

## GRADED QUESTIONS ON AUDITING 2018

### **TOPIC 1: CORPORATE GOVERNANCE AND STATUTORY MATTERS**

#### **2.9 Requirements of sound corporate governance pertaining to board of directors and board committees (25 Marks-34 Minutes)**

##### **Scenario**

The list of senior executives and officers of Bevington (Pty) Ltd, a large manufacturer of children's clothing, is as follows:

1. Virat Amla	-	Chairman and non-executive director
2. Frans Klewsner	-	Deputy chairman and chief executive officer
3. Noddy Nkwe	-	Financial director B.com
4. Mary Smith**	-	Human resource director B.A
5. Marshall Gibbs**	-	Production director B.Sc
6. Mills Ndou***	-	Marketing director (formally a CA(SA) before moving into marketing).
7. Eric Hougaard	-	Non-executive director (former production manager at Bevington (Pty) Ltd).
8. Victor Botha*	-	Company Secretary C.I.S
9. Ashley Willemse*	-	Chief audit executive CA(SA)
10. Russell Brent	-	Independent non-executive director (Practicing chartered accountant and registered auditor)
11. Serena Court	-	Independent non-executive director and fashion editor of a national magazine B.A (journal)
12. Bongzi Zulu Ltd	-	Independent non-executive director and chairwoman of her own toy company Playme (Pty)
13. Chris Eubank	-	Independent non-executive director and retired businessman

\*Victor Botha and Ashley Willemse are not directors.

\*\*These directors have a limited understanding of integrated reporting and related processes and controls.

\*\*\*Mills Ndou has a sound Knowledge of integrated reporting and related processes and controls as he has maintained his interest therein.

The board considers sound corporate governance to be important and wishes to follow the recommendations of King IV. In view of this, it has decided to appoint an audit committee as the company is required to have its AFS externally audited by virtue of its public interest score.

##### **Required**

##### **Qa) Identify the factors the board should consider to determine the appropriate number of members of the board. (4)**

**Ans:(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)

##### **Qb) Comment on the composition of the Board of Bevington (Pty) Ltd in terms of recommendations of King IV. (8)**

**Ans:(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
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)

**Qc) Indicate in terms of recommendations of King IV giving a brief reason, whether each of the above**

**1. Is eligible for appointment to the audit committee**

**2. Should normally attend meetings of the audit committee. (10)**

**Ans: (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 (Note 1) (½)	Not normally (½)
Marshall Gibbs	No (½)	Executive director (Note 1)	Not normally (½)
Mills Ndou	No (½)	Executive director (Note 1)	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.

**Qd) Indicate who you would recommend be appointed to the audit committee, assuming that it will consist of three members.**

**Justify your choice. (6)**

**Ans: (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.

## 2.23 Audit committee (20 Marks-24 Minutes)

### Scenario

JayB Ltd is a listed manufacturing company. Due to resignations from the audit committee the company wishes to appoint three new members to join the only remaining member from the previous committee. The remaining member is Robbie Wessels, an independent non-executive director of JayB Ltd and a certified financial analyst. The procedure which the company will follow will be to request the nominations committee to present its recommendations to the shareholders as to who the shareholders should elect to the audit committee at the upcoming annual general meeting.

The nominations committee has called for the names of individuals to be submitted to it for considerations for the appointment to the audit committee. The following names have been put forward:

- |                    |   |   |
|--------------------|---|---|
| 1. Gambhir Gull    | - | Company secretary of JayB Ltd.  |
| 2. Rod Dodger      | - | Professor of corporate law at Unisa and not connected to JayB Ltd in anyway.  |
| 3. Karl Zeiss      | - | Chairman and non-executive director of JayB Ltd.  |
| 4. Terry Ticker    | - | Senior partner of Ticktok Inc, JayB Ltd's auditors. He is not the designed auditor, but does advise the company on taxation.  |
| 5. Aaron Khumalo   | - | CA(SA), senior manager of JayB Ltd's BB – BEE function.   |
| 6. Klark Gayble    | - | CA(SA) an independent non-executive director of JayB Ltd.   |
| 7. Theuns Jordaan  | - | Production director of MayB (Pty) Ltd, a subsidiary of JayB Ltd.  |
| 8. Jennifer Jacobs | - | An industrial Psychologist who has no connection with the JayB group, But is well known in business circles.  |
| 9. Rod Grind       | - | CA(SA) and former chairman of JayB Ltd who retired four years ago. He holds 4% of the shares in JayB Ltd and his company Rodds (Pty) Ltd supplies JayB Ltd with certain manufacturing materials. Although he resigned his chairmanship he still holds a position of non-executive director of JayB Ltd. |

### Required

**Q2.23 Indicate whether each of the above is eligible for appointment to the audit committee of JayB Ltd if the company is to comply with the highest standards of corporate governance. Fully justify your decisions.**

**Ans: Reference: King IV Report and Companies Act of 2008**

#### Eligibility to be appointed to the audit committee:

- 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)
- 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)
- 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)
- 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)
- 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)
- Klark Gayble: - He is appointable as he is an independent non-executive director with the necessary financial expertise and experience. (1½)
- 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

### 4.18 Components of internal controls (12 Marks-15 Minutes)

#### Scenario

UK2010 (Pty) Ltd is a manufacturing company with a large labour force. Each of the procedures or actions listed below (1 to 10) relates to one (or more) of the components of internal control, as identified by ISA 315 (Revised), namely:

1. Control environment
2. Risk assessment
3. Information system (relevant to financial reporting)
4. Control activities
5. Monitoring of controls

1. UK2010 (Pty) Ltd engages an independent labour consultancy to conduct a review of the company's payroll activities in an annual basis. This includes a report to the directors on employee satisfaction, the company's adherence to fair labour practice legality of employees, etc.

2. Access to hardcopy employee records is restricted to the human resource manager and her senior administration clerk.

3. When the factory administration clerk has batched the wage period's clock cards he takes control totals, including the total number of clock cards in the batch. When the data capture clerk in the payroll section receives the clock cards, he counts them before signing a batch control sheet to acknowledge receipt.

