

Tutorial Letter 202/1/2014

Internal Auditing: Theory and Principles

AUI2601

Semester 01

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

CONTENTS

1	BRIEFING	3
2	KEY TO ASSIGNMENT 02/2014 (FIRST SEMESTER)	4

1 BRIEFING

This tutorial letter contains the solutions to Assignment 02 for this semester. Your 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.

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

After you have marked your own answers, please 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 solve 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 make you fail.

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

We trust that you have found the assignment both interesting and informative and that it has helped you with your examination preparation. Should you encounter any difficulties regarding this internal auditing module, please do not hesitate to contact us.

Lecturer: AUI2601

2 KEY TO ASSIGNMENT 02/2014 (FIRST SEMESTER)

QUESTION 1

15 marks

Question	Correct answer	Study guide reference
1.1	B	Study Unit 3.1.2
<p>This question required you to know the principles that govern the Code of Ethics and you had to choose the incorrect principle.</p> <p>Option B is the correct option as responsibility is not a principle of the Code of Ethics.</p> <p>Options A, C and D are incorrect as the four principles that internal auditors are expected to apply and uphold are integrity, confidentiality, competence and objectivity.</p>		
Question	Correct answer	Study guide reference
1.2	D	Study Units 2 and 5.1
<p>Option D is correct. A chief audit executive (CAE) is defined as a person in a senior position responsible for effectively managing the internal audit activity. (IIA Standards Glossary).</p> <p>Options A and B are incorrect as these are external parties to the organisation and the CAE is a senior person in the organisation.</p> <p>Option C is incorrect as this is one of the responsibilities of the board. (IIA Standards 1110).</p>		
Question	Correct answer	Study guide reference
1.3	C	Study unit 7.1.4
<p>An audit procedure is defined as procedure that the auditor should perform to determine whether control activities are working effectively. An audit procedure has a certain structure. It must start with a verb, for example: inspect, observe, reperform, compare, discuss and enquire, etc.</p> <p>Option C is correct as the auditor is not performing a procedure to determine whether a control activity is working effectively, he or she is recommending an improvement to an inadequate or ineffective control.</p> <p>Options A, B and D are incorrect as these are examples of audit procedures.</p>		
Question	Correct answer	Study guide reference
1.4	C	Study Unit 6.1.4
<p>Option C is correct as the Institute of Internal Auditors (IIA) defines controls as “any action taken by management, the board and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved.”</p> <p>Option A is incorrect since the IIA Standards 2130 states: “the internal audit activity assists the</p>		

organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.” Therefore, internal audit is **not** responsible for establishing and maintaining the internal control system. Its role is to **assist by** evaluating the effectiveness and efficiency of the control system.

Option B is incorrect as the external auditor is an independent and external party with no operational responsibility in the organisation.

Option D is incorrect as the audit committee has an **oversight responsibility** (not primary responsibility) for the system of internal controls.

Question	Correct answer	Study guide reference
1.5	A	Study Unit 2.1

This question required you to know the four functions of management and select the option that was **not** a function of management.

Option A is correct as reviewing is not a function of management. Reviewing forms part of control.

Options B, C and D are incorrect as planning, organising, directing and controlling are the four functions of management.

Question	Correct answer	Study guide reference
1.6	D	Study Unit 7.1.4

Option D is correct since this is the definition of sufficient evidence.

Option A is incorrect since this is the definition of relevant evidence.

Option B is incorrect since this is definition of competent evidence.

Option C is incorrect since this is the definition of useful evidence.

Question	Correct answer	Study guide reference
1.7	C	Study Unit 8.1.4

Option C is correct because according to Practice Advisory 2330-1 “working papers document the information obtained, the analyses made, and the support for the conclusions and engagement results.”

Working papers also help in performing the engagement, serving as a guide for subsequent engagements, providing a basis for evaluations, assisting in training, supporting discussion with engagement client and containing documentation relevant to disputes or litigation that may arise from the engagement. Hence, they primarily benefit the internal auditors.

