



AUI3701

October/November 2017

The Internal Audit Process: Planning the Engagement

Duration 2 Hours

100 Marks

EXAMINERS

FIRST

SECOND

MRS L SNYMAN

MRS BM VAN WYK

Use of a non-programmable pocket calculator is permissible.

Closed book examination

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[TURN OVER]



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THIS PAPER CONSISTS OF **Twelve (12)** PAGES

QUESTION	TOPIC	MARKS
1	Multiple Choice	24
2	Code of Ethics and Fraud	27
3	Documenting Business Processes	30
4	Planning and analytical procedures	19
Total		100

NOTE:

Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the candidate's ability to organise and present such knowledge in written language of an acceptable standard will be taken into consideration by the examiners

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QUESTION 1

24 marks

REQUIRED

For each subsection of this question, select only the **one** alternative that you consider to be the most appropriate answer. Write down the number of the subsection and the letter preceding the selected alternative. Answer the subsections of this question in numerical sequence. For example

1.1 A

1.2 B

Each question counts **1½ marks**

- 1.1** Which of the following is **not** a typical “rationalisation” of a fraud perpetrator?
- A It is in the organisation’s best interest
 - B The company owes me because I’m underpaid
 - C I want to get back at my boss (revenge)
 - D I’m smarter than the rest of them
- 1.2** Internal auditors would be more likely to detect fraud if they developed/strengthened their ability to
- A Recognise and question changes which occur in organisations
 - B Interrogate fraud perpetrators to discover why the fraud was committed
 - C Develop internal controls to prevent the occurrence of fraud
 - D Document computerised operating system programs
- 1.3** Red flags are conditions that indicate a higher likelihood of fraud. Which of the following would **not** be considered a red flag?
- A Management has delegated the authority to make purchases under a certain dollar limit to subordinates
 - B An individual has held the same cash-handling job for an extended period without any rotation of duties
 - C An individual handling marketable securities is responsible for making the purchases, recording the purchases, and reporting any discrepancies and gains/losses to senior management

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- D The assignment of responsibility and accountability in the accounts receivable department is not clear

1.4 Which of the following is considered an example of a compliance audit?

- A The examination of a company's claim, that its product is superior to that of a competitor on specific dimensions
- B The examination of a school district networked computer system
- C The examination of a company's adherence to government-mandated safety provisions
- D The examination of a company's financial statements

1.5 The auditor obtains an understanding of the entity and its environment by performing all of the following assessment procedures except

- A Inquiries of management and others
- B Compute the level of fraud risk
- C Analytical procedures
- D Observation and inspections

1.6 If there is a suspicion that the amounts paid for the hours worked, are not being accounted for as wages, which engagement procedures will be performed to test for completeness in wage payments?

- A Perform a reverse employee identification, working from employee to personnel records and returns
- B Enquire of senior management, about the practice of employing workers illegally
- C Be alert to payments without source documents of any kind, especially cash amounts
- D All of the above

[TURN OVER]

- 1.7** Which control(s) would best prevent that the electronic funds transfers (EFTs) are made to incorrect employee bank accounts?
- A Review whether every employee signed the payroll schedule as verification that all recorded information is correct
 - B Review the changes to the employee master file data affecting bank account details to ensure that it is supported by authorisation of the employee and confirmation by the bank of employee bank details accepted for EFTs
 - C A and B
 - D None of the above
- 1.8** Enterprise risk management
- A involves the identification of events with negative impacts on organisational objectives
 - B includes the selection of the best risk responses for the organisation
 - C guarantees the achievement of organisational objectives
 - D requires internal auditors to establish risk and control activities
- 1.9** Which one of the following statements is **true**? The objective of the internal audit reporting stage is for the internal auditor to
- A persuade management to accept the conclusions
 - B inform management to realise an opportunity for improvement
 - C obtain results to report to management
 - D take action to implement the desired changes
- 1.10** According to the International Standard for the Professional Practice of Internal Auditing (Standards) communications that are to the point and avoid unnecessary elaboration, superfluous detail, redundancy and wordiness are
- A accurate
 - B objective
 - C clear
 - D concise

[TURN OVER]

