

Audit Procedure/Test of controls

What is an audit procedure?

Audit procedures aim to satisfy audit objectives. The audit procedure helps the auditor to determine whether the control is working as intended or not. The audit procedure instructs the auditor to perform a specific step and tells them how to perform the step in order to achieve the audit objective.

How do you formulate an audit procedure/test of control?

When formulating an audit procedure, one should remember that you need to have 3 following elements in the test of control:

HOW

WHAT

WHY

Explanation:

HOW: The how is the verb (action word) that describes the action that needs to be performed. Examples of the “how” is inspect, observe, recalculate, inquire, etc.

WHAT: The “what” is the document/physical evidence and/or the action being performed that you are referring to for the specific test. Examples of source documents or physical evidence would include invoices, goods received notes, security guard at the gate, petty cash count, journals, etc.

WHY: This describes the reason for performing the test of control. You should look at the objective of control here. The following internal control objectives are important for establishing the reason for performing the test of control:

Occurrence and authorization:

- Occurrence: all recorded transactions and events actually occurred and pertain to the entity.
- Authorisation: All transactions are authorized in accordance with management/entity policies.

Completeness and accuracy:

- Completeness: All transactions and records have been recorded.
- Cut-off: Transactions and events have been recorded in the correct accounting period.
- Accuracy: Amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Classification: Transactions and events have been recorded in the proper accounts.

Examples:

1. Inspect that invoices are numbered in sequence to confirm that all sales transactions are recorded.

- Inspect = **HOW** = verb
- Sequence of invoices = **WHAT** = Source document
- To confirm that all sales transactions are recorded = **WHY** = reason = completeness.

2. Observe that the receiving clerk physically counts the goods received and compare the quantity, quality and description to the delivery note and purchase order.

- Observe = **HOW** = verb
- That the receiving clerk physically count the goods received = **WHAT** = action or control being performed.
- And compare the quantity, quality and description to the delivery note and purchase order = **WHY** = reason = accuracy.

3. Inspect a sample of orders for the signature of the acquisition manager for proof of authorisation.

- Inspect = **HOW** = verb
- A sample of orders = **WHAT** = Source document
- For the signature of the acquisition manager for proof of authorisation = **WHY** = reason = authorisation.

4. Inquire whether outstanding orders are followed up by the administrative clerk to confirm that all orders are received.

- Inquire = **HOW** = verb
- Whether outstanding orders are followed up by the administrative clerk = **WHAT** = action or control being performed.
- To confirm that all orders are received = **WHY** = reason = completeness of orders.

Questions:

Question 1

You have been assigned to assist with the following internal audit for the months of May to June: The internal audit of sales and inventory.

Sales and inventory

During your preliminary review you discovered the following:

- Vaccine orders can only be placed by sales representatives. The sales representatives employed by Farmer Meraai visit the farmers at their farms and use a notebook computer, linked through a wireless internet connection, to enquire into the availability of the required finished product inventory and to place orders.
- Once the order has been processed, the items are transported to the farmer using any available company to perform the courier service.
- Internal restocking orders are created whenever finished product inventory levels fall below the reorder point. The internal restocking order informs the production department to start with the manufacturing of the relevant animal vaccine.
- Most of the products supplied by Farmer Meraai reach obsolescence fairly rapidly.
- The annual finished product inventory count is performed at year-end using the services of professional counters. The count is also supervised by the external auditors.
- Over the past years significant amounts of finished product inventory were written off as a result of inventory declared obsolete during or directly after the annual inventory count.

REQUIRED

- 1.1** Recommend improvements to the above system that would assist Farmer Meraai to render an improved service to its customers and to minimise the inventory losses. (6)
- 1.2** Formulate **six (6)** internal audit procedures to determine the cause of the unusual inventory write-offs after the annual inventory count. (9)

Question 2:

The chief audit executive (CAE) decided that, while you are busy assisting the procurement department, you may as well perform the assurance audit of the procurement function originally scheduled for later in the year.

After identifying the risks, you have compiled the following audit objectives to include in your audit programme.

- I. Validity: To ensure that only valid purchases are recorded.
- II. Completeness: To ensure that all the goods received from suppliers are recorded as purchases in the purchase journal.
- III. Valuation: To ensure that the liability in respect of credit purchases is recorded at the correct value.
- IV. Cut-off: To ensure that purchases accounted for in the current period relate only to goods received in the current period.

