be ordered resulting in wastage/ obsolescence, cash flow problems. (1½)
- Orders may be placed fraudulently by buyers or others, resulting in payment by the company for goods never received or used by the company. (1½)
- The company paying unnecessarily high prices either because competitive prices are not sought, or because of fraud, e.g. buyers taking bribes or kickbacks. (1½)
- Requisitions from stores, manufacture or sales departments not acted upon (timeously or at all) by the ordering department resulting in production delays, lost sales due to items being "out of stock". (1½)
- Orders placed, not timeously acted upon or not acted upon by suppliers resulting in the same problems as in 1.6. (1½)
- Order forms misused e.g. to facilitate private purchases by employees, for which the company will ultimately pay. (1½)

b) Recommendations for improvements to internal controls of receiving of goods

Recommendation	Reasons
<ul style="list-style-type: none"> • The "receiving/despatch" area should be split into separate areas, one for "receiving" and one for "despatch". (1½) 	Splitting the "receiving" and "despatch" areas, and ensuring they are access controlled and secure will reduce the risk of fraud and theft

Recommendation	Reasons
<ul style="list-style-type: none"> Both should adjoin the warehouse but should be secure and access controlled from the warehouse and each other. (1½) 	<p>in the receiving function of the cycle e.g. it will be harder to steal goods by sending them out on a delivery vehicle instead of transferring them to the warehouse. (1½)</p>
<p>Each of the seven warehouse assistants should be allocated to a specific function (segregation of duties), either “receiving”, “despatch” or “custody of inventory in the warehouse”, and should be restricted to that function. (The allocation will have to be done once an analysis of each functions requirement has been carried out). (1½)</p>	<p>This will enhance segregation of duties between these three functions and improve isolation of responsibilities. This will in turn reduce the risk of theft and fraud in the cycle. (1½)</p>
<p>The purchase order documentation should be re-designed to include an additional copy of the purchase order which is headed “Goods Received Note” (multi-part stationery) and this copy should be sent to the receiving department with the copy of the purchase order which is already sent to the warehouse. (Note: If the single copy of the purchase order is used as a GRN, “receiving” will have no documentation to refer to at a subsequent time, e.g. to resolve a query). (1½)</p>	<ul style="list-style-type: none"> It is unacceptable that goods are received from a supplier without being checked by the receiving staff as this facilitates theft, acceptance of incorrect goods, damaged goods, short deliveries etc., as it becomes impossible to isolate the point at which theft occurred, goods were damaged or went missing. (1½) Writing out a GRN causes the delay and providing a prepared GRN (which will provide details of the supplier and lists the goods ordered) will facilitate the proper checking of goods promptly and efficiently. (1½) Not having to write out a GRN in detail will result in more accurate and complete receiving documentation. (1½)
<p>The warehouse assistant (now a receiving clerk) should compare the goods actually received to the purchase order/GRN and supplier delivery note not just against the supplier delivery note, in addition to checking that the delivery is for a valid order. Discrepancies should be clearly marked on the purchase order/GRN and supplier delivery note. (1½)</p>	<p>The intention of this control is to compare what was received to what was ordered so that:</p> <ul style="list-style-type: none"> Invalid orders will be identified (1½) Incorrect deliveries (quantities and type) will be identified (1½) Goods on the order but not delivered at all are identified. (1½)
<p>When the goods are moved from the receiving area, one of the custody assistants must check the goods he is taking custody of against the GRN and sign the GRN to acknowledge the transfer. (1½)</p>	<p>This control makes use of the segregation of duties created by splitting the receiving, despatch and custody and isolates responsibility for the goods at all times. (1½)</p>

c) Recommendations for improvements to internal controls of preparation of payments

- Jean Senna should present Manual Pettit with all the documentation supporting each creditor's payment on the list given to Manual Pettit, e.g. order, GRN, supplier delivery note, invoice. (Note: the creditors list is in effect the cheque requisition.) (1½)

- Before making out the cheques, Manual Pettit should agree the creditor's details and amount on the list to the supporting documentation for completeness, accuracy and validity. (1½)
- Manual Pettit should "stamp/initial" the supporting documentation in such a manner that it cannot be presented in support of another (fraudulent) payment. (1½)
- The cheques plus their supporting documentation should be presented to a second signatory who should again validate the payment against the supporting documentation before signing the cheque. He or she should also "stamp/initial" the supporting documentation. (1½)

Comments:

Remember that **weaknesses** are from the viewpoint of the company: "What is the company currently doing" and why this is a weakness / risk? **For example:**
Cheques are not sequentially numbered (weakness).

