

Tutorial Letter 102/3/2013

Advanced Application in the Internal Auditing Process

AUI303C

Semesters 1 and 2

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

CONTENTS

1	BRIEFING	3
2	ADDITIONAL QUESTIONS	4
3	SIMULATED EXAMINATION	28

“A failure is a man who has blundered, but is not able to cash in on the experience.”

Elbert Hubbard

1 BRIEFING

Dear Student

In this tutorial letter you will find additional questions and a simulated examination exercise. Our intention with the additional questions supplied in this tutorial letter is to help you to test your knowledge and understanding of the tutorial matter for each topic in this module. The answers to these questions are contained in Tutorial Letter 103/3/2013.

After you have revised the content of the underlying modules, you can proceed with studying this module as follows:

- Page through the study guide. This will enable you to understand the layout of the module and the various topics covered. It will also give you an idea of the volume of work covered in the various topics.
- While paging through the study guide, highlight all the references to the prescribed textbooks and the outcomes you must achieve to pass this module.
- Develop a study plan that will suit your unique personal situation and enable you to achieve the outcomes of this module as listed in the study guide by the time you write the examination. Once you have a proper study plan, you can continue your studies of this module.
- Read through all the topics in your study guide and then study the individual topics. You need to study not only the content of the study guide, but also the passages referred to in the prescribed textbooks. While doing this, make proper summaries or notes.
- When you are sure that you know and understand the work covered in the individual topics, you must test your knowledge and understanding by answering the questions contained in this tutorial letter. Mark your answers by referring to Tutorial Letter 103/3/2012, which contains the answers to all the additional questions.

The questions contained in this tutorial letter are at the same level as those you will find in the examination. Please remember, however, that the questions in the examination are all new questions.

Once you have covered all the work and references according to your study guide and after you have worked through all the additional questions per topic, you should write the simulated examination paper which is also provided in this tutorial letter. Pay close attention to the instructions provided for the completion of this exercise.

Continuous hard work in this module will surely be rewarded with success. Feel free to contact your lecturers should you encounter any difficulty with your studies.

Lecturer: AUI303 C

Desiree Sebastian

012-429-4074

sebasd@unisa.ac.za

2 ADDITIONAL QUESTIONS

MULTIPLE CHOICE QUESTIONS

Topics 1 & 2: The principles, role and application of the business management approach in the internal audit process

REQUIRED

For each subsection of this question, select only **one** alternative that you consider to be the correct answer. Then write down, as your answer, the number of the subsection and the letter that precedes 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 Which one of the following assertions with regard to the concept of "planning", in a management context, is **not true**?
 - A Planning requires imagination, vision and thought.
 - B Strategic planning includes the formulation of the mission and objectives of the organisation and the development of methods in order to achieve them.
 - C Planning can also be seen as forecasting.
 - D Environmental factors have a material influence on the potential success of planning.

- 2 Management-oriented auditing requires an understanding of management principles. Nearly every defect the internal auditor discovers can find its root cause in...
 - A the improper training of employees.
 - B the violation of some management principle.
 - C insufficient supervision of all new employees.
 - D the fact that employees are negative as they perceive their salaries to be insufficient.

- 3 The internal auditor can best assist the managers of the organisation with the effective application of management principles and practices by ...
- A identifying and minimising the business risks for them.
 - B investigating only completed work, and focusing all comments on the completed work reviewed.
 - C completely monitoring all the activities the managers are involved in, to ensure that the managers properly apply all the relevant management principles.
 - D assisting managers on request with problem solving, and monitoring those activities and systems which the managers cannot monitor themselves.

Topic 3: Planning the internal audit engagement

- 4 Which stipulation regarding an organisation's internal control system is **inappropriate**?
- A No one person should be responsible for both the custodial and the recording responsibilities relating to an asset.
 - B Transactions must be properly authorised before they are processed.
 - C Because of the cost-benefit relationship, internal control measures may be applied on a test basis.
 - D All company cheques should be signed by two or more authorised personnel.
- 5 A local government agency received a national government grant for assisting families with low incomes. The agency is required to investigate each family's financial position. The amount of the assistance depends on the family's size, income and the ages and school attendance of the children. Which audit procedure will be the best test of efficiency of the agency's approach?
- A Check whether the agency is investigating the eligibility of beneficiaries and the propriety of funds disbursement.
 - B Check the degree of efficiency the agency is achieving in the disbursement of national funds, by using analytical review procedures.
 - C Review the accuracy of the disbursement reports furnished to the national government.
 - D Interview families to determine the adequacy of the funds in relieving their financial position.

- 6** Which financial ratio can you use during the preliminary survey to assist you to measure the long-term solvency of an organisation?
- A Current asset ratio.
 - B Accounts receivable turnover rate.
 - C Debt to assets ratio.
 - D Gross profit margin.
- 7** In internal auditing, risk assessment is a process that is crucial to the development of.....
- A sound audit work schedules.
 - B of effective audit work schedules.
 - C efficient audit work schedules.
 - D effective and efficient audit work schedules.
- 8** Which alternative best describes why, during an internal audit assignment, an internal auditor compares the inventory turnover rate of a company with established industry standards?
- A To evaluate the accuracy of internal financial reports of the company.
 - B To test the company's controls designed to safeguard assets.
 - C To determine whether the company is complying with established procedures regarding inventory levels.
 - D To assess the reasonableness of the disclosed performance (profits) of the company and to determine where additional audit work may be needed.
- 9** Alpha Limited recently issued a guarantee for a material liability of Beta Limited, a related company.
- Which audit procedure would provide the internal auditor of Alpha Limited with the best evidence of the existence of the guarantee?
- A Review the directors' minutes of Alpha Limited.
 - B Review the working papers of the previous internal audit for guarantees.
 - C Question the chief accountant regarding the existence of any guarantees.

