

## **AUE2602**

### **FIRST SEMESTER 2018**

#### **ACTIVITIES FROM STUDY GUIDE TO FOCUS ON:**

#### **TOPIC 1 – CORPORATE GOVERNANCE:**

##### **ACTIVITY 1 – Indemnification and Directors' Insurance**

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

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

##### **FEEDBACK ON ACTIVITY 1**

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

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

There is a link between good governance and compliance with the law.

##### **ACTIVITY 9 – Governing structures and delegation**

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

These appeared as follows:

##### **1. Board of directors (Governing Body)**

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

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

##### **2. Committees**

###### **2.1 Nomination Committee**

- Donald Winthrop (chairman)
- Charles Tree

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

###### **2.2 Remuneration committee**

- Donald Winthrop (chair)
- Monty Mann
- Koos Katswinkel

### 2.3 Audit committee

- Monty Mann (chair)
- Christo Wells
- Mitchell Street (Internal Audit manager)
- External Audit
- Fred Carver (finance manager)

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

### 3. Risk committee

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

### REQUIRED

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

## FEEDBACK ON ACTIVITY 9

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

### 1. Board of Directors

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

### 2. Board committees

#### Nominations Committee:

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

#### Remuneration Committee:

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

#### Audit committee:

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

### **3. Risk committee**

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

### **4. General**

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

### **ACTIVITY 16 - Assurance**

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

1. The manager of the company's largest retail outlet requested that one of the internal auditors be seconded to the outlet for a period of three months, as the outlet's accountant was to be away on maternity leave.
2. The finance director has requested internal audit to install the software for a new wage application, and control the conversion to the new system. Internal audit has the necessary expertise.
3. The warehousing manager has requested that internal audit evaluate the operational efficiency of the company's distribution system for the dispatch of goods from the central warehouse to the outlets.
4. The head office finance manager has requested internal audit to perform a surprise physical verification of the existence of fixed assets at two other large retail outlets, e.g. shop fittings, tills, furniture, office equipment including computer hardware.
5. The finance director has requested that internal audit perform an in depth analysis of the monthly trading returns submitted by the outlets to head office.
6. The managing director has requested that Josh Kronveld make a presentation to the Board on the laws and regulations that govern the company and its operations, highlighting any areas where laws or regulations are not being complied with.
7. The external auditors have requested that the members of the internal audit department, attend the financial year-end inventory counts on their behalf, at four of the company's retail outlets. The external auditors will have their own teams at the other outlets.
8. The human resources manager has requested that Josh Kronveld be present at the annual wage negotiations to ensure that company policy and labour law requirements are adhered to.
9. The finance manager has requested that in future, Josh Kronveld authorize the write-off of bad debts at the end of each month after investigation of the debtors' circumstances.
10. The chairman of the social and ethics committee has asked Josh Kronveld if his three qualified internal auditors could assist the local community college by lecturing on the college's evening auditing courses.

## REQUIRED

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

### FEEDBACK ON ACTIVITY 16

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

1. This request should be politely refused. Internal audit is essentially an independent monitoring and assurance function, reporting to the audit committee; it should neither perform any operational duties, nor supervise or direct staff not employed by internal audit. To fulfil the role of outlet accountant would result in both of the above. In addition the future relationship between the retail outlet and the internal audit department would not be independent.
2. This request should also be politely refused.
  - 2.1 As internal audit has the expertise, they may offer to evaluate the software and the conversion at any point in time and report their findings, but should not undertake operational responsibility for "installing" systems. (In effect, they should be part of the post-implementation review and probably should have been involved in evaluating the suitability of the new wage application software.)
  - 2.2 In future, internal audit may be called upon to give an independent assessment of the new application; they cannot also be the installers.
3. This is a perfectly valid request as it fits into the scope of internal audit's functions. These include performing assessments of internal control and evaluating business processes.
  - 3.1 Provided at least one member of the team understands the logistics of retail distribution, the assignment may be accepted.
4. As the verification is to be on a surprise basis it would appear that some kind of fraud or misappropriation of assets is suspected.
  - 4.1 If this is suspected, internal audit could justifiably be involved as one of its basic functions is to provide an independent source of information regarding instances of fraud, corruption etc., at the company.
  - 4.2 If this is just an arbitrary request from the finance manager (no suspicion of theft or fraud) Josh Kronveld should not involve his department as internal audit is not responsible for routine asset safeguarding procedures.
  - 4.3 Clearly this request is also not part of a planned internal audit risk evaluation relating to fixed assets.
5. Josh Kronveld will have to establish the intention of this request. If the finance director intends that this in-depth analysis becomes a regular monthly procedure, it becomes an operational duty and should not be taken on by internal audit.
  - 5.1 However, if this is in effect a once off evaluation of the trading data to evaluate its validity, accuracy and completeness, or for example to specifically identify fraudulent practice at an outlet(s), the assignment could be undertaken.
6. This is an acceptable request. Part of internal audit's scope of work should be to assist in the monitoring of the company's compliance with laws and regulations. This assignment requires internal audit to evaluate the company's responses to the risk of failing to comply with laws and regulations.
7. Co-operation between internal audit and external audit is to be encouraged and Josh Kronveld should make every attempt to accommodate the request.