Internal controls are from the internal auditor/management's viewpoint: "What should the company do to counter the weakness / risk" and how would this action prevent the risk? **For example:**
Cheques should be sequentially numbered and the sequence of all cheques should be reviewed and gaps should be followed up on by a person independent of the person preparing the cheques for payment.

Did you notice how the scenario was incorporated in the answer and it is not merely a "memory dump"?

QUESTION 10.12 IN GRADED QUESTIONS

30 marks

Reference: Jackson & Stent (2014: 11/9 – 11/10)

Weakness 1

There is a lack of division of duties between the **initiation** of the order and its **execution**. (1½)

Explanation 1

- 1.1 The buying officers decide what to order without the authority of a signed requisition from the warehouse **and** they place the order. (1½)
- 1.2 This means that a buying officer can place an order fraudulently (e.g. order goods for himself). (1½)

Weakness 2

There is no sound basis for the placing of orders e.g. no reorder level or quantity, no sales projection data etc. (1½)

Explanation 2

- 2.1 When deciding what inventory to purchase, the buyers simply look at the quantity on hand on the perpetual inventory. There is no guidance on which to base the quantity of toys to be ordered or whether a particular toy should be ordered at all. (1½)

- 2.2** This is inefficient management of the company's resources i.e. tying up funds in excess inventory and potential loss from redundant/obsolete inventory. (1½)
- 2.3** It may also lead to the failure to order enough inventory resulting in lost sales. (1½)
- 2.4** As there is no reconciliation between physical inventory on hand and the masterfile there may be no physical inventory and a quantity reflected in the masterfile. Hence no order may be placed when an order is necessary. (1½)

Weakness 3

Orders placed are not authorised by the senior buyer Goliath Booysen. Additions to the preferred supplier masterfile are not authorised by Goliath Booysen. (1½)

Explanation 3

As Goliath Booysen does not see the orders before they are sent, there is no check that they are for goods for the company, from an approved supplier. This combined with weakness 2 makes it even easier for an employee to place an invalid order. (1½)

Weakness 4

Access to the local area network at systems level is inadequate. (1½)

Explanation 4

The use of a general password to get onto the network amounts (almost) to uncontrolled access. This weakness at systems level weakens access to applications on the network, in this case acquisitions and payments. (1½)

Weakness 5

Access at application level is inadequate which severely weakens (failure to apply need to know/minimum entry principle) division of duties isolation of responsibility. (1½)

Explanation 5

- 5.1** All employees in the "ordering" and "receiving" functions of the acquisition cycle have access to all the modules in the application by virtue of a common password. (1½)

In effect, this means that at least nine employees are able to initiate an order place an order effect a masterfile amendment e.g. add a supplier **and** in the case of the receiving clerks gain easy access to the goods ordered **and** amends the records. (1½)

- 5.2** The above substantially increases the risk of invalid purchase transactions occurring. For example, a receiving clerk could easily place an order for goods for himself, receive the goods, steal them, amend the inventory records if necessary, and have the company pay for the goods. (1½)

Weakness 6

Poor programming/application design results in the need for employees to enter extensive information which is already in the database (failure to apply minimum entry principle). (1½)

Explanation 6

When creating a purchase order, although the format comes up on the screen, the buyer must still enter all the details pertaining to the supplier and the goods to be ordered. In principal the **minimum** amount of information e.g. quantity and product number should have to be entered. (1½) Information already on the database should automatically be included. This enhances the

accuracy and completeness of the order being placed as fewer keying in errors will be made e.g. incorrect descriptions, product numbers etc. (1½)

Weakness 7

The receiving clerk checks what has been delivered against the supplier's delivery note **only**, not against the purchase order. (1½)