- D Request a written confirmation from the lawyers of Alpha Limited on all the guarantees issued by the company.
- 10** During the training of junior internal auditors on the methods available to document processes during a preliminary survey, you describe to them how to develop a flowchart that shows the flow of documents in a specific business process. Such a document flowchart would represent...
- A the sequence of logical operations performed during the execution of a computer program.
- B the flow of forms that relate to a particular transaction throughout the organisation.
- C the flow of data through a series of automated data processing information systems.
- D the alternative logical options available for a document at a specific point in the business process.

Topic 4: Conducting the internal audit engagement

- 11** Which of the following procedures would provide the best evidence of the effectiveness of a credit-granting function?
- A Observe the credit-granting process.
- B Review the trend in receivables write-offs.
- C Ask the credit manager about the effectiveness of the function.
- D Check for evidence of credit approval on a sample of customer orders.
- 12** An internal auditor has set an audit objective of determining whether all cash receipts are deposited intact daily. To achieve this objective, the internal auditor interviewed the supervisor, who assured him that all cash receipts are deposited as soon as is reasonably possible. The assurance of the supervisor can be used as evidence that is...
- A sufficient but not reliable or relevant.
- B sufficient, reliable and relevant.
- C not sufficient, reliable or relevant.
- D relevant but not sufficient or reliable.

- 13** The identification of damaged and obsolete inventory is important when valuing inventory. The best auditing procedure to discover damaged inventory included in closing inventory is to...
- A compare the physical quantities of slow-moving items with corresponding quantities of the previous year.
 - B review management's inventory certificate for accuracy.
 - C inspect inventory during the physical inventory count.
 - D test the overall fairness of the inventory values by comparing the company's inventory turnover ratio with the industry average.
- 14** Management requests that you recommend to them an optimal level for spare part inventory held on site at the factory to minimise factory downtime. Which one of the following techniques would be the most effective to determine the optimal inventory level of the spare parts?
- A Researching the maintenance history of the factory to determine the future needs for spare parts.
 - B Using the actual maintenance performed in the past to project future maintenance requirements and adapting this projection, adding additional maintenance needed given the relative age of the factory.
 - C Using actual maintenance performed in the past to determine the cost of factory downtime owing to a shortage of spare parts.
 - D Facilitating a brainstorming session with the factory manager to determine the future spare part needs.
- 15** The IIA Standards define relevant evidence as
- A information that supports engagement observations and recommendations and is consistent with the objectives for the engagement.
 - B information that helps the organization meet its goals.
 - C the best attainable through the use of appropriate audit techniques.
 - D factual, adequate and convincing.
- 16** A major distinction between statistical and judgmental sampling is that...
- A judgemental sampling allows the quantification of the sampling error.
 - B statistical sampling virtually eliminates sampling risk.

- C statistical sampling provides an objective means of determining sample size.
- D judgemental sampling results in smaller sample sizes.
- 17** Statistical sampling differs from other sampling methods in the sense that...
- A statistical sampling produces representative samples, whereas the other methods do not.
- B an auditor does not have to exercise professional judgement when applying statistical sampling as he/she must when applying other sampling methods.
- C statistical sampling is based on the theory of probability, which is not the case with other sampling methods.
- D statistical sampling can deliver absolute assurance, which is not possible with other sampling methods.
- 18** Which alternative should be identified as a deficiency by an audit supervisor when he reviews a set of working papers?
- A A memorandum explaining why the time budget for a part of the audit was exceeded.
- B An audit finding recorded in the working papers and draft report that omits the criteria used for evaluation.
- C A memorandum explaining why an audit programme step was omitted.
- D A letter to the auditee outlining the scope of the audit.
- 19** Which form of audit evidence would the internal auditor consider to be the most reliable?
- A A sales invoice of the organisation together with a delivery note signed by the customer.
- B Direct confirmation from a debtor of his account balance after the internal auditor has mailed the account personally to the debtor.
- C A crossed cheque and bank statement submitted by the auditee to the internal auditor upon his request during the audit.
- D A paysheet prepared by the wage clerk and checked and approved by the accountant.
- 20** Working papers are the property of the internal audit activity and usually contain confidential information. How would the internal audit activity best protect its working papers to ensure that the confidential information contained in them is not put at risk?

- A All working papers must be protected in a manner that is appropriate given the information contained in the specific working paper.
 - B Only staff of the internal audit activity are allowed to access the working papers.
 - C All the confidential information is deleted from the working papers after the internal audit report is issued.
 - D The administrative section of the internal audit activity is responsible for protecting the working papers.
- 21** Engagement work programmes, with the objective of testing controls, should...
- A be tailored for each operation evaluated.
 - B be generalised to fit all situations without regard to departmental lines.
 - C be generalised so as to be usable at all locations of a particular department.
 - D reduce costly duplication of effort by ensuring that every aspect of an operation is examined.
- 22** How would you best describe the requirements of the information the internal auditor must identify to achieve the objectives of an audit?
- A The information must provide a sound basis for the audit conclusions.
 - B The information must be useful and convincing.
 - C The information must provide an absolute basis for the audit conclusions.
 - D The information must be sufficient and reliable.
- 23** During the use of sampling, how would you know if the sample provides sufficient information?
- A When you are sure that the sample provided you with the most relevant information.
 - B When you know that you used the best information that is reasonably obtainable.
 - C When you are reasonably sure that there is a logical relationship between the information and the audit objectives.
 - D When you are reasonably sure that the sample is representative of the population.
- 24** Which one of the following renders the most reliable information during the audit of the occurrence of sales transactions?

