



AUI3702

October/November 2016

THE INTERNAL AUDIT PROCESS TEST OF CONTROLS

Duration 2 Hours

100 Marks

EXAMINERS

FIRST

MS M EDWARDS

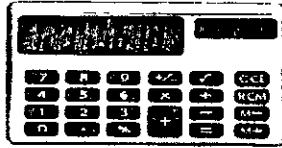
SECOND

MRS BM VAN WYK

Use of a non-programmable pocket calculator is permissible

Closed book examination

This examination question paper remains the property of the University of South Africa and may not be removed from the examination venue



AUI3702

October/November 2016

THE INTERNAL AUDIT PROCESS. TEST OF CONTROLS

Duration 2 Hours

100 Marks

EXAMINERS

FIRST

MS M EDWARDS

SECOND

MRS BM VAN WYK

Use of a non-programmable pocket calculator is permissible

Closed book examination

This examination question paper remains the property of the University of South Africa and may not be removed from the examination venue

THIS PAPER CONSISTS OF **ELEVEN (11)** PAGES

Question	Main topic	Marks
1	Multiple-choice questions	30
2	Risk and controls – cash cycle	32
3	Risk and sampling	<u>28</u>
		<u>100</u>

Please note:

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

[TURN OVER]

QUESTION 1

30 marks

Required:

For each subsection of this question, select only **one** alternative that you consider to be 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 From a modern internal auditing perspective, which one of the following statements represents the most important benefit of an internal audit activity to management?

- A Assurance that published financial statements are correct
- B Assurance that fraudulent activities will be detected
- C Assurance that the organisation is complying with legal requirements
- D Assurance that there is reasonable control over day-to-day operations

1.2 According to the Internal Auditing Standards, the purpose of an internal auditor's review for effectiveness of the system of internal control is to ascertain whether

- A the system is functioning as intended
- B the system is functioning efficiently and economically
- C the organisation's goals and objectives have been achieved
- D financial and operating data are reliable

[TURN OVER]

- 1.3** Which one of the following best describes an internal auditor's purpose in reviewing the adequacy of the system of internal control?
- A To help determine the nature, timing and extent of tests necessary to achieve the audit objectives
 - B To ensure that material weaknesses in the internal control system are corrected
 - C To determine whether the internal control system provides reasonable assurance that the organisation's objectives and goals are met efficiently and economically
 - D To determine whether the internal control system ensures that the accounting records are correct and that financial statements are fairly stated
- 1.4** Which of the following activities would **not** be presumed to impair the independence of an internal auditor?
- I Recommending standards of control for a new information system application
 - II Drafting procedures for running a new computer application to ensure that proper controls are installed
 - III Performing reviews of procedures for a new computer application before it is installed
- A I only
 - B II only
 - C III only
 - D I and III

[TURN OVER]

- 1.5** Which one of the following statements would be an appropriate reason for the internal audit activity **not** to participate in the systems development process?
- A Participation would affect audit independence, and the auditor would not be able to perform an objective review after the system is implemented
 - B Participation would delay project implementation
 - C Participation would cause the auditor to be labelled as a partial owner of the application, and the auditor would then have to share the blame for any problems that remain in the system
 - D None of the above answers are correct
- 1.6** Which one of the following is the **major purpose** of performing analytical procedures in internal audits?
- A To perform additional audit procedures
 - B To plan the audit engagement
 - C To obtain audit evidence
 - D To study relationships among elements of information
- 1.7** In which of the following situations does the auditor potentially lack objectivity?
- A An auditor reviews the procedure for a new electronic data interchange connection to a major customer before it is implemented
 - B A former purchasing assistant performs a review of internal controls over purchasing, four (4) months after being transferred to the internal auditing activity
 - C An auditor recommends standards of control and performance measures for a contract with a service organisation for the processing of payroll and employee benefits
 - D A payroll accounting employee assists an auditor in verifying the physical inventory of small motors

[TURN OVER]

- 1.8** An exception report for management is an example of which of the following?
- A preventive control
 - B detective control
 - C corrective control
 - D directive control
- 1.9** According to the Internal Audit Standards, the term “risk appetite” means which of the following?
- A risk avoidance
 - B risk limitation
 - C risk acceptance
 - D risk spreading

Question 1.10, 1.11 & 1.12 relate to the following scenario:

