

**AUI3702**

October/November 2014

THE INTERNAL AUDIT PROCESS: TEST OF CONTROLS

Duration 2 Hours

100 Marks

EXAMINERS
 FIRST
 SECOND

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Use of a non-programmable pocket calculator is permissible

Closed book examination

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

QUESTION	MAIN TOPIC	MARKS
1	Multiple-choice questions	21
2	Weaknesses and recommendations – acquisitions and payments process	30
3	Audit objectives and tests of controls	15
4	Ratio analysis and audit sampling	22
5	Audit reporting	<u>12</u>
		<u>100</u>

PLEASE NOTE:

Although the primary purpose of this examination is to test the candidate's knowledge of and ability to apply the subject matter, the examiners will also take into consideration the candidate's ability to organise and present such knowledge in acceptable, written English

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QUESTION 1

21 marks

REQUIRED

For each subsection of this question, select only **one** alternative that you consider the most correct answer. Then, as your answer, write down the number of the subsection and the letter that indicates the alternative you have selected. 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 conduct violates the **integrity** principle of the Code of Ethics
- A The internal auditors perform a detailed risk assessment and identify the key controls relating to credit sales before they decided on the tests to be performed
 - B An internal auditor is assigned to an audit of controls in the procurement section, which is headed by his father
 - C While auditing the controls over wage pay-outs, an auditor finds that some controls have been circumvented. She discusses her finding as a possibility of fraud with her colleague in the canteen over lunch
 - D The internal auditor uses an unrevised audit programme, which was used three years ago, to conduct an organisation-wide audit on credit sales
- 1.2 Which of the following are elements included in the control environment described in the COSO internal control framework?
- A Integrity and ethical values, management's philosophy and operating style, and human resource policies
 - B Organisational structure, commitment to competence and planning.
 - C Competence of personnel, backup facilities, laws and regulations
 - D Risk assessment, assignment of responsibility and human resource practices

- 1.3 There are certain types of IT risks that tend to be common across organisations and industries. The unauthorised disclosure of business partners' proprietary information or individual's personal information may result in loss of business, lawsuits and reputation impairment, describes
- A access risk
 - B availability risk
 - C confidentiality and privacy risk
 - D system reliability and information integrity risk
- 1.4 According to the King III Report on Corporate Governance, which of the following is **not** the audit committee's responsibility regarding combined assurance?
- A Monitoring the appropriateness of the company's combined assurance model
 - B Ensuring all the significant risks facing the company are adequately dealt with
 - C Monitoring the relationship between the external assurance providers and the organisation
 - D Providing an independent assurance on risk management and systems of internal control
- 1.5 In combined assurance, which of the following is **not** an external assurance provider?
- A Sustainability assurance providers
 - B External auditors
 - C The risk management function
 - D Regulators

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- 1.6 A major distinction between statistical and non-statistical sampling is that
- A non statistical 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 non statistical sampling results in smaller sample sizes
- 1.7 One payroll control objective is to ensure that there is adequate segregation of duties Which of the following activities is incompatible?
- A Hiring employees and authorising changes in pay rates
 - B Preparing the payroll and filing payroll tax forms
 - C Signing and distributing payroll cheques
 - D Preparing attendance data and preparing the payroll
- 1.8 Which of the following controls would help prevent overpaying a supplier?
- A Reviewing and cancelling supporting documents when a cheque is issued
 - B Requiring the cheque signatory to mail the cheque directly to the supplier
 - C Approving the purchase before ordering from the supplier
 - D Reviewing the accounting disclosure for the expenditure
- 1.9 During an audit of the **receiving operations** of a manufacturing organisation, an internal auditor will be most concerned with the risk that the function has
- A received goods that were ordered
 - B failed to detect the receipt of goods of poor quality
 - C an insufficient staff complement to perform all the tasks

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D paid inflated prices for goods from related parties

1.10 Which of the following statements is an audit objective?

- A Observe the deposit of the day's cash receipts
- B Determine whether cash receipts are adequately safeguarded
- C Analyse the pattern of any cash shortages
- D Reperform each month's bank reconciliation

1.11 Which one of the following activities may be performed by an internal auditor as an **assurance** service?

- A Drafting procedures for systems of control
- B Designing systems of control
- C Reviewing systems of control before implementation
- D Installing systems of control

1.12 A working paper is complete when it

- A complies with the internal audit activity's format requirements
- B contains all the attributes of an observation
- C is clear, concise and accurate
- D satisfies the audit objective for which it was developed