- A A copy of the customer's original order.
- B The shipping document, the signed goods received note and the matching invoice.
- C The customer subsequently paid the outstanding balance as per the monthly statement.
- D The customer's order and a note from the deliverer stating that the goods were delivered, but the person accepting the delivery is illiterate.

Topic 5: Reporting and monitoring progress

- 25** The main reason for issuing an internal audit report is to...
- A give auditees an opportunity to respond to the matters addressed by the report.
 - B give management an opportunity to take corrective action for reported findings.
 - C provide the external auditors with a basis for relying on the work of the internal auditor.
 - D report to interested parties on audit findings and recommendations.
- 26** A major objective of reviewing the draft internal audit report together with the auditee is to...
- A ensure that everything was covered in the audit.
 - B resolve any disputes on the facts presented.
 - C reach agreement on the distribution of the audit report.
 - D ensure that appropriate audit procedures were used.
- 27** According to the International Professional Practices Framework (IPPF), a signed written report should be issued...
- A only when an opinion is expressed.
 - B at the conclusion of the internal audit process.
 - C on predetermined dates as the audit progresses.
 - D only if so required by the particular audit.
- 28** After you reviewed the final communication of the audit report, you realised that the company's senior management decided to accept the risk of not implementing the recommendations. What would your next action be?

- A Notify the commissioner of companies.
- B Perform additional audit procedures.
- C Discuss the matter with senior management and ensure that there is clarity about the effect of the risk.
- D Conduct a follow-up engagement to determine whether any of the recommendations were implemented.
- 29** All the members on your audit team received training that enables them to discuss the conclusions and recommendations during an exit interview with the appropriate manager before the final audit report is issued. What is a primary reason for such an exit interview?
- A The Standards require an exit interview.
- B The notes of the interview become a basis for follow-up audits.
- C The notes on the interview can be a valuable aid if disputes arise during the discussion of the final audit report.
- D The information learned can be used to better utilise scarce audit resources in future audits.

LONG QUESTIONS

QUESTION 1

10 marks

Topics 1 & 2:

Explain the business management approach to an internal audit for the benefit of a new internal auditor.

QUESTION 2

19 marks

Topics 1, 2 & 3

Internal auditors are expected to have a sound knowledge of general business management principles because internal auditing focuses on:

- the effective and efficient management throughout an organisation; and
- the evaluation of performance, considering risk management, control and governance, and proposals for improvements.

REQUIRED	Marks
2.1 Explain why it is important for the internal auditor to know the different management principles.	(5)
2.2 Explain control as a management principle.	(5)
2.3 Briefly explain the relationship between preventative control measures and efficient management.	(3)
2.4 Briefly describe the most important elements of any good management control system from the viewpoint of management.	(6)

QUESTION 3 **33 marks**

Topics 1 & 2

As the chief audit executive (CAE) of the new internal audit activity of Nvuku Limited, you would like to be involved in the planning meetings of the company. The chief executive officer (CEO) of the company wants to know how you, as the internal auditor, can contribute to planning meetings and whether you should play a role in the decision-making processes of the company.

REQUIRED	Marks
3.1 Describe why top management should involve the internal audit activity in the planning done by top management.	(11)
3.2 Describe the role that you, as the internal auditor, should play in the decision-making process.	(10)
3.3 Develop a questionnaire that can be used to evaluate the fundamental planning elements during your review of the overall planning for the company.	(12)

QUESTION 4 **13 marks**

You are in charge of training the newly appointed junior internal audit staff. Your training mimics the audit process and you start with the preliminary survey.

REQUIRED	Marks
List and describe the steps in the preliminary survey.	(13)

QUESTION 5**19 marks****Topics 3 & 4**

You are the internal auditor of Excell Management Solutions Limited, a company that sells, installs and maintains a variety of office automation solutions for small to medium-sized enterprises. You are responsible for auditing the sales transactions and trade receivable accounts for January, February and March.

The following is a summary of the company's budgeted and actual sales for the three months:

Period	Budgeted sales (R)	Actual sales (R)
January	253 500	126 750
February	253 500	380 250
March	253 500	190 125

REQUIRED**Marks**

- 5.1** Describe the additional information you would need to obtain during your preliminary survey to enable you to audit the sales transactions of Excell Management Solutions Limited. Also state the specific reason why you would require each item of additional information. **(10)**
- 5.2** Describe the analytical review procedures you would perform to test the reasonableness of the purchases figures of the months January, February and March. **(9)**

QUESTION 6**12 marks****Topics 1,2 & 3**

Sally May is a newly appointed internal auditor at Quickfood Limited, a large retail store in the food industry which operates through branches in all the large cities and major towns in the country. The company recently implemented a new point of sales system coupled with internet inventory ordering capabilities. The senior internal auditor sent Sally May on a nationwide tour of Quickfood Limited branches to perform walkthrough tests on the points of sale and the internet inventory ordering system.

