



Tutorial Letter 102/3/2018

Corporate Governance in Accountancy

AUE2602

Semesters 1 and 2

Departement of Auditing

This tutorial letter contains the suggested solutions to questions included in tutorial letter 103.



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FEEDBACK ON SUPPLEMENTARY *DO* QUESTIONS

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Please note the mark allocation per point included in the suggested solutions may be 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 2.9 IN GRADED QUESTIONS

25 marks

Reference: King IV Report

(a) Factors to consider to determine the appropriate number of members of the board:

1. The collective skills, knowledge and experience needed for the board to meet its responsibilities. (1½)
2. The appropriate mix of executive, non-executive and independent non-executive directors. (1½)
3. The need to have sufficient qualified members to serve on board committees. (1½)
4. The need to secure a quorum at meetings. (1½)
5. Regulatory requirements, e.g. JSE regulations state that a listed company must appoint a financial director. (1½)
6. Diversity targets (experience, age, race and gender). (1½)

(b) Composition of the board:

1. The roles of chair and chief executive officer are held by different people, which is in accordance with principle 7. (1½)
2. However, the chair, Virat Amla, does not appear to be an independent, non-executive director as recommended by the principle 7.31. (1½)
3. It appears that no lead independent non-executive director has been appointed by the board. One of the functions of a “lead independent, non-executive director” is to act as chair in situations where the chair’s independence is questionable or impaired (the chair is conflicted) (principle 7.32). (1½)

4. The fact that the deputy chair is also the senior executive officer is not in accordance with the recommendations of the King IV Report.
 - 4.1 The roles of CEO and chair should be independent of each other, but whenever the deputy chair acts as chair, this requirement will not be met (principle 7.34). (1½)
 - 4.1 It will present a problem with the succession plan as the deputy chair should not be appointed chair until three years have elapsed since his or her resignation as CEO (principle 7.34). (1½)
5. There is an appropriate mix of executive and non-executive directors on the board, particularly in view of the fact that non-executive directors are in the majority and four of the six non-executive directors are independent non-executive directors (principle 7.8). (1½)
6. Although he should not be the deputy chair, the fact that the CEO is on the board complies with the King IV recommendations that the CEO be appointed to the board. King IV also requires that “at least one other executive director be appointed to the board”. This requirement has been satisfied (principle 7.9). (1½)
7. Judging by the experience, occupations and qualifications, gender and race of the directors there is enough collective skill, knowledge and experience for the board to meet its responsibilities and satisfy diversity targets (principle 7.7). (1½)
8. There also appears to be an appropriate number of directors to be an effective board but some difficulty may arise with satisfying committee requirements, e.g. audit. (1½)

(c) Composition of the audit committee:

Name	Eligible	Reason	Attend meetings
Virat Amla	No (½)	Chair of the board and not independent (½)	May attend by invitation (½)
Frans Klewsner	No (½)	Executive director (½)	No (½)
Noddy Nkwe	No (½)	Executive director (½)	No, but may be invited for specific matters on the agenda (½)
Mary Smith	No (½)	Executive director (<i>Note 1</i>) (½)	Not normally (½)
Marshall Gibbs	No (½)	Executive director (<i>Note 1</i>)	Not normally (½)
Mills Ndou	No (½)	Executive director (<i>Note 1</i>)	Not normally (½)
Eric Hougaard	No (½)	Not independent non-executive director (½)	Not normally (½)
Victor Botha	No (½)	Not a director - company secretary (½)	Yes, to record minutes (½)
Ashley Willemse	No (½)	Not a director - chief audit executive (½)	May attend by invitation (½)
Russell Brent	Yes (½)	Independent non-executive director (½)	Only if appointed (½)
Serena Court	Yes (½)	Independent non-executive director (½)	Only if appointed (½)
Bongi Zulu	Yes (½)	Independent non-executive director (½)	Only if appointed (½)
Chris Eubank	Yes (½)	Independent non-executive director (½)	Only if appointed (½)

Note 1: The presence or lack of financial expertise of these directors does not affect their eligibility, it is the fact that they are executive directors.

(d) Composition of the audit committee:

Of the thirteen individuals listed, only four are eligible for appointment as none of the others satisfies the basic requirements to be appointed: independent and non-executive and a director. (1½)

Of the four available candidates:

1. Russell Brent satisfies the basic requirements and is likely to have the necessary expertise, skills, competency and financial literacy to fulfil his function on the audit committee and ask probing questions about the company's financial reporting and related processes, risks and internal controls. I would recommend his appointment. (1½)
2. I would not recommend Serena Court as it is very unlikely that she would have the necessary knowledge of financial reporting to fulfil the role and duties of an audit committee member. In all likelihood she sits on the board to provide fashion insights to the children's clothing market. (1½)
3. This leaves just Bongi Zulu and Chris Eubank. They both clearly have business experience and probably some understanding of the necessity for and role of an audit committee. (1½)
4. However, there is no guarantee that simply because she is the chair of a company that Bongi Zulu will have the necessary financial expertise or knowledge of integrated reporting to make a meaningful contribution. (1½)
5. Likewise Chris Eubank is retired and there have been major developments in financial reporting matters. Will he be up to date? Furthermore being a "business" man does not equate to having the necessary expertise on reporting matters. He may be experienced in other aspects of business. (1½)
6. With regard to the necessary expertise required by the audit committee, King IV requires a collective ability. Even though Russell Brent appears to have the ability, he cannot be a "one man band". The other members must be able to contribute to the audit committee in meeting its responsibility. (1½)
7. I would therefore recommend that one of either Bongi Zulu or Chris Eubank be appointed (preferably Bongi Zulu on the evidence available) and that the company appoint an additional independent non-executive director who has the specific expertise needed to give the committee the collective knowledge, skills and competency it requires. (1½)

Comments:

For question 2.9 (b) both compliance and non-compliance should be covered in your answer. Note that the required did not specifically state this, therefore you deal with both.

Know and understand the principles of the King IV 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 IV Report. If you are able to do this question, you should not have a problem in the assignments and exams!

Refer to the tables in learning unit 1.3.3 of your study guide, which summarise important principles regarding the board of directors and board committees. It is still important to refer to the King IV Report as well.

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

QUESTION 2.23 IN GRADED QUESTIONS

20 marks

Reference: King IV Report and Companies Act of 2008

Eligibility to be appointed to the audit committee:

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 (Companies Act: section 94). (1½)
2. Rod Dodger:
 - To be appointed to the audit committee, the individual concerned must be a director of JayB Ltd (Companies Act: section 94). He would therefore have to be appointed (in terms of the Companies Act and requirements of the MOI) as a non-executive director. (1½)
 - He appears to be independent and has the advantage of being a corporate law expert, which would be useful. (1½)
 - Provided the financial expertise of the audit committee as a whole will enable the committee to fulfil its function, any lack of financial expertise on the part of Rod Dodger should not be a problem. (1½)
 - However, whether he would have the necessary knowledge of the company (as a new director) or the requisite knowledge of financial risk, financial reporting, IFRS and global sustainability reporting initiatives, is doubtful. (1½)
3. Karl Zeiss:
 - Although Karl Zeiss is a non-executive director (and presumably independent), King IV recommends that the chair of the board not be a member of the audit committee. If he is to be a member of the audit committee and chair of the board, it would threaten his objectivity and lead to the perception that the audit committee is not truly independent. (1½)
 - He may be invited to attend meetings. (1½)
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 his firm is the auditor of JayB Ltd, Section 90 of the Companies Act 2008 disqualifies him from being a director. (1½)
5. Aaron Khumalo:
 - He is not appointable as he is not a director (Companies Act, section 94). (1½)
 - Even if he were appointed a director, he is still involved in the “day to day business” of JayB Ltd and therefore not independent or non-executive (Companies Act, section 94 and King IV) and therefore cannot be appointed despite the fact that he has the required financial literacy. (1½)

6. Klark Gayble: - He is appointable as he is an independent non-executive director with the necessary financial expertise and experience. (1½)
7. Theuns Jordaan: - He is not a director of JayB Ltd so on this count, is not appointable. (1½)
 - He is an executive director of MayB (Pty) Ltd which is a subsidiary of JayB Ltd (and therefore a related company) so is disqualified from being appointed to the committee by Companies Act, Section 94(4)(ii). (1½)
 - It is unlikely that he would have the necessary financial expertise or knowledge of financial/sustainability reporting, and risk governance. (1½)
8. Jennifer Jacobs: - She would have to be appointed to the board as a director (non-executive). (1½)
 - 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). (1½)
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 Companies Act, Section 94(4)(b)(iii) and would not be regarded as an independent non-executive director in terms of King IV and should therefore not be appointed. (1½)
 - The fact that he also has a 4% shareholding does not automatically exclude him unless the value of the shareholding is material to Rod Grind in which case his independence would be, or would at least be seen to be, impaired. (1½)
 - As a CA(SA) and former chairman of JayB Ltd, he is likely to have the necessary financial knowledge and experience. He is already a non-executive director, it is only his independent status which is in question. (1½)

Comments:

With this question, you had to incorporate your knowledge of the Companies Act as well as the King IV Report.