4. The foremen are responsible for checking and authorizing (signing each clock card) overtime hours entered on the clock and calculated by the wage administration clerk.

5. Employees are paid by electronic funds transfer. To effect the transfer, two senior employees are required to enter their unique passwords. One password "approves" the transfer and second password "releases" the payment. Before "approving" and "releasing", the senior employees must check the supporting documentation.

6. The paymaster (senior manager) carefully reviews the bi-weekly reconciliation of wages paid for the current wage period to the previous wage period.

7. The company subscribes to Labourwatch, a quarterly journal which contains important information about any current or pending strike action and other labour related threats to the industry.

8. Write access to the employee Masterfile is restricted to the human resource manager's senior administration clerk.

9. All individuals who apply to work in the payroll section must pass a test of competency (set by the company's human resource department) on the payroll package used by the company before they can be considered for the position.

10. The company uses a well known payroll package, Payday, for processing the payroll.

#### Required

**Q4.18 Indicate to which component(s) of internal control each action or procedure listed above (1to10) applies. Where you select control activity as the component, indicate the type of control activity you consider the action or procedure to be.**

**Ans: 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 <b>AND</b> 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.

#### 4.29(b) General vs application controls, weaknesses in general controls (31 Marks)

##### Scenario

You are a member of the computer audit section of your firm. The team is about to commence the audit of a new client, The Chairman Chairman (Pty) Ltd, a manufacturer of office furniture. You have been requested to perform a review of general controls at the company.

The following information is relevant:

1. The company has a centralised IT department. Data is processed on a mainframe computer which is located in the computer room along with various other pieces of computer equipment. The various departments are linked to mainframe by an online terminals.
2. The IT department which is headed by Michael Morgan the IT Manager, reports to Peter Breedt the financial manger as he (Peter Breedt) has a keen interest in computers. However, the management style at The Chairman (Pty) Ltd is very relaxed and Peter Breedt does not interfere with Michael Morgan, leaving the IT department's affairs to him. The IT department is staffed by an adequate number of personnel whose individual skills combine to run the IT department and service the user departments.

The various members of the IT department assist each other with their duties on a day to day basis.

3. Access to the computer room is controlled by a security keypad. The access code which must be keyed in to activate the door, is the current date. (The Keypad is programmed to automatically change the access code to the following day's date at midnight). On visiting the computer room on two consecutive days, you found that the system worked efficiently.
4. To link your own laptop to the system, you could plug the laptop into one of the spare access points in the staff tea room. Peter Breedt informed you that no user identification was necessary and that the passwords to get onto the system and into any application was the first name and first letter in the surname of the head of each section, for example, his password was "PeterB" and this would get you "where you need to go."
5. The company does not have a documented disaster recovery plan. Peter Breedt does not believe that this is necessary as the company has not suffered any disasters in the past and is fully covered by insurance in the event of a disaster.

##### Required

**Q4.29(b) Discuss fully, based on the information given above, the weaknesses in the general controls at The Chairman (Pty) Ltd.**

**Ans: 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 Breedt 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

### 8.2 Functions in the revenue and receipts cycle (15 Marks – 18 Minutes)

#### Scenario

Greenbox (Pty) Ltd is a large wholesaler of garden equipment. The company's revenue and receipts cycle is well staffed and is divided into clearly defined functions, namely receiving of orders, warehousing (picking), dispatch, invoicing, recording of sales, mailroom and receipting/cashier. It also has a "goods returned" function which handles the return of goods by customers and a credit management section. The following control procedures take place in the day to day running of the company. (Note: these procedures are in random order).

1. Jonny Greenfingers follows up on trade references supplied by prospective customers seeking credit.
2. Carl Camelion, checks the detail on all internal sales orders prepared by the six order clerks.
3. Walter Weed, one of the warehouse clerks, makes out a back order note for an item which is ordered but is not "instock".
4. The gate controller counts the number of boxes on the company's delivery truck and agrees it to the delivery notes held by the driver.
5. Themba Treetops compares the goods to be delivered, to the picking slip and delivery note as they are packed into boxes for delivery.
6. Harriet Hedge phones all debtors who have exceeded their credit terms every 48 hours to establish when Greenbox (Pty) Ltd can expect payment.
7. When customers collect goods they have ordered, they sign a delivery note and retain a copy.
8. Benji Berry checks the sequence of the invoices entered in the sales journal to identify missing invoices.
9. Gustav Glass compares prices on the invoice to the official pricelist and reperforms the VAT calculation.
10. Petrus Prunus regularly reviews bank deposits from customers made by EFT.



11. Lolly Lupin makes out credit notes for defective goods which are sold and returned by customers. Before doing so she obtains the authority of Petrus Prunus to issue the credit note.
12. Daisy Dumisa goes through the "back orders" file on a weekly basis to ascertain the status of a backorder.
13. Petrus Prunus reviews the general journal frequently and follows up on any journal entries pertaining to debtors, such as bad debts written off.
14. Internal sales orders sent to the accounting department are filed in numerical sequence.
15. Themba Treetops goes through the days picking slips at the end of each day to confirm that they have all been acted upon.

#### **Required**

**Q8.2 Indicate the function under which each of the control procedures (1-15) is most likely to occur at Greenbox (Pty) Ltd.**

**Ans: 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)

### **8.9 Internal controls in various functions of the revenue and receipt cycle. (33 marks – 40 Minutes)**

#### **Scenario**

You have been approached by John Stone, the owner of Stonebrix (Pty) Ltd, to advise on the design of an internal control system for revenue and receipts. Stonebrix (Pty) Ltd is a newly formed company which will sell bricks to building contractors. Sales will only be made to account holders on credit. John Stone has instructed you to design a manual system as he has not yet decided on whether to implement a fully integrate computer system or outsource the accounting function. He has also requested that you make use of the personnel who are already employed by Stonebrix (Pty) Ltd, i.e he does not wish to employ any more staff. He is quite prepared to have whatever documentation is necessary printed, and to incur any other reasonable expenditure for an efficient system to be put in place.

