

Tutorial Letter 202/2/2014

The Internal Audit Process: Tests of Controls

AUI3702

Semester 2

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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1 BRIEFING

This tutorial letter contains the solutions to Assignment 02 for this semester. The lecturer has marked a selection of the questions in this assignment. The marks you received for your answers to these questions will constitute your mark for this assignment and will contribute towards your year mark.

You need to assess your answers to the other questions yourself by comparing your answers with those provided in this tutorial letter.

Use the marking plan as a guide to award yourself marks for your answers. Take care not to mark the same concept more than once just because it appears more than once, perhaps in different words or in a different format.

After you have marked your own answers, reflect carefully on your result to determine why you could not allocate full marks to your answers. Please ensure that you allocate marks only to valid answers. It is imperative that you identify your problem areas now, while you can still do something about them. If you do not solve all your problems as soon as you have identified them, you may repeat the same mistakes in the examination, and that could prove very costly.

Marking your answers should enable you to identify any problems you may be experiencing. Your marks for this assignment will be an indication of your level of knowledge of the content of the module at this stage. You should still have enough time left to revise the work and solve the identified problem areas before the examination.

We trust that you found the assignment both interesting and informative and that it has served as an aid for your examination preparation. Should you encounter any difficulties with this module in internal auditing, please do not hesitate to contact us.

Lecturer: AUI3702

2 KEY TO ASSIGNMENT 02/2014 (SECOND SEMESTER)

QUESTION 1

15 marks

Question	Correct answer	Study guide reference
1.1	A	Study unit 4.2
<p>Option A is correct. Information is deemed sufficient if it is factual, adequate and convincing so that a prudent informed person would reach the same conclusion as the internal auditor (PA 2310-1). The results of a properly executed statistical sampling procedure are usually sufficient for an internal auditor's purposes. A sample by definition can provide only reasonable assurance. Due to cost-benefit considerations, absolute assurance is seldom possible.</p> <p>Option B is incorrect because the logical relationship indicates relevance.</p> <p>Option C incorrect because cost-benefit considerations usually preclude absolute assurance.</p> <p>Option D is incorrect since the best information reasonably obtained is reliable information.</p>		
Question	Correct answer	Study guide reference
1.2	D	Study unit 2.2
<p>Option D is correct. The COSO internal control framework lists the following seven elements of the control environment:</p> <ul style="list-style-type: none"> • Integrity and ethical values; • Commitment to competence; • Board of directors or audit committee; • Management's philosophy and operating style; • Organisational structure; • Assignment of authority and responsibility; and • Human resource policies and practices. <p>Option A is incorrect. Strategic alignment is not an element of the control environment.</p> <p>Option B is incorrect. Planning is not an element of the control environment.</p> <p>Option C is incorrect. A backup facility is not an element of the control environment.</p>		
Question	Correct answer	Study guide reference
1.3	B	Study unit 2.2
<p>Option B is correct. Control environments reflect the attitude and actions of the board and management regarding the significance of control in the organisation.</p> <p>Option A is incorrect. Risk assessment identifies and analyses external or internal risks to the</p>		

achievement of the objectives at the activity level and the entity level.

Option C is incorrect. Control activities are the policies and procedures helping to ensure that management directives are executed and actions are taken to address risks to the achievement of objectives.

Option D is incorrect. Monitoring is a process that assesses the quality of the system's performance over time.

Question	Correct answer	Study guide reference
1.4	D	Study unit 4.2

Option D is correct. Monetary-unit sampling, results in the selection of every nth monetary unit. Therefore, a 1 000 monetary unit item is 1 000 times more likely to be selected than a 1 monetary unit item. The probability of selection of a sampled item is directly proportional to the size (value) of the item.

Option A is incorrect. Each monetary unit, but not each invoice has an equal probability of being selected unless all invoices are for the same amount.

Option B is incorrect. The probability of selection can be calculated using the monetary value of the item and of the population.

Option C is incorrect. It is possible for two or more monetary units to be selected from the same item; for example, a 4 500 item would be represented by four monetary units if every 1 000th monetary unit is selected.

Question	Correct answer	Study guide reference
1.5	A	Study unit 2.2

Option A is correct. Senior management is primarily responsible for establishing a proper organisational culture and specifying a system of internal control.