She was also instructed to consider the inventory holding position of each individual branch and the possible impact that internet ordering might have on the inventory holding. The objectives given to her were to familiarise herself with the company and its systems and to ensure that the new systems were implemented as planned.

REQUIRED	Marks
6.1 Comment on the clarity, attainability and completeness of the objectives set for Sally May.	(6)
6.2 Discuss the strategic considerations that Sally ought to take into account when she evaluates the internet ordering system and its impact on the inventory system	(6)

QUESTION 7 **19 marks**

Topic 3

The COSO study defined three categories of objectives that also act as the starting point of any risk assessment. These three categories are then further divided into detailed objectives, after which the risk relating to each of the objectives is identified. Only then can attempts be made to control the identified risk.

REQUIRED	Marks
7.1 List and describe these three categories of objectives.	(9)
7.2 Identify risks for each of the following objectives:	
• to protect cheques against misuse and loss; and	(5)
• to bank deposits promptly to ensure the receipt of the maximum amount of interest.	(5)

QUESTION 8 **29 marks**

Topic 1, 2, 3 & 4

The procurement manager asks you to assist him by evaluating the methods he uses to direct his staff towards achieving the procurement objectives. The procurement function's objective is to speedily purchase all goods requested by the factory staff. The current procurement manager decided on this objective when he became the procurement manager 18 months ago. A customer satisfaction survey showed that the factory staff is very pleased with the increased efficiency of the procurement section and that out-of-stock situations in the factory reduced by 35%. The staff in the procurement function is less satisfied and complains of being required to work overtime frequently. Overtime paid to the procurement staff increased to eight hours per person per month on average. Initially the staff was pleased with the additional money they earned while working overtime, but recently they have become increasingly dissatisfied and are refusing to work any overtime.

	Actual expenses	Budgeted expenses
Average monthly purchases	R650 350	R453 250
Average monthly salaries	R230 650	R168 450

REQUIRED**Marks**

- 8.1** Write a memorandum to the procurement manager describing how to improve the procurement function by improving the directing of the function. **(11)**
- 8.2** Identify six (6) risks in the procurement function from the information given in the scenario. **(6)**
- 8.3** Describe the analytical review procedures you would perform in order to improve your understanding of the operations of the procurement function during the preliminary survey stage of the internal audit of the procurement function. **(12)**

QUESTION 9**14 marks****Topics 3 & 4**

The managing director of Smart Systems requested you to review their newly developed security gate system that is designed to enhance security at the gates to sport stadiums. The manager of the research and development department is very keen to start manufacturing this newly developed product and to market it around the world.

The new, more secure entrance gates operate on a turnstile gate linked to a smart card ticket. The smart card ticket holder partially enters the gate and inserts the smart card into the indicated slot. If the smart card shows a valid ticket for the match, then the gate will allow the person to go through the turnstile. If the ticket is not validated, the person must reverse to exit the gate.

Smart card tickets are bought at a cost of R10 each, whereas normal tickets cost R0,50 each to print. It will be possible to reuse smart cards or to load more than one game on a smart card. To change to smart card technology the offices where tickets are issued also need to be upgraded. The expected cost of the upgrade to smart card technology is R5 000 per ticket office.

The factory will need to retool some of the manufacturing units at an approximate total cost of R1 500 000 to manufacture the gates. The cost to manufacture one smart card turnstile system is R450 000 per stadium, and it is estimated that installation will cost R130 000 per stadium. When the turnstile smart card concept is moved into production, the development team will each receive a once-off bonus of 25% of their annual salary. This bonus scheme was initiated to motivate the research and development department to increase their development of practical marketable products. Previously, all newly developed products were tested extensively before they could be manufactured. The marketing manager estimates that

he will be able to sell the smart card turnstile systems to four stadiums per year in the first two years of production at a cost of R1 500 000 per stadium.

REQUIRED**Marks**

9.1 Write a memo to the managing director in which you identify seven (7) risks from the above scenario and recommend methods to manage the identified risks in a manner that will not impact negatively on the sustainability of the company. (Indicate the risks and recommendations in a table format within the memo.).

(14)**QUESTION 10****15 marks****Topic 3 & 4**

You are the chief audit executive (CAE) of a large manufacturing organisation, and you use analytical review procedures in your planning to identify conditions that may require subsequent auditing procedures. You know from experience that if the computations are used properly, and are integrated with pertinent information obtained from other sources, these procedures can be a valuable tool in the internal audit process.

You have obtained the following information in respect of certain aspects of the organization prior to the preparation of the year-end financial statements:

		2012	2011
		R	R
Inventory	Raw materials	1 100 000	1 000 000
	Work-in-progress	400 000	500 000
	Finished goods	5 500 000	4 000 000
Sales		28 000 000	25 500 000
Cost of sales		20 000 000	18 700 000
Trade receivables		4 800 000	5 200 000
Creditors		3 000 000	2 800 000
Bank overdraft		1 900 000	1 400 000

The following ratios are for 2011:

- Inventory turnover ratio 4.7 times
- Trade receivables collection period 74.4 days

REQUIRED**Marks**

10.1 Calculate the organisation's inventory turnover ratio, trade receivables collection period and acid test ratio, and interpret the results.

