TOPIC 8

FINANCE AND INVESTMENT CYCLE

TOPIC OVERVIEW

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

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

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

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

This topic is divided into the following learning units:

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

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
8.1 Capital expenditure	• Describe, explain and evaluate capital expenditure as part of the finance and investment cycle by referring to the characteristics of fixed asset acquisition transactions. • Identify and explain the risks associated with fixed asset acquisitions and describe and apply the internal controls that could be implemented to mitigate the risks.	2 2

LEARNING UNIT 8.1

CAPITAL EXPENDITURE

INTRODUCTION

Jackson & Stent (2014:14/2) explains that this cycle essentially deals with the transactions which a company enters into to raise **finance**, for example by borrowing money from a bank or investment company, as well as with the **investments** the company makes, whether it be in property, plant and equipment, or by making long-term loans or investing surplus funds.

8.1.1 CHARACTERISTICS OF CAPITAL EXPENDITURE

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

STUDY

Jackson & Stent (2014:14/2)

Risks and internal controls in the cycle are now explained.

8.1.2 RISKS AND INTERNAL CONTROL FOR CAPITAL EXPENDITURE

Compensating controls over capital expenditure transactions entail **planning**, **authorisation**, **implementation** and **review and approval** (Jackson & Stent (2014:14/3).

STUDY

Jackson & Stent (2014:14/3–14/4)

Jackson & Stent (2014:14/4–14/5) – The Finance and Investment Cycle at Proride (Pty) Ltd

ACTIVITY 1

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

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

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2014:14/2)

1. **Non-routine transactions** such as fixed asset acquisitions do not usually occur every day and the number and frequency of transactions are considerably less than for example sales, purchases, salaries and wages. The size of transactions is usually significant (the amounts are large) and these transactions are frequently subject to legal and regulatory requirements.
2. Because of the characteristic mentioned in 1, transactions in this cycle are not subject to the routine everyday controls relating to transactions. Internal controls over non-routine transactions such as finance and investment transactions are still based on the five components of internal control (as explained in topic 2), but "**compensating controls**" would be implemented.
3. The major risks for capital expenditure with reference to the internal control objectives are explained in section 2.6 in Jackson & Stent (2014:14/2) and are not repeated here.

Note: The main risks explained under section 2.6 in Jackson & Stent (2014:14/2) are associated with the finance and investment cycle as a whole, but take note that these risks are also specifically applicable to **capital expenditure** in the cycle.

ACTIVITY 2

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

1. Each sectional accountant is responsible for capital expenditure for his/her section.
2. A budget is prepared in the office of the financial director. Budgeting figures are calculated by increasing the previous year's budget by the average consumer price index for the year. Sectional accountants are notified as to what their section can spend on the purchase of capital items.

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

REQUIRED

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

Do not concern yourself with payments to creditors.

Structure your answer in the tabular format given below:

Weakness	Explanation and improvement

FEEDBACK ON ACTIVITY 2

Weakness	Explanation and improvement
1. The acquisition (investment in) fixed assets is not **planned.** • There is no evaluation of whether the items purchased by the five sectional accountants are required. • Any member of the section can request equipment without providing proper motivation.	• The company should appoint a fixed asset committee consisting of senior experienced management which to take responsibility for evaluating the need for the purchase and evaluating how capital expenditure will be financed. • All requests for fixed assets from sections must be fully motivated. • The fixed asset committee should be responsible for preparing an annual capital expenditure budget.

2. The budgeting process is totally ineffective. • Simply increasing the prior year budget by an index has resulted in sections being allocated money which they do not require and which will be wasted. • This weakness is compounded by the fact that sections are “punished” for not spending their allocation by having their budgets reduced.	• A proper budgeting system for capital expenditure should be put in place: • Each section should carefully evaluate their actual capital expenditure needs (and planned disposals) for the upcoming year. The budget should not be based on adjusted figures for the previous year. • The sectional budgets should be submitted to the fixed asset committee for their approval, which should only be given after careful consideration of the motivation. • There should be ongoing comparison of actual capital expenditure with budgeted expenditure.
3. There is inadequate authorisation of capital expenditure. • Sectional accountants have complete authority to purchase equipment provided they have not exceeded the budget. • In effect the sectional accountants can make a purchase and authorise it, which shows a lack of division of duties. • As there appears to be no reconciliation or follow-up of items actually purchased, this lack of division of duties becomes more serious.	• The fixed asset committee should approve the budget, which will then become the fundamental authorising document. • See point 4.
4. The controls over the requisitioning and ordering and receipt of capital expenditure items are inadequate. • No properly designed, pre-printed, sequenced (and authorised) requisition form is presented to support the purchase request (e-mail is sent). • The order is placed by the assistant to the sectional accountant (not the buying department), without any follow up with the supplier as to availability and price and alternative suppliers. • Items purchased should not be delivered to the individual sections as this weakens division of duties.	• A properly designed (two part) pre-printed, sequenced, capital expenditure requisition must be prepared and signed by a senior person in the section requiring the item, for example the warehouse manager requiring a new fork lift. • This requisition should be submitted to the sectional accountant, who should authorise the requisition (sign) after confirming that the request complies with the capital expenditure budget. • A copy of the requisition should be sent to the company's buying department, and the second copy filed in numerical sequence. • The order department should – confirm that the goods requisition appear on the capital budget – check with the preferred supplier as to availability, current price and delivery particulars – make out and sign a three-part pre-printed, sequenced (capital expenditure) order

	• Items purchased should be delivered to North Shore Ltd's receiving department, where a pre-printed, sequenced, three-part "capital item goods received note" should be made out after the items delivered have been checked to the supplier delivery note.
5. There is a serious lack of division of duties in respect of the assistant to the sectional accountant. This person • places the order (on the strength of an e-mail) • receives the goods • "authorises" payment (by sending the unchecked documentation to creditors) • writes up the records (fixed asset register)	• On receipt of the item, a responsible official in the section should check the item delivered against the original requisition and the "capital item goods received notes", before signing them. • Once the above procedures are complete, the assistant to the sectional accountant can write up the sectional fixed asset register.

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

SUMMARY

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

CONCLUSION

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