Option B is incorrect. Management administers risk and control processes. It cannot delegate this responsibility to the external auditors or the internal audit activity.

Option C is incorrect. The board has oversight governance responsibilities but ordinarily does not become involved in the details of operations (design of controls).

Option D is incorrect. Senior management is not likely to be involved in the detailed design and day-to-day operations of a control system.

Question	Correct answer	Study guide reference
1.6	C	Study units 1.1.3 and 5.1

Option C is correct. Risk management is a key responsibility of senior management and the

board. To achieve its business objectives, management ensures that sound risk management processes are in place and functioning. Boards have an oversight role to determine that appropriate risk management processes are in place and that these processes are adequate and effective. In this role, they may direct the internal audit activity to assist them by examining, evaluating, reporting and/or recommending improvements to the adequacy and effectiveness of risk management processes (PA 2120-1, para 1).

Option A is incorrect. Internal auditors are generally involved in the assurance and advisory role. The board has an oversight role.

Option B is incorrect. Management performs the implementation role in risk management and the board has an oversight role. Internal auditors are generally involved in the assurance and advisory role.

Option D is incorrect. Management is responsible for risk management, not the oversight role performed by the board.

Question	Correct answer	Study guide reference
1.7	B	Study units 1.1.3 and 7.1

Option B is correct. According to Practice Advisory 2440-1, "Internal auditors discuss conclusions and recommendations with appropriate levels of management before the chief audit executive (CAE) issues the final engagement communications." These discussions and review help avoid misunderstanding or misinterpretation of fact.

Option A is incorrect. The internal audit activity is responsible to revise and forward engagement communications to the audit committee.

Option C is incorrect. Engagement communications should be discussed with the client management first.

Option D is incorrect. The ideal arrangement is to send all engagement communications to the audit committee.

Question	Correct answer	Study guide reference
1.8	B	Study unit 4.2.3

Option B is correct. The population is the group of items about which an auditor wishes to draw conclusions.

Option A is incorrect. The attribute of interest is the characteristic of the population the auditor wants to estimate.

Option C is incorrect. The sample is the subset of the population used to estimate the characteristic.

Option D is incorrect. The sampling unit is the item that is actually selected for examination. It is

a subset of the population.

Question	Correct answer	Study guide reference
1.9	A	Study unit 4.2.2

Option A is correct. Monetary-unit sampling (MUS) is appropriate for testing account balances, such as those for inventory and receivables, in which some items may be far larger than others in the population. MUS is most useful if few misstatements are expected. Moreover, it is designed to detect overstatements. It is not effective for estimating understatements because the greater the understatement, the less likely the item will be selected.

Option B is incorrect. An audit of account payable is primarily concerned with understatements.

Option C is incorrect. As the expected amount of misstatement increases, the MUS sample size increases. MUS may also overstate the upper misstatement limit when misstatements are found. The result might be rejection of an acceptable balance.

Option D is incorrect. The items in the population must be arranged by cumulative monetary total. The first monetary unit is chosen randomly, the second equals the random start plus the sample interval in monetary units, and so forth.

Question	Correct answer	Study guide reference
1.10	D	Study unit 3

Option D is correct. Attendance data are accumulated by the timekeeping function. Preparing the payroll is a function of the payroll department. For control purposes, these two functions should be separated to avoid the perpetration and concealment of irregularities.

Option A is incorrect. Hiring employees and authorising changes in pay rates are both human resource functions.

Option B is incorrect. Preparing the payroll and filing payroll tax forms are both functions of the payroll department.

Option C is incorrect. Proper treasury functions include signing and distributing payroll cheques.

