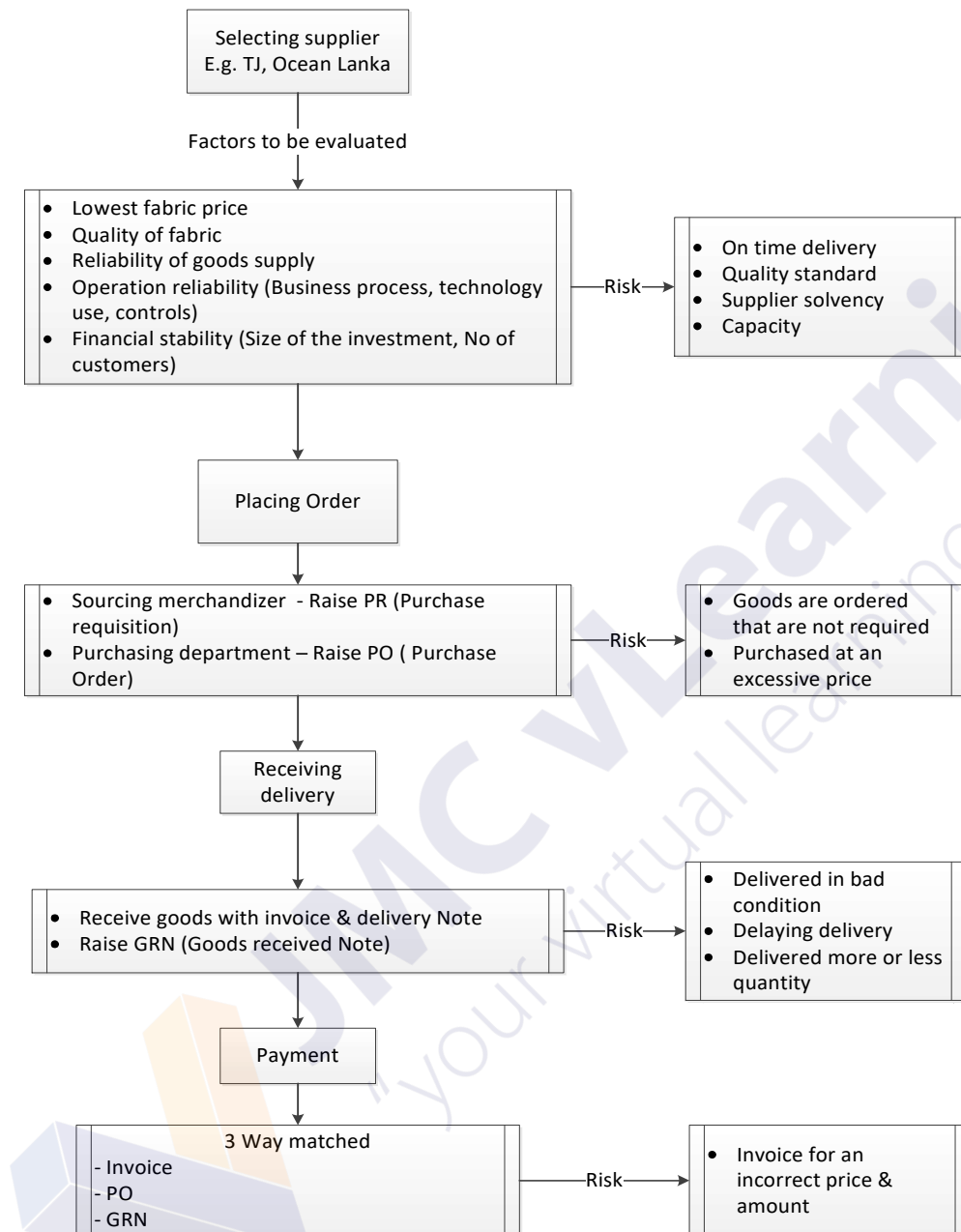# JMC vLearning
"your virtual learning partner"

Business Process

Chartered Accountancy
Corporate Level
Advanced Audit & Assurance (AAA)

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ACA, B.Sc. (Accounting and Finance)

Think – Your best teacher is your last mistake

01.   Purchasing Process

```
┌─────────────────────┐
│ Selecting supplier  │
│ E.g. TJ, Ocean Lanka│
└─────────────────────┘
   Factors to be evaluated
            ↓
```

Factors to be evaluated		Risk →	
• Lowest fabric price • Quality of fabric • Reliability of goods supply • Operation reliability (Business process, technology use, controls) • Financial stability (Size of the investment, No of customers)			• On time delivery • Quality standard • Supplier solvency • Capacity

```
┌───────────────┐
│ Placing Order │
└───────────────┘
```

	Risk →	
• Sourcing merchandizer - Raise PR (Purchase requisition) • Purchasing department – Raise PO (Purchase Order)		• Goods are ordered that are not required • Purchased at an excessive price

```
┌──────────────┐
│  Receiving   │
│  delivery    │
└──────────────┘
```

	Risk →	
• Receive goods with invoice & delivery Note • Raise GRN (Goods received Note)		• Delivered in bad condition • Delaying delivery • Delivered more or less quantity

```
┌──────────┐
│ Payment  │
└──────────┘
```

3 Way matched	Risk →	
- Invoice - PO - GRN		• Invoice for an incorrect price & amount

The Procumbent Process Insight

Budgetary controls in purchasing

There should be **budgetary controls** over purchase **quantities & prices**. The budgetary control reporting system should ensure that **significant differences** between actual & budgeted purchase quantities or process are reported to **management for investigation**