Topic 1 being Corporate Governance will count between 20% and 30% of your final examination. Thus, please ensure that you spend adequate time on studying this topic.

Topic 2 Internal Control

Feedback on supplementary Do questions on Topic 2

QUESTION NUMBER 4.18 IN GRADED QUESTIONS

12 marks

Reference: Jackson & Stent (2016: 5/5-5/18)

Components of internal controls and types of control activities:

Nr.	Component of internal control	Category (types) of control activity
1.	Monitoring of controls (1½)	
2.	Control Activities (1½)	Access/Custody Control (1½)
3.	Control Activities (1½)	Division of Duties and Isolation of Responsibility (signing) (1½)
4.	Control Activities (1½)	Division of Duties and Approval/Authorisation AND Isolation of Responsibility (1½)
5.	Control Activities (1½)	Custody Control (over bank account) OR Division of Duties (approve and release) AND Approval Authorisation (1½)
6.	Control Activities (1½)	Comparison and Reconciliation (1½)
7.	Risk Assessment (1½)	
8.	Control Activities (1½)	Access control AND Isolation of Responsibility (to the senior admin clerk) (1½)
9.	Control Environment (1½) (Human Resource Policies and Practices)	
10.	Information System (1½) (relevant to financial reporting)	

Comments:

To be able to answer this question, you need to know the different components of internal control as well as the different categories of control activities.

This question has been provided to test your understanding of the theory specifically relating to internal control components in topic 2. You should be able to apply the theory to scenario.

Remember that it is very important for you to have a good understanding of this foundational knowledge, as it will prepare you for later studies in auditing.

QUESTION 4.29 (b) IN GRADED QUESTIONS**31 marks****Reference:** Jackson & Stent (2016: 5/5-5/18)**Weaknesses in the general controls:****1. Control environment**

1. A sound control environment is very important in a computerised environment and management should be control orientated in their attitude and the example they set.

This does not appear to be the case at The Chairman (Pty) Ltd

- 1.1 The management style at the company is “very relaxed”. (1½)
- 1.2 The IT department reports to Peter Breedts but he does not “manage” the department, leaving this up to Michael Morgan. The IT department can thus do what it likes. (1½)

2. A sound security policy enhances the control environment.

- 2.1 However, The Chairman (Pty) Ltd does not appear to apply even the most fundamental requirement: that of least privilege (see access control – logical). (1½)

2. Organisation Structure

1. The organisation structure of the IT department within itself and in relation to other departments should
 - Establish clear reporting lines/levels of authority **and**
 - Lay the foundation for segregation of duties to enhance the control environment.

This has not been achieved at The Chairman (Pty) Ltd:

- 1.1 There is no steering committee to oversee computer matters. (1½)
- 1.2 IT has no representation on the board of directors. (1½)
- 1.3 The IT department reports to a user department manager. (1½)
- 1.4 There appears to be no clear segregation of duties in the IT department with IT staff assisting each other with their duties on a day to day basis e.g. no split between development/programming and technical etc. (1½)
- 1.5 Little attention appears to be paid to security, a very important aspect of computing. (1½)

3. Access control – physical

1. Although access to the computer room is controlled by a keypad and code, it is a very ineffective method as in practice anyone can gain access at any time. This places the computer facility at risk. (1½)
2. The code is:
 - 2.1 A general code; a code/password should only be given to those who require access to the facility and that code/password should be unique to that individual. (1½)
 - 2.2 Far too simple and will become known very quickly to all staff members. (1½)

3. There should be no (physical) general access points to the system as this increases the risk of unauthorized access.

4. Access controls – logical

1. Access onto the system and into the applications is totally inadequate and increases the risk of unauthorized access, destruction of data, breaches of confidentiality and the introduction of virus contamination. (1½)
2. As the system can be accessed by simply plugging in any computer from one of the spare access points, there can be no terminal identification controls – i.e. the system does not check that the computer is authorised to be on the system. (1½)
3. As there is no user identification (terminal/user) required it would appear that appropriate access tables, which define all authorised terminals, users, programmes etc, are not in use. (1½)
 - 3.1 Thus user and terminal profiles cannot be set up ...
 - to control access to applications, modules etc. (1½)
 - to allocate access, e.g. read only, read write. (1½)
4. The “password” control is ineffective. (1½)
 - 4.1 Passwords are not unique to individual staff members (there should be no group passwords, e.g. departmental passwords). (1½)
 - 4.2 The existing passwords are not random, as they are made up on a fixed basis (department head first name and surname, initial). (1½)
 - 4.3 This combined with 2 and 3 above means that virtually all employees (and others) will have access to all applications from any department/terminal. (1½)

5. Continuity of Operations

1. The fact that the company does not have a documented disaster recovery plan, places the company at risk. (1½)

The reasons given for this do not justify the decision.

- 1.1 A disaster can strike at any time. Because they have not suffered one previously appears to be good fortune.
- 1.2 Whilst insuring against disaster is a necessary precaution, it does not prevent disaster and does not cover the problems, which will be consequential to the disaster, e.g. loss of information/data that can never be recovered.
2. Without a disaster recovery plan, staff will not know what to do, what to prioritise, where to obtain back up data or how to proceed with important processing tasks. (1½)
3. If the company has no recovery plan it is most unlikely that they have adequate back-up strategies. (1½)

Note: You may also raise the (apparent lack of) competence of the IT manager as a weakness (personnel practices).

Comments:

Notice that some of the points raised above did not receive any marks. These comments are internal controls that should be in place and was included for completeness and as explanations for the identified weaknesses.

Topic 4 Revenue and Receipts Cycle

Feedback on supplementary Do questions on Topic 4

QUESTION NUMBER 8.2 IN GRADED QUESTIONS**15 marks**

Reference: Jackson & Stent (2016: 10/2-10/5)

Functions in the revenue and receipts cycle

1. Credit management. (1)
2. Order Department (receiving customer orders and sales authorization). (1)
3. Warehousing. (1)
4. Despatch. (1)
5. Despatch. (1)
6. Credit management. (1)
7. Despatch. (1)
8. Recording of Sales. (1)
9. Invoicing. (1)
10. Mailroom receipting/cashier. (1)
11. Goods returned function. (1)
12. Ordering department (or warehousing). (1)
13. Credit management. (1)
14. Invoicing. (1)
15. Warehousing. (1)

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 (2016: 10/2-10/5; 10/10-10/19)

QUESTION 8.9 IN GRADED QUESTIONS**33 marks**

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

Internal controls of various functions in the revenue and receipts cycle**1. Receiving customer orders**

1. Marcia Oliver should be responsible for receiving all customer orders i.e. customers arriving to place orders should be attended to by her, phone orders should be put through to her and faxed/posted orders handed to her. (1½)
2. All orders should be recorded on pre-printed, sequenced, multi-copy internal sales orders. (1½)
3. The ISO should be designed to enhance accuracy of recording e.g. the codes and descriptions of the fifteen lines of bricks sold by Stonebrix (Pty) Ltd should be shown on the ISO. Each line should have a space in which the quantity ordered and price can be entered by Marcia Oliver. (1½)
4. Marcia Oliver should have a list of approved customers and their account numbers and a price list. (1½)
 - 4.1 She should also be given a copy of the “daily stock report” every morning. This will enable her to check stock availability when an order is placed. (1½)
5. On receiving an order (by whatever means), Marcia Oliver should confirm that the contractor placing the order is on the approved customer list. If not, the customer must be referred to Preggs Naidoo, the credit controller. No ISO will be made out for non-approved customers. (1½)
 - 5.1 She should also check the “daily stock report” and inform the customer accordingly. If the customer wishes to be placed on “backorder” Marcia Oliver should note this in a back order register. (1½)
6. Where a contractor’s employee comes in personally to place the order, he should check all the details recorded on the ISO (e.g. contractor name, contact details, delivery address, description and quantity of bricks ordered). Where possible a customer order reference should be entered but in any event, the contractor’s employee should sign the ISO as authority for the order. (1½)
7. Where the order is taken over the phone, Marcia Oliver should confirm all order details, (as in 6 above) by reading back to the customer placing the order. Marcia Oliver must insist upon a customer order reference or identification of the person placing the order. (1½)
8. Any faxed or posted orders should be attached to copy 3 of the ISO (see below) once the ISO has been completed by Marcia Oliver. (1½)

9. Marcia Oliver should make out the ISO in triplicate, and once she is satisfied that it is accurate and complete, she should sign it. (1½)
10. The ultimate distribution of the ISOs will be
 - 10.1 Copy 1 – sent to Preggs Naidoo for sales authorization, and then to Bridge Zuma
 - 10.2 Copy 2 – sent to Petra Petersen in accounting
 - 10.3 Copy 3 – to be filed numerically and to remain with Marcia Oliver. (1½)
11. At a later stage, a copy of the despatch note should be sent to Marcia Oliver. She should match the despatch note to its ISO and follow up on any ISOs which have not resulted in dispatches. (1½)

Note: This control is also carried out by Petra Peterson (see invoicing) but for a slightly different reason. As orders are placed with Marcia Oliver, it is a good idea to keep her informed as customers will probably phone her to enquire about the status of their order.