(1½ marks each)

QUESTION 2**20 marks****2.1 Composition and duties of the audit committee as per King III****References:**

- Study guide, sections 2.1.1.2
- King III Report on Corporate Governance

Audit committee composition - King III Report: Principle 3.2

- All members of the audit committee should be independent non-executive directors. ✓
- The audit committee should consist of at least three members. ✓
- The chairman of the board should not be the chairman or member of the audit committee. ✓
- The committee collectively should have sufficient qualifications and experience to fulfil its duties. ✓

(Marks as indicated; maximum of 3 marks)

Audit committee duties - King III Report: Principle 3.2

- The audit committee should oversee integrated reporting. ✓
- The audit committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities. ✓
- The audit committee should satisfy itself of the expertise, resources and experience of the company's finance function. ✓
- The audit committee should be responsible for oversee of internal audit. ✓
- The audit committee should oversee the risk management process (financial reporting risks, internal financial controls, fraud risks and IT risks related to financial reporting). ✓
- The audit committee is responsible for recommending the appointment of the external auditor and oversee the external audit process. ✓
- The audit committee should report to the board and shareholders on how it has discharged its duties. ✓

(Marks as indicated; maximum of 7 marks)

Comments:

This was a theoretical question. You had to identify which principle in the King III Report covered the audit committee's composition and duties.

2.2 Composition and duties of the audit committee as per PFMA

References:

- Study guide, sections 2.1.2
- *Public Finance Management Act No 1 of 1999 and the Treasury Regulations*

Audit committee composition - *Public Finance Management Act No 1 of 1999, Section 77*

An audit committee must consist of at least three persons √ of whom, in the case of a department:

- one must be from outside the public service; √
- the majority may not be persons in the employ of the department, except with the approval of the relevant treasury √; and
- the chairperson may not be in the employ of the department. √

(Marks as indicated, to a maximum of 3 marks)

Audit committee composition duties - *Treasury regulations, Section 6*

Audit committees should at least **oversee** the following:

- the effectiveness of the internal control systems; √
- the effectiveness of the internal audit function; √
- the risk areas of the institution's operations to be covered in the scope of internal and external audits; √
- the adequacy, reliability and accuracy of the financial information provided to management and to other users of such information; √
- any accounting and auditing concerns identifies as a result of internal and external audits; √
- the institution's compliance with laws, regulations, institutional instructions and standard operating procedures; √ and
- the activities of the internal audit function, including its annual work programme, co-ordination with the external auditors, the reports of significant investigations and the responses of management to specific recommendations. √

(Marks as indicated, to a maximum of 7 marks)

Comments:

This was a theoretical question. You had to identify which section in the PFMA and Treasury Regulations covered the audit committee's composition and duties.

QUESTION 3**18 marks****3.1 Internal controls****References:**

- **Study guide, section 3.1**
- **Jackson and Stent, Chapter 10**

Receiving orders

- Internal sales orders must be numbered sequentially. ✓
- No orders must be accepted from customers who do not have an account on the website. ✓
- Available credit should be checked before an order is authorised. ✓
- The responsible clerk must sign all internal sales orders to indicate verification of information, payment and products ordered. ✓

Warehouse

- Picking slips must be matched to the delivery note to identify orders that have not yet been sent to customers. ✓
- Stock levels should be accessible from the website so that out-of-stock items can be ordered. ✓
- The picker should initial the picking slip for each item picked and indicate on the picking slip those items that cannot be supplied. ✓
- The warehouse foreman should conduct supervisory checks to ensure that all goods picked are supported by signed picking slips. ✓
- The stores clerk should check the goods picked against the picking slip. ✓
- The stores clerk should prepare the delivery note from the picking slip. ✓
- In cases where goods are out of stock, the stores clerk should prepare the back-order note from the picking slip and cross-reference both documents. ✓
- The stores clerk should send a copy of the back-order note to the order clerk to enable the order clerk to notify the customer. ✓
- The stores clerk should send a copy of the back-order note to the buying department. ✓

Despatch

- On receipt of the goods, the picking slip and delivery notes from the warehouse, the despatch clerk should check the quantities and description of goods against the authorised picking slip and delivery note. ✓
- The despatch clerk should sign the picking slip and delivery note to acknowledge receipt of the goods. ✓
- The despatch clerk should retain two copies of the delivery note and return the signed picking slips to the warehouse. ✓
- The goods picked should be checked against the picking slip and delivery note as they are packed into a box for delivery. ✓
- The address on the box should be checked against the delivery address on the documentation and the box should be sealed immediately. ✓
- The despatch clerk should prepare a two-part list of deliveries to be made. ✓ The list should be matched to the delivery notes and the physical goods loaded on to the vehicle. ✓
- Delivery staff should supervise loading the truck and sign a copy of the delivery list to