(9)

- 10.2** List two audit procedures for each of the ratios in 10.1 above that will help you ascertain whether or not the figures provided are reasonable. **(6)**

QUESTION 11**18 marks****Topic 3 & 4**

You are the senior internal auditor in charge of the audit of inventory at Fastserve Limited, a retail company. At year-end, the inventory on hand on the shop floor is counted and a correcting journal entry is passed to ensure that inventory as well as cost-of-sales are correctly reflected in the annual financial statements. At the previous year-end the external auditors insisted on a significant number of adjustments to the inventory account at year-end. These past adjustments prompted the financial director to request a quarterly internal audit assessment of the value of inventory on hand.

The audit procedures performed during the previous periods identified the following focus areas as high-risk areas:

- The company's organisational objectives require a fast turnaround time for inventory.
- When goods are moved from the storeroom onto the shop floor, the cost of inventory is transferred to the cost-of-sales account.
- The latest cost price of each inventory item is maintained by the information system and used for the costing of inventory items.
- The inventory quantities can be manually adjusted by the inventory manager, but the unit cost of the inventory is automatically determined by the information system.

REQUIRED**Marks**

- 11.1** Comment on the acceptability of the current practices as described in the focus areas. **(6)**
- 11.2** Describe the audit procedures you will perform to substantiate the inventory value for each quarter. **(12)**

QUESTION 12**12 marks****Topics 3 & 4**

You are the internal auditor responsible for the audit of the bank accounts of Egglo. Egglo supplies various seeds and insecticides to farmers. Egglo is a family business with all the shares held by the Drummer family trust. The grandfather is the managing director and all the sons, Peter, Steve and Eric, work as managers for Egglo. You are the first internal auditor appointed by the company with the aim of helping the company to improve its processes and

to grow. You completed a preliminary review of the bank and cash section for September. During your preliminary review you identified the following unusual transactions from a review of the cash payments journals:

Date	Cheque	Details	Account allocation information	Amount
1/9	321	Cash	Weekly wages	R110 780
2/9	336	Du Toit & Sons	Refund – refund of goods sold in August: insecticides that had already expired	R36 500
6/9	345	Cemco (Pty) Ltd	Chemicals – insecticides bought from a new supplier	R45 680
20/9	369	E Drummer	Purchase of shares in Cemco (Pty) Ltd	R150 000

REQUIRED**Marks**

- 12.1** Describe why these transactions could be considered unusual/risky if you assume that each transaction described above is unique in the given month. **(6)**
- 12.2** Describe an audit procedure that you would perform to help you substantiate each of the identified transactions described above. **(6)**

QUESTION 13**10 marks****Topic 4**

It is the policy of the internal audit activity of the organisation where you are employed as a senior internal auditor to apply the monetary unit sampling (MUS) technique as far as possible. You are busy with an investigation of the sales records for the past six months and you have already established the following information for the purposes of applying this technique:

Total value of the population – R7 350 000

Internal control – reasonable

Confidence level – 90%

Monetary precision – R69 000 (P)

The details of the first seven sales invoices are as follows:

Invoice number	Invoice amount (R)
101	11 100
102	9 500
103	21 000
104	14 600
105	17 200
106	31 200
107	8 300

TABLE A

Reliability factors (R)	1,0	1,1	1,2	1,3	1,4	1,6	2,0	2,3	3,0	4,6
Confidence levels	63%	66%	69%	72%	75%	80%	86%	90%	95%	99%

REQUIRED

Marks

- 13.1** Explain the concept "monetary unit sampling (MUS)". **(3)**
- 13.2** Use the above information with the aid of table A to establish the number of sample items you would select for your investigation. For purposes of your calculations you can accept that no errors will be found. Show all your calculations. **(4)**
- 13.3** Select the first three invoices for the sample. Accept a random starting point of R12 700. Show how you arrived at your answers. **(3)**

QUESTION 14

27 marks

Topic 4

- 14.1** As the chief audit executive (CAE) of a large food processing company, you are in the preliminary stages of compiling the audit programme for conducting the fieldwork of the audit of the revenue and receipts cycle of the company.

Your planning procedures indicated that the business has no specific risk factors concerning this cycle. You also ascertained that the performance standards set for this cycle are appropriate and reasonable.

Your audit objective is to ensure that all elements of the control measures concerning this cycle comply with the standards accepted by management.

REQUIRED**Marks**

Develop the audit procedures that should be followed to determine whether the company's accepted control measures have been applied meticulously throughout the revenue and receipts cycle.

(10)

14.2 As part of the audit of the revenue and receipts cycle you wish to verify the trade receivables balance at year-end. You plan to make use of a statistical sampling technique to determine the fairness of the trade receivables figure on the balance sheet. Your main concern is the overstatement of trade receivables accounts. You therefore want to use a sampling technique that sets value as the objective of the audit and not the number of trade receivables accounts. Furthermore, you do not plan to determine the standard deviation of the population when using this statistical sampling technique.