REQUIRED

Marks

- 2.1 Describe **two (2)** audit procedures for each of the audit objectives identified. **(12)**

Solutions:

Question 1

1.1 Improving the system

- As the company clearly uses a system that allows for online access, access to the system could be further diffused to allow the farmers to at least order vaccines over the Internet, or by phone or fax. At the moment they can only order these goods from the sales staff that might not be sufficiently available as they visit the farmers on their farms. (1½)
- The policy of using any available courier can be very expensive. Review the cost thereof and try to negotiate a relationship with one company for a specific courier service at a set price. This might lead to better courier services country wide at a lower cost. (1½)
- The expiry dates on finished product inventory items should be closely monitored to enable the sales staff to run special promotions on those products to ensure that as many of the products whose expiry dates are in the foreseeable future are sold in time. (1½)
- Restocking occurs automatically whenever the finished product inventory reaches a specified level resulting in the production of unnecessary finished product inventory. A printout can be generated daily, listing all the finished product inventory items that reached reorder levels. This should be reviewed before the internal restocking order is placed to ensure that the finished product inventory items that are ordered to be manufactured are in fact needed and will be sold before they reach their expiry dates. (1½)
- Demand for the finished product inventory should be analysed over a number of years and the information should be used to project sales and determine production and internal re-order quantities. (1½)
- The expiry dates of the relevant finished product inventory items should be captured together with the quantities of finished product inventory available to ensure that the inventory will be better managed and that there would be a timely removal of old inventory to ensure that no vaccines that already reached its expiry date is sold. (1½)
- Processes should be put in place to ensure that vaccines are sold on the basis of first in first out. (1½)

- Analyse the sales made to farmers to determine what type of vaccine products they buy and if they buy it during specific seasons and amend the inventory reorder levels and manufacturing accordingly. (1½)

1.2 Audit procedures to determine the cause of significant inventory write offs

- Obtain minutes of the management meetings to identify information which could assist you in performing the procedures. (1½)
- Review the list of finished product inventory items that were written-off during the inventory count for the last two years to determine whether any pattern is evident i.e.
- the finished product inventory items written-off as obsolete are related to a certain product or spread across all products? (½)
- the finished product inventory items written-off were manufactured from material received from a specific supplier or suppliers? (½)
- Ask the purchase- and inventory managers if they are prepared to speculate on the underlying cause of the finished product inventory write-offs. (1½)
- Ask the inventory manager why the obsolete inventory items were not identified earlier and what controls are to be implemented to prevent a reoccurrence. (1½)
- Perform a physical inspection of a sample of the actual inventory items written-off and ensure that the inventory items are in fact obsolete, and that the write-off was properly authorised. (1½)
- Determine the authorisation level of the person who approved the write-offs. (1½)
- Obtain reasons in writing for the write-offs. (1½)
- Ensure that the write-offs were in line with company policies and procedures in respect of write-offs. (1½)
- Enquire from the inventory manager into why the automatic internal re-order levels were not adjusted or the quantity of inventory manufactured at a time, reduced to limit the possibility of future inventory write-offs. (1½)

- Determine how internal re-order levels are calculated and whether consideration has been given to all factors that may influence these levels. (1½)
- Observe the procedures followed when finished product inventory are dispatched to a customer and determine if the inventory are delivered on a first in first out basis. (1½)
- Enquire from the sales staff if they were informed of finished product inventory items nearing their expiry dates and how this is monitored and obtain written confirmation on the process followed. (1½)
- Inspect a sample of finished product inventory returned and ensure that the goods have not reached their expiry date. (1½)
- Inspect that the sales policy stipulates specifically that no returns are accepted after a certain date. (1½)

Question 2:

Audit objective	2.4 Audit procedure
<p>Validity: To ensure that only valid purchases are recorded</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. √½ • Select a sample of recorded purchases from the purchase journal and inspect the related purchase order for evidence of authorisation. √½ • Follow the details of purchases selected from the purchase journal through to the original order as well as the supplier's invoice and statement. √½ • Inspect the goods received notes for the signature of the store officials acknowledging receipt of the goods. √½ • For a sample of invoices, agree the quantity received on the invoice to the

Audit objective	2.4 Audit procedure
	<p>goods received note.</p> <ul style="list-style-type: none"> For a sample of invoices, compare the invoice to the approved supplier list to ensure that the purchases are received from a valid supplier. <p>(marks as indicated, maximum of 3 marks)</p>
<p>Completeness: To ensure that all the goods received from suppliers are recorded as purchases in the purchase journal</p>	<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 to 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. $\sqrt{1/2}$ <p>(marks as indicated, maximum of 3 marks)</p>
<p>Valuation: To ensure that the liability in respect of credit purchases is recorded at the correct value</p>	<ul style="list-style-type: none"> Analyse the reasonableness of the total creditors' balance owing by reconciling the total amount owed to suppliers to 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. $\sqrt{1/2}$

Audit objective	2.4 Audit procedure
	(marks as indicated, maximum of 3 marks)
<p>Cut-off: To ensure that purchases accounted for in the current period relate only to goods received in the current period</p>	<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. $\sqrt{1/2}$ • Ascertain and record in the working papers the last goods received note number at the cut-off date by inspecting the printout on 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 suppliers 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 on the accounting system? $\sqrt{1/2}$ <p>(marks as indicated, maximum of 3 marks)</p>