1.13 When an internal auditor uses monetary-unit statistical sampling to examine the total value of invoices, each invoice

- A has an equal probability of being selected
- B has an unknown probability of being selected
- C has a probability of being selected proportional to its monetary value

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D can be represented by no more than one monetary unit

1.14 An internal auditor decides to perform an inventory turnover analysis for both raw materials and finished goods inventory. The analysis would be potentially useful in

- A identifying products for which management has not adjusted to changes in market demand
- B identifying obsolete inventory
- C identifying potential problems in purchasing activities
- D All the answers are correct

(Some questions have been adapted from Gleim and Vallabhaneni: CIA Exam Reviews)

QUESTION 2

30 marks

Fantasy Ltd is a toys wholesaler. The company purchases its inventory from local companies which either manufacture or import toys. Over the last few years little attention has been paid to the accounting and related internal control systems at Fantasy Ltd and evidence of this has started to show. You have been asked by the financial controller to review the company's systems commencing with the acquisitions and payments cycle.

Ordering of goods

The ordering department consists of five order clerks and the chief order clerk, Given Khumalo. The toys which the company sells are broken down into five product categories, namely, boardgames, arts and crafts, dolls, video games and model vehicles. Each order clerk is allocated to a product category and is responsible for purchasing inventory for his or her category. Given Khumalo is responsible for monitoring and analysing the toy market and working with the sales department in deciding on which new toy lines which should be purchased.

All the company's applications are resident on a local area network. To access the network employees must enter their own unique user ID and password.

The inventory masterfile is divided into the five product categories. Each morning the order clerk accesses the category for which he or she is responsible and based on the quantity on hand according to the masterfile, decides whether to place an order. The inventory masterfile contains details of the company's preferred supplier.

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and the order clerks will normally place the order with that supplier. However, if the preferred supplier is "out of stock" the order clerks will source the item from another supplier. If this is the case, the order clerks will add the new supplier's details to the inventory masterfile. A supplier code must also be entered so that a computer generated purchase order can be printed.

To create the purchase order the order clerk accesses the "create purchase order" module of the acquisitions software. Access to the "create purchase order" module is restricted to the order clerks. The order clerk then captures all the compulsory fields (the supplier code, quantity and description of the goods to be ordered etc.) Once all the details have been captured, a two-part sequenced order is printed out. The order clerk mails the top copy to the supplier and files the second copy numerically in a lever arch file. Each order clerk's purchase orders have their own numerical sequence. To ensure that they do not duplicate an order once it has been placed, the order clerk updates the inventory masterfile by entering a date in the "pending order field".

Receiving of goods

Goods ordered by Fantasy Ltd are delivered in boxes which display the quantity and description of the contents on the outside of the box, e.g. ten Lego sets. Each delivery is supported by a supplier delivery note, which lists the quantities and description of the goods being delivered.

All goods delivered are directed to the "Receiving Department", a physically secure area attached to the warehouse. Any one of the three receiving clerks will accept a delivery. The receiving clerk will determine the validity of the order for the goods being delivered by entering the purchase order number (taken from the supplier delivery note) into the computer via a terminal in the receiving department. The receiving clerk has read access to the Purchase Order file on the system. If the purchase order is valid, the words "accept delivery" appear on the screen.

The receiving clerk then agrees the number of boxes delivered and the quantity and description of the goods as per the details recorded on the boxes, to the supplier delivery note. If there are any discrepancies, the receiving clerk changes the delivery note accordingly. He and the person delivering the goods will sign both the copies of the delivery note to acknowledge the changes.

The receiving clerk then accesses the "create goods received note" module. This module is restricted to the receiving clerks. The screen comes up formatted as a goods received note which the receiving clerk then completes taking the information from the supplier delivery notes. Once the goods received notes have been completed, the quantities on the inventory masterfile are automatically updated and the date in the "pending order field" is deleted to show that the order has been received. The receiving clerk prints out one copy of the goods received note. This is attached to the supplier delivery note and is filed sequentially and retained in the receiving department. (The goods received notes remain on the system to be

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accessed and printed out by the creditors/accounting department where they are matched to the supplier invoice when it arrives)

The boxes are placed in a secure area until the warehouse packers have time to move them into the warehouse, unpack them and place the toys on their respective shelves in the warehouse

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|-----------------|---|--------------|
| REQUIRED | | Marks |
| 2.1 | Identify eight (8) weaknesses in the above system | (12) |
| 2.2 | Recommend eight (8) (manual and automated) internal controls needed to eliminate the identified weaknesses | (12) |