Options A, B and D are incorrect as benefits to the executive management, the audit committee and the external auditor are secondary.

Question	Correct answer	Study guide reference
1.8	B	Study Unit 7.1.4
<p>Option B is correct since analytical information results from analysis and verification and includes computations and comparisons (the calculations of average travel expenses are analytical information). The travel expense receipts are documentary information.</p> <p>Options A, C and D are incorrect since physical evidence (which is information obtained by observing people, property and events) and oral evidence (which is information that consists of letters or statements in response to enquiries or interviews), are not included in the scenario.</p>		
Question	Correct answer	Study guide reference
1.9	A	Study Unit 5.1.1
<p>Option A is correct since the charter should establish the internal auditor's position within the organisation in order to fulfil his or her obligations and responsibilities.</p> <p>Option B is incorrect since the internal audit activity should not specifically identify what activities will be audited.</p> <p>Option C is incorrect because the internal auditors are obligated to make all needed disclosures to the audit committee.</p> <p>Option D is incorrect since access to the external auditor's working paper cannot be guaranteed in the charter.</p>		
Question	Correct answer	Study guide reference
1.10	B	Study Unit 4.1.2
<p>This question required you to understand the personal characteristics of an internal auditor and to choose the option that was incorrect.</p> <p>Option B is correct. Internal auditors must be practical and never allow theoretical knowledge to distort their practical judgement, experience or reasoning.</p> <p>Options A, C and D are incorrect as these are characteristics that internal auditors should possess.</p>		

(1½ marks each)

QUESTION 2**15 marks****Part A****2. Scenarios permissible in terms of the IIA Code of Ethics****Reference: Study Unit 3.1****2.1** This activity is a violation of the IIA Code of Ethics (not permissible). (1)

Code of Ethics
Rules of Conduct

Competency

Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services. (Rule of Conduct 4.3) (1)

By cancelling all training, the chief audit executive is failing to ensure the required proficiency of the internal audit staff. (1)

(Maximum 3 marks)

2.2 This activity is a violation of the IIA Code of Ethics (not permissible). (1)

Code of Ethics

Objectivity

Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment. (Rule of Conduct 2.2) (1)

Accepting a gift of moderate value is prohibited and his or her objectivity is impaired. (1)

(Maximum 3 marks)

2.3 This activity is a violation of the IIA Code of Ethics (not permissible). (1)

Code of Ethics
Rules of Conduct

Objectivity

Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization. (Rule of Conduct 2.1) (1)

Auditing an activity for which his wife is responsible may impair his unbiased assessment due to their relationship and would cause a conflict of interest (1)

(Maximum 3 marks)

2.4 This action is permissible under the IIA Code of Ethics. (1)

Code of Ethics
Rules of Conduct

Confidentiality

Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization. (Rule of Conduct 3.2) (1)

This action is permissible because the hospital is not a competitor or supplier of the internal auditor's employer. Hence no conflict of interest occurred. (1)

(Maximum 3 marks)

2.5 This activity is a violation of the IIA Code of Ethics (not permissible). (1)

Code of Ethics **Rules of Conduct**

Integrity

The internal auditor failed to perform his work with diligence. Internal auditors shall perform their work with honesty, diligence, and responsibility. (Rule of Conduct 1.1) (1)

Internal auditors shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization. (Rule of Conduct 1.3) (1)

Internal auditors should disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review. (Rule of Conduct 2.3) (1)

Therefore, the internal auditor is party to the illegal activity by not reporting it to the audit committee. (1)

(Maximum 3 marks)

(Maximum of 10 marks)

Comments:

*This is an application-type question and tests your understanding of the Code of Ethics: The Principles and the Rules of Conduct, and how to apply these to the scenarios in the question. Read each scenario carefully and think of the ethical behaviour that the scenario is depicting, then determine if there has, or has not been, a violation. Next, if you are stating it is a violation of the Code, you should explain why. Be clear about your reasons because we need to determine whether you really understand the Code of Ethics and its Rules of Conduct. Do not just state it is a violation; explain **how** the objectivity, competency, integrity or confidentiality has been violated.*