12. She should also regularly check on the status of backorders, notifying the customer as soon as an order can be filled. (1½)

2. Sales authorisation

1. On receiving the ISOs, Preggs Naidoo should confirm by reference to the contractor's (debtor) account and information file that the contractor is not in breach of his credit limits and terms and will not be put in such a position if the contractors order is processed. (1½)
 - 1.1 If the contractors' terms/limits will be exceeded, Preggs Naidoo should contact the contractor to resolve the issue. (1½)
2. If the creditworthiness issue cannot be resolved to the satisfaction of Preggs Naidoo (who should have some discretionary powers) and John Stone, the order should go no further. (1½)
3. If Preggs Naidoo is satisfied with the creditworthiness of the customer, he should authorize the sale by signing and dating the ISO. (1½)
 - 3.1 Any ISOs which he does not authorize, should be filed and retained by Preggs Naidoo and followed up as the situation develops, e.g. the contractor pays his account. (1½)
4. The authorised ISOs should be returned to Marcia Oliver and an authorised copy of the ISO should be handed (brickyard controller) to Bridge Zuma for processing. (1½)
5. Where a potential customer is referred to Preggs Naidoo, credit application procedures should be carried out. (1½)
 - 5.1 A credit application form must be completed by the contractor. Banking details, trade reference, financial information, etc should be provided. (1½)
 - 5.2 Preggs Naidoo should follow up by contacting trade references, credit bureaux to the extent that he requires to assess the creditworthiness of the contractor. (1½)
 - 5.3 Preggs Naidoo should set the terms and limits for the contractor and have them approved by John Stone or Shannon Green. (1½)

3. Brickyard and Despatch

1. On receipt of the authorised ISO, Bridge Zuma should initiate the processing of the order by making out a pre-printed, numerically sequenced, multipart despatch note as per the details of the ISO, including a cross reference to the ISO number.

Copy 1 and 2 – to accompany the delivery

Copy 3 – to remain with Bridge Zuma filed in numerical order with the corresponding ISO.

Copy 4 – sent to Marcia Oliver for matching to ISO. (1½)

2. Bridge Zuma and the driver transporting the delivery, should supervise the loading of the truck. On completion, the driver should sign copy 3 of the despatch note (or notes if he is making more than one delivery) to acknowledge that he has taken responsibility for the bricks. (1½)
3. As indicated, copy 1 and 2 of the despatch note should be taken by the driver. When the driver leaves the premises, the security guard should check the load on the truck and agree it to the despatch notes. These should be stamped/signed by the guard to acknowledge the procedure has been carried out. (1½)
4. On delivery, both copies of the despatch note should be signed by the contractor to acknowledge the delivery. The driver should also sign both copies. (1½)
 - 4.1 Copy 1 of the despatch note should be kept by the customer.
 - 4.2 Copy 2 should be retained by the driver as proof of delivery. (1½)
5. On returning to the brickyard, the driver should pass copy 2 of the despatch note to Petra Peterson (the bookkeeper). (1½)

Note: A further control which could be implemented is the introduction of a delivery list to be drawn up by Bridge Zuma for the driver. This is usually only necessary when drivers are making numerous deliveries each time they go out. This is unlikely when delivering bricks.

4. Invoicing

1. On receipt of the despatch note from the driver, Petra Peterson should match it to her copy of the ISO sent to her by Marcia Oliver and agree the details. (1½)
2. Once ISOs have been matched to despatch notes, they should be removed from their temporary file and filed with the despatch note in the numerical sequence of the despatch notes. (1½)
 - 2.1 Before creating invoices, Petra Peterson should sequence check the despatch notes and follow up on any missing numbers. (1½)
3. Petra Peterson should timeously complete a pre-printed, numerically sequenced, multi-part invoice. (1½) She should
 - 3.1 Agree the details on the ISO and despatch notes (as above) including the details of the customer per the debtors' ledger. (1½)
 - 3.2 Confirm prices quoted to the customer against the official price list. (1½)
 - 3.3 Cross-reference the invoice to the despatch note. (1½)
 - 3.4 Sign the invoice. (1½)

4. Carmen Twitty (or Marcia Oliver) should check the invoices prepared by Petra Peterson to confirm
 - 4.1 Prices, extensions, casts, VAT calculations, are correct. (1½)
 - 4.2 Invoices are cross-referenced to the despatch notes and that all despatch notes have resulted in an invoice. (This can be done by cross-referencing the sequentially filed despatch notes held by Bridge Zuma to the invoices). (1½)
5. The invoices should be used as follows:

Copy 1 – sent to the customer.
 Copy 2 – filed alphabetically with the corresponding ISO and despatch note.
 Copy 3 – filed numerically and used by Petra Peterson to write up the sales journal. (1½)
6. On a frequent and regular basis, Petra Peterson should follow up on any (non-recent) ISOs held in her temporary ISO file to determine why no matching despatch note has been received. (1½)
7. Every month Shannon Green should sequence check the file of invoices and the sales journal for breaks in sequence. (1½)

Comments:

Did you notice how the solution used the information provided in the scenario and did not just copy and paste from the text book. The text book is there to provide the basis from which you should work, but if you understand the concepts and how the internal controls work, you can apply this theory to almost any scenario.

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

QUESTION 8.13 IN GRADED QUESTIONS**30 marks**

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

Weaknesses and explanations in the receiving of orders function:

No.	Weakness	Explanation
1.	An inventory availability check is not done prior to accepting an order. (1½)	- As customers will not be informed of inventory availability problems: * back-orders may not be initiated, resulting in lost sales. (1½) * goodwill will be eroded as Quik Tyre (Pty) Ltd bases its marketing on quick delivery. (1½)
2.	Customers are not required to quote a buying reference number when placing orders. (1½)	- Customers may reject deliveries on the basis that: * they do not know to which order the delivery relates (1½) or * that they did not place the order. (1½)

No.	Weakness	Explanation
3.	Donny Lopez does not confirm: * customer details, e.g delivery addresses, when customer details appear. * customer order details once the order is placed (i.e. code and quantity). (1½)	- Failure to confirm customer and order details may result in: * deliveries to incorrect addresses. (1½) * incorrect invoicing. (1½) * incorrect goods being supplied (type and quantity). (1½)
4.	The software does not automatically link the tyre code with the description when the tyre code is entered. (1½) (minimum entry principle)	- Having to enter the tyre code and description may result in Donny Lopez inserting an incorrect description next to the tyre code. This may result in confusion/delay/incorrect deliveries when the tyres are picked for delivery. (1½)
5.	Controls over the log of overrides are inadequate: * there should be no write access at all to the log. (1½) * the financial accountant does not have read access. (1½) * the file is not reviewed on a daily basis by Gene Kelly. (1½)	- The object of having a computer generated log is to provide an independent and unalterable record of what activity has taken place on the system for review purposes. Donny Lopez can conceal any overrides which are invalidly given by deleting them from the file thus negating the control. (1½) - The financial accountant is unable to make an independent check on the reasons for overriding an important control. (1½) - Donny Lopez may regularly override the “in arrears” control without justification and without the knowledge of his superiors. (1½) Note: All the above may result in increased bad debt write-offs.
6.	The control over extension of credit to customers is very weak: * there is no follow up on the application for credit (even the references). (1½) * no credit limits or terms are set. (1½) * Donny Lopez, in effect, is also able to extend credit. (1½)	- Before granting credit, Gene Kelly should evaluate the creditworthiness of the proposed customer (1½) by: * at least following up with the trade references provided or with a credit bureau. (1½) - Simply determining whether all information requested has been provided is completely worthless unless it is verified. (1½) - The idea behind carrying out the creditworthiness evaluation is to decide on the appropriate credit terms and limits which can be granted to the proposed customer to prevent losses from the customer not paying amounts owed. As this does not happen, a customer can