REQUIRED**Marks**

- a) Indicate which audit sampling technique you will employ to achieve your objective. **(2)**
- b) Describe the basic steps to be taken when applying this sampling technique to audit the fairness of the trade receivables figure. **(10)**
- c) Discuss the reasons why an internal auditor might choose to identify "strata" in a population and then utilise stratified sampling rather than to take a random sample of an entire population. **(5)**

QUESTION 15**9 marks****Topic 4**

In applying the monetary unit sampling technique during the internal audit, the following errors were discovered in a sample:

Error value	Item value
R	R
Errors of overstatement	
1 600	1 700
200	500
Errors of understatement	
840	1 100
195	150

Other information relevant to this sample:

Total value of population
Confidence level

R 1 500 000
95%

Sample size	250
J-factor	1 000
R	3,0

REQUIRED**Marks**

Calculate the adjusted monetary precision and draw a conclusion regarding the extent of the audit procedures to be performed by the internal auditor. Use the above information and the applicable tables in your study guide to arrive at the conclusion. Show all your calculations.

(9)**QUESTION 16****18 marks****Topic 4**

The following extract from a working paper was prepared by a junior internal auditor assigned to examine the operations of a loan department of a large bank, and is presented to you for review:

I have examined some of the loan agreements and noted the following exceptions:

Loan contracts		Exceptions
Bush LW	α	No signature
De Waai P	μ	Interest payments calculated incorrectly
Smith K	\times	No appropriate collateral
Malekeng P	4	No physical address

Conclusion

Contract on loan agreements with clients need improvement.

REQUIRED**Marks**

- 16.1** By referring to Practice Advisory 2330, criticize the above working paper in respect of its design and content. Give reasons for your answer. **(14)**
- 16.2** Describe additional important points relating to audit working papers that can help to improve the junior internal auditor's skills in preparing good working papers in future. **(4)**

QUESTION 17**25 marks****Topic 4**

You are the internal auditor responsible for auditing the sales function of Maxwell (Pty) Limited, a company that specialises in manufacturing and installing of home security solutions. The

sale and installation of new home security solutions forms 60% of the company's annual revenue. You decided to use statistical sampling to audit the company's sales. You want to make sure that all sales are recorded accurately and completely, and in addition that only valid sales are recorded during the financial period. You used a CAAT program to calculate the number of transactions in the population and also to calculate the sample size. The sales process starts with a customer placing an order, and then a technician will visit the relevant premises and give the customer a prenumbered quote. After acceptance of the quote, the work begins within a week and the customer is invoiced on completion.

REQUIRED**Marks**

- 17.1** Explain why it would be to your advantage to use statistical sampling in this instance. **(3)**
- 17.2** Based on the above information, do the following:
- a) Define the three (3) audit objectives. **(4½)**
 - b) Formulate two (2) audit procedures for each audit objective. **(9)**
 - c) Describe which statistical sampling technique would be the best method to use. Substantiate your answer. **(4½)**
 - d) Define the population. **(1)**
 - e) Describe which sample selection method should be used. Substantiate your answer. **(3)**

QUESTION 18**10 marks****Topic 5**

- 18.1** During an internal audit departmental meeting you state unconditionally your belief that senior executives should be interested in receiving copies of internal audit reports, particularly in respect of those risk areas being identified for which they are accountable.

The Chief Audit Executive (CAE) then asks you to give a presentation at the next departmental meeting, illustrating qualities in internal audit reporting that will help capture and hold the interest of senior executives.

REQUIRED**Marks**

- Draw up a list of qualities a written internal audit report should contain which, in your opinion, will help to capture and hold the interest of senior executives. **(5)**

18.2 Assume that you are busy with an internal audit and your findings are so serious that, in your view, they require immediate action by management.

REQUIRED**Marks**

Describe your plan of action with regard to the significance of these audit findings. **(5)**

QUESTION 19**19 marks****Topic 5**

The International Professional Practices Framework (IPPF) does not prescribe a formal format for internal audit reports, but does establish guidelines for writing good internal audit reports. In addition, report writers should follow certain practical rules to make their reports more understandable and acceptable.

REQUIRED**Marks**

19.1 Describe the established guidelines and other practical rules that ought to be followed to make internal audit reports more understandable and acceptable to the people for whom they are intended. **(16)**

19.2 Explain the objectives of an internal audit report. **(3)**

QUESTION 20**29 marks****Topic 5**

The following draft internal audit report was given to the director of internal auditing for final review:

To: *Audit Committee*
From: *Chief Audit Executive*
Subject: *Fixed assets*

The property management department has the responsibility for the proper recording of fixed asset acquisitions, withdrawals and depreciation charges. The property management department maintains a fixed asset subsidiary system, on computer, that substantiates the fixed asset movements, accumulated depreciation and depreciation expense.

The reason for this audit was to aid management by performing an independent appraisal and evaluation of the property management department's procedures and control over fixed assets.

We found the controls over the complete and accurate recording and classification of fixed asset additions to be adequate and operating effectively. Procedures did not exist, however, for the property management department to be made aware of, or to properly record, any withdrawals or disposals of fixed assets. We recommend that management develop procedures for recording all fixed asset withdrawals or disposals. The controls over the complete and accurate validation of the different types of fixed asset, accumulated depreciation and depreciation expense were adequate and operating.

We would like to thank the head of the property management department and his staff for the assistance and courtesy extended to us during the course of the audit.

*J Junock
Junior Internal Auditor*

*R Nuckette
Chief Audit Executive*

In reviewing the junior internal auditor's detailed audit working papers, the director of internal auditing noted the following information with regard to the tests performed:

- The manager of the property management department informed the junior internal auditor that his section was currently developing a procedure to ensure that all departments properly inform the property management department of asset withdrawals and disposals.
- Period audited: 1 January 2012-30 September 2012.
- The previous audit of fixed assets was performed approximately 18 months ago (June 2010). At that time four findings were noted. All recommended corrective actions were accepted and the junior internal auditor noted that the corrective procedures were operating efficiently.

