


**AUI3702
AUI303C**

May/June 2014

THE INTERNAL AUDIT PROCESS: TEST OF CONTROLS

Duration 2 Hours

100 Marks

EXAMINERS
 FIRST
 SECOND

 MISS D SEBASTIAN
 MRS BM VAN WYK

Use of a non-programmable pocket calculator is permissible

Closed book examination

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THIS PAPER CONSISTS OF TEN (10) PAGES

QUESTION	MAIN TOPIC	MARKS
1	Multiple-choice questions	15
2	Weaknesses and recommendations – payroll process	28
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4	Audit procedures – procurement process	15
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		<u>100</u>

PLEASE NOTE:

Although the primary purpose of the 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

[TURN OVER]

QUESTION 1

15 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 order. For example,

1.1 A

1.2 B

Each question counts 1½ marks

1.1 Select the alternative that correctly completes the following sentence

Controls are only effective and useful if

- A they are recommended by internal or external auditors.
- B they are developed and implemented in order to achieve a specific objective
- C they are applied to the financial transactions of an organisation
- D they eliminate the possibility that irregularities can occur

1.2 An internal auditor's preliminary analysis of accounts receivable revealed that the accounts receivable turnover rate had increased. Why would this information be important to the manager?

- A Relaxation of credit policy should be considered
- B It will influence cash flow which should be taken into consideration for transactions
- C The cash discount offered had increased
- D The increase was due to an increase in cash sales

- 1.3 During the performance of an audit, audit risk can best be described as the risk that the internal auditor
- A may fail to detect a significant error or weakness during the performance of the audit
 - B may not be able to adequately evaluate a section due to a poor internal control system
 - C may not have the expertise required to perform the specific audit
 - D may miss testing faulty documents due to the use of sampling techniques
- 1.4 According to the COSO Internal Control - Integrated Framework, a precondition for risk assessment is the
- A appointment of a risk manager
 - B organisational independence of the internal audit activity
 - C establishment of organisational objectives
 - D implementation of control procedures over activities
- 1.5 Which one of the following is an audit objective?
- A To determine whether inventory on hand is sufficient to meet the projected sales targets
 - B To observe the physical inventory count
 - C To include information about stock-out situations in the internal audit report
 - D To search for the existence of obsolete inventory by computing inventory turnover by product line
- 1.6 The **most** persuasive evidence to test the **existence** of newly acquired delivery trucks would be
- A certificate received from specialist third party

[TURN OVER]

- B confirmation letters from management
 - C observation of the auditee's procedures
 - D a physical examination
- 1.7** Which one of the following documents would provide the best evidence that a purchase transaction has actually occurred?
- A The supplier's invoice for the procured goods
 - B The ordering department's original requisition for the goods
 - C The cancelled cheque issued in payment of the procured goods.
 - D The receiving memorandum (goods received note) documenting the receipt of the goods
- 1.8** Which one of the following alternatives is a key issue to consider when developing audit objectives?
- A The qualifications of the audit staff selected for the engagement
 - B. The auditee's objectives and control structure
 - C The recommendations of the auditee's employees
 - D The recipient of the internal audit report
- 1.9** Which one of the following activities may be performed by an internal auditor?
- A Drafting procedures for systems of control
 - B Designing systems of control
 - C Reviewing systems of control before implementation
 - D Installing systems of control

[TURN OVER]

- 1.10 In an internal audit report, which attribute should the recommendation address?
- A Effect
 - B Condition
 - C Cause
 - D Criteria

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

QUESTION 2

28 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 has therefore asked internal audit to review the process in terms of wage calculation 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.
- The warehouse has a front entrance 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, who ensures that each person clocks only one card, is only in place during the busy periods of the day. 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.

[TURN OVER]

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 the clockcards available at the start of a working week. They also issue Apple Smith with a list of all employees to whom a clockcard has been issued.
- From the clock card Apple Smith calculates the total normal and overtime hours worked by each employee. 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. Subsequently, 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 13 00 on Friday, Granny Tree locks the pay packets and a copy of the department's wage listing in each supervisor's office safe. At 15 00 on Friday afternoons, each supervisor pays wages to the staff in his or her department. Employees are required to sign the wage listing as evidence of receipt 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.
- Unclaimed wages are captured in the unclaimed wages register and the unclaimed wage pay packets are locked in the office safe.

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

[TURN OVER]

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**

- 2.1 Identify the weaknesses in the above payroll system **(14)**

- 2.2 Recommend the internal controls needed to eliminate the identified weaknesses. **(14)**

Structure your answer in the following format:

2.1	Weaknesses	2.2	Controls

QUESTION 3 **35 marks**

You have just been promoted to the position of senior internal auditor and your new responsibilities include providing training to internal audit trainees. Three of your internal audit trainees have come to you for assistance with ratio analysis, sampling procedures and working paper requirements in their respective audits.