8. It is questionable whether the presence of Josh Kronveld at these negotiations would be of any value. The human resources director should be fully familiar with company policy, and the adherence to labour law requirements is best left to the judgement of lawyers.

8.1 In addition, a (presumably) annual wage negotiation is really an operational activity in which Josh Kronveld should not be involved. Josh Kronveld should probably explain to the HR manager that he is not likely to add much value to the negotiations.

9. This request should be declined. Internal audit should not approve any accounting transactions. This is an operational activity. The only thing that internal audit could do, would be to monitor (from time to time) that the correct procedures (controls) are exercised in the writing off of bad debts particularly if there is a perceived risk that controls and procedures are not being followed.
10. This request should be accepted as a service to the local community. It will enhance the image of the company and make a positive contribution to the community which is one of the company's stakeholders.

## **TOPIC 2 – INTERNAL CONTROL:**

### **ACTIVITY 2 – Limitations of Internal control**

Management design an internal control system, which theoretically addresses risk.

List **six inherent limitations of internal control** and provide an example of each.

#### **FEEDBACK ON ACTIVITY 2**

1. **Management's usual requirement that the cost of internal control does not exceed the expected benefit to be derived (cost/benefit):**  
Safeguard of shoes, vs. safeguarding of diamonds or precious metals.
2. **The tendency for internal controls to be directed at routine transactions rather than non-routine Transactions:**  
There is a risk that the sale of private items in the company will not be entered in the records, as it is a non-routine transaction.
3. **Potential for human error due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions:**  
A person not understanding what is expected from them or they are simply careless.
4. **The possibility of circumvention of internal controls through the collusion of a member of management, or an employee, with parties outside or inside the company:**  
A warehouse supervisor in charge of receiving goods from supplier must acknowledge a receipt and makes a fraudulent secret agreement with a supplier's delivery personnel.
5. **The possibility that a person responsible for exercising an internal control could abuse that responsibility:**  
A shop manager overriding a control without authority because the customer is a friend or family member.
6. **The possibility that control procedures may become inadequate due to changes in conditions and, therefore, compliance with procedures may deteriorate:**  
Due to too many customers a Sales clerk may stop checking the customer's credit limits before the sale is made or confirming that the customer's account is up to date.

### **ACTIVITY 3 – Monitoring of controls**

#### **Internal control -**

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

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

## REQUIRED

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

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

### FEEDBACK ON ACTIVITY 3

1. Components of internal control:
  - Control environment
  - The entity's risk assessment process
  - The information system
  - Control activities
  - Monitoring of controls
- 2.

Policies and/or procedures (a) – (f)	Component of internal control
a) Regular meetings are held at divisional and departmental levels to consider the risks at specific levels within the organisation.	The entity's risk assessment process/control environment
b) Weekly reports on invoicing and debt collection are produced by the online system and are reviewed by management.	Monitoring of controls/control activities/control environment/the information system
c) When goods are delivered by a supplier, the receiving clerk counts the goods and then signs the delivery note as proof that he was responsible for receiving the delivery.	Control activities
d) From inspection of the minutes of the board of directors' meetings it appears as though all directors are involved in the decision-making process.	Control environment
e) Procedures are in place to resolve incorrect processing of transactions.	The entity's information system and related business processes/control environment
f) The entity operates within specific operating guidelines and time is taken by management to create and implement systems and procedures.	Control environment

## **ACTIVITY 1 – General Controls**

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

### **REQUIRED**

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

### **FEEDBACK ON ACTIVITY 1**

1. It requires **general** controls (not application controls).  
It requires only **physical** access controls (not logical access controls).  
It requires **access controls**.

**General physical access controls includes** aspects such as:

- control over visitors from outside the company to the IT building, for example they should be escorted to the IT department
  - controlled access to company personnel other than IT personnel
  - physical entry to the data centre to be controlled, for example closed circuit televisions (CCTVs) at entrances
  - access control over remote workstations/terminals, for example terminals should be secured to desks
2. All **logical access controls** are preventative in nature and consist of the following:
    - identification of users and computer resources
    - authentication of users and computer resources
    - authorisation of the levels of access to be granted
    - logging of access and access violations
    - access tables
  3. **Control over passwords is fundamental to successful, logical access controls.**
    - Passwords should be unique to each individual.
    - Passwords should consist of at least six characters, be random and not obvious.
    - Passwords/user-IDs for terminated or transferred personnel should be removed/disabled at the time of termination or transfer.
    - Passwords should be changed regularly and users should be forced by the system, to change their password.
    - A new employee should be prompted to change his initial password.
    - Passwords should not be displayed on PCs at any time, be printed on any reports or logged in transaction logs.
    - Encryption of password files is essential.
    - Personnel should be prohibited from disclosing their passwords to others and subjected to disciplinary measures should they do so.
    - Passwords should be changed if confidentiality has been violated, or violation is expected.
    - passwords should not be obvious, e.g. birthdays, names,