Documents in purchasing process

01.   Purchase requisition
- The purchase requisition note is used by purchasing department as authority to place a purchase order with a supplier
- The store department, which makes a purchase requisition when the inventory level for the inventory item falls to a reorder level.
- A manager in a department who has authority to make purchase requisition for specified purpose up to an approved value limit

PURCHASE REQUISITION			Reg No	
Department/ Job number			Date	
Requested by				
Latest date required				
Quantity	Code Number	Description	Estimated cost	
			Unit	Rs
Authorized signature				

02.   Purchase Order
- Copies of Purchase order are sent to the person who submitted the purchase requisition (Often the shopkeeper) & accounts department
- The purchasing department prepares a purchase order, which is sent to the supplier.
- Copies of purchase order
    - ✓ Retained in the purchasing department
    - ✓ Sent to the accounts department
    - ✓ Sent to the storekeeper who made the purchase requisition

PURCHASE ORDER/ CONFIRMATION
Our order ref :- Date :-
To :-
Please deliver to the above address ordered by :-
Passed & check by :-
Total value Rs :-

	Subtotal		
	Vat & 11%		
	Total		

Points to note:-

- Some manufacturing organizations have a computerized system for managing materials purchasing & production scheduling, known as a **Material requirements planning (MRP) system**
- An MRP system schedules future production and identified the material required for this production work
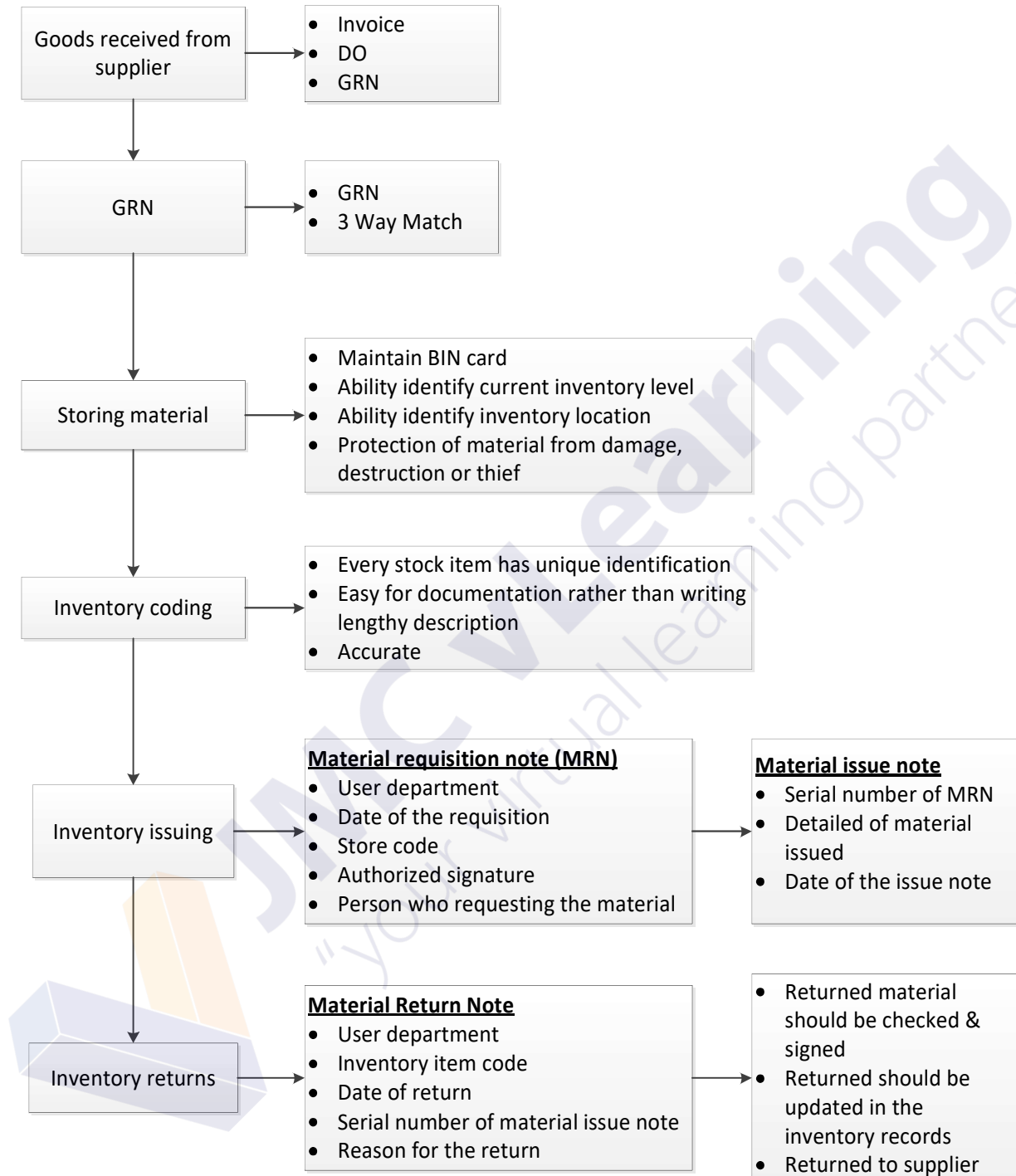
03.   Goods Received Note