- acknowledge receipt of the delivery notes and the corresponding goods. ✓
- The driver should retain one copy of the delivery list and the delivery notes. ✓
- The despatch clerk must retain the signed copy of delivery list. ✓
- Gate controls (security) should check that all the goods to be delivered do appear on the delivery list and are supported by delivery notes. Both copies of each delivery note should be date-stamped by gate control. ✓
- On delivery, the customer should sign both copies of the delivery note (having checked the goods), retain a copy and return the other copy with the courier service. ✓
- The courier service should return the signed delivery notes when collecting the next delivery. These documents should be kept for queries from customers. ✓

(Maximum of 18 marks)

Comments:

Internal controls are put in place to ensure that organisational and audit objectives are achieved. It is those procedures/ processes that should take place to ensure that the organisation meets its objectives and mitigate risks. Developing and implementing internal controls are responsibilities of management.

QUESTION 4

10 marks

4. Tests of control for automated controls

References: Study guide, section 4.1.2.2

- Observe the clocking in of employees - that the normal process is followed and there is no manual override of the system controls (e.g. the security guard letting employees in without swiping). ✓
- Inspect the biometric masterfile (file of employee names with thumb prints) from human resources and compare it with the employee masterfile (employee name and ID). Follow up with human resources on any discrepancies (additional thumb prints). ✓
- Inspect the access profile report of the payroll system for the following:
 - The supervisor has read access only to the employee hours on the system; ✓
 - Each payroll clerk has write access only to his/her allocated employees; ✓
 - Each payroll clerk has write access only to the deduction fields of their allocated employees; ✓
 - The payroll manager has only read access to the system. ✓
 - Only the payroll manager has access to authorise the payroll file for payment. ✓
- Attempt to gain access to the payroll system by entering a fictitious username and password and confirm that it is rejected. ✓
- Inspect a sample of activity reports to confirm that:
 - only authorised users have access to the payroll system. ✓

- access to the system is only during working hours. Access gained after working hours or in weekends should be followed up by the payroll manager. ✓
- Inspect a sample of exception reports to confirm that:
 - unauthorised accesses have been followed up by the payroll manager. ✓

(10 marks as indicated)

Comments:

*This was a practical question. You had to work through the case study given and from that information compile the test of controls for automated controls. Therefore test of controls for **manual** controls will not be marked. The case study provides you with the system of internal control. You should compile audit procedures to test the working of the system of internal control.*

QUESTION 5

20 marks

5.1 Risk identification

References:

- **Study guide, section 3.1**
- **Internal auditing: assurance & consulting services (Reding et al), Chapter 5: *Business processes and risks***

- a) Purchase of unauthorised goods or purchase of goods for personal use. ✓
- b) Company paying for goods not received. ✓
Incomplete records. ✓
- c) Goods ordered and invoiced may not have been received or there was theft of goods after delivery. ✓
- d) Purchase of unauthorised goods or purchase of goods for personal use. ✓
- e) Fraud may occur by employees presenting the same documentation twice for payment. ✓

(Maximum of 5 marks)

Comments:

This was a practical question. You had to read through the internal control questionnaire, and for each of the questions identify the risk that is addressed by that question, in other words why is that question asked? What will happen if that internal control procedure is not performed?

5.2 Test of controls

Reference: Study guide, section 4.1.2 and 5

a)

- Enquire of the buyers whether they ever order goods without a written order. $\sqrt{1/2}$
- Select a sample of purchases from the purchases journal, trace to supporting documentation and inspect the written order and the signature thereon. $\sqrt{1/2}$

b)

- Observe the receiving clerks and note whether they count properly and prepare and sign goods received notes. $\sqrt{1/2}$
- Select entries in the purchase journal and inspect the related GRN, ensuring that it is properly signed and that the details agree with the order/supplier delivery note. $\sqrt{1/2}$

c)

- Enquire of the storeman and the receiving staff about the operation of this control. $\sqrt{1/2}$
- Inspect a sample of the GRN and note the signatures of the receiving clerks and the storeman. $\sqrt{1/2}$

d)

- Select payments from the payments cash book and inspect the supporting authorised order, supplier delivery note, the GRN and the purchase invoice to confirm that they agree with the payment made. $\sqrt{1/2}$
- Enquire of the cheque signatories whether they check the aforementioned documentation before signing the cheque. $\sqrt{1/2}$

e)