## **TOPIC 4 – REVENUE AND RECEIPTS**

### **ACTIVITY 1 - Activities and functions in the Cycle:**

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**

- 1. Order department:**
  - Receives orders from its customers, supplies the goods from its warehouse and charges the sale to the customer's account
  - To assess whether orders should be accepted and whether the customer is creditworthy and has not exceeded his credit limit.
- 2. Warehouse/despatch:**
  - To accept orders promptly and accurately and to ensure only authorised orders are acted upon.
  - Manual function of picking goods from the warehouse using a signed copy of the ISO (picking slip), and creating a delivery note.
  - Goods which cannot be picked because they are "out of stock" will also be identified and a back order note created.
- 3. Invoicing:**
  - To notify the customer promptly of amounts due for goods supplied.
  - On return of the signed delivery note it should be matched with the sales order and an invoice should be generated.
- 4. Recording sales and raising the debtor:**
  - Record the sales made and to raise the corresponding debtor promptly.
  - Invoices must be recorded accurately and entered against the correct debtor in the debtors' ledger.
  - Total sales for the period must also be posted to the sales and debtors control accounts in the general ledger.
- 5. Receiving and recording payment from debtors:**
  - To record the receipts from debtors in the cash receipts journal and credit the debtors' accounts promptly.
  - Receipts must be recorded accurately and entered against the correct debtor.
  - The total amount received from debtors for the period must also be posted to the debtors control account in the general ledger.
- 6. Credit management:**
  - To limit the loss from bad debts and to encourage debtors to pay promptly.
  - Credit management should also identify debtors to be handed over to lawyers and subsequently written off if necessary.

## **ACTIVITY 7 – Computerisation of the Cycles \*\*\*\*\***

1. Describe **the application controls** that should be present in a computerised environment to ensure that only **authorised amendments** are **made to the debtors' masterfile** in a credit sales accounting system.
2. Mention things that could go wrong (**risks**) if no application controls exist over amendments to the debtors' masterfile, for each of the objectives of control.

### **FEEDBACK ON ACTIVITY 7**

1. Application controls that should be present in a computerised environment to ensure that only authorised amendments are made to the debtors' masterfile. This includes:
  - All amendments to be recorded on hardcopy masterfile amendment forms (MAFs).
  - MAFs to be pre-printed, sequenced and designed in terms of sound document design principles.
  - The MAFs should be:
    - signed by two reasonably senior employees in the section
    - Cross referenced to the supporting documentation.
  - Restrict write access to the debtors masterfile to a specific member of the section by the use of user ID and passwords
  - All masterfile amendments should be automatically logged by the computer on sequenced logs and there should be no write access to the logs
  - To enhance the accuracy and completeness screen aids and programme checks can be implemented.
  - The logs should be reviewed regularly by a senior staff member
  - The sequence of the logs themselves should be checked
  - Each logged amendment should be checked to confirm that it is supported by a properly authorised MAF
2. Things that could go wrong (risks) if no application controls exist over amendments to the debtors masterfile:
  - **Occurrence:** Unauthorised and fraudulent amendments could be made to the detriment of the company, for example a debtor's credit limit could be increased, allowing the debtor credit facilities which he/she cannot pay within the allowed payment terms.
  - **Accuracy:** Incorrect amendments could be made to the debtors' masterfile, for example a change in a debtor's postal address could be recorded incorrectly, resulting in a debtor not receiving monthly statements and not paying his/her account (accuracy) or an incorrect change to a debtor's account number could result in incorrect postings (classification).
  - **Completeness:** Amendments to the debtors' masterfile could be incomplete, for example a new debtor is not loaded onto the debtors' masterfile and his/her purchase order would not be accepted and processed (completeness) or amendments could be made in the incorrect period (cut-off).

## **ACTIVITY 8 – Computerisation of the Cycles**

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.

### **FEEDBACK ON ACTIVITY 8**

1. **“Real time”:**  
This term means that transaction data are entered immediately online as each transaction occurs and relevant program checks take place as information is keyed in. This means that transactions are not batched before entering.
2. **Application controls** to ensure that **orders received from customers are accurately entered** into the **computerised credit sales system**.

**Internal control objective:** Accuracy

#### **Input controls:**

1. **Screen formatting:** the screen will be formatted to look like a sales order document.
2. **Minimum entry:** entering the inventory item code, will bring up the description of the item being ordered and the price.
3. **Mandatory fields:** to proceed with the order, a number must be entered in the quantity field and a customer order reference must be entered.
4. **Alphanumeric check:** no alphanumeric characters to be entered on a quantity field.
5. **Limit or reasonableness check:** reasonable quantities are to be entered
6. **Screen prompts** will require the order clerk to confirm details of order and important details.
7. **Fields on the “on screen sales order”** which cannot be changed by the order clerk.
8. The system will allocate a **customer reference number** to every sales order which is given to the customer at the time of placing the order in order for the customer to follow up on inaccurate information on the sales order.

Only application controls relevant to input and accuracy are included as required.

