FEEDBACK ON SUPPLEMENTARY *DO* QUESTIONS

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

Topic 1 Corporate governance and Statutory Matters

Feedback on supplementary Do questions on topic 1

QUESTION 2.8 IN GRADED QUESTIONS **30 marks**

Reference: King III Report

Mullins Inc. has not properly complied with the principles of sound corporate governance.

1. Board of Directors

1.1 The board does not contain the right mix of executive and non-executive directors to maintain the required balance of power as required by the King III Report which requires the majority to be non-executive directors of which the majority should be independent. (Principle 2.18) Mullins Inc. has six executive directors to two non-executive directors. (1½)

1.2 The majority of non-executive directors should be independent but only one non-executive (Pete Copley) is clearly an independent director. (Principle 2.18)(1½)

1.3 The chairman in not an independent non-executive director, as recommended by the King III Report and has styled himself as the executive chairman. (Principle 2.16) (1½)

1.4 Until the creation of the position for Rob Mullins, the company did not have a chairman. The King III Report reflects that the chairman of the board plays an important role in leadership and governance of the company, and should bring independence and credibility to the board. While Rob Mullins's business credibility appears excellent, he is not independent and still acts as an executive. (1½)

1.5 Not being interested in "the financial function" at all, combined with the fact that he has brought Perry Majola onto the board, raises the question as to whether Rob Mullins could act effectively as an independent non-executive chairman. (1½)

1.6 The board meets the requirements for the number of yearly meetings according to the King III Report which is at least four times per annum. (Principle 2.1 point 1) (1½)

1.7 The fact that Thembi Mbethe is often forced to tender her apologies raises the question as to whether she is fulfilling her responsibilities (as a director) in a very important portfolio. All directors should attend all board meetings. (Principle 2.19 point 83) (1½)

1.8 In terms of Principle 2.21 the board should be assisted by a competent, suitably qualified and experienced company secretary. This position has been vacant at Mullins Inc for at least six months and will be filled in the course of the upcoming year. (1½)

2. Committees

The King III Report recommends that large entities have four standing board committees, namely risk, audit, nomination and remuneration committees. Mullins Inc. only has remuneration and audit committees. (1½)

2.1 Nominations Committee

- Rob Mullins appoints board members. Principle 2.19 requires that directors should be appointed through a formal process. (1½)
- The King III Report recommends that nominations for directorship are made by the board, assisted by the nominations committee. (1½)
- The nominations committee can be chaired by the chairman of the board, and should consist of non-executive directors, the majority of whom are independent. The fact that Rob Mullins is not a non-executive director further complicates the issue. (1½)

2.2 Risk Committee

- Mullins Inc. does not have a risk committee. King III recommends that a risk committee be established that is chaired by a non-executive director and whose membership includes both executive and non-executive directors, senior managers and independent risk management experts where necessary. (1½)

2.3 Audit Committee.

- In terms of Principle 2.23 point 131 of the King III Report, the committee should be chaired by an independent non-executive director. Rob Mullins is not an independent non-executive director. (1½)
- The chairman of the board should not be on the audit committee. (Principle 3.2 point 11) Rob Mullins acts as the chairman of the board as well as the audit committee. (1½)
- In terms of the King III Report, the audit committee should consist of independent non-executive directors. (Principle 3.2) Rob Mullins and Perry Majola are not independent non-executive directors by virtue of their recent executive positions with the company and Thembi Mbethe is currently the (executive) director of marketing. (1½)
- In terms of Principle 3.2 audit committee members should be suitably skilled and experienced and collective have sufficient financial knowledge and a good knowledge of financial risk. Perry Majola is a CA(SA) with a great deal of experience so qualifies on this count but Rob Mullins is not interested in financial matters and relied/relies on Perry Majola and Thembi Mbethe is a marketing executive and unlikely to understand such things as

IFRS and financial risk. There is no way that collectively, the audit committee will be able to fulfil the major responsibilities of an audit committee, for example overseeing integrated reporting. (1½)

- In terms of the King III Report the audit committee must consist of at least three directors. Mullins Inc. complies with this principle. (1½)
- In terms of the King III Report, the audit committee should meet as frequently as necessary to perform its functions, but at least twice a year. (Principle 3.1 point 7). They do not comply. (1½)
- The fact that the audit committee meets once a year after the completion of the audit, illustrates that the committee and the board have no idea about the function and role of an audit committee. The audit committee is supposed to work with the external auditors on preparation for the audit, resolving audit issues, and reporting on how it has fulfilled its function ***in the financial statements***. If the committee meets once a year after the audit is complete, the directors are not "ensuring that the company has an effective and independent audit committee". (1½)

2.4 Remuneration Committee

- The remuneration committee should be chaired by an independent non-executive director. (principle 2.23 point 131). Rob Mullins is not an independent non-executive director. (1½)
- The remuneration committee should consist only of non-executive directors the majority of whom are independent non-executive directors. (Principle 2.23 point 131). This creates a level of impartiality and independence so executives are not setting their own levels of pay. At present the committee has no independent non-executive directors, and only one non-executive director. (1½)