1. Stonebrix (Pty) Ltd purchases its bricks from the manufacturer and stores them on its property in a large brickyard. The company sells only popular types of brick and thus holds only fifteen different types in its brickyard in symmetrical piles. Bricks are stacked on wooden pallets in piles of 500 and wrapped in industrial transparent plastic. This makes the counting of bricks on hand quick and simple. Bricks are counted every afternoon after the last delivery and the quantity entered on a preprinted "daily stock report" by Bridge Zuma.

2. Building contractors either send a member of their staff (e.g. foreman or driver) to place an order or they phone or fax the order through. Orders are seldom sent through the post.

3. Stonebrix (Pty) Ltd delivers the bricks to its customers. A delivery to its customers. A delivery charge is built into the cost of the bricks regardless of the delivery destination. Due to the difficulty of transporting bricks, customers do not collect their orders.

4. The staff of Stonebrix (Pty) Ltd consists of

- \*John Stone – general manager (and owner)
- \*Shannon Green – employed as the financial and administration manager
- \*Preggs Naidoo – who has some credit management and general accounting skills
- \*Bridge Zuma – the brickyard controller/administrator
- \*Marica Oliver – general administration
- \*Petra Peterson – qualified bookkeeper
- \*Carmen Twitty – reception and secretarial

In addition the gate at the entry/exit point for the premises is manned by a security guard and there are two labourers who assist with loading etc in the brickyard. The company also employs three truck drivers.

#### **Required**

**Q8.9 Describe the control procedures/activities which you consider should be implemented for the revenue and receipts cycle of Stonebrix (Pty) Ltd. Your recommendations should be set out under the following headings and should indicate the staff member who should carry out the procedures/activities you recommend.**

#### **1. Receiving customer orders (10 Marks)**

#### **Internal controls of various functions in the revenue and receipts cycle**

- Ans:**
1. Marica 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 authorization (8 Marks)

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 dispatch (7 Marks)

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 (8 Marks)

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)

**Note:** You are **not** required to deal with functions other than 1-4 above, or with the control environment, risk assessment and monitoring components of the internal control process.

**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.

#### 8.13 Weakness in the revenue and receipts cycle. (30 Marks – 36 Minutes)

##### Scenario

Quik Tyre (Pty) Ltd sells tyres to garages and fitment centres on credit. The accept phone orders only, as their main marketing strategy is quick delivery. Garth Galian, the financial accountant, has approached you for advice regarding the company's credit sales system (which was developed in-house some years ago), as a number of problems have been experienced lately in the "receiving of orders" section. This has resulted in customer dissatisfaction, excessive bad debts and numerous problems with invoices and delivery notes which are either incomplete or incorrect with regard to customer details.

Your observation and enquiry of Donny Lopez, the order clerk, revealed the following:

1. When a customer telephones, Donny Lopez asks for the customer's account number and enters it.
  2. If the account number is accepted the customer's details then appear on the screen.
  3. If any part of the customer's account is more than 60 days in arrear an "in arrear" field appears on the screen indicating the amount which is in arrears.
  4. Whenever this "in arrear" field appears, a programme control prevents Donny Lopez from proceeding with taking the order. Occasionally a customer's account will be in arrear because a credit note has not been passed by Quik Tyre (Pty) Ltd. In these situations Donny Lopez will override the in arrears, take the order and later process a credit note.
  5. On discussion with the customer about the amount in arrears, Donny Lopez may decide to override the "in arrear" control, depending on the information provided by the customer.
  6. Every time the "in arrear" field is overridden the amendment (override), together with a brief reason for the override (which is keyed in by Donny Lopez) is logged by the computer.
- Note: if a customer order is not to be accepted, Donny Lopez does not proceed with the order but refers
7. Should Donny Lopez or Gene Kelly wish to follow up on the log of overrides of the "in arrear" control, they may do so as they both have read/write access. No other accounting personnel have access to this file
  8. Once Donny Lopez has entered a valid customer account number (see 1 above) and if necessary, resolved any problems relating to amounts in arrear he can proceed with the order.
  9. Using Quik Tyre (Pty) Ltd product catalogue the customer informs Donny Lopez of the tyre code and a description of the tyres required. Donny Lopez keys these in and the telephone conversation is terminated.
  10. The order details are written to a "daily order file" and a multi-part, sequenced internal sales order form/ picking slip is printed.
  11. If a potential customer (one with no account number) wishes to place an order he is referred to Gene Kelly who emails a credit application form to the customer. This must be completed by the potential customer and emailed back to the customer.
  12. Once this is returned, Gene Kelly confirms that the names of two credit references have been given, checks that all information requested on the form has been provided, and if satisfied, signs the credit application form, and prints out a hard copy.
  13. The hardcopy is then passed to Donny Lopez who

\*accesses the Masterfile amendment module of the revenue application,

\*adds the new customer to the debtors Masterfile, and

\*phones the customer informing him of his account number.

14. Additions to the Masterfile are written to a log. Logs are sequenced by the computer. Donny prints a copy of the log from time to time and files it away in case there is a query.

**Note:** the software has suitable programme and screen aid checks to enhance the accuracy and completeness of data keyed in.

#### Required

**Q8.13 Identify and explain the weaknesses in the “receiving/authorising of orders” procedures at Quik Tyre (Pty) Ltd as described above.**

**Ans: 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)
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 make unlimited purchases. (1½) - 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.	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) □ 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)	- As Donny Lopez has access to debtors masterfile, he is able to “create” new debtors accounts which: □ 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:

	<p>□ The log of masterfile amendments is not reviewed and tied back to supporting documentation by an independent person. (1½)□</p>	<p>□ inaccurate and incomplete details may be captured resulting in problems later in the cycle e.g. invoices incorrectly addressed. (1½)</p> <p>□ Gene Kelly can easily initiate the addition of fictitious or non-creditworthy debtors to the masterfile. (1½)</p> <p>- As the log is not tied back to sequenced MAF's it is not possible to establish:</p> <p>□ whether all amendments have been made accurately. (1½)</p> <p>□ only authorised amendments have been made. (1½)</p> <p>□ all approved amendments have been entered. (1½)</p>
<p><b>Comments:</b> 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.</p>		

## Topic 5 Acquisitions and Payments Cycle

### 10.3 General and applicaion controls in the acquisitions and payments cycle (12 Marks – 14 Minutes)

#### Scenario

Consider each of the following policies/procedures/activities which relate to the acquisitions and payment cycle at Blackcharge (Pty) Ltd, a large industrial equipment supply company. (Note: policies/procedures/activities listed below are in no particular order. Consider each one separately.