Explanation 7

- 7.1** Adjusting the supplier delivery note for discrepancies between the goods delivered and the supplier delivery note but not for discrepancies with the purchase order will result in the company accepting (and ultimately paying for) goods in excess of what they ordered or which they did not order at all. (1½)
- 7.2** As the inventory masterfile is updated by what was actually received and the "pending order field" is cleared, the buyer will not know if there has been an over or under supply of what he actually ordered. (1½)
- 7.3** Short deliveries will not be addressed as no comparison is made between what was actually ordered and received. (1½)

Weakness 8

There is no checking or acknowledgement of receipt of the goods when they are moved from the "receiving department" to the warehouse (poor isolation of responsibilities). (1½)

Explanation 8

As the boxes are placed in the cage to be dealt with by warehouse staff when they have time, there is a period when nobody has responsibility for the goods; if discrepancies are discovered the goods receiving clerks can simply say they put the goods in the cage and the warehouse staff can say the goods were not put in the cage, i.e. were not in their custody. (1½)

Weakness 9

Nobody counts/checks the contents of boxes for quantities and goods actually delivered and nobody checks for damaged goods. (1½)

- * The receiving clerk checks only to the details on the side of the box. (1½)
- * When the toys are unpacked from the boxes in which they are delivered, the warehouse packers do not check what has actually been received against any documentation before the goods are packed away on the shelves. (1½)

Explanation 9

As Toy-Toy (Pty) Ltd does not know exactly what toys they actually received they will in all likelihood ...

- * be paying for goods they never received/are damaged. (1½)
- * have very poor inventory records which will result in losses through inefficient inventory management. (1½)

Weakness 10

- 10.1** As in weakness 6, poor application/programme design results in the receiving clerk having to enter data that is already on the system when they create the goods received note. (1½)

- 10.2** The receiving clerk has complete control over the information that is entered onto the system as ...
- * he does not simply update **authorised** information already on the system **and** (1½)
 - * nobody checks that the details on the GRN agree with the supplier delivery note. (1½)

Explanation 10

- 10.1** Again the less information that has to be entered, the less errors of **accuracy** and **completeness** will arise. This will result in fewer problems in the functions which flow from the GRN e.g. inventory record maintenance and payment to creditors. (1½)
- 10.2** In respect of weakness 9, significant fraud is possible by the simple entry of fictitious (invalid) information, e.g. the receiving clerk can make out a completely (or partially) fictitious GRN, arrange for a fictitious invoice/statement to be sent to Toy-Toy (Pty) Ltd by a fictitious supplier and share the ensuing payment to the supplier. (1½)
- * Making this type of fraud even easier, is the lack of access controls and division of duties as explained in weakness 5.

Weakness 11

Controls of masterfile amendments are inadequate. (1½)

Explanation 11

As ...

- * at least nine employees have access to the masterfile amendment module of this application and as
- * Goliath Booyesen does not authorise additions of suppliers and
- * there does not appear to be any documentation (MAF) to support amendments and
- * there is no review of logs of masterfile amendments for accuracy, completeness and validity by an **independent** manager, any number of employees could make invalid amendments to facilitate fraud. (1½)

Weakness 12

The lack of supervisory and managerial controls results in a poor control environment. (1½)

Explanation 12

As neither Goliath Booyesen nor any other members of the management get involved in the activities described, employees will before long realize that they can do precisely as they please, including engage in fraudulent activities for their own benefit. (1½)

Comments:

It is easier to identify weaknesses in a particular function in a business cycle if you are familiar with the risks and internal controls that could be implemented to mitigate those risks.