- Record of goods received at the point of receipt. This record is used to confirm all goods have been received and often compared to a purchase order before payment is issued.
- Copies of GRN
  - ✓ The purchasing department, as confirmation that the purchase order has been fulfilled
  - ✓ The accounts department, as evidence that the goods have been received & used for 3way match
  - ✓ The copy of the GRN held by the storekeepers should be used to update the inventory record

GOODS RECEIVED NOTE WAREHOUSE COPY		
		NO 5576
DATE :- TIME:-		
SUPPLIER & SUPPLIER'S ADVISED NOTE NUMBER		
Quantity	Reference number	Description
Received in good condition :-		

Business Risk in the Procumbent Process

Risk	Internal control
Supplier unable to provide the goods, or cannot provide goods to the required quality	Formal selection and evaluation process is used
Goods are ordered that are not required	- Purchase requisition should be authorized - Purchase requisition will be checked in the purchasing department & the accounts department - Use ROL & ROQ for standard store items
Goods are ordered from a non-existing supplier (Fraud)	- Buyers should use suppliers only if they are on approved list - There should be a control over updates to the master file containing information about suppliers
Goods may be ordered at an excessive price	- Specialist buyers may be employed. - There may be fixed priced agreement with suppliers
Goods are not delivered or delivered in bad condition	- Delivery note should be singed only if the goods appear to be in the correct quantity and condition
Supplier submit invoice for incorrect amount	Accounts department check the invoice details against purchases order & GRN (3way match)
Suppler may deliver more goods or less goods than ordered	- Good physical verification at the time of unloading - Take security guard confirmation - Use possible parameter such as boxes, Kg, Yard tec…

02.   Inventory Management Process

```
┌─────────────────────┐        ┌─────────────────────┐
│ Goods received from │ ─────► │ • Invoice           │
│ supplier            │        │ • DO                │
│                     │        │ • GRN               │
└─────────────────────┘        └─────────────────────┘
          │
          ▼
┌─────────────────────┐        ┌─────────────────────┐
│ GRN                 │ ─────► │ • GRN               │
│                     │        │ • 3 Way Match       │
└─────────────────────┘        └─────────────────────┘
          │
          ▼
┌─────────────────────┐        ┌─────────────────────────────────────┐
│ Storing material    │ ─────► │ • Maintain BIN card                 │
│                     │        │ • Ability identify current inventory│
│                     │        │   level                             │
│                     │        │ • Ability identify inventory location│
│                     │        │ • Protection of material from damage,│
│                     │        │   destruction or thief              │
└─────────────────────┘        └─────────────────────────────────────┘
          │
          ▼
┌─────────────────────┐        ┌─────────────────────────────────────┐
│ Inventory coding    │ ─────► │ • Every stock item has unique       │
│                     │        │   identification                    │
│                     │        │ • Easy for documentation rather than│
│                     │        │   writing lengthy description       │
│                     │        │ • Accurate                          │
└─────────────────────┘        └─────────────────────────────────────┘
          │
          ▼
┌─────────────────────┐   ┌────────────────────────────────┐   ┌────────────────────────────┐
│ Inventory issuing   │ ─►│ Material requisition note (MRN)│ ─►│ Material issue note        │
│                     │   │ • User department              │   │ • Serial number of MRN     │
│                     │   │ • Date of the requisition      │   │ • Detailed of material     │
│                     │   │ • Store code                   │   │   issued                   │
│                     │   │ • Authorized signature         │   │ • Date of the issue note   │
│                     │   │ • Person who requesting the    │   │                            │
│                     │   │   material                     │   │                            │
└─────────────────────┘   └────────────────────────────────┘   └────────────────────────────┘
          │
          ▼
┌─────────────────────┐   ┌────────────────────────────────┐   ┌────────────────────────────┐
│ Inventory returns   │ ─►│ Material Return Note           │ ─►│ • Returned material        │
│                     │   │ • User department              │   │   should be checked &      │
│                     │   │ • Inventory item code          │   │   signed                   │
│                     │   │ • Date of return               │   │ • Returned should be       │
│                     │   │ • Serial number of material    │   │   updated in the           │
│                     │   │   issue note                   │   │   inventory records        │
│                     │   │ • Reason for the return        │   │ • Returned to supplier     │
└─────────────────────┘   └────────────────────────────────┘   └────────────────────────────┘
```

02.1   Classification of inventory

- Raw material & component
- Work in progress
- Spare part/Consumables
- Finished goods

