

**AUI3702**

May/June 2017

**THE INTERNAL AUDIT PROCESS: TEST OF CONTROLS**

Duration 2 Hours

100 Marks

**EXAMINERS**

FIRST

SECOND

MS M EDWARDS

MRS BM VAN WYK

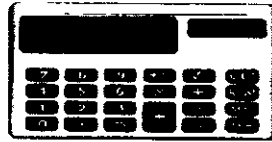
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**Use of a non-programmable pocket calculator is permissible**

**Closed book examination**

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**[TURN OVER]**



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THIS PAPER CONSISTS OF FIFTEEN (15) PAGES

Question	Main topic	Marks
1	Multiple-choice questions	30
2	Sampling and audit procedures	26
3	Internal controls	24
4	Weaknesses, risks and audit objectives	<u>20</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

**THIS INFORMATION IS RELEVANT TO 1.1 TO 1.6**

The internal auditing department has just completed an audit of loan processing and commercial loan account balances for a financial institution. The following are a few excerpts from their working papers indicating potential audit findings:

- I We took a statistical sample of 100 loan applications and determined that only 85 loans were granted.
- II Of the 85 loans granted, we noted that 4 loans should have been reviewed and approved by the loan committee, but were not. Company policy states that all loans must be approved by the committee prior to funding. Each of the 4 loans, however, was approved by the chief operating officer (COO) who indicated it was a competitive loan situation to a new customer and in the best interests of the financial institution to expedite the loan and establish a firm relationship with a growing customer. All of the other loans were formally approved by the loan committee.
- III Of the 81 loans approved by the loan committee, we found 7 where the actual amount loaned exceeded the approved amount.
- IV We noted 3 instances in which loans were made to related groups of companies without an analysis of the total amount of loans made to the controlling entity. There may be statutory limitations on the amount of loans that can be made to any individual controlling organisation.

**[TURN OVER]**

- V Of the 81 loans approved by the loan committee, we found that 14 contained either insufficient documentation or were not received by the committee in a timely fashion in advance of their meeting. The statistical sample was taken with a 95% confidence level using attribute sampling with a tolerable error limit of 4%.
- 1.1 Regarding item I only, which one of the following audit conclusions is justified?
- A There is 15% deviation rate in total loans processed
  - B There is a problem in processing that should be followed up by the auditor to determine why 15 of the loans may have been lost
  - C The loans that have been made comply with company procedures while the loans that were not made, do not
  - D None of the above
- 1.2 Regarding item II, which of the following would be correct?
- a) The sample deviation rate exceeds 4%
  - b) The auditor should examine the nature of the loans approved by the chief operations officer (COO) to see if there is a pattern
  - c) The audit finding should be included in the auditor's report with a recommendation that the loan committee review the loans
- A a) only
  - B b) and c) only
  - C c) only
  - D a), b) and c)

- 1.3 Assume with regard to item II, the COO asks the loan committee to review the loans on an after-the-fact basis. Assume further, upon subsequent review, the loan committee approves the loans on the after-the-fact basis. Which of the following conclusions would be correct regarding the reporting of the audit finding in the auditor's report?
- a) The sample deviation rate will drop to 0%
  - b) The item should still be reported in the audit report because it wasn't approved in a timely manner in accordance with company policy
  - c) The item should be reported as a non-deviation because subsequent action validated the COO's approach
- A a) only
- B b) only
- C c) only
- D a), b) and c)
- 1.4 Regarding item III, which one of the following actions would be **inappropriate** on the part of the auditor?
- A Examine the loans to determine if there is a pattern of the loans to companies. Summarise amounts and include in the audit report
- B Report the amounts to the loan committee and leave it up to them to correct. Take no further follow-up action at this time and do not include the items in the audit report
- C Follow-up with the COO and include the COO's acknowledgement of the situation in the audit report
- D Determine amount of differences and make an assessment as to whether or not the random differences are material. If the amounts are not material, not in violation of government regulations, and can be rationally explained, omit the finding from the audit report

[TURN OVER]