(1½ for each valid comment to a maximum of 30 marks)

Comments:

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

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

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

QUESTION 2.20 IN GRADED QUESTIONS **28 marks**

Reference: King III Report

1. No, there is no legal obligation to appoint an audit committee, and a private company is not bound by the requirements of the King III Report, but see below. (1½)

- The Companies Act 2008 requires only that public companies (and state owned enterprises) appoint audit committees. (1½)
- The King III Report recommends that all entities "regardless of the manner and form in which they are incorporated" should adopt the principles in the King Code and consider best practice recommendations included in the King III Report. (1½)
- If Cranks (Pty) Ltd voluntarily decides to have an audit committee, its composition, purpose and duties should be defined in the Memorandum of Incorporation (MOI) and the company must then comply with the MOI. In deciding on composition, purpose and duties the shareholders should follow the King III Report recommendations. (1½)

2. The shareholders of Cranks (Pty) Ltd should appoint the audit committee at the Annual general meeting (AGM). The audit committee should consist of independent non-executive directors which should be elected at the AGM. (1½)

- The CEO should not appoint members to the committee but the board ***could*** do so. Any conditions pertaining to the appointment of directors in the MOI and Companies Act would also have to be considered if additional directors have to be appointed to the board itself. (1½)
- The King III Report specifically stipulates that the CEO should not be the chairperson or a member of the audit committee. The chairperson should be an ***independent non-executive director***. (1½)

3. An audit committee is a committee of the board which is appointed primarily to ensure the integrity of the company's integrated reporting (Annual Financial statements (AFS), sustainability reporting etc.) as well as the integrity of the internal financial controls and risk management process. (1½)

- The essence of the committee is that it provides an ***independent*** overseeing role with regard to the matters discussed above. It also acts as the interface between external audit and the company. (1½)
- Like the audit committee, the internal audit department is an important component of the corporate governance structures of the company. (1½)
- Internal audit is essentially a mechanism which is designed to assist the board in meeting its governance responsibilities evaluating the company's governance processes including ethics
  a) performing objective assessments of the effectiveness of risk management and internal control framework (1½)
  b) systematically analysing and evaluating business processes (1½)
  c) providing a source of information regarding fraud, corruption, unethical behaviour and irregularities. (1½)

- Internal audit is far more involved in the governance process on a daily basis. It is not an "overseeing" role. (1½)
- Internal audit should report to the audit committee (independence) and is an important source of information for the committee. (1½)

4. The audit committee should be composed solely of independent non-executive directors.

- The chairperson of the audit committee must be an independent non-executive director and should not be the chairperson of the main board (of directors). (1½)
- There should be at least three members of the committee. (1½)
- Members of the committee should be suitably skilled and experienced and ***collectively*** have sufficient knowledge of financial matters, internal control and sustainability reporting. (1½)
- Anyone can be invited to meetings of the committee if they have a contribution to make, e.g. the chief audit executive should attend. (1½)

5. Benefits of having an audit committee

- Improves communication between internal auditors, external auditors, the board and management by providing a formal channel of communication. (1½)
- Enhances the independence of both the internal and external audit functions. (1½)
- Improves the image of the company and enhances the stakeholders confidence in the company and its financial and sustainability reporting, e.g. your bankers, finance providers. (1½)
- Duplication of audit effort (internal and external) is minimised resulting in a more efficient and cost effective audit. (1½)
- A competent independent "party" is created to receive and deal appropriately with concerns or complaints relating to e.g.
  a) accounting practices adopted by the company(1½)
  b) content or auditing of AFS(1½)
  c) the internal financial controls of the company. (1½)
- Enhances the role and image of independent non-executive directors. (1½)
- Ensures that the directors of the board as a whole meet their legal obligations, particularly in respect of financial reporting, e.g. gives "non-financial" directors "somebody" they can rely on. (1½)
- Enhances the overall integrity and quality of the company's reporting. (1½)
- There are very few disadvantages in having an audit committee, but there is a financial cost. (1½)
- In some cases the audit committee may cause delays in resolving matters, but this problem can usually be solved by proper planning. (1½)

6. Successful audit committee

- Ensure that the requirement for an audit committee is stipulated in Cranks (Pty) Ltd's Memorandum of Incorporation and that it lays down the duties and responsibilities of the committee clearly and concisely. This will formalise the audit committee, get the shareholders behind the decision to establish the committee, and provide the committee with permanence. (1½)

- Ensure that the committee is made up of individuals who have the right credentials to fulfil the function:
  a) Independent non-executive directors(1½)
  b) sufficiently technically skilled (including strong financial literacy) (1½)
  c) strong on ethical and moral front; honest, independent, impartial, co-operative but firm,conservative and decisive(1½)
  d) chairperson should be strong minded and decisive. (1½)
- Ensure that the other directors (executive and non-executive) give the audit committee their full support. (1½)
- Provide members of the audit committee with the right to unrestricted access to all information they require to perform their function. (1½)
- Ensure that the audit committee is supported by a well staffed competent internal audit department which is led by a competent chief audit executive. (1½)
- Make the audit committee itself accountable by requiring it to report on its own performance to the board annually. (1½)

1½ for each valid comment to a maximum of 28 marks)

Comments:

This question is presented in a question and answer format and is intended to test your knowledge regarding audit committees and internal audit. The solution does provide references to the Companies Act. This is just to establish a more well-rounded response. However you will **not** be required to discuss the Companies Act implications when providing your solution to a corporate governance question.