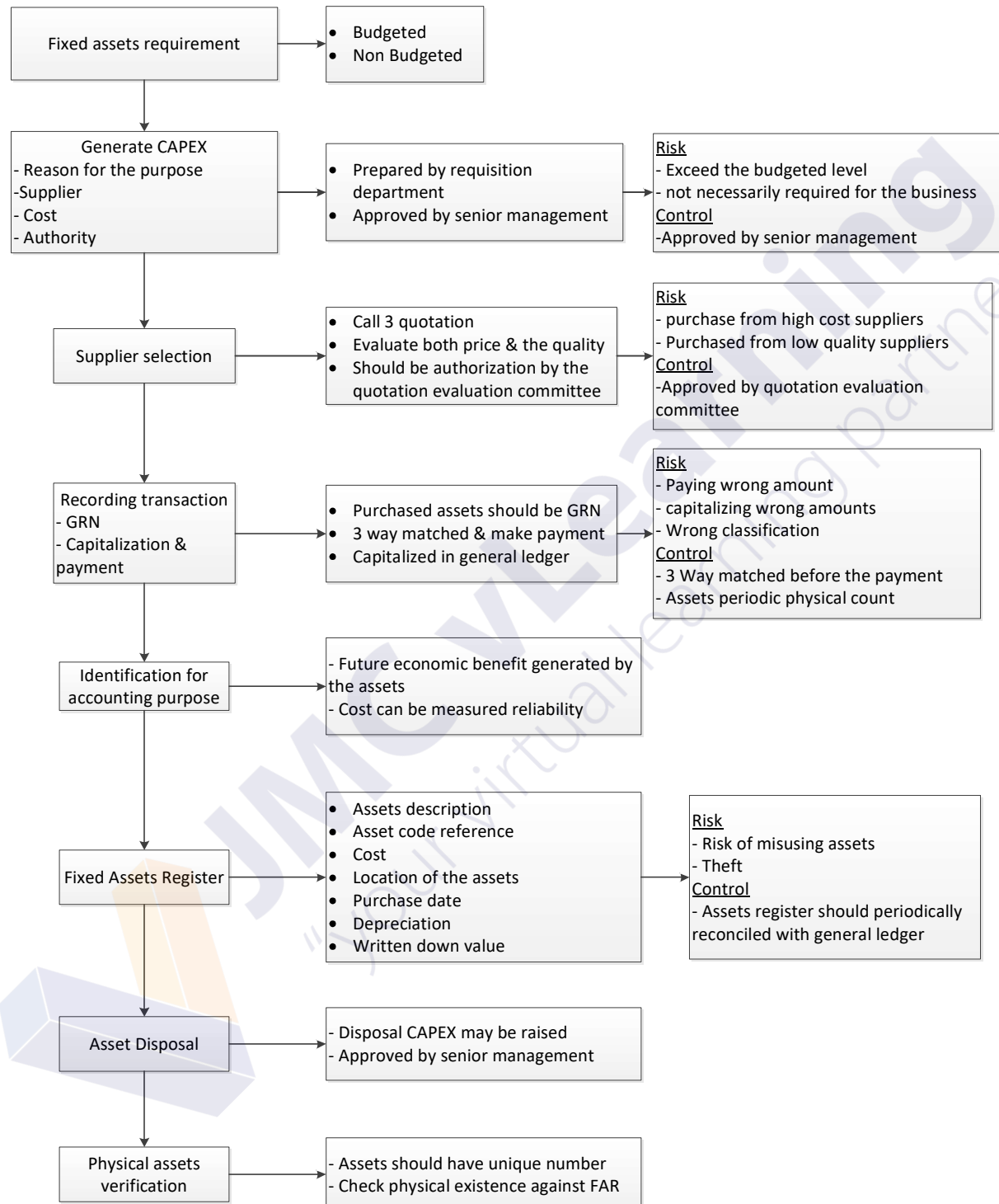**02.2   Perpetual inventory model**

System where inventory records are updated whenever goods are received & issued. Mostly computerized inventory system can be treated as perpetual inventory system

02.3   Business risks involved with the inventory management

Risk	Internal control to mitigate the risk
Risk of shortage	- Monitoring minimum inventory level regularly - Placing orders considering re order level
Risk of excessive inventory	- Maintain EOQ level - Regular monitoring of maximum inventory level
Physical risk	- Security guard - CCTV - Restrict access only to authorized persons
Risk in errors	- Conducting physical verification regularly - Carry out inventory reconciliation - Conducting inventory cycle count
Risk of issuing inventory	Material Requisition Note
Accepting goods without referring to order details	Check GRO with PO

03.   Property Plant & Equipment

```
┌──────────────────────────┐      ┌──────────────────────────┐
│  Fixed assets requirement │─────▶│  • Budgeted              │
│                           │      │  • Non Budgeted          │
└──────────────────────────┘      └──────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐   ┌──────────────────────────────────┐
│     Generate CAPEX        │   │ • Prepared by requisition│   │ Risk                             │
│ - Reason for the purpose  │──▶│   department             │──▶│ - Exceed the budgeted level      │
│ -Supplier                 │   │ • Approved by senior     │   │ - not necessarily required for   │
│ - Cost                    │   │   management             │   │   the business                   │
│ - Authority               │   │                          │   │ Control                          │
│                           │   │                          │   │ -Approved by senior management   │
└──────────────────────────┘   └──────────────────────────┘   └──────────────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐   ┌──────────────────────────────────┐
│                          │   │ • Call 3 quotation       │   │ Risk                             │
│   Supplier selection     │──▶│ • Evaluate both price &  │──▶│ - purchase from high cost        │
│                          │   │   the quality            │   │   suppliers                      │
│                          │   │ • Should be authorization│   │ - Purchased from low quality     │
│                          │   │   by the quotation       │   │   suppliers                      │
│                          │   │   evaluation committee   │   │ Control                          │
│                          │   │                          │   │ -Approved by quotation           │
│                          │   │                          │   │ evaluation committee             │
└──────────────────────────┘   └──────────────────────────┘   └──────────────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐   ┌──────────────────────────────────┐
│  Recording transaction   │   │ • Purchased assets should│   │ Risk                             │
│ - GRN                    │   │   be GRN                 │   │ - Paying wrong amount            │
│ - Capitalization &       │──▶│ • 3 way matched & make   │──▶│ - capitalizing wrong amounts     │
│   payment                │   │   payment                │   │ - Wrong classification           │
│                          │   │ • Capitalized in general │   │ Control                          │
│                          │   │   ledger                 │   │ - 3 Way matched before the       │
│                          │   │                          │   │   payment                        │
│                          │   │                          │   │ - Assets periodic physical count │
└──────────────────────────┘   └──────────────────────────┘   └──────────────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐
│  Identification for      │   │ - Future economic benefit│
│  accounting purpose      │──▶│   generated by the assets│
│                          │   │ - Cost can be measured   │
│                          │   │   reliability            │
└──────────────────────────┘   └──────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐   ┌──────────────────────────────────┐
│                          │   │ • Assets description     │   │ Risk                             │
│                          │   │ • Asset code reference   │   │ - Risk of misusing assets        │
│  Fixed Assets Register   │──▶│ • Cost                   │──▶│ - Theft                          │
│                          │   │ • Location of the assets │   │ Control                          │
│                          │   │ • Purchase date          │   │ - Assets register should         │
│                          │   │ • Depreciation           │   │   periodically reconciled with   │
│                          │   │ • Written down value     │   │   general ledger                 │
└──────────────────────────┘   └──────────────────────────┘   └──────────────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐
│     Asset Disposal       │   │ - Disposal CAPEX may be  │
│                          │──▶│   raised                 │
│                          │   │ - Approved by senior     │
│                          │   │   management             │
└──────────────────────────┘   └──────────────────────────┘
            │
            ▼
┌──────────────────────────┐   ┌──────────────────────────┐
│  Physical assets         │   │ - Assets should have     │
│  verification            │──▶│   unique number          │
│                          │   │ - Check physical         │
│                          │   │   existence against FAR  │
└──────────────────────────┘   └──────────────────────────┘
```