- 1.5** Regarding item IV, which of the following would be correct?
- a) The deviation rate is under 4%, therefore the finding need not be reported to management and the audit committee
  - b) The auditor should review appropriate regulations and possibly get legal counsel opinion on the finding prior to including the finding in the final audit report
  - c) The auditor should report the finding to the COO who approved the loans and ask for a follow-up report during the audit scheduled next year. No further action need to be taken at this time
  - d) Review a plan by the loan committee to prevent such occurrences in the future and include a summary and analysis of the plan in the final audit report
- A a) only
- B c) only
- C b) and d)
- D b only
- 
- 1.6** Regarding item V, which one of the following conclusions/audit actions is appropriate?
- A There is no audit finding since the loan committee approved all of the loans
- B Before issuing a final audit report, the auditor should investigate to determine the reasons for the lack of documentation and timely submittal to the loan committee and include that analysis in the report
- C The auditor should include the audit findings in the report only if the auditor is to determine the cause of the findings
- D Both B and C are correct
- 
- 1.7** Which one of the following documents would provide the best evidence that a purchase transaction has actually occurred?
- A Cancelled cheque issued in payment of the procured goods
- B Ordering department's original requisition for the goods
- C Receiving memorandum documenting the receipt of the goods
- D Supplier's invoice for the procured goods

**[TURN OVER]**

1.8 The auditor wants to understand the actual flow of data regarding cash processing. The most convincing evidence would be obtained by which one of the following?

- A Reviewing the systems flowchart
- B Performing a "walk-through" of the processing and obtaining copies of all documents used
- C Reviewing the programming flowchart for evidence of control procedures placed into the computer programs.
- D Interviewing the senior accountant

1.9 The auditor is concerned with the overall valuation of inventory. Rank the following sources of audit evidence from **most** persuasive in addressing the assertion as to the valuation of inventory.

- I Calculate inventory turnover by individual product
- II Assess the net realisability of all inventory items with a turnover ratio of 2.0 or less by interviewing the marketing manager as to the marketability of the product
- III Calculate the net realisable value (NRV) of all inventory products (using audit software to calculate NRV based on the selling price) and compare NRV with cost
- IV Take a statistical sample of inventory and examine the latest purchase documents (invoices and receiving slips) to calculate the inventory cost.

- A I, II, III, IV
- B I, IV, II, III
- C IV, I, III, II
- D II, III, IV, I

- 1.10** The auditor wishes to test the assertion that all claims paid by a medical aid company contain proper authorisation and documentation, including but not limited to the validity of the claim from an approved doctor and an indication that the claim complies with the claimant's policy. Which one of the following is the **most** appropriate audit procedure?
- A Select a random statistical sample of all policyholders and examine all claims for the sampled items during the year to determine if they were handled properly
  - B Select a sample of claims filed and trace to documentary evidence of authorisation and other support documentation
  - C Select a sample of claims denied and determine that all claims denied were appropriate. The claims denied file is much smaller and the auditor can obtain greater coverage with the sample size
  - D Select a sample of paid claims from the claims/cash disbursement file and trace to documentary evidence of authorisation and other supporting documentation
- 1.11** Which one of the following procedures would provide the most relevant evidence to determine the adequacy of the allowance for doubtful accounts receivable?
- A Confirmation of the receivables
  - B Analysis of the following month's payments on the accounts receivable balances outstanding
  - C Test the controls over the write-off of accounts receivable to ensure that management approves all write-offs
  - D Analyse the allowance through an aging of receivables and an analysis of the current economic data



**1.12** Which one of the following audit procedures would provide the **least** relevant evidence in determining that payroll payments were made to bona fide employees?

- A Reconcile time cards in use to employees on the job
- B Examine cancelled cheques for proper endorsement and compare to personnel records
- C Test for segregation of the authorisation for payment from the hire/fire authorisation.
- D Test the payroll account bank reconciliation by tracing outstanding cheques to the payroll register.

**1.13** An auditor performs an analytical review of a division's operations and notes the following:

- Current ratio – increasing
- Quick ratio – decreasing
- Number of days sales in inventory – increasing
- Sales – constant
- Current liabilities - constant

From this, the auditor can conclude that:

- I The company has produced less product this year than last year.
  - II Cash or accounts receivable have decreased
  - III The gross margin has decreased
- A I only
  - B II only
  - C I and III
  - D II and III

- 1.14** An auditor must weigh the cost of an audit procedure against the persuasiveness of the evidence to be gathered. Observation is one audit procedure that involves cost/benefit trade-offs. Which of the following statements regarding observation as an audit technique are correct?
- I Observation is limited because individuals may react differently when being observed
  - II When testing financial statement balances, observation is more persuasive for the completeness assertion than it is for the existence assertion
  - III Observation is effective in providing evidence on how the company's processes differ from that specified by written policies
- A I only
  - B II only
  - C I and III only
  - D I, II and III
- 1.15** Which one of the following represents the **most** significant risk in the payroll cycle?
- A The distribution of payroll costs to the various service organisation is not verified by the payroll supervisor
  - B The payroll clerk responsible for verifying the accuracy of pension plan allotments, is also responsible for correcting errors related to this processing
  - C Due to unexpected employee retirements, a system of job rotations was not adhered to during the year
  - D Additions and changes to the payroll are not initiated by the Human resources department

