

**AUI3702**

May/June 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

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THIS PAPER CONSISTS OF TEN (10) PAGES

Question	Main topic	Marks
1	Multiple-choice questions	15
2	Audit procedures – payroll and personnel cycle	15
3	Weaknesses and controls – acquisition and payments cycle	25
4	Sampling and ratio analysis	26
5	Risks and controls – revenue and receipts cycle	<u>19</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.

Question 1

15 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 It is highly possible for error or fraud to occur, without proper segregation of duties in the revenue and receipts cycle. Which of the following is a typical example of an error occurring due to lack of segregation of duties in the revenue and receipts cycle?

- A Unauthorised purchases.
- B Overstating of assets.
- C Unrecorded sales transactions.
- D Overpayment for goods and services

1.2 To ensure that all transactions and events have been recorded is a core definition of which of the following assertions?

- A Occurrence
- B Completeness.
- C Cut-off.
- D Classification.

1.3 Which of the following statements does not form part of the definition of audit risk?

- A. Material errors may occur
- B The auditor may misinterpret evidence.
- C. The client's system of internal control will not guarantee the prevention of correction of such errors.
- D Any remaining material errors will not be discovered by the auditor.

- 1 4 Which of the following is permissible under the IIA code of ethics?
- A. In response to a subpoena, an auditor appeared in a court of law and disclosed confidential, audit related information that could potentially damage the auditor's organisation.
 - B. An auditor used audit related information in a decision to buy stock issued by the employer corporation
 - C. After praising an employee in a recent audit engagement communication, an auditor accepted a gift from the employee
 - D. An auditor did not report significant observations about illegal activity to the board because management indicated that it would resolve the issue.
- 1 5 To verify the proper value of costs charged to real property records for improvements to the property, the best source of information is
- A. Inspection by the internal auditor of real property improvements.
 - B. A letter signed by the property manager asserting the propriety of costs incurred
 - C. Original invoices supporting entries into accounting records.
 - D. Comparison of billed amounts with contract estimates
- 1 6 An objective of an internal audit review reads as follows. "to protect cheques against misuse and loss " All of the following risks are appropriate **except...**
- A. Deposits might not be recorded correctly
 - B. Cheques might be stolen by an employee.
 - C. Cheques might be stolen by a person outside the organisation
 - D. Cheques might be misused by an employee
- 1 7 Which one of the following analytical trends indicates the possibility of an increase in obsolete inventory on hand?
- A. a decrease in the inventory turnover rate.
 - B. a decrease in the ratio of gross profit to sales
 - C. a decrease in the ratio of inventory to accounts receivable
 - D. a decrease in the ratio of inventory to accounts payable
- 1.8 Which one of the following represents an internal control weakness in the payroll department?
- A. Pay-cheques are distributed by the employees' immediate supervisor.
 - B. The timekeeping function is independent of the payroll department

- C Payroll records are reconciled with quarterly tax reports.
- D Payroll department personnel are rotated in their duties.

1.9 The annual audit plan is normally done on the basis of ..

- A. special requests from management and the Audit Committee.
- B. what was done in the previous year.
- C the organisation's overall risk assessment.
- D the availability of resources.

1.10 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.

Question 2

15 marks

You are currently a member of the team on the audit of JumboFeeds (Pty) Ltd, a company with a large labour force. The following controls/policies/procedures have been implemented at the company in their payroll and personnel cycle.

- a) For an employee to be successfully entered on the employee masterfile, a valid income tax number and identity number for the new employee must be entered in the designated field
- b) Programme changes to the payroll software must be authorized, inter alia, by the internal audit section. The Chief Audit Executive (CAE) signs a programme change form as evidence of approval.
- c) To gain access to the company's local area network, an employee must enter his user ID and password.
- d) The company has a computerised (biometric scanner) timekeeping system, every morning the factory manager reviews an on-screen report which lists the name and section of any employee who is absent from or late for work. The manager prints the on-screen report and files it as evidence of review.
- e) The company's network is linked to its bank via the internet; the bank's software which enables this access and facilitates, inter alia, the payment of wages and salaries by EFT, is loaded on only one terminal at JumboFeeds (Pty) Ltd. The two authorised personnel are required to enter their respective passwords upon payment of employee wages.

- f) As part of induction processes, all new employees in the employee payroll section are required to write a computer literacy test and demonstrate their computer skills. Employees who achieve below 60% in the test are required to go for a compulsory computer course and produce passed certificates as evidence of which a copy is stored in their employee files.
- g) Rigby Bedlington the human resource manager, frequently reviews the log of amendments to the employee masterfile. He signs the log as evidence of review.
- h) At the monthly directors meeting, a report on various statistics pertaining to the labour force is presented. This includes month to month comparisons of such things as, time lost to labour disruption disciplinary hearings, hours lost to sick leave etc. The report is discussed by the directors and any action required is minuted.

Required

Marks

The senior internal audit manager has given you the following duties with regard to the audit:

- 2.1 Provide an explanation of the concept combined assurance that can be used in presentations to the audit committee (3)
- 2.2 Compile one test of control (audit procedures) to test the reliability of each of the controls identified in the above cycle. (12)

Question 3

25 Marks

You are currently an internal auditor working at Footwear Limited, a retail store selling the latest brands of footwear. You have been assigned to conduct the internal audit of the acquisitions and payments cycle. Based on your discussion with the manager in charge, Mr Nike, you have come up with the following system description:

Ordering of goods

- Each floor is made up of a different section, e.g. men shoes, kiddies, ladies, etc. Mr Nike feels that the employees working on the floors understand best which stock is needed and therefore place their orders directly with the order clerk
- The order clerk writes the order on a piece of paper which he gives to the buyer.
- Orders are placed based on the floor attendant's intuition on what the best sellers are. This is dependent on how the customers buy the current stock

- Orders are placed by the buyer from the first supplier who has stock. Like this the company makes sure that the stock is received in the best time possible.