1. Each morning, after careful scrutiny of the inventory requisitions to be sent to the ordering department, the warehouse manager signs each requisition.
2. All Blackcharge (pty) Ltd employees are required to attend a business ethics workshop annually.
3. Blackcharge (Pty) Ltd places orders with approved suppliers only. Each supplier has a supplier code, and if the ordering clerk does not enter a valid code when creating an order, she cannot proceed with preparing an order.
4. Senior and middle management within the acquisitions and payments cycle meet regularly with the company's risk committee to discuss operational supply risks in its industry.
5. Once the ordering clerk has processed the requisitions from the warehouse, the file of purchase orders must be approved by the senior buying officer. Write access to the approval function is restricted to the senior buyer.
6. Each year a systems analyst from Blackcharge (Pty) Ltd IT department meets with employees in the acquisitions and payments cycle to explore and suggest changes to the application software which could improve the efficiency and effectiveness of the cycle.
7. Any proposed changes arising pot of (6) above, must be, inter alia, evaluated by Giles Jacobs the financial accountant, internal audit and the IT manager.
8. When an invoice is received by Blckcharge (Pty) Ltd, it is matched and cross checked to the corresponding order, supplier delivery note and goods received note.
9. Before any employee in the acquisitions and payment cycle can access the computer system, she must identify herself and authenticate herself.
10. When goods ordered are delivered by a supplier, the goods receiving clerk must enter Blackcharge (Pty) Ltd's order number (taken from the supplier's delivery note) onto the system. This will bring details of the order onto the screen in the form of a GRN.
11. To effect an EFT payment to a trade creditor, Silent Mthenbu, the senior creditors manager, must authorise the payment file (on the system) and Giles Jacobs, the financial accountant, must release the payment.
12. Once a week a log of all purchase orders which have been outstanding for longer than 10 working days is printed and followed up by the ordering clerk.

#### Required

**Q10.3 Indicate whether each of the above policies/procedures/activities is a general control or an application control.**

**Ans: 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.

### 10.10 Weaknesses in the acquisitions and payments cycle (25 Marks – 30 Minutes)

#### Scenario

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

1. When an invoice is received from a supplier it is promptly written into purchase journal by Stella Stirling and filed alphabetically by supplier name. When the suppliers' monthly statement arrives Stella Stirling agrees the invoices received to the statement. She also checks that any payments that were made to the supplier by Delmundo (Pty) Ltd are reflected on the statement.
2. If an invoice reflected on the statement has not been received, Stella Stirling highlights the invoice(s) and marks it "outstanding" on the statement. The full amount reflected on the statement is paid. When the outstanding invoice is received, it is filed with the statement to which it relates and the "outstanding" written on the statement is crossed out and dated, and the word "received" written next to it.
3. Using the statements Stella Stirling then makes a list of the names of all creditors and the amounts which they are to be paid. No other information or supporting documentation is provided with the list. The list is passed to Mary Roosevelt for payment.
4. To pay creditors, Mary Roosevelt accesses the electronic funds transfer facility on her computer and compiles a schedule of payments to be made by EFT to creditors. She obtains this information from the creditors list prepared by Stella Stirling. She carefully checks the details e.g. bank, branch code, account number of the creditor to be paid against the hard copy file which she keeps for all creditors. If there is a creditor on the list provided by Stella Stirling which is not on Mary Roosevelt's hardcopy list, she phones the creditor to obtain the necessary bank details to enable her to make the payment. She updates her hard copy file. She then accesses Delmundo (Pty) Ltd's bank account via her terminal and updates the list of beneficiaries which can be paid by EFT. To add a beneficiary, Mary Roosevelt must enter her unique password.

Once she has completed the EFT payment schedule she asks Stella Stirling to carry out an on screen random check of the details entered before authorising and releasing the transfer. Mary Roosevelt is the only employee to have access to the EFT facility and EFTs can only be made from her terminal. Each payment on the creditors list for which an EFT has been made is cross referenced by date to the EFT schedule by Stella Stirling.

5. Stella Stirling passes the creditors list to Dean Ramjan as he is solely responsible for the cashbook i.e., writing it up, posting to the general ledger and subsidiary ledgers and reconciling it monthly.

#### Required

**Q10.10 Identify the weaknesses in the payments system described above by John de Marzo. For each weakness you identify, explain briefly why you consider it to be a weakness.**

**You are not required to make recommendations.**

**Ans: Reference: Jackson & Stent (2016: 11/9 – 11/13)**

**Weaknesses 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 costs, extensions, 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.

### **10.13 (b,c,d) Risks, internal controls and application controls relating to the acquisitions and payments cycle (40 Marks – 48 Minutes)**

#### **Scenario**

You are a member of the team engaged on the audit of 2<sup>nd</sup> Part (Pty) which sells second hand motor spares and accessories. The company purchases its inventory from two sources, namely scrap yards and manufacturers of car spares and accessories, who sell their production overruns and slightly damaged inventory items to 2<sup>nd</sup> Part (Pty) Ltd.

You have been assigned to the year-end audit of the acquisitions and payments cycle and have ascertained, inter alia, the following information.

1. One of the major business risks faced by 2<sup>nd</sup> Part (Pty) Ltd is that the company may purchase parts and accessories which have been stolen from manufacturers, or which come from stolen or hijacked vehicles. To counter this, the company carries out a comprehensive investigation into their suppliers before conducting business with them. The company's accounting systems are fully computerised (they are run on a local area network (LAN) which links all departments/sections) and once a supplier has been approved, it is entered on the "approved supplier Masterfile". The financial controller, Bernard Bunz, has emphasised the importance of dealing only with approved suppliers, and maintaining detailed supporting documentation for all purchases, due to the widespread dishonesty and criminal activity in the trade.