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

Topic 2 Internal Control

Feedback on supplementary Do questions on topic 2

QUESTION NUMBER 4.15 IN GRADED QUESTIONS **11 marks**

Reference: Jackson & Stent (2014: 5/5-5/18)

c) In terms of ISA 315, internal control is defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of the entity's objectives with regard to:

- the reliability of the entity's financial reporting; (1½)
- the effectiveness and efficiency of its operations; and (1½)
- its compliance with applicable laws and regulations". (1½)

d) The components of internal control are:

- the control environment - example (v) (1½)
- risk assessment - example (iv) (1½)
- the information system - example (i) (1½)
- control activities - example (ii) (1½)
- monitoring of controls - example (iii) (1½)

f) An **information system** is a combination of machines, computers, software, people and data. (1½)

Business processes are the activities which are designed to purchase, produce, sell and distribute the company's products, ensure compliance with laws and regulations, and record information. (1½)

The information system and related business processes work together to:

- Initiate, record, process and report transactions. (1½)
  - Capture events and conditions other than transactions (e.g. impairments). (1½)
  - Accumulate, record, process and summarise information for the preparation of the financial statements. (1½)

(1½ for each valid comment to a maximum of 11 marks)

Comments:

This question has been provided to test your understanding of the theory specifically relating to internal controls in topic 2. Remember that it is very important for you to have a good understanding of this foundational knowledge, as it will prepare you for later studies in auditing.

QUESTION 4.20 IN GRADED QUESTIONS **25½ marks**

Reference: Jackson & Stent (2014: 5/7-5/18)

Nr.	Component of internal control	Category of control activity
1.	Control environment (1½)	
2.	Control activity (1½)	Custody control (1½)
3.	Information systems (1½)	
4.	Control activity (1½)	Comparison and reconciliation (1½) and performance review (1½)
5.	Control activity (1½)	Authorisation (1½), Isolation of responsibility (1½) and performance review (1½)
6.	Risk assessment process (1½)	
7.	Control activity (1½)	Custody control (physical) (1½)
8.	Monitoring (1½)	
9.	Control activity (1½)	Segregation of duties (1½) and custody control (1½)

(1½ for each valid answer to a maximum of 25½ marks)

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.

QUESTION 4.23 IN GRADED QUESTIONS **10 marks**

Reference: Jackson & Stent (2014: 8/34-8/39)

PART A

1. A mandatory field control requires you to enter an important bit of information. For example, until you enter a delivery address, you cannot proceed with placing an order (completeness – no delivery address, company doesn't know where to deliver). (1½)

2. If you enter anything other than a numeric (number) in the quantity field the process will cease – you cannot continue placing the order (accuracy and completeness). (1½)

3. If 2 occurs, you will get a message on the screen which says something like "re-enter quantity make sure it is a number" (accuracy and completeness). (1½)

4. Screen formatting enables you to find your way around the webpage and place an order easily, efficiently and without frustration. (1½) Places to enter all details of the goods you wish to buy, will be clear and unambiguous (accuracy and completeness). (1½)

5. Minimum entry ensures that you have to key in as little as possible. (1½) Data is already "on the webpage" and all you need to do is "click and select". Once you click on a particular icon a list will "pop up" (or "drop down") from which you can make a choice e.g. instead of typing in the title and artist of a CD you wish to purchase you simply "click and select" (having defined say, the type of music you want.) (1½)

(1½ for each valid comment to a maximum of 10 marks)

Comments:

This question covers control techniques and application controls. Ensure you understand all the different controls available to be able to answer a question where application controls are part of the internal controls that could be implemented to mitigate risks provided.

Topic 4 Revenue and Receipts Cycle

Feedback on supplementary Do questions on topic 4

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

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

1. Credit management. (1)

2. Order Department (receiving customer orders and sales authorization). (1)

3. Warehousing. (1)

4. Despatch. (1)

4. Credit management. (1)

5. Despatch. (1)

6. Recording of Sales. (1)

7. Invoicing. (1)

8. Mailroom receipting/cashier. (1)

9. Goods returned function. (1)

10. Ordering department (or warehousing). (1)

11. Credit management. (1)

12. Invoicing. (1)

15. Warehousing. (1)

(1 for each valid comment to a maximum of 15 marks)

Comments:

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

QUESTION 8.12 IN GRADED QUESTIONS **40 marks**

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

Weakness 1

Credit Management

1 Credit is extended to customers who are not creditworthy (Peter Polar believes bad deb is too high) (1½)

Explanation:

1.1 Ben Chetti has no means of checking whether an order is from a customer who is in good standing with the company before initiating the sale. (1½)

1.2 This weakness arises because