No.	Weakness	Explanation
		<p>make unlimited purchases. (1½)</p> <ul style="list-style-type: none"> - As Donny Lopez can override the “arrears” control he is actually able to extend credit to a customer by allowing the customer to make purchases despite being in arrear. (The “in arrear” control is designed to control the granting of excessive credit.) (1½)
7.	<p>Control over masterfile amendments is inadequate as there is a total lack of division of duties for approving and recording masterfile amendments and the fact that Donny Lopez can also authorise and process credit notes: (1½)</p> <ul style="list-style-type: none"> * Donny Lopez has access to the masterfile amendment module and initiates orders and can extend credit. (1½) * No sequenced masterfile amendment form is made out, checked and authorised, to support the approved credit applications. (1½) * The log of masterfile amendments is not reviewed and tied back to supporting documentation by an independent person. (1½) 	<ul style="list-style-type: none"> - As Donny Lopez has access to debtors masterfile, he is able to "create" new debtors accounts which: <ul style="list-style-type: none"> * have not been subjected to any creditworthiness controls or been “approved” by Gene Kelly. (1½) * These “debtors” could be completely fictitious e.g. to obtain free tyres for himself or a friend. Once tyres have been obtained, he could simply pass a credit note to reduce the amount owing in the masterfile to nil. (1½) - As the MAF’s are not checked and approved by an independent person: <ul style="list-style-type: none"> * inaccurate and incomplete details may be captured resulting in problems later in the cycle e.g. invoices incorrectly addressed. (1½) * Gene Kelly can easily initiate the addition of fictitious or non-creditworthy debtors to the masterfile. (1½) - As the log is not tied back to sequenced MAF’s it is not possible to establish: <ul style="list-style-type: none"> * whether all amendments have been made accurately. (1½) * only authorised amendments have been made. (1½) * all approved amendments have been entered. (1½)

Comments:

This question asked you to identify and explain weaknesses in the revenue and receipts cycle.

The solution covers all weaknesses identified for each of the relevant phases (e.g. Processing of orders) in the revenue and receipts cycle and then provides an explanation of why the activity is identified as a weakness.

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. Thus the application of the theory

to a scenario is a skill that you must acquire as it will be of benefit to you in your later 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. If you understand the “how and why” of internal controls you should not have a problem identifying where the weaknesses are.

Topic 5 Acquisitions and Payments Cycle

Feedback on supplementary Do questions on Topic 5

QUESTION 10.3 IN GRADED QUESTIONS

12 marks

Reference: Jackson & Stent (2016: 8/7, 8/26)

General and applicaion controls in the acquisitions and payments cycle:

1. Application control. (1)
2. General control. (1)
3. Application control. (1)
4. General control. (1)
5. Application control. (1)
6. General control. (1)
7. General control. (1)
8. Application control. (1)
9. General control. (1)
10. Application control. (1)
11. Application control. (1)
12. Application control. (1)

Comments:

The internal controls are from the acquisitions and payments cycle (Topic 5), but without the foundation laid in Topic 2, you would not have been able to answer this question. It is important to realise that the topics of this module should not be viewed in isolation. Most of the principles in Topic 2 and 3 are applied in each of the business cycles.

QUESTION 10.10 IN GRADED QUESTIONS**25 marks****Reference:** Jackson & Stent (2016: 11/9 – 11/13)**Weaknesse and explanations in the payments function:****Weakness 1**

The invoices received from suppliers are not matched to any other documents e.g. internal order, supplier delivery note or goods received note. (1½)

Explanation:

Delmundo (Pty) Ltd could be paying for goods which were:

- 1.1 never ordered or never delivered; (1½) OR
- 1.2 incorrect in terms of description, quantity or price. (1½)

Weakness 2

Before the invoice is paid (goods paid for) 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). (1½)

Explanation:

If nobody checks the above, the risk that employees are purchasing goods for themselves and having the company pay, is significantly increased. (1½)

Weakness 3

The full amount as reflected on the statement is paid, even where no invoice has been received. This problem is increased by the fact that nobody seems to follow up on whether an invoice was subsequently received. (1½)

Explanation:

Delmundo (Pty) Ltd may be paying for goods incorrectly charged to them. (1½)

Weakness 4

No checks are carried out on the casts, extentions, calculations and VAT on the purchase invoice. (1½)

Explanation:

This may result in inaccurate payments and under recovery of VAT. (1½)

Weakness 5

No creditors' ledger appears to be maintained. (1½)

Explanation:

- 5.1 Creditors are paid on the strength of an external document only. By having a creditors ledger (properly controlled and written up) a more accurate record of purchases and payments (and related adjustments) is maintained. (1½)
- 5.2 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. (1½)

Weakness 6

There is insufficient control over payments made by EFT. The company's bank account is inadequately protected. (1½)

Explanation:

- 6.1 In effect there is only one “signature” required to access the company’s bank account and transfer funds, i.e. Mary Roosevelt. (1½)
EFT payments should be controlled by strong segregation of duties, particularly the authorisation and release functions. The ability to add a beneficiary should be highly controlled, made only on the strength of approval from a senior member of staff after careful scrutiny of supporting documentation including written confirmation of the new beneficiaries banking details. (1½)
- 6.2 EFTs are made without supporting documentation and can be made by Mary Roosevelt at any time and for any amount. (1½)
- 6.3 The fact that Stella Stirling carries out on screen random tests is no control at all. The transfer can be made whether she is there or not. Mary Roosevelt could be making absolutely sure that every payment on the list of creditors is correctly paid (and have Stella Stirling check every single payment in detail but still be making fictitious payments to herself or others). (1½)
- 6.4 Making fictitious payments is made even easier for Mary Roosevelt because she creates and maintains bank details etc for payees. (1½)
- 6.5 Furthermore nobody at any stage (before or after the payment) checks whether payments to creditors or others are valid. (1½)
- 6.6 The fact that EFT is only available from Mary Roosevelt’s terminal and that she is the only one with access is positive but in this situation ineffective in preventing invalid payments. (1½)

Weakness 7

Review procedures by more senior employees appear to be non-existent, which amounts to a lack of detective controls and a weak control environment. (1½)

Explanation:

- 7.1 There appears to be no review of the cashbook/reconciliation carried out by “management”. Dean Ramjan is “solely” responsible for maintaining the cashbook. With no independent review of his work, he has the opportunity to cover up misappropriation, particularly if he is colluding with another member(s) of the accounting department. (1½)
- 7.2 There is no review of EFT payments made (by anyone). This simple control provides an opportunity for an (independent) senior employee to pick up payments that look suspicious (e.g. strange payee, or strange amount). (1½)

Note: This would be a useful review for John de Marzo to carry out, to keep him informed of who is actually being paid and to improve the control environment.

Weakness 8

Almost total lack of involvement of senior personnel/owner. (1½)

Explanation:

With such a small staff, and a lack of basic controls, the owner/senior management should be playing an active role e.g. second “signatory” on EFT, reviewing supporting documentation etc. The lack of this involvement weakens the control environment considerably and facilitates fraud and collusion. (1½)

Comments:

This question covers various areas of the acquisitions and payments cycle. It is a good question to test your knowledge and understanding of this cycle.

This question asked you to identify and explain weaknesses in the acquisitions and payments cycle.

The solution covers all weaknesses identified for each of the relevant phases (e.g. Processing of orders) in the revenue and receipts cycle and then provides an explanation of why the activity is identified as a weakness.

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. Thus the application of the theory to a scenario is a skill that you must acquire as it will be of benefit to you in your later 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. If you understand the “how and why” of internal controls you should not have a problem identifying where the weaknesses are.

QUESTION 10.13(b, c, d) IN GRADED QUESTIONS**40 marks**

Reference: Jackson & Stent (2016: 8/16 – 8/22 and 11/16 – 11/18)

(b) Risks of unauthorised access to data and programmes

1. The risk of unauthorised access in a networked environment increases because:
 - 1.1 the computer equipment (terminals/workstations/servers) are “geographically” spread out making **physical** access to the system far more difficult to control, e.g. LAN’s do not make use of terminal rooms which can be physically secured to prevent unauthorised access. (1½)
 - 1.2 in a network resources are shared by many users. Thus there are many “points of entry” or “links” to data and programs through which unauthorised entry can be gained resulting in an increased risk of manipulation, destruction or theft of data. (1½)

(c) Valid, accurate and complete additions to the approved supplier masterfile.

Validity (occurrence and authorization)

1. Amendments should only be made on the strength of pre-printed, sequenced masterfile amendment forms (MAF). (1½)
2. Every MAF should be signed by two senior employees after scrutiny of the supporting documentation arising from the approval process. (1½)
3. Write access to the approved supplier masterfile should be restricted to a designated employee independent of the buying department, by means of user profiles/password. (1½)
Note: access could be restricted to a designated terminal but is more commonly achieved through attaching privileges to the employee.