2. No Inventory is purchased without an official printed order. Order forms are computer generated and cannot be created for a supplier not on the approved supplier Masterfile. Orders are initiated on the strength of a signed requisition sent to buying department by the warehouse manager.



Note: Suppliers, both scrap yards and manufacturers, regularly contact the warehouse manager to notify him of availability of second hand parts, overruns or damaged items. If the warehouse manager considers the item should be ordered, he negotiates the price which he then enters, with other details, on the requisition. Controls over the ordering function, both manual and computerised, are sound.

3. All deliveries from suppliers are routed to a physically secure Deliveries Bay for the unloading and receiving of goods. The three receiving clerks make use of a single terminal in the bay which is linked to LAN. As goods delivered are mostly second hand or slightly damaged, receiving clerks do not perform quality checks on deliveries. All deliveries are sent with a computer generated copy of the goods received note, to the "Quality Check and Reconditioning" section where all items purchased are put into saleable condition, e.g. cleaned, rubber seals etc replaced, tested and repackaged. From this section they are moved into the warehouse, where they are stored by part number, description etc. (Any items which are "damaged beyond repair" are returned to the supplier).

4. Hard copy of all documentation is sent to, or printed out in, the accounting department where it is matched and filed temporarily to await the supplier's invoice. The necessary checks are carried out before the purchase journal is written up. The supporting documentation is then filed alphabetically by supplier.

At an interim audit conducted earlier in the year, you had extracted a sample of purchase transactions for detailed testing. Although these tests had proved satisfactory, you decided to extract a small sample of purchase transactions from the purchase journal for the month of April (financial year-end 30 April) on which to perform detailed procedures. One of the purchase transactions selected, and for which you obtained the supporting documentation was:

Creditor: Crash'nSmash (Pty) Ltd  
Amount: R97620.14

### **Required**

**Q10.13 b) Explain why there is increased risk of unauthorised access to data and programmes in a networked environment (e.g. 2<sup>nd</sup> Part (Pty) Ltd's local area network).**

**Ans: 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)

**Q10.13 c) State the controls which should be in place at 2<sup>nd</sup> Part (Pty) Ltd to ensure that additions to the "approved supplier masterfile" are valid, accurate and complete. (Do not concern yourself with controls or procedures to approve suppliers).**

**Ans: 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)

**Q10.13 d) Discuss the manual and programmed (automated) application controls which you would expect to be in place for the receiving of deliveries from suppliers.**

**(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)

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

#### 11.1 (a,d) Documents used in the inventory and production cycle. Objectives of internal controls in the inventory and production cycle (9 Marks)

##### Scenario

Toyco (Pty) Ltd manufactures unique toys in small batches and makes use of the following documentation:

- \*purchase order
- \*picking slip
- \*inventory adjustment form
- \*sales invoice
- \*production report
- \*supplier delivery note
- \*customer remittance advice
- \*transfer to finished goods note
- \*clock cards
- \*job cards

All components used in the manufacturing process are received from suppliers at the central receiving bay and subsequently transferred to the components warehouse. Toys which have been manufactured are transferred from production to the finished goods warehouse. The company uses a "job cost" costing basis for accumulating costs and maintains computerized perpetual inventory records.

##### Required

**Q11.1 a) Identify from the list above, those documents which Toyco (Pty) Ltd would use in their inventory and production cycle, and briefly describe what each document is used for.**

**Ans: 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)

**Q11.1 d) State the three broad objectives that a well designed, properly implemented internal control process for the inventory and production cycle will achieve.**

**Ans: 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.

**11.8 (b) Weaknesses in a system of internal control in the inventory and production cycle. (20 Marks)**

**Scenario**

You are on the audit of EagleEye (Pty) Ltd a company which manufactures security devices, e.g. burglar alarm units, surveillance cameras, etc.

Some months prior to the audit, the company appointed Simon Brown as the internal auditor of the company. He reports to Krishen Vather the financial manager. Prior to his appointment as internal auditor, Simon Brown had been an administration clerk in the creditors section. However, due to a restructuring of the creditors section, his position had become redundant, and his options were either to leave the company or accept the newly created post of internal auditor. Although he has no formal training in auditing, Simon Brown is regarded as a competent and enthusiastic staff member who could develop into a satisfactory internal auditor.

It has also been decided that, as internal auditor, he could be used effectively if staff members in the accounting department are absent, on annual or sick leave, to carry out their responsibilities.

You had considered the possibility of relying on some of the work which Simon Brown had carried out relating to the inventory and production cycle and using him to assist with certain aspects of the year-end inventory audit, but decided at this stage it was not appropriate to do so.

In addition to your audit responsibilities, Krishen Vather has requested that you evaluate certain aspects of the production cycle and make recommendations for improvement where necessary. He believes that improvements are required and that the Board would be receptive to reasonable recommendations. He has provided you with the following narrative description:

**Systems description – production**

1. The company manufactures a standard range of products, each of which has its own product code.
2. Manufacture is carried out by ten technicians who each have their own workstation in the factory. The workstation consists of a bench and all the necessary equipment the technician requires to build and test the products.
3. The factory foreman, Frans Flinthoff, is in charge of the factory and reports to the production manager.
4. The sales department notifies the production manager of demands for the company's products on a weekly basis (This procedure works well).
5. A large "production blackboard" is positioned at the entrance to the factory this blackboard displays each workstation number and the name of the technician assigned to that workstation. Below these headings are columns to enter the date, product code and quantity of the product to be manufactured.
6. Each Monday morning the production manager assigns work to the technicians by updating the date, product code and quantity columns on the blackboard.
7. All of the technicians are trained to manufacture all of the company's products and have an assembly manual to which they can refer if necessary.
8. Components for manufacture are kept in a warehouse adjoining the factory. As technicians generally know what components are needed to manufacture each product (they can refer to the assembly manual), they will personally select the components from the warehouse shelves as they require them.
9. Once the technician has constructed and thoroughly tested a batched of items, he loads them onto a trolley and takes to the finished goods warehouse.
10. On arrival at the finished goods store he unloads the items in the receiving area and returns to his workstation.
11. Before the end of each working day a warehouse clerk who is responsible for keeping the components warehouse and finished goods warehouse clean and tidy, takes the items manufactured from the receiving area places them on the allocated shelves in the warehouse. No perpetual inventory records are maintained.