REQUIRED	Marks
20.1 Identify the deficiencies in the draft internal audit report and explain why you consider them to be deficiencies.	(14)
20.2 Describe the appropriate layout of a well-written internal audit report.	(10)
20.3 Explain the attributes/elements on which internal audit findings should be based.	(5)

QUESTION 21**27 marks****Topics 1 - 5**

You were requested by the financial manager to specifically audit credit purchases and trade payables for the months July to September. She informed you that she is concerned because out-of-inventory situations increased in this period, linked to a rather erratic purchase pattern for the same months. The monthly reports generated by the integrated financial system show large deviations in inventory on hand and purchase patterns. To properly evaluate the risks, you decided to perform a preliminary survey. During the preliminary survey you discovered the following:

- The purchasing manager was diagnosed with cancer at the end of May. He was on sick leave for the whole of June after an operation, and for two weeks during July, August and September while undergoing chemotherapy treatment. He must still undergo another three treatments over the next three months.
- Although one of the buyers was seconded to stand in for the purchasing manager in June, he was only instructed to attend meetings and to order the same goods for June as ordered in May.
- It is normally also the responsibility of the purchasing manager to identify which type and quantity of goods must be purchased by analysing reports on the actual sales on a monthly basis, and to instruct the buyers accordingly.
- The purchasing manager receives a weekly printout that summarises the type and quantity of goods sold in that week. He types this information into a spreadsheet that is programmed to calculate the type and quantity of goods to be purchased and produces a purchase list. It takes him about a day to enter each week's list. Owing to his illness, he was unable to perform this function, and based the purchases for July, August and September on one week's actual sales because he was only able to capture one week's sales.
- You discovered after reviewing the spreadsheet that it was programmed to convert a month's sales to a purchase list, and the fact that only a week's sales were entered meant that only a quarter of the required goods was incorporated in the purchase list. You also discovered that the accounting information system can produce a similar monthly purchase list if the correct parameters are set on the system. It is fairly easy to set these parameters.
- When out-of-inventory situations occur, the sales manager sends an urgent request for goods to the purchase section that leads to an immediate order from an approved supplier. These immediate orders are 2% more expensive.

REQUIRED	Marks
21.1 Identify the risks highlighted by the information obtained during the preliminary review, given that the purchasing section's objective states that goods will be purchased in a <i>timely manner</i> at the <i>best price</i> .	(3)
21.2 Describe how the general management principles of planning, organising, directing and control can be used to address the problems you identified.	(8)
21.3 In a memo to the purchasing manager, develop a complete audit finding on the results of your preliminary survey.	(10)
21.4 List four (4) analytical review procedures you could use to help the purchase section to identify which products to purchase for the next month.	(6)

3 SIMULATED EXAMINATION

QUESTION 1

24 marks

Fruit Packing (Pty) Ltd is a company that helps farmers to harvest and pack fresh fruit. You are one of a few trainee internal auditors employed in the internal audit activity. Fruit Packing (Pty) Ltd has recently experienced disputes over the recorded accuracy of wages paid and hours worked. Management asked the internal audit function to review the process in terms of wage calculations and pay-outs. You have been assigned to the audit team to carry out this task.

The following information was obtained regarding the payroll system of the packing department:

Timekeeping and supervision

- Packing employees are remunerated hourly: normal hours are eight hours a day, five days a week. Having to work overtime has become so common that supervisors no longer specifically approve overtime, and employees work overtime if they feel it is necessary.
- There is an entrance at the front of the warehouse where a mechanised clockcard system and a turnstile are in place. When entering or exiting the warehouse, employees take their clockcards off a card rack, clock the cards, which activate the turnstile, and then place the clockcards on a second card rack once they have passed through the turnstile.
- A security guard is only in place during the busy periods of the day to ensure that each person clocks only one card. The turnstile is locked once all employees have left the warehouse in the evening. Employees do not have to produce their identification cards when clocking in or out.

Payroll preparation

- Apple Smith and Granny Tree staff the payroll department and report to Berry Khumalo, the payroll supervisor. Wages are paid every Friday for the week, which ends on Wednesday. Apple Smith collects the clockcards from the card racks early on a Thursday morning, before any of the employees arrive. He checks the number and details on the clockcards collected against the list of clockcards issued to him by the personnel department.
- The personnel department is responsible for making available the clockcards at the start of a working week. They also issue Apple Smith with a list of all employees for whom a clockcard has been issued.

- Apple Smith calculates the total normal and overtime hours worked for each employee from the clockcard. He then prepares the payroll using the hours calculated and the authorised lists and schedules of wage rates and deductions.
- Berry Khumalo performs random checks on Apple Smith's calculations, casts and extensions and compares the net wages total for the current week with the previous week's net total wages. If these differ substantially, he asks for an explanation. He signs the payroll as evidence of these checks.
- Apple Smith advises the cashbook clerk telephonically of the exact amount of net wages and instructs her to issue a cheque payable to "Cash". The cashbook clerk takes the cheque to be signed by two authorised signatories and then gives the cheque to Granny Tree.
- Early on Friday morning, Granny Tree cashes the cheque, prepares the pay packets and updates the accounting records. Berry Khumalo authorises all postings to the general ledger to ensure they are correctly and timeously entered.