Receiving of goods

- The goods receiving function is at the back of the store Suppliers can access the function easily through the parking lot which ensures a smooth flow on incoming goods.
- Goods are received by any of the order clerks or buyers that are in the back of the store. The person who receives the goods compares the invoice to the order form and if it is correct off loads the goods. One copy of the goods received note and invoice is retained by the person receiving the goods.
- Goods are immediately moved to the warehouse by the warehouse clerk after a phone call from the person receiving the goods

Payment of goods

- All payments are made by the payment function. On a monthly basis, the payment clerk receives the creditor's statement The creditor's clerk produces a cheque requisition based on the statement.
- There are two cheque signatories for all cheque payments The cheque signatones receive the cheque requisitions from the creditor's clerk, on a monthly basis, and complete and sign upon receipt. The creditor's statement is attached to the cheque requisition for information purposes. All documentation is then returned to the creditor's clerk for issuing and filing

Required

Marks

- | | | |
|-----|---|------|
| 3.1 | Name the five components of internal control as per the COSO framework | (5) |
| 3.2 | Identify the weaknesses in the above acquisitions and payments cycle. | (10) |
| 3.3 | Recommend a relevant internal control per identified weakness to mitigate the identified weaknesses | (10) |

Structure your answer in the following format.

3.2 Weaknesses	3.3 Controls

Question 4

26 Marks

You are currently a senior internal auditor working at Hotels Ltd. You are currently in charge of two audits. The audits are in the following phases.

- Revenue and receivables audit: Sample selection
- Financial audit: Analytical procedures

Part of your supervisory duties is to assist the junior auditors with areas which they are experiencing difficulty in

Revenue and receivables audit

The junior auditor has studied monetary unit sampling at university, however this is the first time that he is doing it in practice. He has collected all the information and has asked you to assist with some definitions and the calculations. The information is as follows

It is the policy of the internal audit activity of the organisation 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 – R9 500 000

Internal control – reasonable

Confidence level – 95%

Monetary precision – R75 000 (P)

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

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
4.1 The acceptable error rate is the total number of errors which the auditor is prepared to accept within a given population (expressed as a percentage of the population). What are the four factors that must be taken into account when determining the acceptable error rate?	(4)
4.2 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	(7)
4.3 Select the first three invoices for the sample. Accept a random starting point of R13 500 Show how you arrived at your answers	(3)

Financial audit: Analytical procedures

The internal auditor in charge of the analytical procedures has taken ill and will not be in for two weeks. The deadline for the procedures is in one week and therefore you have to step in to complete his work.

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

	2016
	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 2015:

- 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
Calculate the following ratios for 2016 and interpret each of the results:	
4.4 Inventory turnover rate	(4)
4.5 Average collection period for debtors	(4)

4 6 Gross profit ratio (4)

Question 5

19 Marks

At Stay With Us Hotel, management noticed that not all expenses incurred during a guest's stay is being paid upon checking out. Management approached you to help them identify the possible problems

When you investigated the process the hotel followed, you found the following

- When a guest checks-in, an account is opened against the room number in which the guest will stay.
- All expenses incurred by the guest can be billed to his/her room.
- A guest must check-out by 11:00 on the day of departure
- Services that will be billed extra are the following
 - the bar fridge in the room
 - the bar in the entertainment area
 - dinner
 - room service
 - laundry

The bar fridge in the room is inspected after 12:00 each day. The used items are identified by housekeeping and a record thereof is given to reception to add to the guest's account

- The guest must sign the bill and provide his/her room number at the bar in the entertainment area before he/she leaves. When the cash-up is done at the bar, the signed slip is given to reception to add to the guest's account. The bar is usually manned by only one waiter.
- The bill at the restaurant where dinner is served must be signed by the guest before he/she leaves. The guest must also provide his/her room number to ensure that the bill is added to the correct account. When the cash-up is done at the restaurant, the signed slip is given to reception to add to the guest's account
- When the food ordered from room service is delivered to the guest's room, a bill is also handed to him/her to sign as proof of acceptance of the expense. The signed slip is then handed to reception to be added to the guest's account.
- When the guest wants laundry done, he/she must complete a slip identifying the pieces that will be laundered. This slip indicates the cost associated with the service. The slip must be signed by the guest as acknowledgement of the

cost. This slip is handed in at reception by the laundry service and will be billed to the guest's account

- At reception all bills received before 22:00 are added by the night shift personnel. Bills received after 22:00 will be added by the staff during the next night shift.

Required	Marks
5.1 List 4 risk responses available to an organisation to mitigate identified risks?	(4)
5.2 Provide three (3) audit objectives for the audit of guests' accounts	(3)
5.3 Identify six (6) risks in the process used by personnel at the Stay with Us Hotel, which could lead to expenses not being paid by guests.	(6)
5.4 For each of the risks you have identified in question 3.3, identify one control to be implemented to address the risk.	(6)

Structure your answer in the following format.

5.3 Risks	5.4 Controls