**Required**

**Q11.8 (b) Identify the weaknesses in those aspects of the production cycle described above, and for each weakness make suitable recommendations for improvement. (Do not concern yourself with the costing of manufactured items).**

**Ans: 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.

### 11.12(d) Various matters relating to cycle counts (20 Marks)

#### Scenario

You are in charge of the audit of inventory at Flower Power (Pty) Ltd, a company which sells a wide range of gardening equipment e.g. spades, wheelbarrows, electric hedge cutters etc, to nurseries, garden shops and hypermarkets. The company's premises consist of a single, large warehouse/head office situated in Johannesburg.

The company's inventory records are computerised and a perpetual inventory is maintained.

Responsibility for inventory rests with Ruud van Bakkem, who is the warehouse manager. Sheik Mashaba, the inventory controller, reports to Ruud van Bakkem and is directly responsible for the custody of inventory. The company has, for the first time, appointed an internal auditor. He will join the company on 1 May 2018.

The company conducted a count of all inventory on hand at 31 March, the financial year-end. You and your team had attended. Prior to the count Ruud van Bakkem had informed you that, in his opinion, the theft of inventory by employees from the warehouse has increased. The inventory count proved Ruud van Bakkem's suspicions to be well founded and significant adjustments to the quantities of a number of inventory items in the inventory masterfile (perpetual inventory) had to be made. These adjustments were effected, as with other adjustments made during the year, in compliance with the company's sound controls over masterfile amendments.

After the inventory count, at a meeting held in early April, Ruud van Bakkem sought your advice on how the theft of inventory by employees, could be reduced. You recommended to him that, in addition to the physical controls he intended to install, the company should introduce inventory cycle counts. In your opinion the manner in which Flower Power (Pty) Ltd conducts its year-end inventory counts, e.g. two man teams, double counts etc, would be very suitable for cycle counts. Ruud van Bakkem was enthusiastic and has asked you to draft him a memorandum in which you identify and discuss the key issues in planning cycle counts, how discrepancies between actual quantities and recorded quantities are dealt with, and how cycle counts will reduce the theft of inventory by employees.

#### **Required**

**Q11.12 (d) Draft a memorandum on cycle to Ruud van Bakkem dealing with the matters he raised with you at the post inventory count meeting held in early April.**

**Ans: 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 Bakkem). (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

### 9.8(1) Risks in the payroll and personnel cycle (5 Marks)

#### Scenario

1. Deepdiggers Ltd, a mining company, has a large workforce of around 5000 workers, many of whom are migrant workers from rural region and neighbouring countries. The company has formal risk assessment process which includes a risk committee which meets twice a year to identify and assess risks faced by the company, and consider whether the risks are being appropriately responded to. The risks relating to human resources are always an item for discussion on the agenda.

#### Required

Q9.8 (1) Describe briefly five risks which a company such as Deepdiggers Ltd might face relating to its workforce.

Ans: 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.

### 9.9 Weakness and computerised controls in the payroll and personnel cycle (45 Marks – 54 Minutes)

#### Scenario

You are a newly appointed internal auditor at Calpak (Pty) Ltd. The company is a manufacturer of backpacks and bags for sporting equipment. The company employs approximately 120 hourly paid semi-skilled workers, equally spread over the three sections, cutting stitching and finishing. Each section has a section supervisor who reports to the factory foreman. The wage payroll system is currently completely manual but management now wish to computerize the system. As the first phase of this exercise you have been asked to evaluate the system so that the company will have a better understanding of what weaknesses the computerized system must address. Your initial enquiries have revealed the following:

1. Wages are paid every two weeks. The wage period runs from a Thursday morning to a Wednesday afternoon two weeks later. The work day commences at 7.30am and employees work a daily eight hour shift.
2. On arrival at their section, employees report to their section supervisor who records their presence by ticking the appropriate column on the **daily time sheet**. (see 7 below)
3. Work periods are controlled by a factory siren (hooter). Employees commence work when they hear the siren at 7.30am and end the days shift at 4.30pm, again when the siren sounds. The siren is also used to control tea and lunch breaks.