You are the newly appointed internal auditor of Pitt & Falls Ltd. You received the following document compiled by the previous internal auditor:

Business risks	Impact
a) Business interruption	
b) Destruction or loss of assets	Reduction in value or loss of facilities, equipment and cash
c) Fraud and conflict of interest	
d) Competitive disadvantage	

- 1.10** Which one of the following represents the impact to Pitt & Falls Ltd if the risk of business interruption is to occur?
- A inability to remain abreast of demands of the marketplace
 - B inability to respond effectively to a competitive challenge
 - C significant impairment to the ability to provide a service
 - D intentional abuse of policies, code of conduct and erosion of honesty

[TURN OVER]

1.11 Which one of the following represents the impact to Pitt & Falls Ltd if the risk of fraud and conflict of interest is to occur?

- A inability to remain abreast of demands of the marketplace
- B inability to respond effectively to a competitive challenge
- C significant impairment to the ability to provide a service
- D intentional abuse of policies, code of conduct and erosion of honesty

1.12 Which one of the following represents the impact to Pitt & Falls Ltd if the risk of competitive disadvantage is to occur?

- I the inability to remain abreast of demands of the market place
 - II the inability to respond effectively to competitive challenges
 - III significant impairment to the ability to provide a service
- A I and II only
 - B I and III only
 - C I only
 - D II only

1.13 An auditor prepared a working paper that consisted of a list of employee names and identification numbers as well as this statement "By matching random numbers with employee identification numbers, 40 employee personnel files were selected to verify that they contain all documents required by company policy 501 No exceptions were noted"

The auditor did not place any tick marks on this working paper Which one of the following changes would improve the auditor's working paper the **most**?

- A use of tick marks to show that each file was examined
- B removal of the employee names to protect their confidentiality
- C justification for the sample size
- D listing of the actual documents examined for each employee

[TURN OVER]

- 1.14** Statistical sampling would be appropriate to estimate the value of an auto dealer's 3 000 line-item inventory because statistical sampling is?
- A reliable and objective
 - B thorough and complete
 - C thorough and accurate
 - D complete and precise
- 1.15** Sample size
- A increases with the use of higher confidence levels
 - B decreases with the use of higher confidence levels
 - C remains unchanged with changes in confidence levels
 - D increases with the use of lower confidence levels
- 1.16** Management has requested an audit of promotional expenses. The sales department has been giving away expensive items in conjunction with new product sales to stimulate demand. The promotion seems successful, but management believes the cost may be too high. Which one of the following audit procedures would be the **least** useful to determine the effectiveness of the promotion?
- A a comparison of product sales during the promotion period with sales during a similar non-promotion period
 - B a comparison of the unit cost of the products sold before and during the promotion period
 - C an analysis of the marginal revenue and marginal cost for the promotion period, compared to the period before the promotion
 - D a review of the sales department's reasons for believing that the promotion has been successful

[TURN OVER]

- 1.17** An internal auditor plans to use an analytical review i.e. ratio analysis to verify the correctness of various operating expenses in a division. The use of an analytical review as a verification technique would **not** be a preferred approach if
- A the auditor notes strong indicators of a specific fraud involving this account
 - B the company has relatively stable operations that have not changed much over the past year
 - C the auditor would like to identify large, unusual or non-recurring transactions during the year
 - D the operating expenses vary in relation to other operating expenses but not in relation to revenue
- 1.18** Within an integrated financial system, which one of the following is **not** a major risk consideration associated with the accounts receivable component of the system?
- A Credits may be applied to incorrect accounts
 - B Updates of credit ratings may be untimely
 - C Financial or management reporting may be inaccurate
 - D Transactions may occur with unauthorised vendors
- 1.19** Which control, when implemented, would best assist in meeting the control objective that a system has the capability to hold users accountable for functions performed?
- A Programmed cutoff
 - B Redundant hardware
 - C Activity logging
 - D Transaction error logging

[TURN OVER]

- 1.20 Which one of the following could contribute to discrepancies between receiving reports and the number of units in a shipment?
- A Using inadequate vendor selection procedures
 - B Showing quantities ordered on the receiving department's copy of purchase orders
 - C Failing to compare the quality of goods received with specifications
 - D Accepting improper authorisation of purchases

[Adapted from Gleim CIA review]

QUESTION 2

32 Marks

You have recently been requested to advise a friend of yours on certain aspects of his internal control system for sales and cash in his newly established business

