

Tutorial Letter 102/3/2014

Internal Auditing: Theory and Principles

Semesters 1 and 2

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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“A failure is a man who has blundered, but is not able to cash in on the experience.”

Elbert Hubbard

Please note / important notes:

1 BRIEFING

Dear Student

In this tutorial letter, you will find additional questions that should help you to test your understanding of this module. The solutions to these questions are contained in Tutorial Letter 103/3/2014.

We refer to these questions as “supplementary do questions” in the study guide. When you work through your study guide, you will be prompted to answer these questions.

The questions are on the same level as and similar to the questions you will find in the examination. Answering the questions and comparing your answers to the suggested solutions provided in Tutorial Letter 103/3/2014 will therefore be a valuable exercise. In this way, you will familiarise yourself with the type of questions you can expect in the examination paper for this module and prepare yourself for the examination.

We will also provide a previous examination paper to you at the end of this tutorial letter. This examination exercise will be of best value to you if you complete the paper under examination conditions after you have covered all the work according to your study guide and before you start your final revision for the examinations.

Comparing your solutions to the solutions provided in Tutorial Letter 103/3/2014 should alert you to the areas that need the most revision.

We trust that you will enjoy your studies in this module and that this tutorial letter will assist you in achieving success.

Regards

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2 ADDITIONAL QUESTIONS

Topic 1: The definition of internal auditing

Study unit 1.1: Definition of internal auditing

QUESTION 1

4 marks

Sally Keen is the newly appointed head of internal auditing at Alson Limited. In the past, the internal audit activity spent a considerable amount of time assisting the accounting department with accounting matters. They also helped when accounting staff were on leave. Sally has decided to restructure the internal audit department to function in line with the accepted definition of internal auditing.

REQUIRED

Marks

- | | | |
|-----|--------------------------------------------------------------------|-----|
| 1.1 | Describe the main and ancillary objectives of an internal audit. | (2) |
| 1.2 | Describe the two (2) main focus areas of an internal audit. | (2) |

Study unit 1.2: The origin and development of internal auditing

QUESTION 2

19 marks

You are the chief audit executive (CAE) of Dencel Limited. The chief executive officer (CEO) of the company sends you the following email:

As I am not familiar with the qualifications required for an internal auditor, I want to know the following from you.

REQUIRED

Marks

Answer each of the following questions.

- | | | |
|-----|------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| 2.1 | What were the main components in establishing the required body of knowledge for internal auditors? | (2) |
| 2.2 | Describe how the practice of internal auditing has developed over the past 120 years. Your answer should include international and local developments as well as | (17) |

a discussion of important publications that have shaped the development of the practice of internal auditing.

QUESTION 3

6 marks

Your colleagues do not consider you, as the internal auditor, to be a professional person, seeing that you and your colleagues are employees of the same organisation. You want to prove to them that internal auditors are professional people by linking internal auditors to the description of a professional person, and by explaining to them the role of the internal audit activity as well as the qualifications required to qualify as an internal auditor.

REQUIRED

List the criteria that are generally regarded as the main characteristics of a profession.

Topic 2: The functional role of internal auditing

Study units 2.1 & 2.2: Functions and roles of management and internal auditing in the organisation

QUESTION 4

28 marks

The CAE of your company believes that the best way to learn something is to teach it. It is, therefore, common practice in your organisation for internal audit staff with one or more years of experience to help train the new trainee internal auditors. It is your turn to do so and you must prepare a brief lecture to explain the following.

REQUIRED

Marks

Briefly explain each of the following aspects.

- | | | |
|------------|----------------------------------------------------------------------------------------------------|-------------|
| 4.1 | The four (4) functions of management in an organisation. | (12) |
| 4.2 | The place of the internal audit activity in the organisational plan of an organisation. | (6) |
| 4.3 | The role of the internal auditor as an adviser to members of the organisation. | (4) |
| 4.4 | The internal audit activity as a control function. | (3) |
| 4.5 | The main factors that directly influence the organisational status of the internal audit activity. | (3) |

Topic 3: Professional matters pertaining to Internal Auditing

Study unit 3.1: The professional practices framework of the internal auditing profession

QUESTION 5

15 marks

Your colleagues do not consider you, as the internal auditor, to be a professional person, seeing that you and your colleagues are employees of the same organisation. You want to prove to them that internal auditors are professional people by linking internal auditors to the description of a professional person, and by explaining to them the role of the internal audit activity and the qualifications required to qualify as an internal auditor.