- 1.11** According to Practice Advisory 2410-1 Communication Criteria, engagement observations and recommendations emerge when the following are compared
- A criteria and cause
 - B criteria and effect
 - C criteria and condition
 - D condition and cause
- 1.12** An internal auditor has some suspicion, but no evidence, of potential misstatement of financial statements. The internal auditor has **failed** to exercise due professional care if (s)he
- A Identified potential ways in which a misstatement could occur and ranked the items for investigation
 - B Informed the engagement manager of the suspicions and asked for advice on how to proceed
 - C Contacted the internal auditors with the necessary expertise to determine availability for the possible investigation
 - D Decided that the engagement work program should not be expanded, because there is no evidence, without confirming with the engagement manager
- 1.13** The chief audit executive is concerned that a recently disclosed fraud was not uncovered during the last engagement to evaluate cash operations. A review of the working papers indicated that the fraudulent transaction was not included in a properly designed statistical sample of transactions tested. Which of the following applies to this situation?
- A Because cash operations is a high-risk area, 100% testing of transactions should have been performed
 - B The internal auditor acted with due professional care because an appropriate statistical sample of material transactions was tested
 - C Fraud should not have gone undetected in a recently reviewed area
 - D Extraordinary care is necessary in the performance of a cash operations engagement, and the internal auditor should be held responsible for the oversight

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- 1.14** Which of the following statements describes an internal control questionnaire?
- A It provides detailed evidence regarding the substance of the control system
 - B It takes less of the engagement client's time to complete than other control evaluation devices
 - C It requires that the internal auditor be in attendance to properly administer it
 - D It provides indirect evidence that might need corroboration
- 1.15** In engagement planning, internal auditors should review all relevant information. Which of the following sources of information would most likely help identify suspected violations of environmental regulations?
- A Discussions with operating executives
 - B Review of trade publications
 - C Review of correspondence the entity has conducted with governmental agencies
 - D Discussions conducted with the external auditors in coordinating engagement efforts
- 1.16** When conducting interviews during the early stages of an internal auditing engagement, it is more effective to
- A ask for specific answers that can be quantified
 - B ask people about their jobs
 - C ask surprise questions about daily procedures
 - D take advantage of the fact that fear is an important part of the engagement

QUESTION 2
marks

27

You enjoy your role as the chief audit executive (CAE) of Little Boxes Ltd, a large national construction company for whom you have worked for five years

The internal audit department is in good standing with Little Boxes and enjoys the co-operation of the board of directors. The board members turn to you for advice on financial and commercial matters on a regular basis

The chief executive officer (CEO) of Little Boxes, Mr Masenya, formerly held high profile roles in the city and has been a beneficial appointment for Little Boxes. One of his interests is corporate governance. As a result of all the time you spent together, you enjoy a good

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relationship with Mr Masenya. You worked together, in a consulting engagement, to set very high standards for Little Boxes in a governance improvement plan which included a comprehensive fraud management plan. Tender fraud risk has been prioritised, but a risk response has not been established yet.

As part of the payment and acquisition audit, you inspected payments made to Premium Plumbers Ltd, one of the major suppliers. The agreement between Little Boxes and Premium Plumbers was established after a tender process. Tenders are awarded to suppliers that supply a service at the lowest possible price. The construction director, Mr Build, and the owners of Premium Plumbers have known each other for years. Premium Plumbers offered Mr Build a kickback to ensure that all tender applications with a lower value than their tender should 'disappear' from the tender process to ensure that the tender is awarded to Premium Plumbers. Mr Build requested that over and above the kickback Premium Plumbers must do renovations to senior managements' properties at a below market related discounted price. After Premium Plumbers was offered the tender, Mr Build held a secret meeting with senior management to inform them of the discounted prices for renovations based on the tender deal. These stipulations could not be found anywhere in the tender documentation. None the less, senior management looked forward to the renovations that could be done at their properties.

One of the invoices you evaluated during the audit is payment to Premium Plumbers for private work done for Mr Build. With the invoice is a copy of the instruction to Mr Build to repay the expense covered by Little Boxes, together with evidence of his payment. You noticed that the invoice contains no mention of several items that you know were included from your last visit to his house - such as the jacuzzi, the high-tech shower fittings and the digital musical system. You meet up with Mr Build to discuss the invoice. He explains that the items not listed were given to him as gifts.

Upon further investigation you discovered similar transactions for work done for other senior management. Among them are extensions done at Mr Masenya's house. It will be a particularly difficult matter to raise with him, given his stance on business behavior and your relationship with him.

You decided to report all instances except that of Mr Masenya's in order to protect him from disciplinary steps that must be taken according to the new governance improvement plan.