Structure your answer in the following format:

2.1	Weakness	2.2	Internal controls

- | | | |
|------------|---|------------|
| 2.3 | From the scenario above, formulate four (4) tests of controls for the automated controls | (6) |
|------------|---|------------|

Question 3 **15 marks**

You are a manager at Electra (Pty) Ltd You have been asked to present at an internal audit training session to the internal auditors in your organisation The topic for the training session is "*Identifying risks and formulation of tests of controls*"

The following table contains internal controls for different cycles

	Cycle	Internal control
1	Revenue and receipts	The credit controller signs the internal sales order (ISO) after checking that the customer's credit status is satisfactory
2	Revenue and receipts	The security guard agree that all the goods to be delivered, appear on the delivery list and are supported by delivery notes The delivery note is then date stamped by the security guard
3	Payroll	Employees should present identification and acknowledge receipt of wages by signing the wages register
4	Payroll	Changes to wages rates are recorded on payroll

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		amendment forms and authorised by the Human Resources Manager
5	Acquisitions and Purchases	Quotes are obtained from a number of suppliers before purchasing
6	Finance and Investment	At the board meeting the directors obtain power of attorney to sign a loan contract on behalf of the company This power of attorney is recorded in the minutes

REQUIRED

Marks

- 3.1 State the risk that is addressed by each of the internal controls above (6)
- 3.2 Describe **one (1) test of control** for each of the internal controls above (9)

Question 4

22 marks

Prior to the preparation of the year-end financial statements, you obtained the following information in respect of certain aspects of the organisation

	2014
	R'000
Total Sales	70 500
Cost of Sales	40 600
Credit Sales	62 500
Average inventory	22 600
Average accounts receivables	35 650

The following ratios are for 2013

- Inventory turnover ratio was 1.12 times
- Average collection period for accounts receivables was 194.1 days
- Gross profit ratio was 49.68%

REQUIRED

Marks

- 4.1 Calculate the following ratios for 2014 **and** interpret each of the results
- 4.1.1 Inventory turnover rate (4)

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- 4.1.2 Average collection period for debtors (4)
- 4.1.3 Gross profit ratio (4)

At the organisation where you are employed as a senior internal auditor, it is the policy of the internal audit activity of to use monetary unit sampling (MUS) 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 population R 5 040 000
Internal Control Reasonable
Confidence level 90%
Monetary precision R48 300 (P)

The details of the first seven sales invoices are as follows

Invoice number	Invoice amount (R)
560	11 100
561	9 500
562	15 400
563	14 600
564	8 700
565	13 800
566	11 400

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

- 4.2 Using the above information, with the aid of table A, calculate the following
 - 4.2.1 Sample interval, (4)
 - 4.2.2 Sample size (3)
 - 4.2.3 Select the first three invoices for the sample. Accept a random starting point of R14 536. Show how you arrived at your answers (3)

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Question 5

12 marks

The audit committee of Electra (Pty) Ltd has made a request to the chief audit executive (CAE) to perform an internal audit of the tender committee, as it has been identified by the risk department as being a high risk for the organisation

One of the junior internal audit staff members has compiled the following internal audit working paper

Electra (Pty) Ltd		DS 31 October 2014
Internal audit working paper		
Internal audit of the tender committee		
Audit objective	Audit procedure	Results
To ensure that the tender committee has an approved written charter or agreed upon procedures	<p>Enquire from the secretary and chairperson of the tender committee as to the existence of such a document</p> <p>Request the charter from the secretary and review</p> <p>Review the minutes of board meetings as proof of the fact that the charter has been approved</p> <p>Review the composition, purpose and powers of the tender committee and ensure that it complies with the charter requirements</p>	<p>The secretary and chairperson informed me that no such document exists. The tender committee operates in a manner deemed appropriate by the chairperson</p> <p>Upon review of the board meeting minutes it was noted that that the board felt no charter was necessary as the chairperson of the tender committee is also the chief financial officer and would know what to do</p> <p>No charter or agreed upon procedures exists</p>
Conclusion:		
No formal approved document governs the operations and existence of the tender committee		

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REQUIRED

Marks

- | | | |
|------------|---|------------|
| 5.1 | List the steps the internal auditor should follow when reporting on an audit engagement | (5) |
| 5.2 | Analyse the internal audit working paper and compile an internal audit finding based upon the requirements of the International Professional Practice Framework (IPPF) pertaining to audit findings | (7) |