

Tutorial Letter 202/1/2017

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 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 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 extremely costly.

Marking your answers should enable you to identify any problems you may be experiencing. Your marks for this assignment will indicate 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 have 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 02/2017 (FIRST SEMESTER)

Question 1

10 marks

Question	Correct answer
1.1	A
<p>Option A is correct. A sample need only provide reasonable assurance. Due to cost/benefit consideration, absolute assurance is not necessary. Option B is incorrect. The best evidence reasonably obtainable is a test of competence. Option C is incorrect. The logical relationship is a test of relevance. Option D is incorrect. Due to cost/benefit consideration, absolute assurance is not necessary.</p>	
Question	Correct answer
1.2	D
<p>Option A is incorrect. Sampling from a population of policyholders would be very inefficient for the audit assertion, as many policyholders may not have any activity during the year. Option B is incorrect. A sample of claims filed does provide evidence on the overall processing of claims and thus provides some evidence related to the assertion. However given the assertion, option A is more efficient because it deals with paid claims. Option C is incorrect. The claims denied files provides evidence on the claims denied, but the auditor cannot conclude that all claims that were denied should have been paid. Option D is correct. The auditor is interested in whether the actual claims paid are properly supported. The most appropriate population from which to sample is the claims paid file.</p>	
Question	Correct answer
1.3	A
<p>Option A is correct. If the auditor already suspects fraud, a more directed audit approach would be appropriate. Option B is incorrect. Relatively stable operating data are a good scenario for using analytical review. Option C is incorrect. Analytical review would be useful in identifying whether large, nonrecurring or unusual transactions occurred. Option D is incorrect. Analytical review only needs to have accounts related to other accounts or other independent data. It does not require that they be related to revenue.</p>	
Question	Correct answer
1.4	D
<p>Option A is incorrect. If the vendor was in collusion with the buyer, either no response or an incorrect response would be elicited. Option B is incorrect. If collusion exists, the purchase agent can arrange for th invoice. Option C is incorrect. If collusion exists, the purchasing agent can arrange for the purchase order. Option D is correct. This is an</p>	

example of analytical procedures to detect patterns and trends.

Question	Correct answer
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1.5

C

Option C is correct. Observation is effective for verifying whether particular assets exist at a given time. However, it is of limited use in addressing other assertions. Option A is incorrect. Interviews are the most effective method to fill out questionnaires. Option B is incorrect. The internal auditor will seldom be able to observe a fraud. Option D is incorrect. Observation would provide information on how transactions are processed at one moment in time, not how they are processed throughout the period under engagement investigation.

Question	Correct answer
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1.6

C

Option C is correct. The audit objective is to determine whether the mail room staff are fully productive. By comparing the mailroom staff's productivity with similar organisations (e.g. figures on incoming and outgoing mail backlogs, idle time etc), the auditor can determine whether the mail room staff are fully productive. Option A is incorrect. Interviewing selected mail room staff will not assist in determining whether the staff are productive. Option B is incorrect. Observation is a means of identifying physical information. By observing the mail room staff performing their duties, the auditor would not know whether they were fully productive. Option D is incorrect. Inspection of documents would not provide information on whether the staff is fully productive. The types of documents are not even specified so it would not be possible to determine what the auditor is inspecting.

Question	Correct answer
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1.7

D

Option D is correct because the following 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**.

Option A is incorrect as an internal auditor uses professional judgement in all sampling methods to interpret the sampling results. Option B is incorrect as the other sampling methods might also make use of representative samples. Option C is incorrect as sampling can never provide absolute assurance, as only a sample is tested.

Question	Correct answer
1.8	D
<p>Option D is correct. The precision of an attribute sample (also called the confidence interval or allowance for sampling risk) is an interval around the sample statistic that the auditor expects to contain the true value of the population. In attribute sampling (tests of controls), precision is determined by subtracting the expected error rate from the tolerable error rate in the population. Option A is incorrect. Skewness is the lack of symmetry in a frequency distribution. Option B is incorrect. Dispersion is the degree of variation in a set of values. Option C is incorrect. Reliability is the confidence level. It is the percentage of times the repeated samples will be representative of the population from which they have been taken.</p>	
Question	Correct answer
1.9	B
<p>Option B is correct. In principle, given repeated sampling and a normally distributed population, the confidence level is the percentage of all the precision intervals that may be constructed from simple random samples that will include the population value. In practice, the confidence level is regarded as the probability that a precision interval calculated from a simple random sample drawn from a normally distributed population will contain the population value. Option A is incorrect. The error rate in an attribute sampling application is the proportion of incorrect items in a population. Option C is incorrect. The standard error of the mean is the standard deviation of the distribution of sample means. Option D is incorrect. The lower precision limit is the lower bound of the interval constructed from the sample result at a specified confidence level.</p>	
Question	Correct answer
1.10	C
<p>Option C is correct because non sampling risk occurs when an internal auditor fails to perform his/her work correctly. An example of this risk would be the use of incorrect audit procedures. Option A is incorrect. Alpha risk is the risk that the internal auditor will understate the reliance that management can place on the control to reduce residual risk to an acceptable low level. Option B is incorrect. Sampling risk is the risk that the internal auditor's conclusion based on the sample testing, may have been different from the conclusion reached if the audit procedure had been applied to all items in the population. Option D is incorrect. Beta risk is the risk that the internal auditor will incorrectly conclude that a specified control is more effective than it really is.</p>	