REQUIRED

Marks

Briefly explain each of the following aspects:

- 5.1 Explain in your own words what a professional person is. (3)
- 5.2 Outline the **twelve (12)** minimum standards of conduct as required from internal auditors in terms of the profession's Code of Ethics. (12)

QUESTION 6

12 marks

You are the head of the internal audit department at Mountaineer Limited. During an internal audit staff evaluation, you obtain the following information:

- 6.1 Dice Moloi, a manager in the internal audit department, received a BMW 318i as a gift from one of Mountaineer Limited's main debtors. (3)
- 6.2 Dice Moloi has assigned Peter Nkabinde, a new staff member in the internal audit department to audit the production department. The production department is one of the largest departments in the company. Peter has only recently graduated from Unisa after full-time studies. (3)
- 6.3 John Bergire, a junior internal audit staff member, discussed with his friends the incidence of fraud he had discovered during his audit of the company's debtors. (3)
- 6.4 Susan Cleal, an internal audit staff member, refused to assist the external auditors in the performance of their duties. (3)

REQUIRED**Marks**

Discuss and conclude, with reference to the Code of Ethics, whether or not each of the scenarios below is permissible in terms of the internal auditing Code of Ethics of the Institute of Internal Auditors. Provide reasons for each of your conclusions.

QUESTION 7**4 marks**

Dave de Barros is the new audit manager for Mautja Limited, a company that manufactures heavy machinery. Dave is an industrial engineer with three years work experience. He has recently been transferred to the company's internal audit department after having completed certain internal auditing modules at Unisa. He is planning his first audit project and he has asked you to assist him.

REQUIRED**Marks**

List the **four (4)** aspects Dave should consider during the planning of his audit engagement. Refer to the International Standards for the Professional Practice of Internal Auditing. (4)

Topic 4: The qualifications and characteristics of an internal auditor
Study unit 4.1: Additional questions on the qualifications and characteristics of an internal auditor
QUESTION 8**12 marks**

As part of your organisation's programme to become more involved in community affairs, you visit the secondary schools in your area to tell them about the exciting world of internal auditing.

REQUIRED**Marks**

- 8.1** List at least six (6) of the personal characteristics that could assist an internal auditor to effectively discharge his or her duties as an internal auditor. **(6)**
- 8.2** Describe the formal requirements that prospective internal auditors must meet before they can be awarded the professional Certified Internal Auditor (CIA) certificate. **(6)**

Topic 5: The purpose, authority and responsibility of an internal auditor**Study unit 5.1: The purpose, authority and responsibility of an internal auditor****QUESTION 9****10 marks**

You are a mentor to the junior internal auditors in your internal audit department. Part of your responsibility is to assist them with their studies as well as other aspects concerning their training as internal auditors.

REQUIRED**Marks**

Answer the following questions posed to you by a new junior internal auditor during a mentoring session:

9.1 What are the duties of an internal auditor towards his or her employer? **(6)**

9.2 What is a charter and what are the elements of a charter? **(4)**

QUESTION 10**25 marks**

As part of your organisation's programme to become more involved in community affairs, you visit the secondary schools in your area to tell them about the exciting world of internal auditing.

REQUIRED**Marks**

Name and briefly explain the **five (5)** powers of an internal auditor. Also describe the constraints that management can place on the internal auditor. **(25)**

Study unit 5.2: The internal auditor's role and responsibilities with regard to fraud**QUESTION 11****4 marks**

In a presentation to the management of your company you explained the importance and objectives of internal control, and mentioned reasons why internal control is of cardinal importance to management in their fight against fraud.

REQUIRED**Marks**

Explain why internal control is of cardinal importance to management in their fight against fraud.

QUESTION 12**12 marks**

The internal audit team is investigating the effect of the current state/level of the Rand exchange rate on the company with regard to employee morale, possible diversification (other products, customers, etc) and retrenchments. The investigation was also requested due to suspected employee fraud. You have been asked to present the findings to the board of directors and the audit committee at a meeting specifically arranged for this purpose.

REQUIRED**Marks**

- 12.1** Indicate **five (5)** types of fraud that a company's employees may commit. **(5)**
- 12.2** Explain the factors and/or steps that the internal auditor will take into account when discharging his/her responsibility with regard to the **prevention** of fraud. **(7)**

QUESTION 13**11 marks**

While conducting an internal audit of the security and maintenance facilities of a company's delivery vehicles, you discover that the company is only using security guards to protect their assets, even though, collectively, the vehicles are valued at R5 million.