- Inspect a sample of supporting documents for the “Paid” or “Presented” stamp. $\sqrt{1/2}$
- Enquire of the cheque signatories as to when the procedure of stamping takes place. $\sqrt{1/2}$

(Maximum of 15 marks)

Comments:

*This was a practical question. For each of the controls in the internal control questionnaire you had to compile a **test of control** that would test whether or not the control is functioning.*

An audit procedure has a certain structure. It must start with a verb. For example:

- *inspect (only a document can be inspected)*
- *observe (only an action can be observed)*
- *compare*
- *discuss*
- *enquire etc*

An audit procedure must be stated in full explaining clearly what you want to do and why, using which information. You can refer to Auditing notes, the prescribed textbook for examples of audit procedures for each of the cycles.

QUESTION 6**10 marks****6.1 Difference between statistical and non statistical sampling****Reference: Study guide, section 4.2**

Two criteria are required for a sampling approach to be classified as statistical:

- The sampling units must be randomly selected. ✓
- They must be quantitatively evaluated through the application of probability theory. ✓

The absence of either requirement defines the approach as non-statistical. ✓ With non-statistical sampling the internal auditor determines the sample size and evaluates the results on the basis of subjective audit experience. ✓ (4 marks as indicated)

6.2 The following factors have a direct influence on the nature and size of sampling**Reference: Study guide, section 4.2.2**

- the efficiency of the internal control systems; ½
- the materiality of the population under review; ½
- the volume of the transactions; ½
- the method of record keeping; ½
- the relative risk applicable to the population in relation to the objectives of the organisation and the specific activity under review; ½
- the nature of the audit evidence; ½
- a suggestion of irregularities in the population; ½
- compulsory accounting disclosure; ½ and
- extraordinary items. ½

(Maximum of 4 marks)

6.3 Formulating a statistical finding**Reference: Study guide, section 4.2**

The auditor is 63% confident ✓ that the value of error in the population is less than R8 628. ✓

(2 marks as indicated)

Comments on question 6

Sampling will definitely be tested in some or other way in the examination. You have to be able to do the necessary calculations and interpret the results. You must also be able to identify the sampling method used or recommend a method to be used. Questions on sampling will normally test your knowledge of the theoretical concepts and your ability to apply this knowledge in a

practical scenario.

QUESTION 7

7 marks

7. Audit finding

Reference: Study guide, section 7
Finding and recommendations

Journals were not approved individually. ✓

- a. Criteria: ½ Policy requires that, as a control measure, the debtors manager should approve each journal individually and this approval is given by entering his/her approval number into the requested journal online. ✓ (maximum 1½ marks)
- b. Condition: ½ The updates from the manual system were processed onto the computer system by means of journals. ✓ This amounted to a high volume of transactions which were too many for the debtors manager to inspect and approve individually. ✓ (maximum 1½ marks)
- c. Effect: ½ These journals did not follow the normal control process as prescribed by policy. Owing to the volume of transactions updated the debtors manager gave blanket approval to all the journals run in that period. ✓ Journals do not follow the normal input controls that apply to normal sales and income received transactions. This approach increased the risk of fraudulent transactions. ✓ As the authorisation control was not in place it also increased the risk of errors occurring in the processing of journals. The increase in the total debtors balance and the number of disputed items indicate that it is likely that many errors occurred during the updating process. ✓ (maximum 1½ marks)
- d. Recommendation: ½ It is recommended that a detailed reconciliation of all the manual transactions be performed with the journals used to update the system, including a correction of all the errors identified. ✓ Thereafter the internal audit activity can perform a debtors circulation to identify any issues that have still not been resolved. ✓ (maximum 1½ marks)

(1 mark for audit finding heading; ½ mark for each element and 1 mark for each explanation of each element) (Maximum 7 marks)

Comments

*Based on your theoretical knowledge, you should know that an audit finding consists of a **criteria, condition, cause, effect and recommendation**. You should be able to identify each of these components. You had to apply that knowledge to assess the quality of each of the components from the information and its compliance with the International Professional Practice Framework (IPPF).*

Therefore in your answer, it is recommended to put the answer under each of these elements so that we can see if you are able to identify these elements in a given scenario.

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