04. Payroll Process

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                              ┌─────────────────┐
                              │  Payroll process │
                              └─────────────────┘
```

Joining to the organization & leaving from the organization	Attendance capturing	Payroll processing	Payment of salaries	Payroll reconciliation
Joining - Create payroll record (Payroll officer should be entered data with the higher level approval) **Leaving** - Resignation letter should be handed over to HR department - HR department should communicate to Payroll officer - Payroll officer should prepare the final payment - Name of the employee should be removed from the payroll	- Actual time should be captured through the barcode swipe or figure print - Manual attendance changes should be capered from the audit trial - Proper request/Approval / authorization should required for the manual changes - Over time hours should be recognized after standard working hours	- Segregation of duties (Payroll officer is the only one authorized party to run the payroll) - Finance department should check the accuracy of payroll before payment	- Payroll officer prepares the payroll & passes information to Finance department for payments - Salaries should pay at the specific date or before that - Necessary deductions should be made such as EPF, ETF, PAYE - Unclaimed salaries should keep in a safe manner & relevant signatures should be taken when it pay to the employee	Reconciliation to ensure • Employees have been paid properly • Accuracy of EPF, ETF, PAYE • Accounting entries are correct
Risk	**Risk**	**Risk**	**Risk**	
• Pay for non existing employees • Create fake employees	• Manual attendance changed • collusion	• Segregation of duties • Calculation errors	• Under or over payment • Wrong statutory deduction • Paid to wrong employee	

The payroll system

01.   Objective of payroll system
- Ensure that employees are paid for their work
- System should be to avoid under or over payment

02.   Payroll system
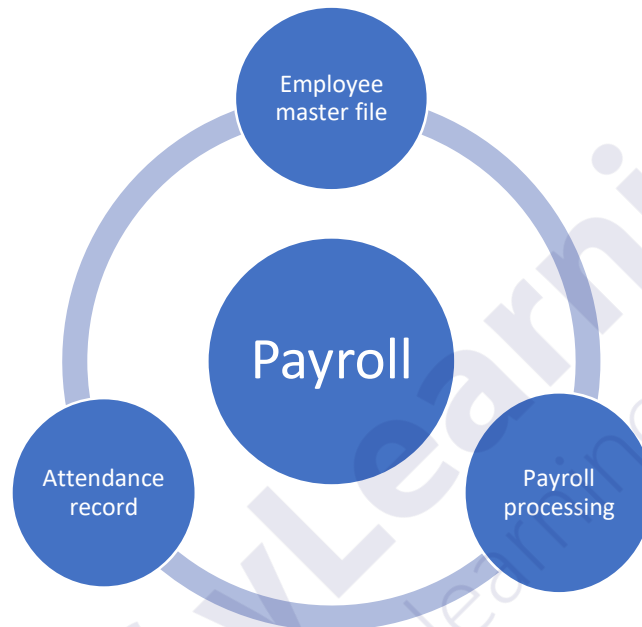
- **Employee master file**
  - ✓ Contain detail of employees, including their job in the organization, salary or wages details
  - ✓ File should be maintained for both active employees & non existing employees
  - ✓ No one should paid a wages or salaries unless they are on the employee master file
- **Attendance record**

  Refer diagram
- **Payroll processing**

  There should be segregation of duties between following there areas
  - ✓ It is responsibility of the Human resource department to keep employee records, and to notify the payroll officer of all relevant details
  - ✓ The payroll officer will maintain the payroll records
  - ✓ Attendance records should be the initial responsibility of the operational managers where the employees work

03.   Key controls objectives, controls & test of controls relevant to the payroll system

Occurrence & existence		
Control objectives	**Controls**	**Test of controls**
Payment is made only to existing employees	▪ Segregation of duties	▪ Observe & evaluate proper segregation of duties
	▪ Personal file held for all employees	▪ Review sample of starters & leavers in the year to ensure correct documentation is in place
	▪ Authorization procedure for hiring, terminating, time worked, wages rate, overtime, benefits etc…	▪ Review & test authorization procedure in place
	▪ Any changes in employment status of employees informed to HRD	▪ Review policies & procedures in place for changing status & consider whether adequate ▪ Review personal files for a sample of employees whose status changed in the years
	▪ Only employees with valid employee numbers are paid	▪ Review & test procedures for entering & removing employee numbers from the payroll master file
	▪ Payroll budgets in place & reviewed by management	▪ Review budget procedure
Completeness		
Control objectives	**Controls**	**Test of controls**
All payroll costs are recorded for work done by employees	▪ Renumbered clock cards in use	▪ Review sequence of clock cards
	▪ Segregation of duties	▪ Observe & evaluate proper segregation of duties
	▪ Custody of cash ✓ Encashment of cheque ✓ Security of pay packets ✓ Security of transit ✓ Security & prompt banking of unclaimed wages ▪ Recording of distribution ▪ Preparation & authorization of cheques & bank transfer lists ▪ Comparison of cheques & bank	▪ Before the wages are paid compare payroll with wags packets to ensure all employees have wages packet ▪ Examine receipts given by the employees; check unclaimed wages are recorded in unclaimed wages book ▪ Observe whether any employee receives more than

	transfers list with payroll ■ Maintenance & reconciliation of wages & salaries bank account	one wage packet ■ Inspect unclaimed wages book entries with the entries on the payroll to ensure they agree ■ Checked that unclaimed wages are banked regularly by inspecting of bank statements ■ Inspect that unclaimed wages books to check it shows reasons why wages are unclaimed **Holyday pay** ■ Verify a sample of payments with the underlying records & check the calculations of the amounts paid by recalculation ■ Examine paid cheques or a certified copy of the bank list for employees paid by cheque or bank transfer

Accuracy , classification & valuation		
Control objectives	**Controls**	**Test of controls**