QUESTION 2**15 marks****2.1 Systems risks and audit objectives: revenue and receipts cycle****References:**

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

Weakness	Business risk
<ul style="list-style-type: none"> • There is a lack of basic division of duties because there is no separate order department to receive and authorise customer orders. The receptionist is not required to record all incoming orders in a register. $\sqrt{1/2}$ 	<ul style="list-style-type: none"> • The risk of orders being lost and not processed is increased. This may result in a loss of income and customer goodwill. $\sqrt{1/2}$
<ul style="list-style-type: none"> • The internal documentation initiating sales transactions is inadequate. $\sqrt{1/2}$ 	<ul style="list-style-type: none"> • The risk of orders not being filled or being lost is significant. This will result in a loss of sales income and customer goodwill. $\sqrt{1/2}$
<ul style="list-style-type: none"> • No credit management controls are in place. All orders received are filled without verifying whether the order is from an existing customer or if the client has credit available. $\sqrt{1/2}$ 	<ul style="list-style-type: none"> • All orders received are filled without verifying whether the order is from an existing customer or if the client has credit available. This will increase the risk of bad debts. $\sqrt{1/2}$
<ul style="list-style-type: none"> • There appears to be no method for identifying orders which have been both faxed and sent through the post. $\sqrt{1/2}$ 	<ul style="list-style-type: none"> • Therefore the same order can be filled twice. There is the risk of loss of inventory, and a decrease in sales income. $\sqrt{1/2}$
(4 marks)	(4 marks)

(Maximum of 8 marks)

Format as required in question = 1 mark

Total = 9 marks

Comments:

This was a practical question. You had to read through the information/case study provided and identify the weaknesses in the cycle. From the weaknesses identified you had to compile a business risk for each weakness. For each business risk, you had to indicate the result of the weakness for the organisation, for example, no credit management controls is a weakness and the business risk would be an increase in bad debts.

2.2. Audit objectives

Reference: Study guide, section 4.1.1

- To ensure that orders are only accepted from valid account holders. $\sqrt{1/2}$
- To ensure that all orders are acted upon timeously. $\sqrt{1/2}$
- To ensure that order details are recorded accurately. $\sqrt{1/2}$
- To ensure that only orders from creditworthy clients are processed. $\sqrt{1/2}$
- To ensure that orders are not processed twice. $\sqrt{1/2}$
- To ensure that all new customers are identified and approved before the orders are processed. $\sqrt{1/2}$

(Mark as indicated, 6 marks)

Comments:

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, 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 3

29 marks

3.1 Audit procedures for an inventory count

References:

- **Study guide, section 5.1.3**
- **Jackson & Stent, chapter 12: *Inventory and Production Cycle***

During the inventory count, the audit team will do the following:

- Observe the method of counting to determine whether the count teams are adhering to the count instructions. $\sqrt{1/2}$