## **TOPIC 5 – ACQUISITIONS AND PAYMENTS CYCLE**

### **ACTIVITY 4 – Risk and Internal control in the Cycle**

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

1. When an invoice is received from a supplier, it is promptly entered into the purchase journal by Stella Stirling and filed alphabetically by supplier name. When the supplier's monthly statement arrives, Stella Stirling agrees the invoices received to the statement. She also checks that any payments that were made to the supplier by Delmundo (Pty) Ltd are reflected on the statement.

2. If an invoice reflected on the statement has not been received, Stella Stirling highlights the invoice(s) and marks it "outstanding" on the statement. The full amount reflected on the statement is paid. When the outstanding invoice is received, it is filed with the statement to which it relates and the "outstanding" mark on the statement is crossed out and dated.

3. Using the statements, Stella Stirling then makes a list of all creditors and the amounts which they are to be paid. The list is passed to Mary Roosevelt, who writes out a cheque for each creditor under R5 000. All cheques are carefully written out and marked "not transferable". Mary Roosevelt signs each cheque and returns them with the list to Stella Stirling. Stella Stirling confirms the amounts of each cheque and that there is a cheque for each creditor on the list under R5 000. Stella Stirling writes the cheque number next to each payment on the list and then mails the cheques to the creditors attached to a Delmundo (Pty) Ltd compliment slip. If the amount to be paid is more than R5 000, it is paid by EFT and not by cheque.

4. To pay creditors over R5 000, Mary Roosevelt accesses the electronic funds transfer facility on her computer and compiles a schedule of payments to be made by EFT to creditors. She obtains this information from the creditors list prepared by Stella Stirling. She carefully checks the details, namely the bank, branch code and account number of the creditor to be paid against a hard copy listing which she keeps for all creditors.

5. Stella Stirling passes the creditors list to Dean Ramjan, as he is solely responsible for the cash payments journal, namely writing it up, posting transactions to the general ledger and reconciling the cash receipts and payments journal to the bank statement monthly.

### **REQUIRED**

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

### **FEEDBACK ON ACTIVITY 4**

1. The invoices received from suppliers are not matched to any other documents, namely the purchase order, supplier delivery note or goods received note. Delmundo (Pty) Ltd could be paying for goods which were never ordered or never received (delivered), and are incorrect in terms of description, quantity or price.
- 2.1. Before the invoice is paid, there is no check to confirm that the purchase is authorised (or even that the goods purchased are of a type used by Delmundo (Pty) Ltd). If nobody checks the above, the risk that employees might be purchasing goods for themselves and have the company pay is significantly increased.

- 2.2. The full amount as reflected on the statement is paid, even where no invoice has been received. Delmundo (Pty) Ltd may be paying for goods incorrectly charged to them.
- 2.3. No checks are carried out on the casts, extensions, calculations and VAT on the purchase invoice. This may result in inaccurate payments and under-recovery of VAT.
- 3.1. No creditors' ledger appears to be kept. Creditors are paid on the strength of an external document (creditor statement) only. By having a creditors' ledger, a more accurate record of purchases and payments is maintained. The creditors' ledger can be reconciled monthly to the creditors' statement and any differences and unusual items can be followed up before payment is made.
- 3.2. There is only one cheque signatory. Having only one cheque signatory provides inadequate security over the company's bank balance. As Mary Roosevelt has access to the cheque book and she is the sole signatory, she can write out a cheque to a fictitious creditor at any time.
- 3.3. Mary Roosevelt does not agree the amounts to be paid to creditors to any supporting documentation (for example approved creditors reconciliations). This increases the risk of invalid payments to creditors as Stella Stirling could add a fictitious creditor to the list from which Mary Roosevelt writes out cheques.
- 4.1. There is insufficient control over payments made by EFT. In effect, there is only one "signature" required to access the company's bank account and transfer funds.
- 4.2. EFTs are made without supporting documentation and can be made by Mary Roosevelt at any time and for any amount.
- 4.3. Nobody checks at any stage during the payment whether payments to creditors or others are valid.
- 5.1. No review of the cashbook is carried out by "management", for example the cash book is not reviewed for missing cheque numbers or unusual payments. With no independent review of Dean Ramjan's work, he has the opportunity to cover up misappropriation.
- 5.2. An almost total lack of involvement by senior personnel/management. With such a small staff, and a lack of basic controls, the senior management should be playing an active role – for example, acting as the second signatory on cheques and EFTs or reviewing supporting documentation. This lack of involvement weakens the control environment considerably and facilitates fraud and collusion.

### **ACTIVITY 7 – Computerisation of the Cycle**

Your textbook, Jackson & Stent (2016:11/24), explains that electronic funds transfer (EFT) is a fast and efficient method of making payments.

1. Explain why the risk of fraudulent payments is very high if strict controls over EFT are not in place.
2. Describe the application controls that should be present to ensure sound control over the preparation and approval of the schedule of payments in a computerised environment.

### **FEEDBACK ON ACTIVITY 7**

1. Theft of funds from the company's bank account can easily occur because EFTs are quick and efficient. Funds can be transferred to another bank account very quickly, if access can be gained to a company's internet bank account.