QUESTION 3

41 marks

3.1 Advantages of having an internal audit function in the organisation

Reference: Study Unit 2.2.3.2

- Many organisations are a blend of business and non-business activities and these developments increase the need for internal auditing in all types of organisations where the complexity of the activities, the volume of transactions and the dependence of a large number of people create operational challenges. (1)

- Whenever organisational responsibilities are established there is a potential need for internal auditing to give assurance that those responsibilities are executed as planned. (1)
- The safeguarding of assets, reliability of financial records and efficiency in operations are basic responsibilities of management and are primary objectives of accounting and administrative controls. Management is aware of the advantages of having an internal audit activity to assist in monitoring such responsibilities. (1)
- Complex organisations have different levels of management. These levels of management work together with the internal audit activity to ensure that the company as a whole works together at achieving the same goals which have been formulated by top management. (1)
- The internal audit report provides management with the assurance that management policy, standards and procedures are satisfactory, that these are being executed and adhered to, and that the risk management, control and governance processes are adequate and effective. (1)
- Any deviations, discrepancies or unsatisfactory aspects from which deductions for reorganisation, adaptation or correction could be made, are brought to management's attention timeously. (1)
- The internal auditor's report assures management that management data, whether operational or financial, are compiled in a consistent, uniform and standardised manner. This forms the basis of the proper interpretation of the information and the true evaluation of the operational results and the organisation's financial state of affairs for further analyses in order to arrive at meaningful management decisions. (1)
- There is always a possibility of discovering fraud and errors when internal auditors carry out a continuous evaluation of the internal control. (1)
- Unexpected visits by the internal auditor will also provide an element of surprise, not only strengthening the moral influence, but also reducing the time available for staff to cover up or rectify fraud and errors. (1)
- The internal audit report offers the auditee an instrument for the evaluation of his or her own work performance and for the timely correction of problems. (1)
- It enables the enterprise to evaluate its working procedures and to rectify any problems in good time. (1)
- The productive use of all available resources is ensured, enabling the organisation to achieve its stated objectives. (1)

(Maximum 6 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

3.2 Examples of how internal auditor can assist the organisation

Reference: Study Unit 2.2.2

The internal audit activity can assist management in:

- Monitoring activities that top management cannot monitor itself. (1) Every year the chief audit executive prepares a schedule of proposed audits that specifies the activities to be monitored. These are presented to the executive management and the board and can be adjusted to meet the needs of senior officials.
- Identifying and minimising risks. (1) The internal audit activity needs to identify areas of high inherent risk, high residual risk and the key controls upon which the organisations is most reliant. Internal auditors should also try to identify unnecessary, redundant or complex controls that inefficiently reduce risk.
- Validating (for accuracy, timeliness and meaningfulness) reports to senior management. (1) Management make their decisions based on reports submitted to them. These reports are reviewed by the internal auditors during their scheduled audits. When these audits are done, the auditors review the reports for accuracy, timeliness and meaningfulness.
- Protecting management in technical fields. (1)
- Helping in the decision-making process – internal auditors can supply or validate the data on which decisions are made; they can evaluate the effects of the decisions and point out risks that were not anticipated. (1)
- Reviewing the present and the past – assessing policies and programs still in the design stage. (1)
- Helping managers manage – the internal auditors can generally find problems and suggest corrections. (1)

(Maximum 7 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

3.3 Requirements as per the internal audit charter that grant the internal audit activity necessary authority

Reference: Study Unit 5.1

- **Access to the books, records, vouchers and accounts.** Authority that the internal auditor must have access to all the information pertaining to the audit assignment at all times. (1)
- **Obtaining information and explanations.** Management should be compelled to furnish the internal auditors with additional information and explanations should they require them. (1)

