

Tutorial Letter 202/1/2015

THE INTERNAL AUDIT PROCESS: TEST OF CONTROLS

AUI3702

Semester 1

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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1 KEY TO ASSIGNMENT 02/2015 (FIRST SEMESTER)

QUESTION 1

15 marks

1.1	A	1.6	C
1.2	A	1.7	B
1.3	A	1.8	B
1.4	B	1.9	D
1.5	A	1.10	D

(1½ marks each)

Comments on question 1

- 1.1 Correct answer is A. One of the best forms of control activities is that performed by a third party. Having bank reconciliations performed by a third party will allow for the easy identification of omissions and errors from an independent point of view.
- 1.2 Correct answer is A. Inventory turnover will provide management with an indication of how often inventory is turned over during the period. A decrease in the inventory turnover ratio could mean a possible increase in obsolete inventory on hand, deterioration in the management of available stock and worsening stock order procedures.
- 1.3 Correct answer is A. Pay-cheques should be distributed by an independent payroll person in the presence of a witness. Employees should provide a form of identification to the independent payroll person as proof. Options B, C, and D are all forms of good controls and are therefore incorrect.
- 1.4 Correct answer is B. The internal auditor informs those in management who need to know about the engagement, conducts meetings with management responsible for the activity under review, summarises and distributes the discussions and any conclusions reached from the meetings, and retains the documentation in the engagement working papers. The sampling plan and audit programme cannot be drafted until risk is assessed and the engagement objectives are set.
- 1.5 Answer A is correct. When one does sampling one wants to ensure that the sample selected is representative of the sampled population. Sufficiency of information, in the sampling context, means that one has reasonable assurance that the sample selected is representative of the population.
- 1.6 Answer C is correct. Analytical procedures are one of many financial audit processes which help an auditor understand the client's business and changes in the business, and to identify potential risk areas to plan other audit procedures. Analytical procedures are not used when testing a control, only for substantive procedures. Therefore, analytical procedures are never sufficient on their own to support management assertions.
- 1.7 Answer B is correct. Evidence provided by the client is the least reliable form of evidence as it lacks independence, ie it is provided by the people who are

responsible for the assertion for which the evidence is required. Therefore, options A, is incorrect as it is information from management. Options C and D are incorrect as it provides confirmation on the value only.

- 1.8 Answer B is correct. The term Debtor Collection Period indicates the average time taken to collect trade debts. In other words, a reducing period of time is an indicator of increasing efficiency. Therefore, an increase in the collection period could be the result of a slackening of the organisation's credit control.
- 1.9 Answer D is correct. Successful management depends mostly on an ability and inclination to move others towards desired goals and a sense for making reasonable decisions. Answer A is incorrect. Management needs to have excellent people skills but that is not the only thing that will result in successful management. Answer B is incorrect as a manager will have the ability to guide the organisation, not control and direct it. Answer C is incorrect as one cannot make the correct decision at all times, it is humanly impossible.
- 1.10 Answer D is correct. Due to the nature of the business of manufacturing body parts, the factory has to ensure that all parts manufactured are of a good quality. Should substandard raw materials be used, the quality of the parts will be affected, which could result in substandard products. This will further result in the possibility of reputational risk, fatalities should any accidents occur, recalls, loss of sales, etc. Thus, the factory should be most concerned if they fail to detect the receipt of substandard raw materials.

QUESTION 2

PART A

18 marks

2.1 & 2.2 Audit objectives and related audit procedures

References: Study guide, study units 3.1 and 4.1

2.1 Audit objective	2.2 Audit procedure
<p>Validity: To ensure that only valid purchases are recorded $\sqrt{1/2}$ (1$\frac{1}{2}$)</p>	<ul style="list-style-type: none"> • Select a sample of recorded purchases from the purchase journal and inspect the related goods received note for evidence that the details of the goods received were inspected during the initial receipt of the delivery. $\sqrt{1/2}$ • Select a sample of recorded purchases from the purchase journal and inspect the related purchase order for evidence of authorisation. $\sqrt{1/2}$ • Follow the details of purchases selected from the purchase journal through to the original order as well as the supplier's