2. Application controls to be present, ensuring a sound control over the preparation and approval of the schedule of payments in a computerised environment

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

- The preparation of the EFT schedule of payments to creditors and the authorization thereof will be carried out by different employees:
- the creditors' clerk will prepare the schedule
- the head of the creditors section will authorize it
  
- As all the information to prepare the schedule is already on the system, the software will be designed to minimize the need to enter any additional information. This enhances accuracy and completeness and prevents the addition of fictitious payments.
  
- Write access to the "prepare payment module" will be restricted to the creditors clerk preparing the schedule.
  
- Once the module has been entered, the creditors clerk will either select a creditor by clicking on the list of creditors which appears on the screen, or alternatively the screen will automatically display the first creditor in alphabetic order
  - the screen will be formatted as a payment document which will reflect the creditors standing data
  - on selecting the "select invoices" option, a dropdown list of all unpaid invoices for that creditor will appear
  - The creditors' clerk will select those invoices which the company should pay, governed by the terms agreed with the creditor. The creditors' clerk will have a facility which enables him to call up supporting documentation on the screen or he may choose to inspect hard copy. This procedure will be followed for each creditor and as each payment document is completed it will be listed on the payments schedule
  - if there is nothing to be paid to a creditor, the creditor will still be listed but the amount to be paid will be nil
  - a financial total of all amounts to be paid to creditors will be computed and there may be a processing control which compares this total with the amount by which the total on the unpaid invoices file has been reduced
  - As the invoices are selected for payment, they will be removed from the file of unpaid invoices or a status code will automatically be attached to indicate that the invoice has been paid. This also ensures that it cannot be selected for payment again.
  
- Once the schedule has been prepared, the creditors clerk will select the proceed option and at this point the file can no longer be altered. The creditors clerk will not have an approve option on his screen.
  
- To approve the schedule of payments, the creditors' section head will access the schedule of payments file. He will have read access only. He should:
  - Review the schedule for reasonableness, looking for any payments which appear abnormal.
  - run reports to assist him in his review
  
- The head of the creditors section should not have write access to the payment schedule file. Any changes he may require will be referred back to the creditors' clerk.
  
- Approval of the payments schedule will be on screen (on the system) and the ability to approve the file will be restricted to the section head.

Note: There is nothing to stop the schedule of payments from being printed out for detailed checking and authorization. If this is the case it will be approved by signature and will need to be agreed to the schedule on the system before the EFT is effected

## **ACTIVITY 8 – Computerisation of the Cycle**

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

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

### **FEEDBACK ON ACTIVITY 8**

1. Restriction of access to the bank account:  
Serious consequences for the business includes:
  - **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 to ensure sound control over the bank account:
  - The terminal onto which the bank's software is loaded, should be in the creditors’ section, and be the terminal of the senior creditors’ clerk.
  - Access to the bank's site should be gained in the normal manner, but to access the company's bank account, the senior creditors’ clerk should need to enter a PIN and password.
  - If this identification and authentication procedure is successful, a menu of the functions available should be displayed, one of which will be “download bank statement”.
  - This function should be linked to the senior creditors’ clerk's user profile to enable him/her to initiate the download.
3. Sound controls over passwords  
The strict control of passwords as part of access controls over the bank account is fundamental to successful, logical access controls. Sound controls over passwords are:
  - Passwords to access the bank account should be unique to the senior creditors’ clerk.
  - Passwords to access the bank account should consist of at least six characters and be random.
  - Passwords and user IDs for terminated or transferred senior creditors’ clerks should be removed or disabled at the time of termination or transfer.
  - Passwords to access the bank account should be changed regularly and the senior creditors’ clerk should be forced by the system to change the password.
  - A new senior creditors’ clerk should be prompted to change the initial password.
  - Passwords to access the bank account should not be displayed on PCs at any time, be printed on any bank statements or logged in bank transaction logs.
  - Encryption of password files is essential.
  - Passwords should be changed if confidentiality has been violated, or violation is expected.
  - Passwords should not be obvious.
  - The senior creditors’ clerk should be prohibited from disclosing his/her passwords to others and subjected to disciplinary measures should he/she do so.
  - Passwords to access the bank account should be changed if confidentiality has been violated, or violation is expected.

## **TOPIC 6 – INVENTORY AND PRODUCTION CYCLE**

### **ACTIVITY 3 – Risk and Internal control in Warehousing**

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. Internal controls implemented to mitigate the risks associated with the physical transfer of inventory in a warehouse:
  - No movement of inventory should take place without an authorising documents.
  - No movement of inventory should take place without the movement being recorded e.g. a delivery note and material issue note.
  - Whenever there is a transfer of inventory between sections, both the deliverer and the receiver should acknowledge the transfer.
  - Documents should be sequenced and filed numerically.
  - Documents must be sequenced checked and missing documents investigated.
2. Internal controls that can be implemented to mitigate the risks associated with the protection of inventory against damage, theft and loss in a warehouse:  
**Preventative:**
  - **Physical controls**
    - entry and exit : minimum entry and exit points
    - controlled entry and exit : gate control and biometric readers
    - restricted entry
    - secure buildings
    - environmental : areas to be dry, clean, neatly packed, pest free and temperature controlled where necessary
    - Surveillance: cameras/video recording over production, receiving and despatch areas.  
**Detective:**
  - **Comparison and reconciliation**
    - physical inventory to be compared to theoretical inventory per the perpetual inventory
    - actual production to be compared to the manufacturing or production schedules
    - actual production to be compared to budgets
    - All material variances should be investigated.