All benefits & deductions (Tax, ETF, EPF) are computed correctly Payroll transactions correctly recorded in the accounting system	■ Verification of payroll amounts & benefits calculation	■ Recalculation benefits & deduction for a sample of employees
	■ Payroll budget review by management	■ Review budgeting procedures
	■ Agreement of gross earning & total tax deducted with taxation return	■ Inspect documentation for evidence of management's review
	■ Changes to master payroll file verified through before & after reports	■ Review reconciliation of before & after reports to payroll master file
	■ Payroll master file reconciled to general ledger	■ Review reconciliation of payroll master file to general ledger. Confirmed whether discrepancies are followed up promptly & resolved

Cut off		
Control objectives	**Controls**	**Test of controls**
Payroll transactions are recorded in the correct accounting period	■ All starters, leavers, changes to salaries & deductions are reported promptly to payroll department & changes are updated in the payroll master file promptly	■ Review entity's procedure for reporting changes to the payroll department ■ Check sample of starters & leavers

Presentation & disclosure assertion		
Control objectives	**Controls**	**Test of controls**
Payroll transactions are properly classified in the financial statements	▪ Chart of accounts ▪ Independent approval & review of accounts charged to payroll ▪ Payroll budget in place and reviewed by management	▪ Review chart of accounts ▪ Review procedures for classifying payroll costs ▪ Review budgeting procedures

04. Business risk in the payroll process

The main risk in the payroll process are that employees may be overpaid, & in some cases (Of frauds) non existing employees may be paid, or former employees may continue to be paid after they left the organization

There will also be risk of under payment to employees, or that new employees will not be paid because they have not been added to the payroll records

05. Business risk in the payroll process

- Gross pay or deduction may be calculated incorrectly
- Errors should be reduced by the process of checking payroll reports before wages & salaries are paid
- Automation of payroll system reduce the risk of errors in computation

06. Risk of incorrect information to the payroll officer

- Risk of failing to provide complete information to the payroll officer should be reduced by means of compliance with procedures, & occasional audit check of procedures (Internal audit)

Questions

01. Briefly explain the new employee recruitment process

02. What are main step of creating a payroll record

03. Explain the leaves handing procedure in an organization

04. Identify & explain risk of fraud relating to payroll system

05. Briefly explain wages & salaries payment process of an organization

06. Explain the relationship/communication between finance & HR department in payroll process

07. What are the type of attendance capturing & provide brief explanation for each

08. How organization calculate Overtime of the employee

09. Briefly explain the deduction from payroll

10. What do understand by payroll reconciliation

05. Cash Management

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                                    ┌──────────────────┐
                                    │  Cash management │
                                    └──────────────────┘
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Need more attention

Cash Receipt	Cash payment	Preparation of bank reconciliation	Short term cash management	Petty cash management
- Receipts from sale of goods, Other income, short term investment - All cash received should properly update in the cash book & relevant other accounts	- All the cheques, Cash payments should enter in cash book - Bank transfers/on line banking should update in to the cash book accordingly - All the payments should support by external document - Payments should be authorized with appropriate authority levels	- Most important internal control to ensure accuracy of cash book - Helps to identify possible errors in the cash book & bank statement - un presented & deposits not realized cheques - Bank charges - Direct deposit by customer - Cancelled cheques	- Cash Surplus – Short term deposit such as treasury bills, demand deposits - cash shortage – Bank OD, Short term barrowings - All of above should be done with relevant approval levels	01. Petty cash float Should maintain weekly or monthly basis 02. Cash collection from sales or debtors should not be used for petty cash purpose 03. Petty cashier is responsible for managing petty cash float 04. Petty cash vouches should be authorized by a responsible person & should be supported with valid external document 05. IOU should be settled with in given time period 06. Petty cash vouchers should have a serial number 07. Cross check attached voucher amount with bill value 08. All petty cash vouchers to be entered in the petty cash book 09. Performing surprise cash count

Risk

Risk	Risk	Risk	Risk	Risk
• Not properly record in the books • No proper valid supportive document	• No proper valid supportive document • Pay for the wrong supplier • Pay wrong amount	• Errors in bank book & bank statement	• Thief • Use for fraudulent activity	• No proper valid document • Use for wrong purposes • Possibility to misuse the petty cash float • Delaying cash settlement • Exceed IOU limit