[TURN OVER]

**1.16** An internal auditor would trace copies of sales invoices to shipping documents in order to determine that?

- A Sales that are billed were also shipped
- B Customer shipments were billed
- C Shipments to customers were also recorded as receivables
- D The subsidiary accounts receivables ledger was updated

**1.17** An audit working paper is complete when?

- A The audit objective has been met
- B Operational activity describing the essential basis of the audit has been included
- C Condensation and careful summarisation of detail is present
- D Working papers are properly indexed and cross-referenced

**THIS INFORMATION IS RELEVANT TO 1.18**

The following information is extracted from a draft of an audit report prepared upon completion of an audit of the inventory warehousing procedures for a division

**Finding I**

We observed that receiving reports were not filled out when the receiving department became busy. Instead, the receiving manager would fill out the reports after work and forward them to accounts payable. There is a risk that all items received might not be recorded, or that failing to initially record might result in some items being diverted to other places. During our tests we noted many instances in which accounts payable had to call to receiving to obtain a receiving report. We recommend that receiving reports be prepared.

**[TURN OVER]**

- 1.18** Which one of the following indicates a major deficiency in Finding I related to the completeness of the audit report?
- A The factual evidence for the audit finding is not given
  - B The cause of the problem is not defined
  - C The risk is presented in an over dramatic fashion
  - D The recommendation is incomplete
- 1.19** In a sampling application, the standard deviation represents a measure of the?
- A Expected error rate
  - B Level of confidence desired
  - C Degree of data variability
  - D Extent of precision achieved
- 1.20** 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

[Adapted from Gleim CIA review]

**QUESTION 2**

**26 Marks**

You are a member of the internal audit team of MakeaBrake Ltd, a company which manufactures braking systems for trucks and cars. The company has a staff of 400 hourly paid employees who are spread over the ten cost centres which make up the entire process of manufacture.

The number, grade and category of employees varies from cost centre to cost centre, some centres, such as quality control, have as few as 10 employees the majority of whom are skilled, whilst others may have as many as 70 employees, the vast majority of whom will be unskilled.

**[TURN OVER]**

Each cost centre is controlled by a foreman. Hours worked are recorded using clock cards and a conventional timing device. The foremen authorise all overtime for their cost centre.

Engagements, dismissals and grade wage rates (which vary considerably from grade to grade) are handled by human resources in conjunction with the foremen and union officials, where necessary.

Wage earners are only paid for hours clocked, i.e. if an employee is ill for a period, he is not paid. (An independent "sick leave" system is in operation.) No wage payouts are conducted, weekly wages are paid directly into employees' bank accounts by electronic funds transfer.

The company's computerised payroll contains the following information:

1. Employee number and name
2. Cost centre
3. Grade and category (skilled/unskilled)
4. Normal and overtime hours worked
5. Gross earnings
6. PAYE deduction
7. UIF deduction
8. Metalworkers Union deductions (compulsory)
9. Net earnings
10. Bank account number
11. SARS tax reference number
12. Identity number

The internal audit team's plan for the audit of wages is to select a base wage period which is comprehensively audited and then to perform analytical procedures for selected other wage periods comparing those periods to the base period. The base period for the current year's audit has been selected and you have been requested by your senior to select a sample from the base wage period payroll for audit.

The sample will be used to:

1. assist in determining whether any fictitious workers appear on the payroll, and
2. determine whether the figures on the payroll for the wage period selected are valid and accurate.

He further informs you that he does not require you to select a statistical sample, a well thought out non-statistical sample will be sufficient. You have general audit software which is compatible with the client's system available to you.