4. The computer should record all masterfile amendments on sequenced logs (no write access to the file). (1½)
5. The logs should be regularly (and frequently) reviewed by the senior buyer and Bernard Bunz. Both should only have read access. (1½)
Logs should be:
 - 5.1 sequence checked (validity and completeness) (1½) **and**
 - 5.2 matched to supporting documentation for authorisation. (1½)

Accuracy and Completeness

1. Program controls should be used to ensure the accurate and complete entry of data from the masterfile amendment (1½):
 - 1.1 mandatory field, e.g. MAF reference number (1½)
 - 1.2 alphanumeric check e.g. on postal code (1½)
 - 1.3 screen formatting and dialogue (1½)
 - 1.4 sequence test on last MAF entered (1½)
 - 1.5 automatic generation of new supplier account number. (1½)
2. When logs are reviewed the details of the amendment should also be checked for accuracy against the supporting documentation. (1½)
3. Write access to the approved supplier masterfile should be restricted to a designated employee independent of the buying department, by means of user profiles/password. Note: access could be restricted to a designated terminal but is more commonly achieved through attaching privileges to the employee. (1½)
4. The computer should record all masterfile amendments on sequenced logs (no write access to the file). (1½)
5. The logs should be regularly (and frequently) reviewed by the senior buyer and Bernard Bunz. Both should only have read access. (1½)
Logs should be:
 - 5.1 sequence checked (validity and completeness) (1½) **and**
 - 5.2 matched to supporting documentation for authorisation. (1½)

(d) Manual and program application controls for receiving of deliveries function

I would expect the following controls to be in place:

1. Access controls
 - 1.1 write access to the "receiving goods module" restricted to the 3 receiving bay clerks by user IDs, passwords linked to user profiles. (1½)
 - 1.2 access to the receiving goods module restricted to the terminal in the receiving bay. (1½)
 - 1.3 receiving clerks would not have write access which would enable them to change details on the "on screen" GRN e.g. add an item ordered. (1½)
2. Valid orders only
 - 2.1 only goods for which there is a valid purchase order should be accepted. Receiving clerk to enter the purchase order number for the delivery (taken from the supplier delivery note). If no number is entered or an incorrect number is entered no purchase order details will appear on the screen and the receiving clerk will not be able to

compile a goods received note. (Receiving clerks will be under strict instructions not to accept deliveries for which there is no purchase order.) (1½)

- 2.2 this is a matching/validation control; the system matches the purchase order entered to the file of purchase orders on the system. If there is a match the screen will come up formatted as a GRN. (1½)

3. Isolation of responsibility

- 3.1 isolating which of the three receiving clerks received the delivery can be achieved by the system

- logging the user ID of the receiving clerk accessing the "receiving goods module" to enter the purchase order number. (1½)
- having the receiving clerk sign the hard copy GRN he produces to accompany the goods to quality check. (1½)

4. Accepting the correct goods (quantity and description)

- 4.1 the receiving clerk will count the goods and compare what has been delivered to the suppliers delivery note and purchase order. (1½)

- items not on the purchase order should not be accepted. (1½)
- short deliveries accepted over deliveries rejected. (1½)
- all discrepancies should be noted on the supplier delivery note and acknowledged by both the receiving clerk and the suppliers delivery personnel. (1½)

5. Compiling the GRN accurately and completely

- 5.1 screen formatting and minimum entry. On entering a valid PO number the screen should come up formatted as a GRN and all fields should be populated. (1½)

- 5.2 receiving clerk should have write access to only the quantity field and a field to record the supplier delivery note number. This will prevent alterations to the goods ordered. (1½)

- 5.3 alphanumeric check on the quantity field (must be numeric), and the quantity field would be mandatory. Supplier delivery note number could also be mandatory. (1½)

- 5.4 screen dialogue if say, quantity field entered differs from quantity field on the system. (1½)

Comments:

Masterfiles contains semi-permanent and permanent information. It is therefore of the utmost importance that access and changes to the masterfile be strictly controlled.

For questions (c) and (d), the assertions were provided. Unless the question specifically asks you to provide these headings, or asks you to only provide internal controls for a specific assertion, you need not present your answer in such a manner. It was provided in order to give additional information and create an opportunity for you to learn.

Topic 6 Inventory and Production Cycle

Feedback on supplementary Do questions on Topic 6

QUESTION 11.1(a,d) IN GRADED QUESTIONS**9 marks****References:** Jackson & Stent (2016: 12/4 – 12/5 and 12/3 – 12/4)**(a) Documents used in the cycle and use thereof**

1. Picking slip - used to identify the goods which must be selected (picked) from the stores to make up an order from a customer. (1½)
2. Inventory adjustment form - used to record adjustments which must be made to correct the perpetual inventory records when actual inventory and theoretical inventory do not agree. (1½)
3. Transfer to finished goods note - used to record the movement of manufactured items from the manufacturing department to the finished goods store. (1½)
4. Clock cards - as this is a manufacturing company, the items manufactured will have to be costed. The clock cards may be used as a basis for allocating the labour charge. (1½)
5. Job card - a job card is used to track the stages of manufacture for specific job and record costs, e.g. wages, materials incurred during each stage. (1½)

(d) Objectives of the internal controls of the inventory and production cycle:

1. Control of physical transfer of inventory (in its various forms). (1½)
2. Protection of the inventory (in its various forms) from damage, loss or theft. (1½)
3. Proper planning, controlling and recording of the costs of manufacture. (1½)

Comments:

You need to know the specific documents used in each cycle as each document are specific for each function on each cycle. Remember, “post-its” are also documents, but obviously not acceptable as an internal control document. Therefore, make sure you know your documents. If it is not documented, there is no audit trail and no proof that transactions occurred.

QUESTION NUMBER 11.8 (b) IN GRADED QUESTIONS**20 marks****References:** Jackson & Stent (2016: 5/7 – 5/17 & 12/6 – 12/10)**Weaknesses and recommendations (internal controls) in the production cycle****Weakness 1**

There is a lack of suitable documentation to initiate production i.e. no “production order”, “job card” or similar document. (1½)

Recommendation:

- 1.1 Pre-printed, sequenced multi-part production orders should be introduced. (1½)

- 1.2 Once sales/marketing have notified the production manager of what is required, he should compile and sign a production order for **each** technician to complete a specific job, e.g. manufacture 25 surveillance cameras. (1½)
- 1.3 The production order should list every component required to construct the item to be manufactured. (1½)
- 1.4 The production order should be distributed as follows:
 - copy 1 – to the technician (1½)
 - copy 2 – to the component warehouse (1½)
 - copy 3 – to foreman/production office (1½)
 - (a fourth copy could be sent to the finished goods store). (1½)

Weakness 2

There are inadequate custody controls over component inventory, e.g. technicians enter the warehouse and select the items they require. The responsibility for custody of inventory is not isolated to a warehousing section; this increases the risk of all kinds of inventory losses. (1½)

Recommendation:

- 2.1 A component warehouse store man should be appointed. (1½)
- 2.2 Technicians and other employees should not be given access to the component store, and physical access controls should be introduced as necessary. (1½)

Weakness 3

- 3.1 No isolation of responsibility for inventory movement. There is no documentation to control the requisitioning or issue of components. (1½)
- 3.2 There is no documentation to control the transfer of completed units to the finished goods store. (1½)

Recommendation:

- 3.1 When the technician requires components he should complete and sign a two-part, pre-printed, sequenced component requisition. (1½)
- 3.2 This document should be cross-referenced to the production order, for which the components are required. (1½)
- 3.3 The technician should detail the components required as per the production order and sign the requisition. (1½)
- 3.4 On receipt of the requisition, the component warehouse store man should:
 - confirm, by reference to his copy of the production order that the components requisitioned are included on the production order (valid). (1½)
 - make out and sign a two-part, pre-printed, sequenced component issue note detailing what is being issued (quantity and description) and cross-reference it to the component requisition. (1½)
- 3.5 On taking the components, the technician should check what he is accepting and sign the component issue note to acknowledge receipt thereof. (1½)
- 3.6 Component requisition and component issue notes should be filed together by numerical sequence (issue note). (1½)

- 3.7 On completion of a batch of units, the technician should complete and sign a two-part “finished goods transfer form”, a pre-printed sequenced document, detailing the quantity and description of items completed and cross-referencing it to the relevant production order. (1½)
- 3.8 Both copies of the transfer document should accompany the goods to the finished goods warehouse where the warehouse clerk should
- check what is being received against the transfer document and (1½)
 - sign both copies (1½)

Weakness 4

No perpetual inventory records for either components or finished goods are kept. This weakens control over inventory. (1½)

Recommendation:

- 4.1 A perpetual inventory system should be introduced. It should be kept up to date by recording movement of both components and finished goods from the documents introduced into the system as above (as well as purchase and sale documentation). (1½)
- 4.2 Regular cycle counts should be conducted and discrepancies followed up timeously. (1½)
- 4.3 The perpetual inventory records should be written up by the accounting department, or someone independent of the custody of inventory. (1½)

(1½ for each valid comment to a maximum of 20 marks)

Comments:

This question asked you to identify the weaknesses in those aspects of the production cycle and for each weakness make suitable recommendations for improvement. Take note of the layout of the solution as the recommendations follow directly after the weakness is described. Also the required made it clear that you do not have to concern yourself with the costing of manufactured items. Please do not waste time by dealing with this issue as it will waste time and not earn you marks.