- **Attending meetings.** To keep abreast of matters concerning planning and policies within the organisations, internal auditors should be invited to the meetings or receive copies of the minutes of such meetings. (1)
- **Believing trusted officials.** Internal auditors are entitled to place reliance on any information supplied to them by trusted employees of the organisation. (1)
- **Independence of the internal auditor.** The organisational independence and objectivity are the primary means that internal auditors use to ensure their independence from the staff of the organisation as well as its normal business activities. (1)

(Maximum 5 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

3.4 Responsibilities of the internal audit activity as per the internal audit charter

Reference: Study Unit 5.1

The chief audit executive and staff of the internal audit department have the responsibility to do the following:

- Develop a flexible annual audit plan using an appropriate risk-based methodology, including any risks or control concerns identified by management, and submit that plan to the audit committee for review and approval as well as for periodic updates. (1)
- Implement the annual audit plan, as approved, including, as appropriate, any special tasks or projects requested by management and the audit committee. (1)
- Maintain a professional audit staff with sufficient knowledge, skills, experience, and professional certifications to meet the requirements of this charter. (1)
- Evaluate and assess significant merging/consolidating functions and new or changing services, processes, operations, and control processes coincident with their development, implementation, and/or expansion. (1)
- Issue periodic reports to the audit committee and management, summarising results of audit activities. (1)
- Keep the audit committee informed of emerging trends and successful practices in internal auditing. (1)
- Provide a list of significant measurement goals and results to the audit committee. (1)
- Assist in the investigation of significant suspected fraudulent activities within the organisation and notify management and the audit committee of the results. (1)
- Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to the organisation at a reasonable overall cost. (1)

(Maximum 7 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

3.5 Practices that would enhance a good relationship between the audit committee and the internal audit activity

Reference: Study Unit 9.1.5

- The chief audit executive should have the following dual-reporting responsibilities:
 - functionally to the audit committee ($\frac{1}{2}$), and
 - administratively to the chief executive officer. ($\frac{1}{2}$)
- The chief audit executive should have ready access to the audit committee. (1)
- The chief audit executive should have direct and regular communication with the audit committee. (1)
- The chief audit executive should attend audit committee meetings. (1)
- The chief audit executive should meet privately with the audit committee (without management's representatives in attendance) on a regular basis. (1)
- The audit committee should approve the appointment or removal of the chief audit executive. (1)
- The audit committee should be advised by the chief audit executive on his relationship with the external auditors (and on how the internal and external audits are progressing). (1)

(Maximum 7 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

3.6 Actions which can contribute to good co-operation and co-ordination between the internal and external auditors

Reference: Study Unit 9.1.3

The following actions could be conducive to good cooperation and coordination between internal and external auditors:

- A uniform examination methodology, that is, both groups of auditors would use similar auditing procedures and standardised audit working papers in the performance of the financial audit process. (1)
- Direct support in that working papers and audit personnel are at each other's disposal. (1)
- Joint training programmes and/or participation in each other's training programmes. (1)
- Exchange of audit reports on matters of mutual interest and the following up of suggestions and recommendations by the other party. (1) This exchange would assist in determining and adjusting the scope and timing of the work, where applicable.
- Sharing of responsibilities in that internal auditors accept responsibility for tasks delegated to them by the external auditors; teamwork in performing certain tasks and supportive presentations to company officials and management. (1)
- The evaluation by internal and external auditors of the effectiveness of each other's work and the reporting on this to management. (1)
- Planning could be undertaken by both groups with each other's audit plans at their disposal and joint audit plans could be developed. Planned audit activities of internal and external auditors need to be discussed to ensure that audit coverage is coordinated and duplicate efforts are minimised where possible. (1)

- Periodic meetings where aspects of mutual interest regarding their audit responsibilities are discussed. (1) Sufficient meetings should be scheduled during the audit process to ensure coordination of audit work and efficient and timely completion of audit activities and to determine whether observations and recommendations from work performed to date require that the scope of planned work be adjusted.
- A professional attitude toward each other and mutual respect for each other's professional responsibilities. (1)

(Maximum 9 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

QUESTION 4

10 marks

4.1 The roles of management and the internal auditor with regards to risk management

Reference: Study Unit 6.1.3 and IIA Standards 2120

Management is responsible for designing, (½) implementing (½) and monitoring (½) the risk management process and integrating it into the day-to-day activities of the organisation. (1)

The internal audit activity should assist the board, director and management by facilitation and consultation in identifying, (½) evaluating (½) and assessing significant risks (½) and by providing independent assurance (1) as to the adequacy (½) and effectiveness (½) of the related internal controls and the risk management process.