4. Workers are not required to sign themselves out at the end of the day, but if they continue to work after 4.30pm, they must notify their section supervisor. On reporting for work the following day they must inform their section supervisor of the number of hours overtime they worked the previous afternoon/evening. The section supervisor records this on the daily time sheet against the employee's name.
5. Three administration clerks from the accounting department are responsible for certain payroll functions. An administration clerk is allocated to each of the three sections i.e. cutting, stitching and finishing.
6. Each administration clerk maintains a ledger of all wage earners in the section for which he is responsible. The factory foreman is responsible for hiring and dismissing staff (as well as receiving notices of resignation). When a change must be made to the employee ledger, the foreman sends a completed, pre-printed, sequenced "Employee Engagement/Dismissal/Resignation Form" to the section administration clerk. This contains full details of the employee, e.g. date of engagement/dismissal, grade and pay scale. The clerk updates his ledger, and files the instruction from the foreman.
7. On Wednesday morning the administration clerks prepare the daily time sheets for their section for the following wage period. Daily time sheets are preprinted and sequenced (each section has its own unique sequence). The sheets consist of a column for the names of employees in the section, as well as a column for each day of the working week in which the section supervisor can tick off each employee's (daily) attendance and enter any overtime worked.
8. Before 7am on Thursday morning, the administration clerks take the daily time sheets (for the following wage period) to the supervisor of the section for which they are responsible, and collect the completed wage period's time sheets. The supervisor and the administration clerk sign the completed wage period's time sheets to acknowledge the transfer.
9. The administration clerks then prepare the wage period (see pt 1) payroll for their section. They calculate the normal hours worked (each "tick" represents 8 hours) and the overtime hours for each employee from the daily time sheets. The employees hourly rate is obtained from the employee ledger and overtime is calculated at the rate of one and a half times the normal wage rate. Using the relevant schedules and tables, the administration clerks calculate PAYE, UIF and medical aid deductions and calculate the net wage payable to each employee as well as the total wages (and deductions) payable for their section. The payroll is preprinted, well designed and pages are numerically sequenced in a bound book.
10. Once the payrolls for the three sections have been prepared, they are sent to the factory accountant who reperforms the calculations on the payrolls, makes any corrections, and signs the payrolls to acknowledge his control procedures. He then prepares and signs cheques for the net wages and all deductions to be paid over e.g. PAYE. The cheques are sent to the financial accountant for a second signature and the payrolls are returned to the respective administration clerks. The factory accountant also prepares a coinage schedule.
11. On receipt of the payrolls the administration clerks prepare a pre-printed paypacket for each employee in their section by writing the details of the employee and the period's wages onto the paypacket.
12. On the Friday morning of a wage payout, Calpak (Pty) Ltd's security section takes the cheque and the coinage schedule to the bank. The cash is placed in three numbered bank bags (per the instructions from the Calpak (Pty) Ltd), sealed, and delivered to the administration clerks by security. The three administration clerks make up the paypackets for their section according to the payroll.
13. At 3pm on a payout Friday, the administration clerks (accompanied by a security guard) distribute the paypackets from three pay points within the factory. Wage earners must present their staff identity card, and sign the payroll next to their names on receiving their wages. As there are only approximately 40 wage earners per section, the payout is completed without significant delay. (Note: do not concern yourself with unclaimed wages).
14. During the course of the following week, the administration clerks update the employee ledger with details of each employee's wages and deductions.

### Required

**Q9.9 a) Identify and explain the weaknesses in the payroll cycle of Calpak (Pty) Ltd based on the information given above. Your explanation must convey why you believe that the weaknesses you have identified are weaknesses. (30 Marks)**

**Q9.9 b) For each weakness, explain in general terms if, and how, a computerized wage system would address the weakness. (15)**

**Ans: 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)

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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.

**9.11(c,e) Internal controls in the payroll and personnel cycle (17 Marks)**

**Scenario**

Times (Pty) Ltd is a manufacturer of timing devices. In addition to a large salaried staff, the company employs about 100 skilled and semi-skilled wage earners. As part of the planning for the audit, you obtained the following information:

1. The 100 employees are spread evenly over three sections.
2. Each section is headed by a foreman. The foreman report to Reagon Seconds, the factory manager.
3. The three sections are located in a single factory building and to enter or leave the building, hourly paid employees must pass a clock card through a clocking machine to record their time of entry or exit and to activate the control gate. The clock is located at the control gate. There is only one point of entry/exit.
4. The clocking procedure is observed by Ben Bigg the factory administration clerk who has a glass fronted office overlooking the clocking area.
5. Employees work Monday to Friday and are required to “clock-in” by 7am and “clock-out” at 4pm. Any additional time worked is regarded as overtime. Overtime work is carefully planned and scheduled by the section foreman. Reagon seconds authorizes the schedule of overtime.
6. Wages are paid every two weeks and the clockcards for each wage period are prepared in the human resources department and sent to Benn Big with a listing of each employee for whom there is a card. Ben Bigg agrees the cards to the list, signs the list and remains a copy.
7. The wage period runs from Thursday morning until Wednesday afternoon two weeks later. Early on the Thursday morning Ben Bigg collects all the clock cards for the wage period just completed from the racks next to the clocking machine, and replaces them with the clockcards for two week wage period commencing that morning.
8. Once the previous period’s cards have been collected, various batch controls and other procedures are carried out before the clockcards are taken to the wage office by Ben Bigg.
9. The wage office is staffed by the paymaster, Jerome Jantjies, and his assistant, Preston Ngcobo. The wages are processed using application software developed and maintained by the company itself. Enhancements to the software are made from time to time by Times (Pty) Ltd’s small information technology (IT) section to keep the application up to date with tax requirements and to provide management with better information for controlling wages, which is a major expense. The company runs all of its accounting applications on a local area network and the IT department is headed by Shakira Maharaj.
10. Preston Ngcobo is responsible for preparing the payroll. Once he has received the clockcards, he selects the “enter hours worked” module and then captures the employee number, as well as the normal and overtime hours from each clockcard. Once he is satisfied that the hours captured are accurate and complete, he selects the “process payroll” option to effect the processing of the payroll. The software is well designed and includes a number of programme (automated) controls to provide valid, accurate and complete capture and processing of data.

**Required**

**Q9.11(c) Identify and explain the controls which should be in place to prevent unauthorized access to the wage application and its various modules on Times (Pty) Ltd’s local area network (8).**

**Ans: 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)

**Q9.11(e) Describe the internal controls which should be implemented over enhancements to the wage application software.**

**Ans: 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**

**12.8 Weaknesses and recommendations in the finance and investments cycle. (40 Marks)**

**Scenario**

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 considerable capital expenditure had been incurred just before the financial year-end (30 June). You found that the same occurred in the other four sections of the company and 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, 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 section.
2. A budget is prepared in the office of the financial director. Budgeting figures are calculated by increasing the prior 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 fork lift, he will email my assistant with the precise details of what is required as well as the name of a supplier. Note of the equipment used by North Shore (Pty) Ltd is particularly complicated, so this method works fine.
5. My assistant will then complete a pre-printed, numerically sequenced, multi-copied order form (which I as sectional accountant will sign) and send the top copy to the supplier. The second copy of the order is sent with the supplier delivery note, to the central creditors department for payment. 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. He retains a signed copy of the supplier delivery note which is sent to the creditors department as described in point 5 above.