QUESTION NUMBER 11.12 (d) IN GRADED QUESTIONS

20 marks

References: Jackson & Stent (2016: 12/11 – 12/12)

(d) Memorandum on cycle counts

MEMORANDUM

From: Joe Tick
Auditor-in-charge

To: Ruud van Bakkem
Warehouse Manager
Flower Power (Pty) Ltd

Date: XX XX 2018

Re: Cycle counts

As a result of our discussion concerning the introduction of cycle counts, I have detailed the following:

1. Planning

1.1 Scheduling of the counts

During April (i.e. as soon as possible) you should schedule the timing of each cycle count to be conducted for the year, e.g. you may decide that counts take place every second Friday or at the end of every third month. (1½)

The frequency of the counts will depend upon the resources you have available (e.g. counters) and the extent to which you wish to strengthen internal control. It is a “cost/benefit” decision. (1½)

Care should be taken to minimise movements of inventory taking place during the count, e.g. cycle counts should be planned for weekends or after hours. (1½)

1.2 Items to be counted

You will need to identify which items are going to be counted at each count. There are numerous ways of doing this:

- Items for each count may be selected on a random basis from the perpetual inventory . (1½)
- High value items may be selected. (1½)
- Categories of items e.g. lawnmowers, pumps, may be selected (1½) or
- The entire inventory population could be divided into sections so that all. (1½)
- Items are counted at regular intervals during the year. (1½)

However, as your major concern is theft, you should identify those items most susceptible to theft and concentrate on regular counts thereof. (1½)

1.3 Method of counting

There are several methods of counting which are acceptable but the method which you adopt for your year-end inventory counts is appropriate and should be used. (1½)

1.4 Personnel

You will need to plan how count teams are made up. Staff members independent of the inventory function must be included and a count supervisor must be appointed. We recommend that this supervisory function should be performed by Sheik Mashaba. (1½)

1.5 Stationery

Pre-printed sequenced inventory sheets will have to be produced for each cycle count. They can be produced by the computer system but will depend upon how you decide to select your items for counting. (1½)

Cycle count inventory adjustment forms (pre-printed, sequenced) will also be required, and should be designed to clearly identify the cycle count to which they refer e.g. by date and warehouse area. (1½)

1.6 Written instructions

Prior to each cycle count, information and instructions should be provided to all employees directly or indirectly in the count, e.g. responsibilities, date, time, items to be counted. (1½)

2. Discrepancies

- 2.1 Where the actual number of items differs from the quantity reflected in the perpetual inventory records, the discrepancy must be recorded on a sequenced "inventory adjustment form". (1½)
- 2.2 All discrepancies should be thoroughly investigated by your warehouse controller and someone independent of the warehousing function. The newly appointed internal auditor would satisfy this requirement. (1½)
- 2.3 The results of the investigation should be:
 - Recorded on the inventory adjustment form (1½) which in turn should be
 - Reviewed and signed (authorized) by you (Ruud van Bekkem). (1½)
- 2.4 Adjustments to the perpetual inventory should be made promptly and should be subjected to the controls over masterfile amendments which are currently in place. (1½)
- 2.5 Inventory adjustment forms should be filed numerically and regularly sequenced checked. (1½)
- 2.6 Periodically a sample of inventory adjustments made, should be extracted from the perpetual inventory records and traced to the inventory adjustment form, to confirm the validity of the adjustment to the records. (1½)
- 2.7 An ongoing analysis of discrepancies should be conducted to identify any trends. (1½)

3. How theft will be reduced

- 3.1 The use of cycle counts is a good example of one of the control activities associated with sound internal control, namely, frequent comparison and reconciliation of actual assets with theoretical assets. (1½)
- 3.2 Because discrepancies (including theft) are timeously identified and investigated, preventive measures can be put in place to reduce the possibility of the discrepancy occurring again, and there is a better chance of catching the perpetrator. (1½)
- 3.3 Once employees who are stealing, perceive that internal control has been strengthened and that the risk of being caught has increased, theft will decline. (1½)

If you have any further queries concerning cycle counts please contact me.

Comments:

There is a difference in cycle inventory counts and year-end inventory counts. This question specifically asked for information and controls of cycle inventory counts. Make sure you read the questions carefully, in order to not waste time and lose potential marks in an exam.

Topic 7 Payroll and Personnel Cycle

Feedback on supplementary Do questions on Topic 7

QUESTION 9.8(1) IN GRADED QUESTIONS

5 marks

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

1. Deepdiggers Ltd: Risks in the payroll and personnel cycle

1. Loss of production from strike action. (1)
2. IT risk. An IT “disaster” which directly affects the processing and payment of wages accurately and timeously. (1)
3. Health risks which threaten the wellbeing and efficiency of the workforce. (1)
4. Outbreaks in xenophobia leading to violence, death and injury to the workforce. (1)
5. Lack of trained and skilled mining personnel. (1)
6. Failure to comply with black economic empowerment and employment equity laws and regulations. (1)

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? For example, weaknesses or risks or internal controls.

In this question, you had to provide risks identified in the work force of Deepdiggers Ltd – thus risks in the payroll and personnel cycle.

Did you notice that the risks identified was not a memory dump? It was specific to the scenario provided. Even though the textbook provides a large volume of risks and internal controls, it is not comprehensive. However, it does teach you how to identify risks and determine appropriate internal controls.

QUESTION 9.9 IN GRADED QUESTIONS

45 marks

Reference: Jackson & Stent (2016: 13/9 – 13/28)

(a) and (b) Weaknesses, explanations and computerised internal controls in the payroll and personnel cycle

a) Weakness 1

The system as it stands presents a significant risk that wages and related accounts will contain a variety of errors. (1½)

Explanation: As the company still performs all aspects of the wage system manually, there is a far greater risk that errors will be made. Administration clerks are required to write names, employee numbers hours etc onto daily time sheets, payrolls and paypackets for 120 wage earners, select payrates, perform calculations etc. (1½)

b) Computerised: Payroll software would perform all of these functions (and others) far more efficiently and accurately, as it is designed with a whole range of programme checks to enhance accurate and complete input and processing e.g. minimum entry, alphanumeric checks etc, reducing manual intervention to a minimum. (1½)

a) Weakness 2

There is generally a poor control environment. (1½)

Explanation: The lack of control over most aspects of the cycle e.g. timekeeping (particularly overtime), payroll checking etc, suggests that the management of the company is not control focused. (1½)

b) Computerised: The control environment is determined by the attitude to and awareness of control of management. If this **attitude** does not change, the control environment will not improve. There is no obvious reason why management will become more control aware because the payroll is processed on a computer and not manually. In fact, if management do not understand the risks which come with computerization the control environment could deteriorate as management may think that the “computer will control everything!” (1½)

a) Weakness 3

There is no human resource department. (1½)

Explanation: A business with an hourly paid staff of 120 warrants an HR department which is responsible for all aspects of labour and which has the necessary expertise to deal with labour law, unions, hiring and dismissal/resignation. By not having an HR department, the company lays itself open to potential costly/disruptive labour problems. (1½)

b) Computerised: 1. A good payroll package will not be a substitute for a human resource section, but it will make such a section far more effective and efficient, which probably means fewer administration employees will be required.
2. Whilst employees with human resource expertise and skills will still be required, basic functions such as appointment/dismissal/resignation, employee record keeping e.g. employee masterfile, will be significantly enabled or enhanced. Specially designed human resource management software is widely available. (1½)

a) Weakness 4

The method of recording actual hours worked is totally inadequate and the company could end up paying wages for hours which were never worked, particularly overtime. (1½)

Explanation: 1. As no independent (supervised) clocking system is in place, an accurate record of when an employee started and stopped work is not available. (1½)
2. It is very simple for a section supervisor to “tick off” an absent employee as being at work and subsequently sharing the extra unearned wages with the employee (collusion). (1½)
3. Overtime is not authorised, the section supervisor is informed but no authority is granted by the factory foreman **before** it is worked. (1½)

4. Furthermore, as there is no means of actually recording the overtime worked, the employees could easily inflate the hours worked when they inform the section supervisor the following day. (1½)
5. As neither the foreman nor anybody else authorizes (or checks up on) the overtime hours **after** they have been credited to the employee,
 - * The section supervisor could easily add overtime hours to employees in his section (in collusion with the employee) (1½) **and**
 - * The administration clerks could do the same. (1½)
 The proceeds could then be shared with the employee.