2.1 Audit objective	2.2 Audit procedure
	invoice and statement. $\sqrt{1/2}$ <ul style="list-style-type: none"> • Inspect the goods received notes for the signature of the store officials acknowledging receipt of the goods. $\sqrt{1/2}$ • For a sample of invoices, agree the quantity received on the invoice to the goods received note. (marks as indicated, maximum of 3 marks)
Completeness: To ensure that all the goods received from suppliers are recorded as purchases in the purchase journal $\sqrt{1/2}$ (1½)	<ul style="list-style-type: none"> • Examine a selection of goods received notes for evidence that they have been matched to the invoices. Check the details of the description and quantity of goods received against the invoices and trace these to the inventory records and the purchase journal. $\sqrt{1/2}$ • Identify a selection of outstanding orders and enquire about the follow-up actions performed. $\sqrt{1/2}$ • Investigate the follow-up actions and identify evidence of the reasons for the outstanding orders. $\sqrt{1/2}$ • Using CAATs, run a sequence check on all the recorded goods received notes to ensure that the numbers are in sequence and that there are no missing or duplicate numbers. $\sqrt{1/2}$ (marks as indicated, maximum of 3 marks)
Valuation: To ensure that the liability in respect of credit purchases is recorded at the correct value $\sqrt{1/2}$ (1½)	<ul style="list-style-type: none"> • Analyse the reasonableness of the total creditors' balance owing by reconciling the total amount owed to suppliers with the total credit purchases made in the corresponding period. $\sqrt{1/2}$ • Use the following formula: Opening balance of creditors for the period tested + credit purchases for the period tested – payments and returns for that period. $\sqrt{1/2}$ (marks as indicated, maximum of 3 marks)
Cut-off: To ensure that purchases accounted for in the current period are related only to goods received in the current period $\sqrt{1/2}$	<ul style="list-style-type: none"> • Enquire from management about the planned procedures to ensure appropriate cut-off and evaluate the adequacy of such procedures. $\sqrt{1/2}$

2.1 Audit objective	2.2 Audit procedure
	<ul style="list-style-type: none"> • Ascertain and record in the working papers the last goods received note number at the cut-off date by inspecting the printout of all the goods received notes. Ensure that these purchases have been taken into account in the correct accounting period. $\sqrt{1/2}$ • At a later date, match the goods received note details to the supplier's invoice and check the entry date of the goods against the accounting records. Note whether the date of the actual receipt of the goods corresponds with the date the goods were recorded as received in the accounting system $\sqrt{1/2}$ (marks as indicated, maximum of 3 marks)

Comments

Question 2.1

In this question you had to identify the audit objectives relevant to the information given in the case study. This was a practical question as you had to work through the information provided and identify the relevant audit objectives.

An audit objective has a certain structure. For example, it will always start with the following words:

- *To ensure/determine ...*

You can refer to Auditing notes or the prescribed textbook for examples of audit objectives ("external auditors" refers to "assertions"). Audit objectives are those objectives which the internal auditor wishes to achieve.

The following are possible examples of the outcomes which an audit objective should achieve:

- *proof of occurrence*
- *proof of completeness*
- *proof of classification*

Question 2.2

This was a practical question. You had to work through the case study given and from that information compile the internal audit procedures. 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.

PART B

13 marks

2.3 Internal control objectives

Reference: Study guide, study unit 3.1

- All amounts due to and in respect of employees have been accounted for. ✓
- Wages paid are received by bona fide employees of the company. ✓
- Wages paid are at the approved rates and for the actual hours worked. ✓
- Expenditure on wages is accurately recorded – (recorded) correct amount, account and period. ✓(✓ additional mark for detail)

(marks as indicated, maximum of 3 marks)

Comments

Question 2.3

In this question you had to identify the audit objectives relevant to the information given in the case study. This was a practical question as you had to work through the information provided and identify the relevant audit objectives.

2.4 Internal control weaknesses

Reference: Study guide, study unit 3.2

- There was no independent check on the casts and extensions of the time cards prepared by Mr Harpic. ✓
- There was no evidence that wage rates were authorised or checked by an independent person. Mrs Domestos, however, does not have access to these. ✓
- There was no reconciliation of total hours captured by Mrs Domestos to the machine-strip prepared by Mr Harpic. ✓
- There was no scrutiny and follow-up of the error report – management supervision. ✓
- Mrs Domestos could inflate the hours of an employee, draw extra cash and make out a new packet with the correct wages payable to him/her. However, if a calculation of the employee's wages accompanies the wage packet, this is not possible. ✓
- The segregation of duties is inadequate. Mr Duck (from the personnel department) could create fictitious employees and persuade someone to clock in and collect the cash on his behalf (it would appear that Mr Duck could even create a time-record and slip it into those sent by Mr Harpic to Mrs Domestos). ✓