Payment of wages

- By 1 pm on Friday, Granny Tree locks the pay packets and a copy of the department's wage listing in each supervisor's office safe. Each supervisor pays wages at 3 pm on Friday afternoons to the staff of his/her department. Employees are required to sign the wage listing as evidence of receipts of their pay packets. Included in the pay packet is a payslip, which provides employees with an analysis of their net wage. Employees are not required to check their pay packets in the presence of the supervisor. Instead, all queries must be referred to the payroll department on Monday morning.

Employees have indicated that they do not want their weekly wages paid into bank accounts; they prefer cash payments.

The company does not wish to computerise its wage system or to use a wage security company because it has its own security department.

REQUIRED	Marks
1.1 Identify the weaknesses in the above payroll system.	(12)
1.2 Recommend the internal control procedures needed to eliminate the identified weaknesses.	(12)

Your answer should be structured as follows:

1.1 Weaknesses	1.2 Controls

QUESTION 2**30 marks**

You are a senior internal auditor at Ponies (Pty) Ltd, a company that manufactures and sells horse-riding equipment. The company has been in business for many years and has an established customer base.

The management of Ponies (Pty) Ltd is now considering procuring another company, Horses Galore (Pty) Ltd, to merge operations and expand the current product line. Horses Galore (Pty) Ltd manufactures and sells horse-riding equipment, horse medication and vaccines. The company imports most of its medical products and vaccines.

The management of Ponies (Pty) Ltd believes that it would benefit the company to procure Horses Galore (Pty) Ltd because this will broaden the company's product base and increase profits.

You have obtained the following information after a request from management to provide them with a recommendation about whether or not the acquisition would benefit the company:

- One of the types of racing bridles manufactured and sold by the company has been declared illegal because it can damage the horse's jaw.
- The company discontinued its policy of sales for cash. All sales are on credit to account holders or by credit card to non-account holders.
- In an effort to boost sales, the company relaxed certain of its credit limits some time during the past year.
- Horses Galore (Pty) Ltd is currently being sued by a horse breeder. The breeder claims that a vaccine purchased from the company led to the deaths of three horses. The total value of the claim is R250 000.
- Imported veterinary products are regulated by the Veterinary Council of South Africa. Strict regulations apply with which companies must comply.

The following financial information was obtained:

	2012
	R '000
Total sales	70 500
Cost of sales	40 600
Sales on credit	60 800
Average stock	22 500
Average outstanding debtors	34 350

The following ratios were calculated for 2011:

Stock turnover rate	1.12 times
Average outstanding term of debtors	194.1 days
Gross profit ratio	49.65%

REQUIRED	Marks
2.1 Calculate the following ratios for Horses Galore (Pty) Ltd for 2012:	
2.1.1 Stock turnover rate;	(3)
2.1.2 Average outstanding term of debtors; and	(3)
2.1.3 Gross profit ratio.	(4)
2.2 Comment on the current year's short-term liquidity and performance of Horses Galore (Pty) Ltd compared with 2011.	(5)
2.3 Identify the risks involved for Ponies (Pty) Ltd in acquiring Horses Galore (Pty) Ltd.	(10)
2.4 Based upon the principles and role of the business management approach, explain how internal auditing can assist the management of Horses Galore (Pty) Ltd.	(5)

QUESTION 3 **21 marks**

BookMail, an organisation that sells books on account to its customers through the postal system, recently employed you as an internal auditor.

New customers of BookMail are required to submit a copy of their ID documents and are limited to an initial maximum purchase of R1 000. No credit checks are performed.

Customers are allowed to pay for their purchases over a six-month period and interest at a rate of prime plus 4% is charged on accounts that are in arrears.

Accounts are sent out to all customers on the 25th of each month. Each account contains details of the outstanding balance and any transactions entered into during that month.

You know that the misappropriation of cash or cheques is a common type of fraud that occurs in any organisation where money is received from debtors (accounts receivable). You decide to review the controls implemented by management regarding the initial receipt, depositing and allocation of payments made by customers (debtors) towards their accounts. Accounts are normally paid by cheque, and the cheques are sent through the mail at the end of the month.

REQUIRED	Marks
3.1 Explain the relationship between audit objectives and audit procedures by describing both and giving an example.	(5)

- 3.2** Discuss the importance of having a well designed audit programme for each internal audit engagement. **(4)**
- 3.3** Design audit procedures that will confirm the reasonableness of the debtors balance (accounts receivable) at month end. **(12)**

QUESTION 4

10 marks

The Chief Audit Executive (CAE) asks you to give a presentation at the next internal audit training session. This presentation must address what an internal audit report should include if it is to capture and hold the interest of senior executives. The CAE identified a need for such a training session after he discovered that few of the senior executive officers in the organisation read the internal audit reports attentively. Some executive officers consider the format and presentation of the internal audit report to be boring and useless, even when the internal audit report deals with a serious risk area that is within the control of these executives.

REQUIRED

Marks

- 4.1** Explain, by referring to the purpose of audit working papers, how audit working papers can assist an internal auditor with compiling the final audit report. **(4)**
- 4.2** Compile a list of requirements that a written internal audit report should comply with and which, in your opinion, will help to capture and hold the interest of senior executives. **(6)**