(Adapted from a question by the Institute of Chartered Accountants of Scotland)

REQUIRED

MARKS

- 2.1** With reference to the scenario and according to the Institute of Internal Auditors Code of Ethics
- 2.1.1** Evaluate whether your actions were permissible or not (6)
- 2.1.2** Suggest corrective action(s) if not permissible (2)
- 2.2** In your opinion, did Little Boxes Ltd successfully manage fraud risk according to the key principles for managing fraud risk, namely
- Fraud risk governance
 - Fraud risk assessment

[TURN OVER]

- Fraud prevention
 - Fraud detection
 - Fraud reporting, investigation and resolution?
- (11)

2.3 Part of a fraud risk management plan is a fraud risk assessment. Fraud risks can be identified by certain elements such as

- Incentives, pressures and opportunities
- Risk of management's override of controls
- Population of fraud risks
- Fraudulent financial reporting
- Misappropriation of assets
- Corruption

You are required to identify the fraud risks in the scenario according to the **applicable** elements mentioned above and explain why it is regarded as such. Elements for which there is no example should be ignored. (8)

QUESTION 3

30 marks

You have recently joined Countryboy (Pty) Ltd, a company which operates a large general dealer outlet in rural Eastern Cape, as an internal auditor. The company sells a wide range of products from bicycle parts to foodstuffs and clothing. Due to difficulties in staffing (and very erratic electricity supply) the company's systems are not computerised.

As your first assignment you have been asked to evaluate certain aspects of the acquisitions and payments cycle and recommend improvements which could be implemented. The financial director (also newly appointed) has acknowledged that aspects of the system are poor, but has stated that computerisation is not an option at this stage and that he does not want to employ additional staff. He is, however, prepared to change job descriptions. Improve documentation if necessary and spend money on reasonable recommendations which you make.

The control procedures over ordering are sound. Due to the location of Countryboy premises, it has been necessary for the company to work closely with suppliers with regard to reliability, pricing etc. and as a result, purchases are only made from approved suppliers. Aspects of certain other functions within the cycle are described below.

Receiving of Goods

All goods ordered are delivered to the "receiving/dispatch" area which adjoins the company's warehouse. Receiving of goods from suppliers as well as deliveries/dispatches to customers by Countryboy take place through this area.

When an order is placed, a copy of the purchase order is sent by the order department to the warehouse administration office where it is filed in numerical sequence. When a delivery from a supplier arrives, the vehicle is directed to the "receiving/dispatch" area. Here any one of the seven warehouse assistants receives the delivery. The warehouse assistants who are responsible for the receiving, dispatching and custody of goods, report to the warehouse

[TURN OVER]

foreman To receive a delivery, the warehouse assistant obtains the purchase order number from the supplier delivery note, and confirms by scanning through the purchase orders filed in numerical sequence in the administration office, that the delivery is in respect of a valid order. As the goods are being offloaded the warehouse assistant checks them against the supplier delivery note and at the same time completes a blank pre-printed sequenced goods received note. Any discrepancies are entered on the supplier delivery note and signed by both the warehouse assistant and the supplier's driver.

As most deliveries consist of numerous packages and boxes, the offloading and completion of the goods received note is a long process. This annoys many of the drivers who want to offload as quickly as possible so that they can start the long return journey. As a result, some of the warehouse assistants allow the supplier delivery staff to offload the goods in the "receiving/dispatch" area without conducting any checks at the time. Once the goods are offloaded, the warehouse assistant responsible signs the supplier delivery note and retains a copy. At a later stage, the warehouse assistant makes out the required goods received note, and as normal, moves the goods from the "receiving/dispatch" area into the warehouse.

Preparation of cheques to pay creditors

Manual Pettit, the financial accountant, keeps the cheque book locked away in the safe. On the 25th of each month, Jean Senna, the creditors clerk, presents Manual Pettit with a list of creditors due to be paid that month as well as the amounts they have to pay. (You may assume that the controls carried out by Jean Senna prior to preparing the list of creditors are satisfactory and that she signs the list). Manual Pettit then makes out a cheque for each creditor's name on the list. Cheques are carefully made out in a manner which significantly reduces the risk of cheque fraud e.g. permanent ink, restrictive crossings etc. He then returns the cheques to Jean Senna who attaches a remittance advice to each and posts them to the creditor.

REQUIRED	Marks
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3.1	Identify the risks which a company faces if it does not implement (put in place) sound control procedures over its "ordering of goods" function	(7)
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3.2	Recommend improvements which should be made to the "receiving of goods function" at Countryboy (Pty) Ltd. Provide reasons for your recommendations. Answer the question according to the following table	(18)
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Recommendation	Reason(s)

3.3	Recommend improvements which should be made to the "preparation of cheques to pay creditors" function at Countryboy (Pty) Ltd. You are not required to provide reasons for your recommendations	(5)
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QUESTION 4

19 marks

Protea Airlines Limited, known as Protea, is a South African low-cost airline, founded in 2010. Protea operates scheduled domestic budget flight services between Johannesburg, Durban, Cape Town and Nelspruit. These scheduled flights are offered under two brands, namely Lula Air and GB-Air. As a low-cost airline, Protea features a fleet of aircraft with high seating density and offers online ticketing only.