Topic 6 Inventory and Production Cycle

Feedback on supplementary Do questions on topic 6

QUESTION 11.7 IN GRADED QUESTIONS

24 marks

References: Jackson & Stent (2014: 8/7 – 8/41 & 12/6 – 12/10)

	General or application control	Objective of the control
1.	General control (1½)	implemented to assist in preventing theft of inventory. (1½)
2.	Application control (1½)	implemented to provide a division of duties between custody of the inventory and record keeping for inventory. (1½)
3.	Application control (1½)	implemented to detect discrepancies between actual and physical inventory to assist in the prevention of theft of inventory and to promote accuracy in inventory record keeping. (1½)
4.	Application control (1½)	implemented to isolate the responsibility for the inventory once it has been transferred from the custody of the goods receiving bay personnel to the warehouse personnel. (1½)
5.	General control (1½)	implemented to improve the control environment at Soundwaves (Pty) Ltd. Reflects management's commitment to the competence of staff and a positive and pro-active philosophy and operating style. (1½)
6.	General control (1½)	this is an action/policy implemented to assist in protecting the company's inventory from theft/deterioration etc, and to protect the company from loss from being underinsured should inventory be stolen/damaged etc. This policy may also be regarded as part of the risk assessment process. (1½)
7.	General control (1½)	implemented to enhance the control environment by the enforcement of integrity and ethical values. (1½)
8.	Application control (1½)	implemented to prevent unauthorised amendments to the inventory records being made (primarily) to conceal theft of inventory. (1½)

Comments:

You need to understand the difference between a general control and an application control. Then you will be able to identify the objective of the control easier as well.

QUESTION NUMBER 11.9 IN GRADED QUESTIONS

30 marks

References: Jackson & Stent (2014: 12/11 – 12/13)

1. There are no written instructions and minimal verbal instructions for the count. (1½)
 - 1.1 The only instructions on what is required of them will be given to count staff at a short (15 mins) “session” with Michael Message right before the count starts. The information given at this session provides no instruction on how the count is to be conducted or what to look out for. (1½)
 - 1.2 Without clearly written instructions count staff are likely to forget (or not know) what exactly they are supposed to do and will have no “terms of reference” to look to. (The problem is made worse by the absence of Michael Message during most of the count.) (1½)
2. The inventory count will be inadequately supervised. (1½)
 - 2.1 As pointed out above, Michael Message will be at a seminar for most of the day. This means that he will not be about to deal with count problems as they arise. (1½)
 - 2.2 Michael Message should not be a member of the “counting teams;” he should play an overall **supervisory** role which includes ensuring that the count is properly conducted. (1½)
3. The count documentation is totally inadequate. (1½)
 - 3.1 As the count sheets will be “created” by the count teams on blank paper they will not be sequenced; hence there is no way of determining if, at the end of the count all inventory sheets are accounted for. (1½)
 - 3.2 As the inventory sheets are not preprinted with inventory numbers/codes and descriptions, numerous errors in code/description could be made by the count teams. This could easily result in incorrect costing of inventory (i.e. wrong cost price allocated to the inventory item.) (1½)
4. No formal method of conducting the count has been identified and explained e.g. sticker, tag, chalk mark, double count etc. (1½)
 - 4.1 The inventory is only counted once (1½)
 - 4.2 Only one team of two counts a section of the warehouse. One person counts and the other one records, nobody checks. Numerous count errors and recording errors could take place. (1½)
5. There is no method of identifying inventory items which have been counted as the count progresses. (1½)
 - 5.1 Count teams don’t identify what has been counted e.g. no sticker, tag or chalk mark system, which means that items could easily be double counted or omitted completely. (1½)
 - 5.2 It will not be possible for Michael Message to go through the warehouse (as he should) to check that everything in the warehouse has been counted. (1½)
6. Count staff have not been instructed to look out for items which appear to be damaged or out of “fashion”, and if they do, how to record it should they identify any such inventory. (1½)