06. Internal controls

Definition

Internal control is broadly defined as a process, effected by an entity's <u>board of directors, management, and other personnel</u>, designed to provide <u>reasonable assurance</u> regarding the achievement of objectives relating to <u>effectiveness & efficiency of operations, financial reporting, and compliance with applicable laws & regulations</u>

COSO internal control framework

COSO internal control framework define the internal control system as,
- Processes put into effect by the board of directors & management
- That are designed to provide reasonable assurance regarding the achievement of the objective in the following areas,
    - Effectiveness & efficiency of operations
    - Financial reporting
    - Compliance with applicable laws & regulations

Objectives of internal control framework

Areas focus	Objective
Effectiveness & efficiency of operations	- Efficient & effective use of resources E.g. Funds, human resource - Provide accurate information for internal decision making. e.g. All operational controls - Safeguarding the assets & records. E.g. misused, stolen
Reliability Financial reporting	- Meet the common use of all users - Prepare financial statement according to the GAAP requirement & LKAS
Compliance with applicable laws & regulations	Ensure *going concern* ability of organization e.g. Inland revenue act, CBSL, Company act

07. Categories of Internal Controls
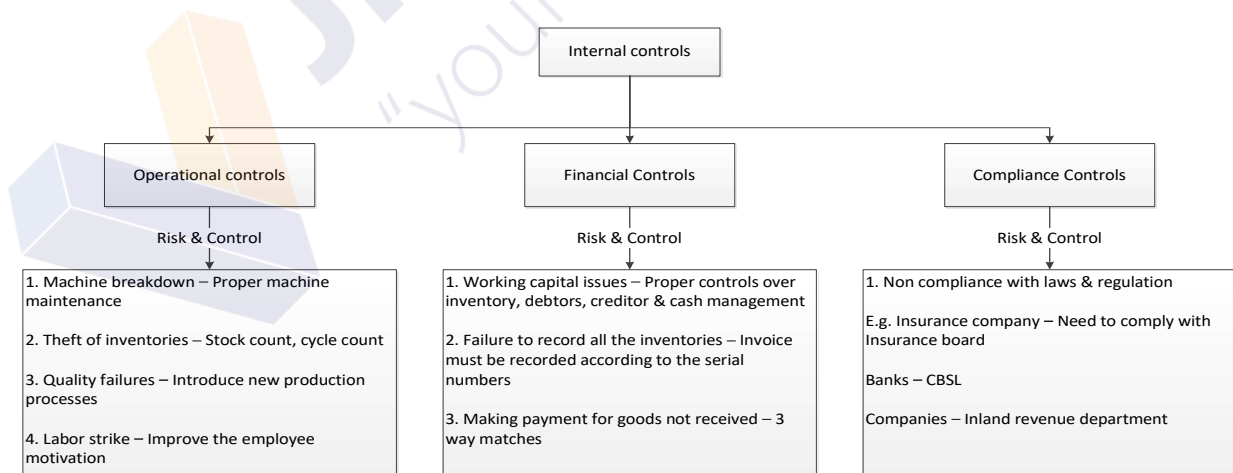
08. Components of Internal Controls System

Component	Description
Control Environment	This refers to culture of the organization & its <u>attitude to risk</u>. The effectiveness of an internal control system depends on the attitude to risk & risk awareness of the people in it ■ Create environment that fosters internal controls ■ Expect Ethical Behavior ■ Hire qualified staff ■ Get to know your staff ■ Clear assignment of responsibility/Job Description ■ Supervision ■ Clear Communication
Risk Assessment	Risk assessment is the <u>identification and analysis</u> of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change. Examples of Financial Risk: ■ Accounting processes ■ Auditing Matters ■ Compliance with Regulatory Issues ■ Falsification of reports/records ■ Fraud ■ Improper receipt of gifts ■ Improper vendor activity ■ Theft ■ Waste and Abuse ■ Misuse of Resources
Control Activities	Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives ■ Segregation of duties ■ Physical controls ■ Authorization & approval ■ Staff Training ■ Policies and Procedures ■ Performance Measures
Information & communication	■ Relevant information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. ■ Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. ■ Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control

	responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. ▪ There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders
Monitoring	A process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties Why Monitoring is Important: ▪ Inherent Risks - Complexity - Decentralization – many hands, need accountability - Repeat Problems - Unresponsive to prior weaknesses ▪ Exposures - Changes in Regulatory Environment - Personnel Changes - System and Process Changes - Rapid Growth - New Programs, services and staff e.g ▪ Management's review of whether bank reconciliations are being prepared in a timely basis ▪ Legal department oversight of compliance

09. Limitation of Internal controls

▪ Lack of communication.
 A lack of proper communication regarding internal control procedures, benefits, needs and responsibilities from the "top", as well as the reporting of weaknesses and problems from the "bottom" have an adverse effect on the success of the internal control system.

▪ People mistakes.
The effectiveness of the internal control system depends on the competence, reliability and due care of the people responsible for its operation. Mistakes/errors threaten the effectiveness of any internal control system.

▪ Management override of controls.
Because of the authority and responsibility of officials high up in the organizational structure, the risk infuses that they can easily override the internal control system.

▪ Inaccurate information.
The introduction of inaccurate information can be used to manipulate information reflecting the effectiveness of the internal control system and/or to conceal certain deliberate actions Collusion. Lack of integrity and dishonesty of employees and officials can lead to collusion amongst two or more people to circumvent the internal control system.

■ Collusion.
Lack of integrity and dishonesty of employees and officials can lead to collusion amongst two or more people to circumvent the internal control system.

■ Complexity.
An increasingly complex internal control system can lead to operational inefficiencies, because employees are unable to cope with the system.

■ Unresponsive to changing circumstances.
Conditions within organizations are not static, e.g. internal control systems that don't change in reaction to new control techniques, or to changes in the organizational environment are left exposed.

Question 01

A. Briefly explain three (03) limitations of internal control. (03 marks)