You are currently employed as chief audit executive (CAE) of Protea and manage a team comprising of twenty members with many years of internal audit experience as a group. The internal audit activity (IAA) performs a variety of internal audit engagements as stipulated in its internal audit charter and in accordance with the International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA).

The current internal audit plan makes provision for conducting a financial audit engagement relating to the revenues of Protea for the financial year ending 31 December 2014. You obtain the following information from the financial manager of Protea:

DATA RELATING TO THE AIRCRAFT FLEET		
	FY 2014 R'000	FY 2013 R'000
Aircraft fleet	16	16
Lula Air – Boeing 737-800	8	8
GB Air – Boeing 737-400	2	5
GB Air – Boeing 737-800	6	3
Seat capacity		
Lula Air – Boeing 737-800	192	192
GB Air – Boeing 737-400	136	136
GB Air – Boeing 737-800	152	152
Total fuel usage (in litres)	197 992	204 172
	870 40	758 40
Total cost of fuel (in Rand)	2 296 717 297	2 225 483 067
Total kilometres flown per aircraft type		
Lula Air – Boeing 737-800	17 050 760	17 050 760
GB Air – Boeing 737-400	6 984 920	14 007 520
GB Air – Boeing 737-800	13 548 800	6 526 200
Number of flights undertaken		
Lula Air – Boeing 737-800	18 094	18 094
GB Air – Boeing 737-400	5 736	13 036
GB Air – Boeing 737-800	13 870	6 570
Cost per litre of jet fuel consumed	R11 60	R10 90
Number of kilometres flown	37 584 480	37 584 480

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EXTRACT FROM THE FINANCIAL STATEMENTS:		
	FY 2014	FY 2015
Operating profit before depreciation, impairments and profit/loss on sale of assets	596 907	169 705
Profit/(loss) on sales of assets	984	-10 669
Impairments	-6 817	-4 049
Depreciation	-236 342	-148 030
Profit from operations	354 732	6 957

ADDITIONAL INFORMATION:

- 1 The revenue is made up as follows

	FY 2014	FY 2013
	R'000	R'000
Flight revenue	5 232 260	4 076 004
Service-based revenue	5 115 761	4 013 200
	116 499	62 804

Flight revenue represents the airfares earned on air tickets issued to passengers only. Once a ticket is issued, passengers have to pay penalties to change reservations while cancellation of a ticket results in a small portion of the ticket being refunded to passengers. The service-based revenue represents revenue generated by Lula Air from selling food and beverages on board flights to passengers as well as fees paid by Lula Air passengers for pre-selecting their seats for a particular flight, the latter only being introduced at the start of FY2014.

- 2 During FY2014, Protea carried 5 050 873 passengers (FY2013 4 795 733)
- 3 The following relates to expenses taken into account in the calculation of the operating profit before depreciation, impairments and profit/(loss) on sales of assets
- 3.1 The IT related costs incurred amounted to R24 122 000 for FY2014 (FY2013 R6 343 300)
- 3.2 Landing fees included in each of the two financial years amount to FY2014 R198 370 000 and FY2013 R165 308 333. A fixed fee per flight (landing) is charged by the airports where the two airlines fly to. The average landing fee for each of the two airlines of Protea Limited is identical.
- 4 GB-Air and Lula Air's fleet sizes are identical. During the 2014 financial year, GB-Air has been replacing its older Boeing 737-400's with the new age Boeing 737-800 aircraft. It still has two of the older model Boeing 737-400 aircraft in its fleet. Lula Air's fleet comprises the newest generation Boeing 737-800 aircraft.

(Adapted UP Exam Question)

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REQUIRED	Marks
4.1 Describe, in detail, how you would plan a internal financial audit engagement relating to the revenue and expenditure of Protea with reference to the IPPF Standard 2200 – Planning the engagement	(7)
4.2 Based on the information provided above, perform a financial analysis of Protea Limited's revenue and expenditure figures Your financial analysis should include	
4.2.1 A comparison of the current year's figures with the previous year for revenue and expenditures indicating the percentage (%) increase or decrease, and	(6)
4.2.2 An explanation of possible reasons for the percentage (%) increase or decrease	(6)

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