- 6.1 This procedure assists in determining whether inventory has been impaired in any way. If a certain cell phone is out of fashion, or technologically inferior it may need to be written down. (1½)
- 6.2 As a result, when pricing impaired inventory, Michael Message could easily end up overvaluing inventory. (1½)
- 7. Sixteen staff members counting inventory throughout the day is inefficient and a waste of resources. (1½)
- 7.1 It appears that even with having to write out inventory sheets, each section can be counted in an hour; therefore with properly prepared inventory sheets and possibly fewer counters, the entire inventory count could be **properly** performed in two to three hours. This could be scheduled to start at 1pm on the 30 April leaving counters to continue with their normal activities for the balance of the day. (1½)
- 8. There is inadequate control over goods received on the day of the count and their inclusion in the inventory balance at 31 March 2016. (1½)
- 8.1 Whilst receiving goods in the normal manner is sound (i.e. checking the delivery, signing the supplier delivery note, creating a GRN) the goods should **not** be transferred to the warehouse and placed on shelves. The goods should be kept together in the receiving bay until the completion of the inventory count. (Note: At the end of the day a separate inventory sheet for these items could be compiled). (1½)
- 8.2 If they are transferred to the shelves there is no way of telling whether they have been included in the count or not particularly in those sections which have already been counted. As it is, there is no indication of what goods have been counted (no tag, sticker and this makes the problem worse. (1½)
- (Note: As these goods were received prior to year-end they must be accounted for as inventory).
- 9. There is a lack of control over the completed inventory sheets. (1½)
- 9.1 As these completed sheets are simply placed on Michael Message's desk *and* as they are not sequenced, a sheet could easily go missing. (1½)
- 10. Adjustments to the perpetual inventory are made on the strength of a poorly organized, totally inadequate inventory count without being followed up (no recount of items or investigation of discrepancies). (1½)
- 10.1 Theoretically the perpetual inventory should reflect the quantities of inventory which *should* be on hand and if the actual inventory differs, actual inventory should be recounted and if there are still differences between *theoretical* and *actual* they should be investigated before adjustments to the perpetual inventory are made. (1½)
- 11. Adjustments made to the perpetual inventory are not independently authorized *and* there is a serious lack of division of duties between the custody of inventory and keeping of inventory records. (1½)
- 11.1 As it stands Michael Message, the inventory controller can easily cover up any shortages in physical inventory by simply adjusting the perpetual inventory records. During the year

or just before the count he could misappropriate inventory and change the perpetual inventory records to agree the records to the quantity per the count. (1½)

11.2 As he puts through the adjustments himself there is no independent verification of the adjustment. (1½)

Comments:

Normally the year-end inventory count internal controls are asked. In this case a scenario was given and you were asked to identify the weaknesses in respect of the inventory count.

Make sure you understand the difference between internal controls and weaknesses.

Topic 7 Payroll and Personnel Cycle

Feedback on supplementary Do questions on topic 7

QUESTION 9.2 IN GRADED QUESTIONS

30 marks

Reference: Jackson & Stent (2014: 13/9 – 13/13)

	Function	Risks
1.	Timekeeping (1½)	implemented to address the risk of fictitious hours being recorded by, for example, an employee clocking the card of an absent employee. (1½)
2.	Personnel (1½)	implemented to minimize the risk of employing individuals who are underqualified, not competent or ethically unsuitable. (1½)
3.	Payroll Preparation (1½)	implemented as one of a number of controls to address the risk of invalid, or inaccurate wages being paid or the omission of wages which should be paid (completeness). (1½)
4.	Payment preparation and payment (1½)	implemented to address the risk of invalid, inaccurate or incomplete EFTs being effected. (1½)
5.	Deductions, Payment and Recording(1½)	implemented to address the risk of Hastings (Pty) Ltd having to pay penalties for late submission of amounts owed or payment of incorrect amounts. (1½)

	Function	Risks
6.	Payroll Preparation (1½)	implemented to address the risk of fictitious employees being added to the payroll by the wage clerk. The entry of the employee number validates (verifies) that the employee is on the masterfile. (1½)
7.	Timekeeping (1½)	implemented to address the risk of employees being remunerated for unauthorised or incorrectly calculated overtime hours. (1½)
8.	Personnel (1½)	implemented to address the risk of negative consequences arising from non-compliance with labour legislation. (1½)
9.	Personnel (1½)	implemented (with other controls) to reduce the risk of fictitious hours being recorded for a fictitious worker and the recording of inaccurate or incomplete hours. (1½)
10.	Timekeeping (1½)	implemented to reduce the risk of hours worked being incompletely or inaccurately entered (keyed in). Used in conjunction with other controls. (1½)

Comments:

For any question relating to weaknesses, risks or internal controls to be implemented remember to always establish which cycle is applicable. Then ask which function is applicable and then “what” is asked? Weaknesses/risks/internal controls.

This question is a good question to get an overview of the payroll cycle broken down into the different functions and the risks associated with each function.