Query 1

Internal audit trainee 1 is involved in the internal audit of the accounts receivable of Future Ltd. He has decided to use monetary unit sampling to test for an overstatement in the 200 accounts listed under accounts receivable at year end. He has decided that a 5% error in the value of accounts receivable is significant and that a 90% confidence level will be suitable, as he does not expect any significant errors. The accounts receivable balance at year-end is R 500 000.

Confidence level	Reliability factor
99%	4.6
95%	3.0
90%	2.3

REQUIRED **Marks**

- 3.1 Explain, step by step, how you would select the sample **(4)**

- 3.2 Calculate the sample size and the sample interval for the internal audit of the accounts receivable balance **(4)**

[TURN OVER]

- 3.3 Calculate the second unit you would select for testing if the first unit you selected was the random starting point of 54. (2)
- 3.4 Formulate a conclusion if the sample results did not reveal any problems during the audit of accounts receivable (2)

Query 2

Internal audit trainee 2 is involved in the internal audit of the accounts receivable (debtors) balance of Starstruck Ltd. She has obtained the following information in respect of certain aspects of the organisation prior to the preparation of the year-end financial statements:

		2013	2014
		R	R
Inventory.	Raw materials	1 000 000	1 100 000
	Work-in-progress	500 000	400 000
	Finished goods	4 000 000	5 500 000
Sales		25 500 000	28 000 000
Cost of sales		18 700 000	21 000 000
Debtors		5 200 000	4 800 000
Creditors		2 800 000	3 000 000
Bank overdraft		1 400 000	1 900 000

The inventory turnover ratio was **4.7 times** for 2013

REQUIRED

Marks

- 3.5 Why and at what stage of the internal audit process is ratio analysis used by an internal auditor? (2)
- 3.6 Calculate the following ratios of the organisation **and** interpret the results
- 3.6.1 inventory turnover ratio (4)
- 3.6.3 gross profit ratio (5)

Query 3

Internal audit trainee 3 was assigned to examine the operations of a loan department at a large bank. The trainee prepared the working paper and asked you to review it before she submits to the audit manager

[TURN OVER]

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

Loan contracts		Exception
Bush L W	α	No signature
De Waal P	→	Interest payments calculated incorrectly
Smith K	X	No appropriate collateral
Malekeng P	4	No physical address

Conclusion:

Contracts on loan agreements with clients need improvement

REQUIRED

Marks

- 3.7 Review the above working paper in respect of its design and content and discuss the shortcomings of the working paper Give reasons for your answer (12)

QUESTION 4

15 marks

The chief audit executive (CAE) decided that, while you are busy assisting the procurement department, you may as well perform the assurance audit of the procurement function originally scheduled for later in the year

After identifying the risks, you have compiled the following audit objectives to include in your audit programme

- I Validity To ensure that only valid purchases are recorded
- II Completeness To ensure that all the goods received from suppliers are recorded as purchases in the purchase journal
- III Valuation To ensure that the liability in respect of credit purchases is recorded at the correct value
- IV Cut-off To ensure that purchases accounted for in the current period relate only to goods received in the current period

REQUIRED

Marks

- 4.1 List **six (6) planning** steps you would need to undertake to properly plan the internal audit of the procurement cycle (3)

[TURN OVER]

- 4.2** Describe **two (2)** audit procedures for each of the audit objectives identified **(12)**

QUESTION 5

7 marks

You are the internal auditor at Fastfix Limited, a national company that specialises in general vehicle maintenance, brake and tyre replacement. There are five branches in Gauteng and two in each of the other provinces. Each branch is required to hold tyres and sets of brake pads in stock based on a list sent to the branches annually.

During your review of branches A and B, you discovered that this list is updated twice a year, and each time the types of tyres and brake pads required to be held in stock are significantly different. Your evaluation of the sales pattern at these branches showed that each branch has a unique sales pattern that depends on the specific location of the branch. You could not find a correlation between the stock items on the list and the sales in either branch.

You also identified that over the last five years the number of stock write-offs, due to obsolete stock at these two branches, increased annually by approximately 5% in the one branch and 3% in the other branch. During the same period the average stock holding also increased by an average of 8% per year. The volume of stock on hand at the moment is causing operational problems at the two branches. The operational manager stated that they were instructed to keep a minimum stock on certain items identified by head office. Currently the stock on hand at the branches is approximately 20% of the annual turnover, whereas the industry standard is 5%.

REQUIRED

Marks

- From the information provided in the scenario above, write a well-structured audit finding, for the purpose of your working papers **(7)**