b) Computerised: Computerisation can greatly enhance timekeeping. The use of biometric readers and magnetic strip card (tag) systems linked to physical access terminals and to the “accounting system” can control who enters the workplace and can record and download hours worked accurately and completely onto the system (no human intervention). (1½)
 Reports can be drawn off the system virtually immediately and hours worked (both normal and overtime) can be authorized on the system before any processing takes place. For example the foreman and factory manager could be required to authorize all hours worked, a control which would virtually eliminate fictitious hours/workers fraud. (NB no control is foolproof!) (1½)

a) Weakness 5

There is a significant lack of **division of duties** in respect of the procedures carried out by the admin clerks.

a) Weakness 6

Supervision/management checks are inadequate which facilitates fraud. (1½)

Explanation 5 & 6: The administration clerks:

1. Make up the payroll from records which they keep. (1½)
2. Have access to the cash (returned to them to make up the paypackets). (1½)
3. Conduct the payout. (1½)
4. As a result of 1 to 3, the wage clerks could easily misappropriate wages. (1½)
5. As neither the foreman nor the factory accountant review/check the payroll to source documents/records, the administration clerks can
 - * add fictitious employees to the payroll. (1½)
 - * use inflated wage rates for a particular employee and collude with that employee to share the “extra” wages. (1½)
6. As the clerks prepare the paypackets (unsupervised), they have easy access to the fictitious wages they have created. (1½)
7. As they conduct the wage payout (again unsupervised), there is little chance of the inclusion of fictitious employees being discovered. (1½)

b) Computerised 5 & 6:

1. Computerisation will address this problem very effectively and efficiently. A strong division of duties can be implemented by the use of user IDs, passwords and profiles which will control which employees have access, and which type of access, to which modules of the payroll system. For example, a supervisor, foreman or wage administration clerk will not be able to add a “fictitious” employee to the payroll as he will have no access to the employee masterfile amendment module. Access will be restricted to the human

resource section. In addition, if payment is made by EFT there will be no cash to steal. (1½)

2. With regard to the lack of supervisory/management checks, payroll software provides for management to carry out numerous “on screen” (convenient) reviews and authorizations. Logs and reports produced by the computer provide independent evidence for management of exactly what the computer has done, who did it, etc. (1½)

a) Weakness 7

No period-to-period wage reconciliation is prepared by the administration clerks (inadequate documentation). (1½)

Explanation: This document provides an explanation as to changes in the amount of wages paid from one week to the next and should be supported by authorised supporting documentation e.g. an increase in the number of staff should be supported by signed “Employee Engagement/Dismissal/Resignation Forms”. If this document was produced, the factory accountant and financial accountant could check the payroll properly before signing the wage cheque. This would reveal fictitious wages, incorrect rates, hours, etc. (1½)

b) Computerised: As indicated above, payroll software has the capacity to produce numerous reports, one of which is likely to be a period to period reconciliation and supporting information which makes review simple and efficient. (1½)

a) Weakness 8

The second signatory does not review supporting documentation before signing the wage cheque. (1½)

Explanation: Whilst the two signature principle is good, it is no use if both signatories do not check the supporting documentation carefully to confirm that the amount being drawn is valid and correct. In this situation the financial accountant simply signs the cheques without reference to any supporting documentation, e.g. the payroll. (In effect, access to the company’s bank account is inadequate.). (1½)

b) Computerised: In a computerized payroll system payment of wages will be by EFT. In an EFT system the “two signature principle” is applied by requiring one employee to “authorize” the EFT and a second employee to “release” the payment. However, if the employees do not perform the necessary procedures to verify the payments they are “authorizing” and “releasing”, the computer will not be any the wiser. In other words, an invalid payment can still be authorized and released if the employees do not carry out their responsibilities. (1½)

a) Weakness 9

Wages are paid in cash. (1½)

Explanation: Paying wages in cash to 120 employees every second week (same day) increases the risk of armed/violent robbery and loss to the company because of theft. (1½)

b) Computerised: The introduction of a computerized system will facilitate payment of wages by electronic funds transfer. This will reduce the threat of armed robbery to nil, but will introduce the risk of theft of the company’s cash resources through fraudulent EFTs if controls are not strictly adhered to. (1½)

a) Weakness 10

No risk assessment or monitoring of the system. (1½)

Explanation: A risk assessment process (either formal or informal) is an important component of internal control, as is the monitoring of the system over time. Management appear not to have identified the risk of fraud, theft and personal safety, which are significant in the company's payroll system. Although the company is now considering computerization, it does not appear that this is a result of having monitored the system over time to identify the system's weaknesses. (1½)

b) Computerised: A computerized system will not "assess risk" and "monitor the system" but it will produce information which can assist management in carrying out these activities effectively. (1½)

Comments:

This question asked you to identify and explain weaknesses in the payroll and personnel cycle. You were also required to state how a computerised system (computerised internal controls) could address the weaknesses.

The solution covers all weaknesses identified for each of the relevant phases and then presents the computerised alternative for improvements. Take note that the weaknesses and recommendations are presented separately under headings for the relevant phase. In addition, that marks were awarded for answering the required by identifying and then explaining the weakness.

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. Thus the application of the theory to a scenario is a skill that you must acquire as it will be of benefit to you in your later 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.

QUESTION 9.11 (c, e) IN GRADED QUESTIONS**17 marks**

Reference: Jackson & Stent (2016: 8/30 – 8/31 and 8/15 – 8/16)

(c) Internal controls to prevent unauthorised access to the wages application

1. Access to the LAN should be restricted to authorized terminals. This is achieved by the use of terminal identification controls (the system will only allow access to terminals which have been authorised and identified to the system). (1½)
2. Access to the LAN itself should be restricted by the use of user IDs and passwords. (1½)
3. Once access to the LAN has been granted, access to the wage application itself and to specific modules within the wage application i.e. masterfile amendments module, should be further restricted to only staff who need access to fulfil their functional responsibility e.g. Preston Ngcobo would have access to the LAN itself and to those modules he needs access to enter hours and process the payroll. (1½)

4. Access to applications/modules within applications will be achieved by the creation of user profiles, which are linked to user IDs, and passwords. The user profiles determine the privileges that are allocated to the user on a least privilege/need to know basis. (1½)
5. Actually restricting access is achieved in different ways. For example, on entering a user ID and password, the computer will confirm that both are valid. If not, the user cannot proceed. If the user ID and password are accepted, the applications/modules to which that user has access will appear on the screen. Alternatively, all modules will appear but those to which the user has access will be highlighted. (1½)
 - 5.1 To gain access the user will “select” and “click”. There will be no response (other than possible screen dialogue) unless the user profile permits it. (1½)
 - 5.2 If a read only privilege is granted, the “screen” will not respond to attempts to write to the module. (1½)
6. There should be a full range of password controls, a very important part of access control e.g.
 - 6.1 Unique to the individual (no group passwords).
 - 6.2 Changed regularly, not obvious.
 - 6.3 Kept secret, do not appear on screen, on printouts etc.
 - 6.4 Six digits, alphabetic, numeric, etc, mix. (1½)
7. There should be automatic shutdown of the terminal in the event of, say, three access violations e.g. incorrect password entered.(1½)
8. There should be a “time out” facility which automatically logs out the user if the module is “open” but no activity is taking place. (1½)
9. Access violations (and access) should be logged by the computer. The logs should be reviewed and access violations followed up in an attempt to identify the perpetrator. (1½)

(e) Internal controls over enhancement of wage application software

1. Requests for programme changes should be documented on prenumbered, preprinted change control forms. (1½)
2. These requests should be evaluated and approved by the
 - * User department (in this case wage section Jerome Jantjies, and management)
 - * Shakira Maharaj the IT manager. (1½)
3. The programme change should be managed as a mini-project, e.g. planned properly, responsibilities allocated, deadlines set and progress monitored. (1½)
4. Changes should be made to a test programme (a copy of the live programme) to avoid corruption of the live programme. (1½)
5. The “changed” test programme should be thoroughly debugged (preferably by someone independent of the programmer making the change). (1½)
6. The programme change should then be discussed with users (wage section/management) and they should sign the relevant change control form if they approve of the change. (1½)
7. The amended test programme should then be placed on the LAN (made live) and the updated “change” logged by the computer. (1½)

8. Shakira Maharaj should regularly (frequently) review the log of programme changes and reconcile it to the change control forms. (1½)
9. All documentation relating to the wage application should be updated to reflect the change. (1½)

Comments:

This question used information learned in Topic 2 applied to the Payroll and Personnel cycle. The theory of topic 2 was applied to the scenario. Remember, that the topics are often interrelated and should not be seen in isolation. Many of the principles relating to internal control are repeated in different shapes and forms within each of the different business cycles.