B. Araliya (Pvt) Ltd. produces coconut oil for the local market. Hemantha who is the storekeeper of Araliya (Pvt) Ltd. places purchase orders when stock level reaches re-order level. The quantity ordered is determined based on the weekly production plan. When coconuts are received in the stores, Hemantha verifies the quantity and quality and raises a GRN. Hemantha checks the accuracy of the supplier's invoice and sends it to the finance department to release the cash required to pay the supplier. Hemantha acknowledges receipt of the cash from the finance department and hands over the cash to the supplier. The finance department performs a monthly inventory count at the stores to verify the stock levels.

   I. State three(03) weaknesses in the internal control system explained above and
   II. Explain how you would overcome each of those weaknesses.

C. You are a member of the team auditing the financial statements of Hiru PLC for the year ended 31st March 2015. Your senior has assigned you to audit the Property, Plant and Equipment of Hiru PLC. You have noted in your preliminary analytical review that there has been a significant increase in Property, Plant and Equipment of the company during the year ended 31st March 2015.

   I. State three(03) internal controls that you would expect to exist in relation to Property, Plant and Equipment of Hiru PLC.
   II. List one audit procedure each you would perform to verify existence, valuation and ownership of Property, Plant and Equipment of Hiru PLC.

10. IT General Control & Application Control

General controls

These are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data Centre and network operations
- System software acquisition, change and maintenance
- Program change
- Access security
- Application system acquisition, development, and maintenance

I. Administrative controls

Controls over 'data centre and network operations' and 'access security' include those that:

- prevent or detect errors during program execution,
    - ✓ Procedure manuals
    - ✓ Job scheduling
    - ✓ Training and supervision

- prevent unauthorized amendments to data files,
    - ✓ Authorization of jobs prior to processing
    - ✓ Back up and physical protection of files
    - ✓ Access controls such as passwords
    - ✓ Testing of back - up procedures, protection against fire and floods.

II. System development controls

The other general controls referred to in ISA 315 cover the areas of system software acquisition development and maintenance; program change; and application system acquisition, development and maintenance.

- ✓ Controls over application development, such as good standards over the system design and program writing, good documentation, testing procedures (eg use of test data to identify program code errors, pilot running and parallel running of old and new systems), as well as segregation of duties so that operators are not involved in program development
- ✓ Controls over program changes – to ensure no unauthorized amendments and that changes are adequately tested, eg password protection of programs, comparison of production programs to controlled copies and approval of changes by users
- ✓ Controls over installation and maintenance of system software – many of the controls mentioned above are relevant, eg authorization of changes, good documentation, access controls and segregation of duties.

Application controls

These are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Application controls apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories:

I. Input controls

The most common example of programmed controls over the accuracy and completeness of input are edit (data validation) checks when the software checks that data fields included on transactions by performing:

✓ Reasonableness check, eg net wage to gross wage
✓ Existence check, eg that a supplier account exists
✓ Character check, eg that there are no alphabetical characters in a sales invoice number field
✓ Range check, eg no employee's weekly wage is more than $2,000
✓ Check digit, eg an extra character added to the account reference field on a purchase invoice to detect mistakes such as transposition errors during input.

When data is input via a keyboard, the software will often display a screen message if any of the above checks reveal an anomaly, eg 'Supplier account number does not exist'.

II. Processing controls

An example of a programmed control over processing is a run-to-run control. The totals from one processing run, plus the input totals from the second processing, should equal the result from the second processing run. For instance, the beginning balances on the receivables ledger plus the sales invoices (processing run 1) less the cheques received (processing run 2) should equal the closing balances on the receivable ledger.

III. Output controls

Batch processing matches input to output, and is therefore also a control over processing and output. Other examples of output controls include the controlled resubmission of rejected transactions, or the review of exception reports (eg the wages exception report showing employees being paid more than $1,000).

IV. Master files and standing data controls

Examples include one-for-one checking of changes to master files, eg customer price changes are checked to an authorized list. A regular printout of master files such as the wages master file could be forwarded monthly to the personnel department to ensure employees listed have personnel records.