REQUIRED**Marks**

- 13.1** Identify the possible consequences or fraudulent activities that may occur if proper internal controls are not in place with regard to the company's vehicles. **(5)**
- 13.2** Suggest the minimum controls the company should have in place in this instance to prevent losses due to employee fraud. **(6)**

Topic 6: Internal Auditing Concepts
Study unit 6.1: Governance, risk management and control
QUESTION 14**14 marks**

One of your close friends, Mike Petersen, works for a large JSE-listed construction company that was awarded the Gautrain contract. Mike is preparing a presentation to the board and senior management of the company to persuade them to establish an internal audit activity for the company and has asked you to assist him in this regard.

REQUIRED**Marks**

- 14.1** Briefly explain the concepts of governance, risk management and control that are included in the definition of internal auditing. **(6)**
- 14.2** Explain the role of the internal audit activity in **risk management** by referring to the Gautrain project. **(8)**

QUESTION 15**12 marks**

While conducting an internal audit of the security and maintenance facilities of a company's delivery vehicles, you discover that the company is only using security guards and no other methods to protect their assets, even though, collectively, the vehicles are valued at R5 million.

REQUIRED

Suggest other preventative and detective controls the company can implement to ensure the effective and efficient physical maintenance and security of its vehicles. **(12)**

Topic 7: The internal audit process
Study unit 7.1: Additional questions on the internal audit process
QUESTION 16**6 marks**

During a meeting with the newly established audit committee a committee member asks you, as the chief audit executive (CAE), the following questions:

- 16.1** What does "materiality" mean in an internal auditing context? **(3)**
- 16.2** What standards must audit evidence comply with in order to be acceptable to the CAE? **(3)**

REQUIRED

Answer the questions put to you by the audit committee member.

QUESTION 17**29 marks**

The internal auditor responsible for the inventory audit asks you to assist him with his planning. He needs assurance that the audit procedures designed by him will achieve the audit objectives for auditing inventory.

REQUIRED	Marks
17.1 Briefly describe the concept "internal audit procedures".	(2)
17.2 Describe what is meant by the internal audit procedures "observing", "questioning" and "verification", and provide examples of how each of these types of audit procedures can be applied in an inventory count.	(12)
17.3 Explain "audit evidence" as one of the basic concepts of internal auditing.	(9)
17.4 Indicate the steps you would follow in planning the audit of inventory as requested by management.	(6)

Topic 8: The internal audit engagement procedures and tools

Study unit 8.1: Internal audit engagement procedures and tools

QUESTION 18 **13 marks**

REQUIRED	Marks
18.1 Describe the objectives and benefits of audit working papers	(8)
18.2 Describe what you understand by the term "internal auditing aids" and give two examples of such aids.	(5)

QUESTION 19 **10 marks**

REQUIRED	Marks
19.1 Briefly describe "audit marks" as an internal auditing aid used by the internal auditor when conducting an audit.	(3)
19.2 Describe the purpose and requirements of audit testing or sampling.	(7)

Topic 9: The relationship between internal auditing and related functions**Study unit 9.1: Internal auditing and related disciplines****QUESTION 20****16 marks**

The relationship between internal auditing and related disciplines must develop in a way that promotes interaction, which in turn promotes efficient service.

REQUIRED**Marks**

- 20.1** Mention those factors that may give rise to a poor relationship between internal and external auditors. **(7)**
- 20.2** List those actions that could be conducive to good cooperation and coordination between external and internal auditors. **(9)**

QUESTION 21**10 marks**

You are a senior internal auditor preparing for a mentoring session. In this session, you aim to deal with the relationships between internal auditing and general management, and internal auditing and financial and management accounting.

REQUIRED**Marks**

Prepare a plan for a presentation on the following topics:

- 21.1** The relationship between internal auditing and general management. **(6)**
- 21.2** The relationship between internal auditing and financial and management accounting. **(4)**

QUESTION 22**16 marks****REQUIRED****Marks**

Describe, using the following headings, how cooperation between the internal and external auditors can influence the interrelationship between the two disciplines:

- Mutual confidence **(5)**

- Nature and advantages of a good relationship (4)
- Limitations and dangers in connection with the work of the internal auditor (7)

3 SIMULATED EXAMINATION

QUESTION	MAIN TOPIC	MARKS
1	Multiple-choice questions	15
2	Part A: The internal audit profession	28
3	Part B: Internal audit planning, fraud and internal control	23
4	Part C: Code of ethics and the audit committee	10
5	Fraud and fraud risk	<u>24</u>
		<u>100</u>

NOTE:

Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the examiners will take into consideration his or her ability to organise and present such knowledge in written language of an acceptable standard.