- There is no indication of any control over the drawing of cash for the wage payout (ie authorisation and security over collection. ✓)
- There is no supervision over or an independent person attending the payout. Two people should be present. ✓
- There is no identification of employees at the payout. ✓
- There is no signature of the employees confirming receipt of wages. ✓
- There is no listing of unclaimed wages at the payout – this should be done by Mr Duck and the second independent person in attendance. (This could also be done at the cashier.) An authorised person should follow up on the subsequent authorised payment or deposit. All unclaimed wages should be returned to the cashier. ✓
- There is no evidence of authorisation of employment of new staff and staff termination. ✓

(marks as indicated, maximum of 10 marks)

Comments:

This was a practical question. You had to read through the information/case study provided and identify the weaknesses in the cycle. Refer to Jackson & Stent for a better understanding of each cycle.

QUESTION 3

10 marks

References: Study guide, study unit 7.2

3.1 Key factors of a finding

Criteria: ½

To identify the criteria applicable in a specific situation you need to include the following two elements:

- the goals, objectives and operating standards that represent what the audited operation needs to accomplish
- the quality of the accomplishment ½

Condition: ½

This involves the facts as determined by the audit procedures performed by the internal auditor. ½

Cause: ½

The underlying cause explains why the condition deviates from the criteria. ½

Effect: ½

The effect must clearly indicate the impact of the deviation from the established criteria. If there is no possible impact it will not be necessary to implement corrective measures, and

the management of the organisation can revisit the necessity of the initial criteria to establish whether they are still relevant. ½

Recommendation: ½

A corrective course of action that could help to resolve the problem identified should be recommended for management's consideration. ½

Comments:

This was a theoretical question. You had to list and define the components of a finding as per the requirements.

3.2 Application of key factors of a finding

Criteria:

The policies and procedures require staff to maintain perpetual inventory records as the ordering of raw materials (chemicals) is automated and based on critical information derived from the perpetual inventory records. ✓

Condition:

Staff members only update the records when there is idle time, but at least once a month. ✓

Cause:

This is due to the fact that the staff have too many responsibilities and do not find the time to update the records. ✓

Effect:

A loss is suffered on account of obsolete inventory being written off and out of stock situations, because ordering does not take place at the correct time and intervals, amount to approximately R100 000 per month and around 10% of the monthly purchases. ✓

Recommendation:

Hire an additional staff member to take on the responsibility of updating stock records as per the perpetual inventory system. ✓ (or any other applicable recommendation)

Comments:

This was a practical question. You had to read through the information/case study provided and relate the information to the various components of a finding. The questions tests your ability to write a finding in a practical situation.

Question 4

13 marks

References: Study guide, study unit 4.2

- 4.1 Audit sampling is the application of an auditing procedure to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection ✓ in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. ✓

- 4.2 The sample. ✓
- 4.3 It is important that the sample should be representative of the population because the auditor wants to draw a conclusion about the population as a whole. ✓
- If the sample is not representative of the population, conclusions drawn about the population are likely be invalid. ✓
- 4.4 Deviations and misstatements are both “errors” uncovered when conducting an audit sample. ✓ However, they differ in that:
- Deviations may be identified when testing controls – the auditor is testing for evidence that a control procedure has not been applied. ½
- Misstatement may be identified when the auditor is conducting a test of detail. ½
- 4.5 Increase in the auditor’s assessment of misstatement – **Increase** in sample size. ✓
The higher the auditor’s assessment of risk of misstatement, the larger the sample size needs to be. Put simply, if the auditor thinks that the risk of misstatement has increased, he expects that there will be more misstatement. To satisfy himself that a material amount of misstatement will not go undetected, the auditor will increase the sample size, ie test more extensively. ✓
- 4.6 A decrease in the use of other substantive procedures directed at the same assertion – **Increase** in sample size. ✓
The less the auditor relies on other substantive procedures (tests of detail or analytical procedures) to reduce to an acceptable level the detection risk regarding a particular account balance or class of transactions, the greater assurance the auditor will require from sampling and, therefore, the larger the sample size is likely to be. ✓
- 4.7 An increase in the auditor’s desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population – **Increase** in sample size. ✓
The greater the level of assurance the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be. ✓

Comments:

This is both a theoretical question and an application question with regard to sampling. The question tests your understanding of sampling if variables are increased or decreased.