"Quick Cash" The business plan is to purchase odd lots of consumer goods from local manufacturers at discounted prices and to sell these from the friend's premises in Fordsburg Quick Cash will not sell a standard range of products, its range will vary according to what products he can purchase as odd lots He has conducted extensive research and is confident that he can source a steady stream of consumer products ranging from items of clothing to garden tools to various foodstuffs The key to success of this business is that he will sell items of good quality at low prices but for cash only – no cheques, no credit cards will be accepted and no accounts will be opened His marketing research has suggested that the concept will be popular with his target market and that the outlet is likely to be very busy

He intends to have three check-out lanes and has managed to secure three cash registers at an auction He does not have the finance available to install sophisticated point-of-sale equipment

The cash registers he purchased are dual roll cash registers and have the following features

- Two till rolls in a lockable compartment The customer receipt is printed off one roll and the details of each sale are recorded on the other This till roll is retained in the register
- The register keeps a running total of sales rung-up
- A process which calculates change to be given to the customer
- A removable lockable drawer in which cash is held
- The register records any "overrides" that have taken place on the register e.g a correction of an incorrect entry by the cashier
- The receipt produced by the register and the till roll retained in the register record the identity number of the till

[TURN OVER]

He intends to keep things simple but he will employ the necessary number of people to run the business efficiently. He will be at the outlet most of the day, from where he will source products from manufacturers and manage the business. The shop will be open during normal weekday business hours and on Saturday mornings.

He also intends to employ three till operators and one till supervisor who will also assist with the administrative functions. The three operators will sit at a different check-out lane each day. He expects to employ a bookkeeper as well as the necessary goods receiving personnel/shelf packers.

He will consider appointing other staff members if you believe it is necessary. He has also told you that proper accounting records relating to sales and cash must be kept.

(Adapted from Graded Questions on Auditing, 2014)

REQUIRED	MARKS
2.1 Identify the two major risks cash based businesses face	(2)
2.2 Explain to your friend how he can create and maintain a sound control environment in his business	(10)
2.3 Describe the policies, procedures and control activities which should be in place at Quick Cash over the collection of cash from the cash registers, the recording of cash sales and the banking thereof	(20)

QUESTION 3 **38 Marks**

Inks Ltd, a large manufacturing company in the printing and stationery sector, has a fully computerised accounting system. The applications are menu driven and are access controlled. One of the modules on the network is "journal entries" and the controls for passing a journal entry are as follows:

- 1 Write access to the module is restricted to a single clerical assistant and the financial controller
- 2 All journal entries regardless of which cycle/account headings are involved, are captured through this module
- 3 When an employee requires that a journal entry be passed, e.g. a discount adjustment to a debtor's account, a "Journal Entry Request" (JER) showing the accounts to be debited/credited must be made out and submitted with supporting documentation to one of three senior accounting personnel for authorisation. JERs are numerically sequenced.

[TURN OVER]

- 4 The senior member of staff authorises the JER (by signing), having scrutinised the supporting documentation, and returns the JER and the supporting documentation to the requester of the journal entry
- 5 The supporting documentation is filed and the JER given to the clerical assistant for entry She captures the journal entries she is given and files the JER in the accounting department's filing room
- 6 A transaction file of all journal entries is kept on the computer by numerical sequence as well as a log of the journal entries.

The senior internal audit manager is somewhat concerned about the controls over journal entries and has assessed the risk that unauthorised journal entries could be passed as high He has decided to conduct a statistically based sample on the journal entries and has asked you, the trainee internal auditor to prepare a document (for discussion with the audit team) listing the ten steps in the sampling exercise, and relating each step to testing the authorisation of the journal entries

(Adapted from Graded Questions on Auditing, 2015)

REQUIRED

MARKS

- | | | |
|------------|--|-------------|
| 3.1 | Based on the information given above, state whether you agree with the internal audit manager's assessment that risk of unauthorised entries is high Justify your answer by referring to the weaknesses in the system | (10) |
| 3.2 | Prepare the document requested by the internal audit manager The document must discuss and apply the steps in the sampling process | (26) |
| 3.3 | Indicate, assuming that we carried out the statistical sampling exercise and that our projected deviation rate exceeded our tolerable deviation rate, whether we can justifiably assume that fraudulent journal entries have been passed Explain | (2) |