### **ACTIVITY 5 – Inventory Counts**

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

#### **FEEDBACK ON ACTIVITY 5**

1. In order to ensure a successful inventory count, the following must be adhered to:
  - proper and timeous planning and preparation
  - standard stationery design principles and controls
  - written count information and instructions to all members involved in the count



2. The procedures that should be followed by the counting team when conducting an inventory count:
  - The count staff should be divided into teams of two, with one member of the team being completely independent of all aspects of inventory.
  - All teams should be given a floor plan of the warehouse which should clearly demarcate the inventory locations for which they are to be held accountable.
  - All inventory should be counted twice. One of the following methods can be adopted:
    - One member of a team counts and the other records, swapping roles thereafter and performing a second count in the same section to which they were assigned.
    - Count teams complete their first counts, hand their inventory sheets back to the count controller and sign for the inventory sheets of another section, thereby doing their second counts on a section already counted by another count team.
  - As items are counted they should be neatly marked by the counters. Alternatively the tag system described under “documentation” can be used.
  - Where count teams identify damaged inventory or inventory in an area of the warehouse which appears unused/excessively dusty, these inventory items must be marked as such on the inventory sheets (potential write downs).
    - The contents of boxes where the packaging appears to have been tampered with, should be counted and the details noted on the inventory sheet.
  - A few boxes should be selected at random in each section and the contents compared with the description on the label to confirm that the contents have not been changed/removed and the seal replaced.
  - the count controller (and assistants) should:
    - Walk through the warehouse once the count is complete and make sure all items have been marked twice or that the detachable portions of all tags have been removed.
    - Examine the inventory sheets to make sure that first and second counts are the same and agree to the quantities recorded on the perpetual inventory if there is one.
    - Instruct the count teams responsible for sections where discrepancies are identified to recount the inventory items in question.
  - the count controller should obtain the numbers of the last goods received note, invoice, delivery note and goods returned note used up to the date of the inventory count.
  - No despatches of inventory should take place on the date of the inventory count.
  - Any inventory received after the count has begun should be stored separately in the receiving bay, until the count is complete and must not be put into the warehouse. This inventory must be counted and added to the inventory sheets after the count is complete.
  - the counters responsible for the count sheets should:
    - draw lines through the blank spaces on all inventory sheets, and
    - Sign each count sheet and all alterations.
  - The inventory controller should check that this procedure has been carried out and should sequence test the inventory sheets to ensure that all sheets are accounted for.
  - Count teams will only be formally dismissed once the count is complete and all queries have been attended to.

## **ACTIVITY 6 – Inventory valuation Concepts**

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**

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

## **TOPIC 7 – PAYROLL AND PERSONNEL CYCLE**

### **ACTIVITY 3 – Risk and Internal control in the Cycle**

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:

1. Wage packets should be made up by two wage department members.
2. On delivery of the payroll and paypackets to a section, the section head should:
  - agree the number of paypackets to the payroll
  - agree control totals and
  - Sign the payroll to acknowledge receipt.
3. The paypackets and payroll should be locked away until payout.
4. The wage payout should be conducted by at least two employees, both to be present at all times.
5. Employees should:
  - present identification
  - acknowledge receipt of their wage packet by signing the payroll
6. Count their cash and immediately report any discrepancies to the paymaster.
7. In principle, employees should not be allowed to accept a paypacket on behalf of another employee.
8. At the conclusion of the payout, the paymaster and foreman who have conducted the payout, should:
  - agree all unclaimed paypackets to the payroll,
  - identify clearly on the payroll, all employees for whom there is an unclaimed packet
  - enter the details of unclaimed wages in an unclaimed wage register
  - Sign the payroll to acknowledge this control procedure.
9. The unclaimed paypackets and payroll should be retained by the paymaster who should lock them away.
10. When employees wish to collect their unclaimed wages, they must identify themselves to the paymaster and acknowledge receipt of their paypackets by signing the unclaimed wage register.
11. Regular independent reconciliations of unclaimed paypackets on hand and the unclaimed wage register should be performed and the unclaimed wage register reviewed for unusual occurrences.
12. Any wages remaining unclaimed after two weeks, should be banked and a copy of the deposit slip attached to the unclaimed wage register and cross-referenced to the relevant entries.

Main risks identified includes:

1. Errors or theft of cash during:
  - drawing of cash
  - making up of wage packets
  - the payout
2. Misappropriation of unclaimed wages

#### **ACTIVITY 4 – Risk and Internal control in the Cycle**

C-Ment Ltd manufactures cement blocks and pavers. The company was started some years ago and has grown steadily to the extent that it currently employs 120 semi-skilled workers. Internal controls have not kept up with the growth of the business and you have been asked to evaluate the current wage system. You have obtained the following information:

1. The manufacturing yard is enclosed by a large security wall. The only access to the yard is through the gate used by vehicles that deliver raw materials and collect finished products. Workers enter and exit through this gate. There is a small gate hut manned by a security guard.