### Required

**Q12.8 Identify and describe the weakness in the system of investing in capital equipment at North Shore (Pty) Ltd, based on the information given above and to recommend improvements to address the weaknesses you have identified.**

**Do not concern yourself with payments to creditors.**

**Ans: 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"> <li>▯ There is no evaluation of whether the items purchased by the five sectional accountants are required. (1½)</li> <li>▯ Any member of the section can request equipment without providing proper motivation. (1½)</li> <li>▯ 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)</li> <li>▯ It also provides an opportunity for misappropriation of equipment by employees. (1½)</li> </ul>	<ul style="list-style-type: none"> <li>▯ The company should appoint a fixed asset committee consisting of senior experienced management which will be responsible for evaluating the need for the purchase of capital expenditure. (1½)</li> <li>▯ and evaluating how capital expenditure will be financed. (1½)</li> <li>▯ All requests for fixed assets from sections and individuals within a section must be fully motivated. (1½)</li> <li>▯ The fixed asset committee should be responsible for preparing an annual capital expenditure budget (see below). (1½)</li> </ul>
<p>2. The budgeting process is totally ineffective. (1½)</p> <ul style="list-style-type: none"> <li>▯ Simply increasing the prior year budget by an index has resulted in sections being allocated money which they do not require and which will be wasted. (1½)</li> <li>▯ This weakness is compounded by the fact that sections are "punished" for not spending their allocation by having their budgets reduced. (1½)</li> <li>▯ 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)</li> </ul>	<ul style="list-style-type: none"> <li>▯ A proper budgeting for capital expenditure system should be put in place (1½)</li> <li>▯ each section should carefully evaluate their actual capital expenditure needs (and planned disposals) for the upcoming year. The budget should not be based on adjusted prior year figures. (1½)</li> <li>▯ the sectional budgets should be submitted to the fixed asset committee for their approval which should only be given after careful consideration of <ul style="list-style-type: none"> <li>▯ the motivation for the expenditure (1½)</li> <li>▯ alternatives the overall budget for the business and other sections (1½)</li> <li>▯ company cash flows (1½)</li> </ul> </li> <li>▯ should an item which appears in the budget not be required, it should not be purchased. (1½)</li> <li>▯ there should be ongoing comparison of actual capital expenditure to budgeted expenditure. (1½)</li> </ul>
<p>3. There is inadequate authorisation of capital expenditure. (1½)</p> <ul style="list-style-type: none"> <li>▯ Sectional accountants have complete authority to purchase equipment provided they have not exceeded the budget. (1½)</li> <li>▯ 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)</li> <li>▯ In effect the sectional accountants can make a purchase and authorise it which is a lack of division of duties. (1½)</li> <li>▯ 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)</li> </ul>	<ul style="list-style-type: none"> <li>▯ The fixed asset committee should approve the budget which will then become the fundamental authorising document. (1½)</li> <li>▯ See points below (4)</li> </ul>
<p>4. The controls over the requisitioning and ordering and receipt of capital expenditure items are inadequate. (1½)</p> <ul style="list-style-type: none"> <li>▯ No properly designed, pre-printed, sequenced (and authorised) requisition form is presented to support the purchase request (email is sent). (1½)</li> <li>▯ The order is placed by the assistant to the sectional accountant (not the buying department) without any follow up with the supplier as to availability and price and alternative suppliers. (1½)</li> <li>▯ The person requisitioning the item stipulates the specific details</li> </ul>	<ul style="list-style-type: none"> <li>▯ A properly designed (two part) pre-printed, sequenced, capital expenditure requisition must be prepared and signed by a senior person in the section requiring the item e.g. warehouse manager requiring a new fork lift. (1½)</li> <li>▯ This requisition should be submitted to the sectional accountant who should authorise the requisition (sign) after confirming that the request complies with the capital expenditure budget. (1½)</li> </ul>

<p>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)</p> <p>Items purchased should not be delivered to the individual sections as this weakens division of duties. (1½)</p>	<p>A copy of the requisition should be sent to the company buying department, and the second copy filed in numerical sequence. (1½)</p> <p>The order department should:</p> <ul style="list-style-type: none"> <li>confirm that the goods requisitioned appear on the capital budget and if so (1½)</li> <li>check with the preferred supplier as availability, current price, delivery particulars, etc, and (1½)</li> <li>make out and sign a three part pre- printed, sequenced (capital expenditure) order (1½)</li> <li>Copy 1 – to the supplier (1½)</li> <li>Copy 2 – to goods receiving department (1½)</li> <li>Copy 3 – to accounting (1½)</li> </ul> <p>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)</p> <p>Copy 1 – sent with the items to the section (with Copy 3 as well) (1½)</p> <p>Copy 2 – sent with supplier delivery note to accounting (1½)</p> <p>Copy 3 – filed in receiving. (1½)</p>
<p>5. There is a serious lack of division of duties in respect of the assistant to the sectional accountant. This person</p> <ul style="list-style-type: none"> <li>Places the order (on the strength of an email) (1½)</li> <li>Receives the goods (1½)</li> <li>"authorises" payment (by sending the unchecked documentation to creditors) (1½)</li> <li>Writes up the records (fixed asset register) (1½)</li> </ul> <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>	<p>The controls suggested above will also address this weakness.</p> <p>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)</p> <p>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)</p>

(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

**Q1. According to the insight education video on the Sales Cycle, what information should be contained on the pre-numbered, internally compiled invoice? (6 Marks)**

**Ans: 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)

**Q2. According to the Insight Education videos, what cycle has the highest risk of theft and why? (3 Marks)**

**Ans: 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

**Q1. According to the Insight Education video on the purchasing cycle, what does the ordering manager do when he/she receives an order form? (6 Marks)**

**Ans: 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

**Q1. What are the six (6) principles demonstrated in the production cycle video (Insight Education) that can be generalized and are the same to all the processes functioning within a company? (9 Marks)**

**Ans: 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

**Q1. According to the Insight Education video on the salaries and wages cycle, name the three stages (not functions) within the cycle. (4-1/2 Marks)**

**Ans: 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)