QUESTION 1

15 marks

REQUIRED

For each subsection of this question, select only **one** alternative that you consider to be the most correct. Then write down, as your answer, the number of the subsection and the letter that precedes the selected alternative. Answer the subsections of this question in numerical sequence, for example:

- 1.1 A
1.2 B

Each question counts 1½ marks.

- 1.1** When hiring new internal audit trainees, which one of the following attributes is most likely to ensure that the applicant's job application is successful?
- A A detailed knowledge of the company and its operations.
 - B The ability to fit well into a social group and enjoy participating in networking opportunities.
 - C The ability to organise and express his or her thoughts in a structured and logical manner.
 - D The average grade he or she has obtained at university for the internal auditing modules.
- 1.2** Which one of the following factors is essential in evaluating the usefulness of audit evidence? The evidence must...
- A be well documented and cross-referenced in the working papers.
 - B help the organisation meet its goals.
 - C bear a direct relationship to the finding and include all of the elements of a finding.
 - D be convincing enough for a prudent person to reach the same conclusion as the internal auditor.
- 1.3** The internal auditor's responsibility for the prevention of fraud would include all of the following **except**:
- A Determining if the organisational environment fosters control consciousness.
 - B Being aware of activities in which fraud is likely to occur.
 - C Ensuring against the occurrence of frauds
 - D Evaluating the effectiveness of actions taken by management to deter fraud.
- 1.4** The requirement that all purchases be made from suppliers on an approved suppliers list is an example of a ...
- A preventive control.
 - B corrective control.
 - C detective control.

D monitoring control.

1.5 The internal auditor prepares audit working papers primarily for the benefit of...

- A the chief audit executive (CAE).
- B the audit committee.
- C the executive management of the auditee.
- D the internal auditing activity.

1.6 The best attainable and most reliable form of audit evidence is ...

- A documentary.
- B competent.
- C relevant.
- D sufficient.

1.7 An element of authority attributed to the internal audit activity that should be included in their charter is the ...

- A establishment of the internal audit activity's position within the organisation.
- B identification of the organisational units where internal audit engagements must be performed and the frequency of such engagements.
- C identification of the different types of disclosures that must be made to the audit committee.
- D access to the external auditor's working papers and engagement letter.

1.8 During the internal audit of the asset acquisition function, the internal auditor asks for the fixed asset register.

Which one of the following powers is being exercised by the internal auditor?

- A Obtaining information and explanations.
- B Having access to books, records, vouchers and accounts.
- C Attending board meetings.
- D Believing trusted officials.

1.9 The Institute of Internal Auditors has developed an International Professional Practices Framework for internal auditors. Which of the following types of guidance are mandatory?

- i. The definition of internal auditing.
- ii. The IIA Code of Ethics
- iii. Practice Advisories
- iv. The International Standards for the Professional Practice of Internal Auditing.

- A i, ii and iv only.
- B ii and iv only.
- C ii, iii and iv.
- D i, ii, iii and iv.

1.10 Which of the following alternatives is not one of the four functions of management?

- A Reviewing.
- B Organising.
- C Directing.
- D Planning.

QUESTION 2

61 marks

Pumpkin Patch Ltd manufactures and sells educational children's toys. The company is located in Johannesburg, with outlets in all major Gauteng cities.

Owing to the nature of the products it produces, Pumpkin Patch has to comply with a number of regulations. Children's toys must comply with numerous safety standards in terms of the material they consist of, and the shape and form of the toy. This is even more relevant here, because the toys produced by Pumpkin Patch Ltd must be of an educational nature and help to develop children's skills.

PART A

28 marks

You are the trainee internal auditor at Pumpkin Patch Ltd. The internal audit team consists of:

- Mr Barney – the chief audit executive (CAE)
- Ms Noddy – the senior internal auditor, and
- Ms Ghoempie – the trainee internal auditor

You have been working together well as a team and management seems to be very supportive of the internal audit activity.