From the risks you should be able to also derive the weaknesses that result in the risks in the scenario as well as the internal controls that should be implemented to reduce/address the risks.

QUESTION 9.6 IN GRADED QUESTIONS**30 marks****Reference:** Jackson & Stent (2014: 8/7 & 8/17 – 8/21 & 8/27 – 8/40)

	General/application control	Preventative/detective control
1.	Application control (1½)	This procedure is designed to contribute towards preventing losses due to employees being remunerated for “clocking” unnecessary overtime hours. It could also be argued that it is a detective control because it provides a means of detecting unauthorised overtime hours, if overtime hours actually clocked are compared to the schedule which they should be. (1½)
2.	General control (1½)	This policy is implemented to detect unauthorised individuals who may be on the company’s premises and would be part of a combination of controls to prevent security problems. (1½)
3.	Application control (1½)	This is a preventive control. It assists in preventing the company from remunerating employees for hours not worked. (1½)
4.	Application control (1½)	Preventive. This control is implemented to prevent employees from being remunerated for unauthorised overtime hours and overtime hours not actually worked. (1½)
5.	Application control in the context of the payroll cycle, but also a general control in the context of the company’s overall access/custody control. (1½)	Preventive. This control is implemented to prevent invalid withdrawals e.g. theft, from the company’s bank account. (1½)
6.	Application control (1½)	Preventive. The control (sealed salary advice) is designed to prevent unauthorised access to confidential information. (The salary advice itself also enables the employee to detect any errors in the amounts paid to them.) (1½)
7.	General control (1½)	Preventive control. This activity/policy is designed to prevent the company from suffering adverse consequences from non-compliance with the law, e.g. penalties, enquiries/law-suits from unfair labour practice, etc, strikes. (1½)
8.	Application control (1½)	Preventive control. This control will be implemented to contribute to the prevention of the inclusion of “fictitious” employees to the payroll. (1½)
9.	Application control (1½)	Detective control. This control is implemented to determine whether any unauthorised amendments to the employee masterfile have been made. (1½)
10.	Application control (1½)	Detective control. This control is implemented in the programme to detect processing errors (or input errors depending on the software.) The control is only effective if the exception report is carefully reviewed and followed up by an appropriate employee in the cycle. (1½)

Comments:

This is a fairly difficult question relating to general and application controls but it illustrates the difference between a general and an application control extremely well. This is a good question to test your understanding of the concepts.

Topic 8 Finance and Investment Cycle**Feedback on supplementary Do questions on topic 8****QUESTION 12.16 IN GRADED QUESTIONS****30 marks**

Reference: Jackson & Stent (2014: 5/5 – 5/18 & 14/3 – 14/5)

1. Control environment**Concern**

Management, including the financial director have shown a distinct lack of control awareness by failing to recognise the risks of the new business activity and allowing the activity to be set up without proper organisational structure, and proper lines of reporting and levels of authority. The lack of control consciousness has opened up the company to the risk of significant abuse. (1½)

Recommendation

All trading be temporarily suspended, previous trades and current holdings be reviewed and investigated. (1½)

2. Risk assessment process**Concern**

- 2.1 There appears to be a totally inadequate risk assessment conducted before investments are made. Material amounts of money are being spent with no proper consideration of risk. (1½)
- 2.2 Inadequate skills on the “two man investment committee” to conduct appropriate risk assessment. Investment in shares successfully can be very difficult and poor decisions can be costly. (1½)

Recommendation

- An expanded investment committee should be formed and designated as a committee of the Board of Directors. (1½)
- A suitable investment consultant/stockbroker should be appointed as a member of the committee to advise accordingly. (1½)
- Risk assessment pertaining to the investment activity should become an automatic function of the company’s normal risk assessment process. (1½)

Concern

- 2.3 There is no defined strategy for making investments; meetings are held “from time to time” or when “cash at bank is healthy”. (1½)

Recommendation

Although there should be flexibility which allows the committee to meet to enable it to take advantage of favourable investment opportunities, the general rule should be that (as indicated)