2. On arriving at or leaving work, employees tick off their names on a “daily time list” entering their time of arrival or departure in the space provided. A large clock is located in the gate hut.

3. The company's administration functions, such as sales and accounting, are located in a small office block next to the manufacturing yard. The accounting section is staffed by a senior accountant, Zeb Matabane, and three clerical assistants. One of the clerical assistants, Milly Moss, is responsible for the wage function which operates as follows:

3.1 Each working day after close of business she collects the daily time lists from the gate hut and replaces them with new lists for the following day. The completed daily time lists are filed in date order in a lever arch file. She also maintains a simple hard copy employee's file for each employee.

3.2 The wage week runs from Thursday morning to Wednesday afternoon. On Thursday mornings Milly Moss calculates the total hours worked by each employee for the week (both normal and overtime) and enters the totals against each employee's name, on a weekly “hour's 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 “hour's summary lists”.

3.3 Once each employee's hours worked have been entered, Milly Moss selects the “prepare payroll” module to start processing the wages and producing the payroll. The payroll reflects employee number, name, section, gross wages, deductions and net pay. It also has a space in which the employee signs on receiving his or her pay.

3.4 Once the payroll has been produced, Milly Moss gives it to Mo Hiten, the cash payment journal clerk, who prepares a cheque for the net amount of the pay (as well as cheques for the amounts to be paid over to SARS for PAYE, UIF etc.). Mo Hiten takes the cheques to Zeb Matabane who signs them.

3.5 The cheque for the net wages and the wage packets is then delivered to WageMaster (Pty) Ltd, a security company which cashes the cheque and makes up the wage packets from the details on the packets. Milly Moss prepares a register which reflects the cheque number, amount and number of paypackets to be collected by WageMaster (Pty) Ltd. This register is signed by a WageMaster (Pty) Ltd employee.

3.6 On Friday morning WageMaster (Pty) Ltd returns the made-up wage packets to Milly Moss who agrees the number of paypackets to the register and signs the security company's delivery note.

3.7 The wage payout takes place at 3 pm on Fridays. At 1 pm Milly Moss leaves the wage packets and a copy of the payroll at the gate hut for collection by the supervisor. The supervisor conducts his or her own payout. He or she hands the paypacket to the employee, who must show his or her staff identity card and sign the payroll next to his or her name.

3.8 Any unclaimed wages are marked as such by the supervisor on the payroll. The unclaimed wages are taken home by the supervisor (all administration office employees finish work at 1 pm on Fridays) and handed to Milly Moss on Monday morning. She agrees the packets she has been given to the payroll and puts the packets in the safe. When the employee returns to work he or she must collect their wage packet from Milly Moss (staff identity card must be produced) and sign the payroll.

## REQUIRED:

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

### FEEDBACK ON ACTIVITY 4

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

#### Points 1–2:

**Weakness:** Controls over timekeeping are inadequate.

**Explanation:**

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

#### Point 3

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

**Explanation:**

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

#### Points 3.2–3.3

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

**Explanation:**

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

### **Points 3.1–3.8**

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

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

**Explanation:**

This will enable her to steal money from the company by:

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

### **Points 3.4–3.5**

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

**Explanation:**

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

### **Point 3.7**

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

**Explanation:**

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

### **Point 3.7**

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

**Explanation:**

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

### **Point 3.8**

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

**Explanation:**

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

## **ACTIVITY 5 – Computerisation of the Cycle**

Internal controls over timekeeping in a wage system are very important.

### **REQUIRED:**

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

### **FEEDBACK ON ACTIVITY 5**

1. The most common example of biometric data is an employee's fingerprint. In a system where the identification of employees to be controlled by biometric data, a finger print is stored on the system so that when the employee places his finger on the scanner, it has a set of prints against which to “match” the finger print.
2. Biometric data overcomes the weaknesses of an identification card or clock card system where an employee can swipe the card on behalf of another employee and thereby create fictitious hours worked.
3. Application controls implemented to ensure good control over timekeeping in a computerised wages system under the activities of
  - **Storing biometric data on the system;**  
For identification of employees to be controlled by biometric data, a thumb print/finger print will need to be stored on the system so that when the employee places his thumb on the scanner, it has a set of prints against which to “match” the thumb print
    - the biometric data will be stored on the employee masterfile
    - access to the module which facilitates the recording of the data should be strictly controlled
    - the responsibility for capturing the biometric data should be assigned to the personnel department
    - Programme controls will prevent the biometric data from being replaced (a variation of write access to the field).
  - **employee identification and recording of hours worked; and**  
The basic controls around exit/entry should apply
    - limited entry points
    - physical access controls, e.g. successful scanning of the employee's thumb print activates a turnstile mechanism
    - Entry/exit point should be generally observed by security.
  - **Reviewing employee attendance.**  
Supervisory personnel should make use of the timing device's storage capabilities to access information pertaining to employee attendance on the system. These reports can be generated daily, weekly and in various formats.
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 foreman should:
  - check the schedule for any incorrect or unusual hours recorded, e.g.
    - normal hours in excess of 40 hours per week
    - high overtime hours and low normal hours

- Confirm that the overtime hours recorded were authorised prior to being worked and/or that they were actually worked.
  - Confirm that there are hours worked for all employees and that any missing normal hours agree with the attendance reports generated by the access/scanning device.
5. 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 includes:

- access to the applicable module will be restricted in the usual manner
- to access a particular employee's record, a valid employee number will have to be entered (verification check)
- It is usually unnecessary for the payroll clerk to have to enter each automatically bring up the next employee's record as each record is confirmed.