(Adapted from Graded Questions on Auditing, 2015)

[TURN OVER]

**REQUIRED**

**MARKS**

- 2.1 Discuss the factors you would consider in deciding on the size of the sample you will select (5)
- 2.2 Indicate whether the population from which you will select your sample, will be all wage earners on the payroll (masterfile) or only wage earners who actually worked during the wage period selected as the base wage period, i.e. excluding employees who were absent from work. Justify your answer (3)
- 2.3 Using the information from the above scenario describe the audit procedures you will carry out on the employees selected for testing in respect of
- 2.3.1 whether they are fictitious, and (12)
- 2.3.2 normal and overtime hours worked to comply with your senior's request (6)

**QUESTION 3**

**24 Marks**

You are the newly appointed financial manager of The Shoebox (Pty) Ltd, which operates a chain of 20 large retail shoe stores in and around Port Elizabeth, selling on a cash only basis

The stores are controlled from a central head office and all inventory is issued to the stores from a central warehouse. All inventory deliveries to stores are made by The Shoebox (Pty) Ltd's own delivery vans

An analysis of the most recent branch accounts revealed that the average gross profit margin for the 20 stores was 51% but that five stores reported margins below 20%

You approached the managers of the stores in question and the company internal auditor and they all ascribed the poor margins to weak internal control systems which enables theft in particular, to go undetected. Their explanation for this, with which you agreed, is that the internal control system has not kept up with the rapid growth of the company. You therefore decided to design internal controls to improve the control over branch inventories

For a number of reasons, it is not feasible to computerise branch activities, although all processing at head office is computerised

**[TURN OVER]**

The stores are staffed by a branch manager, a cashier and between 2 and 5 sales assistants (depending on the size of the store) The company does not wish to change this All the branches' inventory is kept either on display or in storerooms at the back of the shop All inventory items are coded A cash sales invoice, which indicates the item code and description, is made out for each pair of shoes sold No inventory records are kept at the branches

Due to the nature of the stores clientele, the company introduced a "down payment scheme" This enables a customer to purchase shoes over six months by making payments when they are able to The selected shoes are put aside and only once the six payments have been made are the shoes handed over to the customer Internal controls over this scheme are particularly poor

(Adapted from Graded Questions on Auditing, 2015)

**REQUIRED**

**MARKS**

3.1 Using the information from the above scenario design an internal control system for the control of inventory under the following headings

- |   |     |
|---|-----|
| 3.1.1 Despatch from central warehouse to stores | (8) |
| 3.1.2 Physical control over inventory at stores | (8) |
| 3.1.3 The "down payment scheme"                 | (8) |

**QUESTION 4**

**20 Marks**

You have recently been appointed as a junior internal auditor at Bits & Bobs (Pty) Ltd To prepare for your job interview you did some desktop research on the company and found that a leading business magazine rated Bits & Bobs (Pty) Ltd as the leading retailer in its field The journalist evaluated the performance and short-term liquidity ratios of 90% of the companies in the same industry and found Bits & Bobs (Pty) Ltd to be the most successful The company is a retailer that sells spare parts for small electrical appliances

On your first day at Bits & Bobs (Pty) Ltd, one of the internal audit managers informs you that in accordance with the internal audit plan, an internal audit of the revenue and receipts' cycle for the period 1 April 2016 to 31 March 2017 is scheduled to commence within the next week and that you have been assigned to the audit The internal audit manager has compiled the following narrative description of the cycle

- The company receptionist is responsible for opening the daily incoming mail All the orders received from customers are placed in a box marked "Incoming Orders" The box is then sent to the senior warehouse clerk who initiates the collection of the items ordered

**[TURN OVER]**

- Some customers fax their orders directly to the senior warehouse clerk prior to sending their orders through the mail. The company does not accept telephonic orders – when customers phone to place an order they are requested to either fax or submit a hardcopy order
- Sales are only made on credit. No cash sales are permitted
- On receipt of the customer orders/faxes, the senior warehouse clerk makes a photocopy of each. He files the originals alphabetically (by customer name) in a file. He divides the photocopies of orders roughly into two piles and hands a pile to each of the junior warehouse clerks who, among other duties, are responsible for collecting the ordered items from the shelves in the warehouse

**REQUIRED**

**Marks**

- 4.1** In respect of the revenue and receipts cycle of Bits and Bobs (Pty) Ltd & as described in the scenario above, identify **four (4)** weaknesses and  
**4.2** indicate the business risks (4 2) related to each weakness

Structure your answer to question 4 1 & 4 2 as follows

<b>4.1</b>	<b>Weakness (4)</b>	<b>4.2</b>	<b>Business Risk (6)</b>
		Format =(1)	

**(11)**

- 4.3** Based on the risks identified in 4 2 above, formulate the audit objectives for the audit of the revenue and receipts cycle

**(9)**