Topic 8 Finance and Investment Cycle**Feedback on supplementary Do questions on Topic 8****QUESTION 12. IN GRADED QUESTIONS****40 marks**

Reference: Jackson & Stent (2016: 5/5 – 5/17 & 14/2 – 14/5)

Weaknesses and recommendations (internal controls) in the finance and investment cycle.

WEAKNESSES	RECOMMENDATIONS
<p>1. The acquisition (investment in) fixed assets is not planned. (1½)</p> <ul style="list-style-type: none"> • There is no evaluation of whether the items purchased by the five sectional accountants are required. (1½) • Any member of the section can request equipment without providing proper motivation. (1½) • This is going to result in money being wasted on equipment which is not required or not suitable for the needs of the company. (1½) • It also provides an opportunity for misappropriation of equipment by employees. (1½) 	<ul style="list-style-type: none"> • The company should appoint a fixed asset committee consisting of senior experienced management which will be responsible for <ul style="list-style-type: none"> ➤ evaluating the need for the purchase of capital expenditure. (1½) ➤ and evaluating how capital expenditure will be financed. (1½) • All requests for fixed assets from sections and individuals within a section must be fully motivated. (1½) • The fixed asset committee should be responsible for preparing an annual capital expenditure budget (see below). (1½)

WEAKNESSES	RECOMMENDATIONS
<p>2. The budgeting process is totally ineffective. (1½)</p> <ul style="list-style-type: none"> Simply increasing the prior year budget by an index has resulted in sections being allocated money which they do not require and which will be wasted. (1½) This weakness is compounded by the fact that sections are “punished” for not spending their allocation by having their budgets reduced. (1½) This is evidenced by the fact that the sections rush to spend their allocations before the financial year-end resulting in many items of equipment lying about unopened/unused. (1½) 	<ul style="list-style-type: none"> A proper budgeting for capital expenditure system should be put in place(1½) <ul style="list-style-type: none"> ➤ 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 prior year figures. (1½) ➤ the sectional budgets should be submitted to the fixed asset committee for their approval which should only be given after careful consideration of <ul style="list-style-type: none"> the motivation for the expenditure(1½) alternatives the overall budget for the business and other sections(1½) company cash flows(1½) should an item which appears in the budget not be required, it should not be purchased. (1½) there should be ongoing comparison of actual capital expenditure to budgeted expenditure. (1½)
<p>3. There is inadequate authorisation of capital expenditure. (1½)</p> <ul style="list-style-type: none"> Sectional accountants have complete authority to purchase equipment provided they have not exceeded the budget. (1½) Sectional accountants can therefore purchase unnecessary items for their own use at work (e.g. new computer every year, DSTV for the office, cell phones, etc) or which they may take home. (1½) In effect the sectional accountants can make a purchase and authorise it which is a lack of division of duties. (1½) Furthermore, as there appears to be no reconciliation or follow up of items actually purchased, this lack of division of duties becomes more serious. (1½) 	<ul style="list-style-type: none"> The fixed asset committee should approve the budget which will then become the fundamental authorising document. (1½) See points below (4)

WEAKNESSES	RECOMMENDATIONS
<p>4. The controls over the requisitioning and ordering and receipt of capital expenditure items are inadequate. (1½)</p> <ul style="list-style-type: none"> • No properly designed, pre-printed, sequenced (and authorised) requisition form is presented to support the purchase request (email is sent). (1½) • 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. (1½) • The person requisitioning the item stipulates the specific details and supplier which could easily result in the company paying higher prices because of employees directing business to friends or their own private business entities, e.g. the warehouse foreman may receive commission from a forklift company for directing business to it. (1½) • Items purchased should not be delivered to the individual sections as this weakens division of duties. (1½) 	<ul style="list-style-type: none"> • A properly designed (two part) pre-printed, sequenced, capital expenditure requisition must be prepared and signed by a senior person in the section requiring the item e.g. warehouse manager requiring a new fork lift. (1½) • 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. (1½) • A copy of the requisition should be sent to the company buying department, and the second copy filed in numerical sequence. (1½) • The order department should: <ul style="list-style-type: none"> ➢ confirm that the goods requisitioned appear on the capital budget and if so (1½) ➢ check with the preferred supplier as availability, current price, delivery particulars, etc, and (1½) ➢ make out and sign a three part pre-printed, sequenced (capital expenditure) order (1½) <ul style="list-style-type: none"> ✓ Copy 1 – to the supplier (1½) ✓ Copy 2 – to goods receiving department (1½) ✓ Copy 3 – to accounting (1½) • Items purchased should be delivered to North Shore (Pty) 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. (1½) <ul style="list-style-type: none"> ➢ Copy 1 – sent with the items to the section (with Copy 3 as well) (1½) ➢ Copy 2 – sent with supplier delivery note to accounting (1½) ➢ Copy 3 – filed in receiving. (1½)

WEAKNESSES	RECOMMENDATIONS
<p>5. There is a serious lack of division of duties in respect of the assistant to the sectional accountant. This person</p> <ul style="list-style-type: none"> Places the order (on the strength of an email) (1½) Receives the goods (1½) <ul style="list-style-type: none"> “authorises” payment (by sending the unchecked documentation to creditors) (1½) Writes up the records (fixed asset register) (1½) <p>It would seem that it would not be too difficult for this person to misappropriate items of equipment for his or her own use (could even arrange to have the items delivered to his or her home.) (1½)</p>	<ul style="list-style-type: none"> The controls suggested above will also address this weakness. 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. (Copy 3 will be sent back to the receiving department and copy 1 retained in the section to be filed with the requisition.) (1½) Once the above procedures are complete, the assistant to the sectional accountant can write up the sectional fixed asset register. However, it is preferable that a fixed asset register for the whole company is written up and controlled by an employee independent of the sections. (1½)

(1½ for each valid comment to a maximum of 40 marks)

Comments:

This question required you to identify and explain weaknesses in the finance and investment cycle. You were also required to provide recommendations or improvements to the company's control activities/ internal controls in order to address the weaknesses identified.

The solution is presented in a table format. This is important because this is how the required asked you to structure your answer. There is usually presentation marks available for complying with the required.

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. Thus the application of the theory to a scenario is a skill that you must acquire as it will be of benefit to you in your later studies in auditing.

Insight Education website questions on the business cycles

Topic 4 Revenue and Receipts Cycle

Feedback on supplementary Insight Education questions on topic 4

QUESTION 1

6 marks

Reference: Insight Education Sales Video (Time: 12:21)

Information that should be on pre-numbered internal compiled invoice:

1. Reflect the value of the sales as calculated from the authorised price list at the time the order was placed. (1½)
2. It should be based on the actual quantity of goods received by the client as indicated on the delivery note. (1½)
3. It should take into consideration any returns. (1½)
4. Give reference to the original sales order as well as all of the company's details. (1½)

QUESTION 2

3 marks

Reference: Insight Education Cash Cycle (Time: 1:15)

The Cash Cycle (1½) because the company cannot restrict access to the store, as it is open to all members of the public. (1½)

Topic 5 Acquisitions and Payments Cycle

Feedback on supplementary Insight Education questions on topic 5

QUESTION 1

6 marks

Reference: Insight Education Purchasing Cycle (Time 2:21)

Activities of the ordering manager when receiving an order:

The ordering manager should verify all the information on the order form (1½) against the authorised inventory requisition (1½) and the authorised suppliers list (1½) and finally sign off if he or she is satisfied with the purchase order (1½).

Topic 6 Inventory and Production Cycle

Feedback on supplementary Insight Education questions on topic 6

QUESTION 1

9 marks

Reference: Insight Education Production Cycle (Time: 14:08)

Principles (internal controls) demonstrated in the production cycle:

1. All activities should be accompanied by supporting documents. (1½)
2. There should always be monitoring by a person in authority. (1½)
3. Quality, quantity and description evaluations should always be performed. (1½)
4. All stationary and physical goods should be physically secured. (1½)
5. There should always be a follow up process. (1½)
6. The process should be accounted for in the general ledger. (1½)

Topic 7 Payroll and Personnel Cycle

Feedback on supplementary Insight Education questions on topic 7

QUESTION 1

4½ marks

Reference: Insight Education Salaries and Wages Cycle (Time: 1:00)

Three stages in the payroll and personnel cycle:

1. Human Resource. (1½)
2. The process for wage workers. (1½)
3. The payment process for salaried workers. (1½)

Concluding Remarks

We hope that your understanding of the topics has improved after working through these questions and that you are now better equipped for the examination. The questions tests your knowledge of the various topics, therefore, when answering these questions, please use it as a learning opportunity.