On accessing the module, the screen will come up formatted as an employee payment record. This will reveal:

- All standing data applicable to the employee.
- Fields containing year to date earnings.
- Fields revealing the current period's normal and overtime hours worked, the company's contribution to a pension fund or medical aid, etc.
- A selection of fields designated in terms of additional categories of amounts to be paid to the employee.

There will be no write access to:

- the standing data fields
- year to date fields
- Some of the fields already "populated" by the payroll software such as medical aid contributions and deductions, contributions to pension funds.

If hours worked have already been approved on the system, there will also be no write access to the current period's hours worked fields.

If these fields need to be altered in terms of the hardcopy hours worked schedule

- there may be limit checks on the normal and overtime fields
- All changes will be logged and reviewed before the payroll is finally approved.

Additional amounts to be paid to an employee should be authorised in writing by appropriate personnel, after confirming compliance with the underlying conditions for paying the bonus and re-performance of the bonus calculation has taken place.

As the objective is to ensure that the source data is absolutely correct before processing takes place, a second payroll clerk may check the employee payment records in detail or selectively.



## **TOPIC 8 – FINANCE AND INVESTMENT CYCLE**

### **ACTIVITY 1 – Risk and Internal control for Capital Expenditure**

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**

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. Transactions in this cycle are not subject to the routine everyday controls relating to transactions. Internal controls over non-routine transactions such as finance and investment transactions are still based on the five components of internal control, but “compensating controls” would be implemented.
3. Major risks for capital expenditure with reference to the internal control objectives are:
  - That the client understates completeness of the long term liabilities or overstates existence and valuation of the investments which have been made whether these are investments in plant and equipment etc., or in other private or public companies.
  - Due to the legal and regulatory requirements there is also a risk that invalid transactions have occurred, e.g. long-term loans raised in contravention of the Memorandum of Incorporation, or the issue of shares to a director without the appropriate approval in terms of the Companies Act.

Note: These main risks are associated with the finance and investment cycle as a whole, but these risks are specifically applicable to capital expenditure in the cycle.

### **ACTIVITY 2**

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

1. Each sectional accountant is responsible for capital expenditure for his/her section.
2. A budget is prepared in the office of the financial director. Budgeting figures are calculated by increasing the previous year's budget by the average consumer price index for the year. Sectional accountants are notified as to what their section can spend on the purchase of capital items.
3. However, if sections do not spend their capital budget in any financial year, that section's budget is reduced for the following year. As you can see, we all try to avoid a cut in our budget by making sure we spend our budget before the end of the financial year.
4. If a staff member in the section requires equipment, for example in my warehouse section the foreman may decide he needs a new forklift, he e-mails my assistant with the precise details of what is required as well as the name of a supplier. None of the equipment used by North Shore Ltd is particularly complicated, so this method works fine.

5. My assistant then completes a pre-printed, numerically sequenced, multi-copied order form, which the sectional accountant signs before sending the top copy to the supplier. The second copy of the order is sent to the central creditors department for payment, along with the supplier delivery note. The third copy is left in the order book and used by the assistant to write up the new equipment in the assets register.
6. The supplier delivers the equipment to the section and my assistant signs the supplier delivery note after agreeing the items to the supplier delivery note. The assistant retains a signed copy of the supplier delivery note, which is sent to the creditors department as described in point 5 above.

## REQUIRED

Identify and describe the weaknesses in the system of investing in capital equipment at North Shore (Pty) Ltd, based on the information given and to recommend improvements to address the weaknesses you have identified. Do not concern yourself with payments to creditors.

Structure your answer in the tabular format given below:

### Weakness Explanation and improvement

#### FEEDBACK ON ACTIVITY 2

Weakness	Explanation and improvement
<p>1. The acquisition (investment in) fixed assets is <b>not planned</b>.</p> <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 which 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.</li> </ul>
<p>2. The budgeting process is totally ineffective.</p> <ul style="list-style-type: none"> <li>Simply increasing the prior year budget by an index has resulted in sections being allocated money which they do not require and which will be wasted.</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>

Weakness	Explanation and improvement
<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, which shows 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 point 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 (e-mail 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 requisition appear on the capital budget</li> <li>- check with the preferred supplier as to availability, current price and delivery particulars</li> <li>- make out and sign a three-part pre-printed, sequenced (capital expenditure) order</li> </ul> </li> <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>

Weakness	Explanation and improvement
<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 e-mail)</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>