

# **Tutorial Letter 202/1/2016**

**AUI3703**

## **THE INTERNAL AUDIT PROCESS: SPECIFIC ENGAGEMENTS AND REPORTING**

### **Semester 1**

#### **Department of Auditing**

This tutorial letter contains important information about your module.

Bar code

## CONTENT

1	BRIEFING	3
2	KEY TO ASSIGNMENT 01/2016 (FIRST SEMESTER)	4

## 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 to 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 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 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 very costly.

Marking your answers should enable you to identify any problems you may be experiencing. Your marks for this assignment will be an indication of your level of knowledge of the module content 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 regarding this module in internal auditing, please do not hesitate to contact us.

Lecturer: AUI3703

## 2 KEY TO ASSIGNMENT 02/2016 (FIRST SEMESTER)

### QUESTION 1: (15 marks)

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

(1½ marks each)

#### Comments on Question 1

##### **1.1 – C (study guide, section 2.1.3)**

Option C is correct as the confidentiality principle states that *internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.*

Option A is wrong as the integrity principle addresses the judgement of internal auditors not information.

Option B is wrong as the objectivity principle addresses possible conflict of interest of internal auditors not information.

Option D is wrong as privacy is not a principle of the code of ethics.

##### **1.2 – B (study guide, section 7.3.3)**

Option B is correct; because it is an assurance engagement on the adequacy and effectiveness of the controls..

Option A is wrong because an assessment is done on the adequacy and effectiveness of the control. No advice or consulting is taking place on how the controls should be.

Option C is wrong because outsourcing refer to the employment of internal audit staff, when you outsource the internal audit activity you make use of a service provider such as an auditing firm, to do the internal audit assignment on behalf of the company, you are not using staff members employed directly by the company.

Option D is wrong because a compliance engagement is testing whether there is adherence/compliance to the policies and procedures of the company. In this case the design adequacy and effectiveness of controls are assessed.

### **1.3 – D (study guide, section 5.1.2)**

Options A, B and C are incorrect because targets and results refer to effectiveness. Economy refers to the relationship between planned inputs and actual inputs in terms of unit costs. Efficiency refers to the relationship between actual inputs and actual outputs (process flow) and the financial impact is not one of the elements of performance auditing.

### **1.4 – A (study guide, section 10.3)**

Option A is correct as external refers to fraud outside of the company, such as credit card fraud, and the deed meets all the elements of fraud such as:

- A false representation of a material fact, or in some cases an opinion,
- made with the knowledge of its falsity or without sufficient knowledge on the subject to warrant a representation,
- a person acting upon the representation,
- to his or her damage.

Option B is incorrect because to commit embezzlement there is an attempt to conceal the act of misappropriation for example altering a document

Option C is incorrect because misappropriation is only one of the elements of fraud.

Option D is incorrect because management fraud refers to fraud committed by the management of the company.

### **1.5 – B (study guide, section 5.4.2)**

Option B is correct as this is an application control and application controls are user and programmed controls and are embedded in each of the data processing functions, namely input, processing and output.

Options A, C and D are general controls which are defined as general controls cover the entire CIS environment within which each set of application controls functions. General controls are related to all applications and provide a framework within which the CIS department exercises control over the development, operation and maintenance of individual applications.

### **1.6 – D (study guide, section 20.2.2)**

Option D is correct as this is an example of assurance services which is described as: *An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management and control processes*

*for the organisation. Examples may include financial, performance, compliance, system security and due diligence engagements.*

Options A, B and C are examples of consulting services. Consulting services are defined as *Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organisation's governance, risk management and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation and training.*

### **1.7 – B (study guide, section 22.2.2.)**

Internal audit findings may be positive or negative. All audit findings consist of at least two components, namely the criteria or standards that should be achieved and the true state of affairs. Negative findings have three additional components, namely the cause, effect and recommendations for rectifying the situation.

Option B is correct because the cause of a finding presents the factors that give rise to the problem that has been identified.

Options A, C and D are incorrect because they present the other elements of a finding.

### **1.8 – C (study guide, section 7.5)**

A performance objective is a clear statement of what an organisation, unit or activity wants to achieve. When we talk about a performance objective, we automatically include its measure and standard. You must be able to measure the performance objective's level of achievement. In addition you must be able to determine if the level of performance achieved, that is actual performance, meets or exceeds required performance as specified by the standard.

Option C is correct as being specific falls within the abovementioned definition.

Options A, B and D are not correct because it falls outside of the abovementioned definition.

### **1.9 – D (study guide, topic 1)**

Option D is correct as practice advisories are classified as strongly recommended guidance and not mandatory guidance.

Options A, B and C are mandatory guidance.

**1.10 – A (study guide, section 16.3)**

Option A is correct as governance controls are described as those controls mandated by, and controlled by, either the entire board of directors or a board committee in conjunction with the organisation's executive management. These controls are linked with the concepts of corporate governance, which are driven both by organisational goals and strategies and by outside bodies such as regulators. For example, the audit committee of the board does no auditing, but it does oversee both the internal and external auditing of the organisation.

Options B, C and D are not correct as these do not fit the definition of governance controls.

**QUESTION 2:**

(64 marks)

**Study unit 1 Answer to activity 1.1 (3 marks)**

Complying with the code of ethics is what distinguishes an auditor – a professional – from the general public. The code of ethics assumes trustworthiness. It assumes that the auditor is skilled and knowledgeable. When you, as an internal auditor, shed these qualities by failing to comply with the code of ethics, even if it only happens once, you will lose the trust of the people who rely on you to do your job. In future they will have no confidence in your ability to do your job properly.