The financial director, Mr Barbie, asks the internal audit activity to assist with the following tasks because other departments have too much work to do:

- I. performing the monthly bank reconciliations on the company's bank account
- II. conducting surprise cash counts at the company's various manufacturing facilities
- III. performing inventory counts every month as part of the company's internal control over its perpetual inventory
- IV. searching for suitable financial staff
- V. conducting a review to find out the extent to which the marketing department complies with the company's policies and procedures
- VI. drafting a set of procedures for the human resources department to be used when appointing staff

REQUIRED

Marks

- 2.1** Discuss the service the internal audit activity should provide in respect of:.
- | | |
|-----------------------------------|------------|
| 2.1.1 assurance and consulting | (2) |
| 2.1.2 adding value | (2) |
| 2.1.3 the risk management process | (2) |
| 2.1.4 the control process | (2) |
| 2.1.5 the governance process | (2) |
- 2.2** Indicate for each of the tasks (I-VI) above whether or not this task should be performed by the internal audit activity. Give a reason for each answer. **(12)**
- 2.3** Explain the meaning of "independence" in relation to the internal audit activity. **(2)**
- 2.4** Explain how the internal audit activity's "organisational status" can enhance its independence **and** also list the **two (2)** factors that will influence the organisational status of the internal auditing activity. **(4)**

PART B

23 marks

You have been assigned to perform the internal audit of the purchasing process. The following are standard questions in the internal control questionnaire, completed by the purchase manager, Mr Ben Ten:

- I. Is a written order, duly authorised, produced for all purchases?
- II. Do the receiving clerks prepare and sign a goods received note for all goods received?
- III. Are payments for purchases supported by a properly authorised order, a supplier's delivery

note, a goods received note and a purchase invoice?

IV. Are all supporting documents stamped “paid” once they have been presented for signature?

Mr Ben Ten answers “yes” to all the above questions.

In addition to the completed questionnaire, Ms Noddy (the senior internal auditor) obtains the following information:

1. Mr Ben Ten took paint from the warehouse to paint his garage at home.
2. The goods received clerk signed the goods received notes without checking the contents of the boxes delivered.
3. One of the buyers, Ms Tinkerbell, negotiated a new deal to buy all the wood for the production process from one supplier because this will save the company 6% on its annual wood expenditure. The new supplier gave Ms Tinkerbell a voucher for a weekend away at a spa.

REQUIRED

Marks

- | | | |
|------------|---------------------------------------------------------------------------------------------------------------------------------------------------|-------------|
| 2.5 | List the steps in the internal audit planning process and indicate the current step of the process being performed. | (7) |
| 2.6 | List the purpose of each of the questions (I-IV) reflected in the internal control questionnaire. | (12) |
| 2.7 | State the elements of legal fraud or deceit. | (2) |
| 2.8 | With reference to the elements of fraud, determine if any of the above pieces of information (1-3) constitute fraud. Explain your opinion. | (4) |

PART C

10 marks

The audit committee of Pumpkin Patch Ltd requests assurance from the CAE, Mr Barney, concerning Pumpkin Patch Ltd’s compliance with the safety regulations prescribed by the regulators for the production of children’s toys.

No one in the internal audit department has the necessary knowledge and skills to perform this compliance audit. The feeling in the internal audit department is to accept the assignment and learn through “trial-and-error”.

REQUIRED

Marks

- | | | |
|-------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| 2.9 | Discuss what action should be taken by the CAE regarding the above request from the audit committee. Substantiate your answer by referring to the principles and rules of conduct of the code of ethics. | (4) |
| 2.10 | Describe the relationship between the CAE and the audit committee. | (6) |

QUESTION 3**24 marks**

You are an internal auditor at Risky Business, a short-term insurance company. The following applies to the company:

- I. The company adheres to the principles of sound corporate governance
- II. The directors' remuneration is largely dependent on the company's financial results.
- III. Management decisions are strongly influenced by the managing director, a clever but forceful, autocratic man.
- IV. Recommendations made by the internal auditors to the management of the company at the conclusion of the audit are implemented in good time.
- V. The financial director shows little regard for the external auditors, describing the annual audit as an irritation.
- VI. The company has converted itself from a complex corporate structure to a more simple structure by unbundling itself.
- VII. The staff in the information technology department are very inexperienced.
- VIII. The company's motto is "no question – we will be number one" and employees are encouraged to be aggressive and competitive as progress depends upon results.

REQUIRED**Marks**

- 3.1** Explain the internal auditor's responsibility in respect of the prevention and detection of fraud by referring to the Standards. **(4)**
- 3.2** Indicate whether each of the above conditions will **increase** or **decrease** the risk of fraud in the company. Give reasons for your answer. **(20)**

Use the following format to answer the question

Question No.	Increase or decrease	Motivation
(I)		
(II)		