Question 5

18 marks

References: Study guide, study unit 2

- 5.1 A compliance-based approach to internal audit essentially means that the internal auditors carry out procedures to determine whether departments and their staff are

abiding by (complying with) the internal controls, rules and regulations of the company. ✓

A risk-based approach goes a bit deeper in that it requires that internal audit determine whether the risks which the company faces (strategic, financial, regulatory etc) are adequately addressed by the controls which are in place and whether the controls are being adhered to. ✓✓

- 5.2 Yes. ✓ The combined assurance model consists of internal assurance providers of which internal audit is one, external assurance providers (eg external auditors) and management. The efforts of these three parties should provide a co-ordinated approach to all assurance activities. Essentially this means that between the three, the risks faced by the company are identified and responded to. ✓
- 5.3 The audit committee. ✓
- 5.4. False. There is no section which requires an internal audit department; how a company structures itself is largely not addressed by the Companies Act 2008. ✓
- 5.5 Principle 7.1 of King III requires that the board should ensure that there is an effective risk-based internal audit. ✓

It is not compulsory to have an internal audit department, but King III requires that where the board decides not to have an internal audit function, full reason should be disclosed in the integrated report, with an explanation as to how adequate assurance of an effective governance, risk management and internal control environment has been maintained. ✓✓

Where the internal audit function has been outsourced, a senior executive or director should be appointed as custodian of internal audit, with the responsibility to oversee, manage, inform and take responsibility and accountability for its effective functioning. ✓

- 5.6 Perform reviews of the company's governance process including ethics. ✓
- Perform an objective assessment of the adequacy and effectiveness of risk management and all other elements of the internal control framework. ✓
- Analyse and evaluate business processes and associated controls. ✓
- Provide a source of information regarding instances of fraud, corruption, unethical behaviour and irregularities. ✓
- 5.7 Functionally to the audit committee, administratively to the CEO. ✓
- 5.8. Leadership ½
Ability to command respect ½
Communicator and facilitator ½
Strategically and pragmatically minded ½

- Able to influence people ½
- Innovative ½
- Strong on business analysis skills ½
- Integrity and objectivity ½
- Able to maintain confidentiality and act professionally ½

Comments:

This is a theoretical question. The answer did not require you to apply any knowledge. The answer can be found, as is, in the study guide or recommended textbooks. You must remember that a certain percentage of theoretical questions will be asked. Although the percentage is very small at third-year level, these questions are still required. The internal audit theory forms the basis for the practical application.

Question 6

13 marks

References: Study guide, study unit 3.1

- 6.1 As the amount of cash on the premises is significantly reduced, there is less of a security risk for the company and the employees. ✓
 The risk of fictitious employees being included is reduced. ✓
 No disruptions caused by wage pay-outs. ✓
 No theft or loss of unclaimed wages. ✓ max=2
- 6.2 False. ✓ Although management can manipulate profits by overstating/understating the wage expense, it is not a very effective way of reporting fraudulently (eg it does not affect the balance sheet in the same way as understating or overstating assets and liabilities), so material misstatement is more likely to be as a result of misappropriations which have not been detected. ✓
- 6.3 Dummy workmen ½, ghost workers. ½ (any other 2 plausible terms)
- 6.4 The fraudulent practice of one employee clocking in for another employee who is absent is eliminated (buddy clocking). ✓
 Time keeping (eg calculation of hours) becomes far more efficient and accurate. ✓
- 6.5 Because the data is instantly stored, useful reports can be extracted (hardcopy or on-screen) to assist supervisory employees manage their employees better, for example a foreman can access the system each morning to determine which employees have not arrived or have arrived late. ✓
 False It is a substantive test, “substantiating” the employee is a “real, live person who is employed (works for) the company”. ✓ max = 3
- 6.6 False. ½ Evidence pertaining to the “occurrence” assertion is being obtained. (Part of establishing whether a valid wage has occurred – not not fictitious). ½

6.7 It is an illegal act to pay wages below the minimum rate. ✓

If workers were not aware that they were being paid below the minimum wage (unlikely!) the company would be “defrauding” employees. However, there are numerous examples of employees being prepared to work for wages below the minimum rate, so it could be argued that in these cases there is no fraud but paying below the minimum wage remains an illegal act. ✓

6.8 The auditor would do this if he suspected that the company was employing illegal workers, for example illegal immigrants with no work permit. ✓

Comments

This was an application question. You had to understand the payroll and wage cycle and answer the questions accordingly. The question tests you to see if you are able to identify the risks, controls and control weaknesses within the cycle.