- Conduct test counts in both directions in all 10 designated areas:
 - from inventory sheet to physical inventory (existence) $\sqrt{1/2}$
 - from physical inventory to inventory count sheets (completeness). $\sqrt{1/2}$
- Walk through the store and identify any items which may be damaged/not saleable by:
 - being on the lookout for damaged/dusty packaging or packaging which appears to have been tampered with. $\sqrt{1/2}$
- Inspect items which the count teams have identified as damaged/not saleable. $\sqrt{1/2}$
- Obtain a copy of the printout of differences between the inventory master file and the inventory count sheets and follow up by:
 - recounting/checking with the client's count teams ($\sqrt{1/2}$) and
 - confirming that changes made on the inventory count sheets are correct and have been initialled by John Khumalo /count teams. $\sqrt{1/2}$
- Go through the warehouse to identify any items which do not have a pink label stuck on them, and follow up to establish why they have not been counted. $\sqrt{1/2}$
- Test the numerical sequence of inventory count sheets (both before and at the end of the count) to confirm that they are all accounted for and not duplicated. $\sqrt{1/2}$
- Inquire from the count teams/ John Khumalo whether any items sold that had been invoiced but not delivered at 30 April 2014 are not included in the count. $\sqrt{1/2}$
- Record the following:
 - the number of the last of each of the documents used in the inventory cycle (cut-off number), for example, the delivery note, goods received note. $\sqrt{1/2}$
 - the numbers of all GRNs for which invoices have not been received at 30 April 2014 (to be used at a later date for testing completeness of creditors). $\sqrt{1/2}$
- create audit work papers in respect of the attendance:
 - take copies of all adjusted inventory count sheets $\sqrt{1/2}$
 - record details of test counts $\sqrt{1/2}$
 - record details of inventory identified as damaged/not sellable. $\sqrt{1/2}$
- Ensure that the internal auditor compile a stock report in which all findings in terms of the stock count attendance are reported on. $\sqrt{1/2}$
- Inspect the inventory count sheets to confirm that:
 - they are sequentially numbered $\sqrt{1/2}$
 - alterations/corrections have been signed $\sqrt{1/2}$
 - lines have been drawn through blank spaces (so that items cannot be added). $\sqrt{1/2}$
- Ensure that thorough inspections are done of the of count sheets to see that no quantities are reflected on the original count sheets before counting commences. $\sqrt{1/2}$

(Maximum of 18 marks)

Comments:

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

3.2 Substantive procedures using audit software

References:

- **Study guide, section 5.1.3**

- **Jackson & Stent, chapter 12: *Inventory and Production Cycle***
- Stratify population by item category and value. This can be used for planning inventory counts, analytical procedures and selecting samples. ✓
- Scan the inventory masterfile and produce reports of “error conditions” for follow up ✓:
 - blank fields;(½)
 - duplicate item codes; (½)
 - negative quantities or negative unit costs; (½)
 - quantity field is zero, but date of last purchase is more recent than date of last sale; (½)
 - items with amounts in the value field but 0 in the quantity field (½; and
 - date of last sale or last purchase. (½)
- Reperform the quantity x unit cost calculation and compare to value field for each item (report of differences) ✓ and
- Reperform the cast of value field for entire file. ✓
- Analyse inventory masterfile by extracting listings of:
 - inventory items for which unit cost exceeds selling price; ✓
 - inventory items for which the date of the last sale, say, nine months prior to year-end, and the date of the last purchase is within two months of year-end; ✓
 - inventory items for which date of last sale and date of last purchase are, say, six months prior to year end ✓ and
 - inventory items where quantity on hand is excessively more than quantity sold to date. ✓

(Maximum of 8 marks)

Comments:

This was a practical question in which you had to formulate substantive procedures using audit software. Note that in this module we are only covering substantive testing when using audit software.

3.3 Components of IT Controls Framework

References:

- **Study guide, section 3.2**
- **Internal auditing: assurance and consulting services (Reding et al), Chapter 7: *Information technology risks and controls***

a) Governance controls:

- policies (½)

b) IT management controls:

- standards (½)
- organisation and management (½)
- physical and environmental controls (½)

c) IT technical controls:

- systems software controls (½)
- systems development controls (½)
- application-based controls (½)

(Maximum of 3 marks)

Comments:

This was a theoretical question and can be found straight from your study material.

QUESTION 4

6 marks

4.1 Achievement of the audit objective

Reference: Study guide, section 6.1.2

Answer

- Yes, the audit procedure can lead to the achievement of the audit objective. ✓

Motivation

- The audit objective requires the auditor to ensure that all overtime paid in October for wages was approved. ✓
- The procedure as described requires the internal auditor to test for approval by looking for the signature of the foreman as evidence of approval on the worker's clock card. ✓✓

(Maximum of 3 marks)

Comments:

The question required you to understand the relationship between the audit objective and audit procedure, in other words the audit procedure should address the audit objective.

4.2 Conclusion is supported by the evidence

Reference: Study guide, section 6.1.2

Answer

- No, the evidence does not support the conclusion. ✓

Motivation

- The internal auditor was evaluating the effectiveness of a control and found two exceptions out of 20, which is a 10% deviation. ✓
- Such a deviation is in itself material, despite the claim in the conclusion to the contrary. ✓

(Maximum of 3 marks)

Comments:

The question required you to understand the relationship between the conclusion and audit evidence. In other words, do the results of your audit procedures speak to the conclusion that was reached?

QUESTION 5

18 marks

5.1 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 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:

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

12 marks

7.1 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 3 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.

7.2 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 3 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.