- regular meetings should be held at which... (1½)
- detailed cash flow information should be available to ensure that only surplus funds are invested (1½)
- the success (or otherwise) of the portfolio is evaluated (1½)
- proposed investments are carefully considered. (1½)

3. Information system and business process for investing

Concern

- 3.1 No record of decisions of the existing subcommittee is made. (1½)
- 3.2 No written instruction is given to Buller Sharp to initiate the transactions agreed upon. (1½)
- 3.3 Either of the two members of the committee can instruct Buller Sharp (it is therefore possible that the instruction is never given as one party thinks the other has done so). (1½)
- 3.4 Buller Sharp could also forget and claim he was never told (thus missing good investment opportunities), or could initiate unauthorised transactions. (1½)
- 3.5 Instructions are given to the brokers over the phone and a rough diary is kept. (1½)
- 3.6 The company deals with several different brokers. (1½)

Recommendation

- * The decisions taken by the committee should be minuted. (1½)
- * An official “instruction to transact” document should be implemented. This document should be ...
 - pre-printed and sequenced (1½)
 - completed at the conclusion of the meeting, and (1½)
 - signed and dated by the chairman and one other. (1½)
- * The document number should be recorded against the relevant minute and the “instruction to transact” document, listed in a register, sequentially. (1½)
- * The company should decide on one firm to deal with, so as to build up a sound working relationship between itself and the firm. (1½)
- * Although the practice of giving phone instructions to the broker is common, it is probably as well to fax or email a copy of the instruction to transact to the broker, or if the broker attends the investment committee meetings, to send a copy with the broker. (1½)

4. Control activities

Concern

- 4.1 Segregation of duties and comparison and reconciliation.
 - * Buller Sharp plays too great a role in the entire operation. He ...
 - places instructions
 - retains the broker notes
 - keeps the monthly transfer secretary statement, and
 - authorises payment to the broker (1½)
 - * This problem is compounded by the fact that there is no independent reconciliation of the share transactions to confirm whether they took place and that only valid transactions took place. Thus Buller Sharp has access and authority to every aspect of the transaction which makes it far easier for him to perpetrate fraud. (1½)

Recommendation

- * Buller Sharp should continue to receive the broker's notes and should reconcile them with the register of "instructions to transact" to confirm that the purchase or sale was authorised. (1½)
- * Once satisfied that the brokers note represents an authorised trade, he should prepare a pre-printed, etc. EFT document, sign it, cross-reference it to the instruction to transmit register, and enter the share details in a share investment register. (1½)
- * The monthly broker's statement should be sent directly to the financial accountant (or similar senior person) who should reconcile the company's investment holdings to the investment ledger and the broker's notes. (1½)

Concern**4.2 Custody (over the bank account)**

- * The controls over EFT payments are totally inadequate. Access to the bank account should be granted only to senior personnel not to an administration clerk and assistant company accountant. (1½) Of more concern, is the fact that the first authorising person is not shown the supporting documentation, but is simply used to facilitate the EFT. As a junior member of staff, she is unlikely to be able to refuse to enter her password and will have little idea about what she is authorising. (1½) This could easily result in her being implicated in fraud. It also renders the second authority principle, absolutely meaningless.

Recommendation

- * The two "authorising employees" must be senior employees (not Buller Sharp) (1½)
- * Neither of them should enter their passwords without reference to full back-up documentation. Once they have scrutinised the back-up documentation including the "instruction to transact" and the broker's notes, they should each sign (initial) and date the documentation so it cannot be presented again for fictitious payment. (1½)

Note: A full range of EFT controls should be in place.

5. Monitoring**Concern**

There is currently no monitoring by anyone of the performance of the "investment activity" or the control over it. (1½)

Recommendation

The Board of Directors collectively, should review the investment performance and compare it to the performance of independent investment funds and indexes. (1½)

Comments:

The question required you to structure your answer in terms of the components of internal control. Normally you will receive presentation marks in the exam if you adhere to this and it also assists you to think logically and present your answer in this way.

Should the question not specifically require you to structure your answer under specific headings you do not need to do that?

CONCLUDING REMARKS

We hope that by working through these questions, you have added value in the sense that you increased your knowledge regarding the subjects and that you are now better equipped for the examination.