(Maximum 5 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide and the IIA Standards. You have to specifically state management's and the internal auditor's responsibilities regarding the risk management process. Make sure to explain the responsibilities of both parties'.

4.2 Role of internal auditor in detection of fraud

Reference: Study Unit 5.2.2.3

Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organisation, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud. (1)

The internal auditor's responsibilities with regard to detecting fraud are as follows:

- To have sufficient knowledge of fraud to be able to identify indicators that fraud may have been committed. This includes knowledge of the characteristics of fraud, the techniques used to commit fraud and types of fraud associated with the activities reviewed. (1)
- To be alert to opportunities, such as control weaknesses, that could allow fraud. If significant control weaknesses are detected, additional tests conducted by internal auditors should include tests directed toward identification of other indicators of fraud. (1)
- To evaluate the indicators that fraud may have been committed and decide whether any further action is necessary and whether an investigation should be recommended. (1)
- To notify the appropriate authorities within the organisation if it is determined that there are sufficient indicators that fraud was committed, and to recommend an investigation. (1)

(Maximum 5 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide. Do not confuse it with responsibilities of the internal auditors regarding investigation of fraud.

QUESTION 5

19 marks

5.1 Considerations when planning an audit engagement

Reference: Study Unit 7.1.4 and IIA Standards 2201

In planning the engagement, internal auditors must consider:

- The objectives of the activity being reviewed and the means by which the activity controls its performance; (1)
- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level; (1)
- The adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model; (1) and
- The opportunities for making significant improvements to the activity's risk management and control processes. (1)

(Maximum 4 marks)

Comments:

This was a theoretical question. The answer can be found, as is, in the study guide and the IIA Standards

5.2 (a) Audit procedures and (b) kind of audit evidence used

Reference: Study Unit 7.1.4

Control number	Audit procedure (5.2 (a))	Audit evidence (5.2 (b))
1	Observe the opening of mail that it is opened by two people (1), and the recording of payment received in the remittance register. (1)	Physical evidence (1)
	Enquire from the relevant people responsible for opening the mail regarding the process. (1) Obtain signed confirmation of the process from the abovementioned people as evidence. (1)	Oral evidence (1) / Documentary evidence (1)
2	Obtain the copies of the reconciliations (1) and inspect that they are signed off by the reviewer. (1)	Documentary evidence (1)
3	Observe that the employees provide positive proof of identification during the payout of wages (1) and that they sign the wages register as proof of acknowledgement of receipt (1).	Physical evidence (1)
	Inspect and compare the employee's signature in the payroll register (1) to the signature in the employment contract or personnel file. (1)	Documentary evidence (1)
4	For a period of a few consecutive months, obtain copies of exception reports and inspect that they have been signed by the financial director (1). Obtain a payment roll and check that no payment was effected before the date the exception report was signed off. (1)	Documentary evidence (1)
5	Select a sample of payments (1) and inspect that all supporting documentation have been cancelled (stamped "paid" or crossed out). (1)	Documentary evidence (1)

(Maximum 15 marks)

Comments:

This is an application-type question. The first part required you to design an audit procedure to determine whether the control is working as intended. Audit procedures should be simple and should direct the auditor how to obtain evidence to draw conclusions regarding the control that is being tested. Take note verbs in bold that are used to describe audit procedures

Please note, just repeating the control activities given in the scenario does not make it an audit procedure. The control activity is what the organisation has put in place to manage risks. An audit procedure is what the auditor should perform to determine whether these control activities are working effectively.

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

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

The second part of the question required you to identify what type of audit evidence you would obtain while performing the audit procedure.