**Study unit 1 Answer to activity 1.2 (3 marks)**

In your answer you need to mention the following principles of the code of ethics: integrity, objectivity, confidentiality and competence. You also need to discuss each of these concepts by explaining its meaning. You need to make a detailed study of the code of ethics.

**Study unit 2 Answer to activity 2.1 (3 marks)**

Correct alternative is (3): There is no violation of either the Code of Ethics or the Standards. See options (1) and (2). Option (1) is incorrect. The auditor is not withholding information because he or she has passed the information along to the CAE. The information may be useful in a subsequent audit in the marketing area. Option (2) is incorrect. The auditor has documented a red flag that may be important in a subsequent audit. This does not violate the Standards. Option (4) is incorrect. Option (3) is the only correct answer. This refers to the Code of Ethics, namely the objectivity rule of conduct.

**Study unit 2 Answer to activity 2.2 (3 marks)**

Correct alternative is (1): Proficiency in the application of the Standards is required. Option (2) is incorrect. An appreciation of, and not proficiency in, accounting and computerised information systems is required. Option (3) is incorrect. Proficiency in, not an understanding, of audit techniques is required. Option (4) is incorrect. Proficiency in, not a broad understanding of, accounting principles is required when auditing financial records.

**Comments**

These activities above are typical application of the theory in a practical situation. You will be requested to analyse a practical situation in which an ethical principal is questioned.

**Study unit 4 Answer to activity 4.1 (7 marks)**

Fraud auditing involves assisting management in creating an environment that encourages the detection and prevention of fraud in commercial transactions. This may involve helping to set the standard for the organisation by establishing an appropriate code of conduct and conflict-of-interest policy.

During a financial audit, an auditor looks for evidence relating to the reliability and integrity of financial information, the information that is normally intended to be used by management for internal decision-making purposes. Financial audits normally include both a review of the accuracy and completeness of the numbers themselves and an evaluation of the adequacy and effectiveness of the controls that management have implemented to safeguard assets.

**Comments**

This is a theoretical question and you will be able to find the information in the Studyguide.

**Study unit 6 Answer to activity 6.1 (18 marks)**

Reider's definition of performance auditing reads as follows: Operational auditing is an audit of operations performed from a management viewpoint to evaluate the economy, efficiency and effectiveness of any and all operations, limited only by management's desires.

The elements of this definition are as follows:

1. An audit of operations

Performance auditing can be carried out in all functional areas of an organisation, such as marketing, sales, production and human resources. Performance auditing concentrates on the evaluation of policy, procedures, division of authority, quality of



management, effectiveness of methods, special problems and other aspects of an organisation's operations.

## 2. From a management point of view

The principal focus of performance auditing is the achievement of management's objectives in the most economical, efficient and effective manner. For this reason it is important that a performance auditor should understand the way of thinking, objectives and concerns of top management in particular and focus on the aspects that are important to top management.

## 3. Evaluation of economy, efficiency and effectiveness

During an audit of economy and efficiency, the auditor looks at the optimum balance between costs and results. In an audit of effectiveness, the auditor determines whether an operation is fulfilling the purpose for which it was established.

## 4. Any and all operating systems within an organisation

A performance audit can focus on any component of an organisation, whether it is an operating unit, a functional area, a department or an activity within a department, where the audit objective amounts to reviewing the economy, efficiency and effectiveness with which management is achieving its goals.

## 5. Only the needs of management restrict the scope of operational auditing

As previously mentioned, performance auditing should focus on the aspects that are important to management. The freedom of the internal audit function to evaluate all the activities of an organisation should be incorporated in the internal audit mandate.

### Comments

This is a theoretical question and you will find the answer in the Studyguide.

### Study unit 7 Answer to activity 7.1 (10 marks)

Audit objectives for assessing the economic and efficient functioning of DWARF's mechanical plant

1. To determine whether the organisation's policy on purchases will ensure the most economical and effective utilisation of resources
2. To determine whether the stock holding is economical without jeopardising the effectiveness of the mechanical plant
3. To determine whether losses and waste in the mechanical plant are minimised
4. To determine whether the activities of the mechanical plant are grouped in logical, feasible processes or tasks

5. To determine whether document flow and provision of management information throughout the mechanical plant are efficient

### Comments

In this question you had to apply your theoretical knowledge about economy and efficiency and use that knowledge to formulate audit objectives. A general problem is that students formulate audit objectives that do not refer to the economy or efficiency component. For this question write down all the aspects that relate to economy and efficiency and then formulate an audit objective that relates to each of these aspects, taking into account the information provided in the question. For example, efficiency addresses the efficiency of documentation flow. An audit objective would be as follows:

“To determine (formulation of audit objective) whether document flow and the provision of management information (theoretical knowledge regarding efficiency) throughout the delivery department of DWARF (application to question) are optimised”

Note: No marks will be awarded if the audit objectives are not correctly formulated

### Study unit 7 Answer to activity 7.2 (5 marks)

The meaning of mission in the context of organisational performance and the relationship between mission and performance objectives

The mission of the organisation/department/activity is the reason for its existence gives expression to what the organisation/department/activity wants to achieve.

An organisation's mission can be seen as its primary performance objective. All the performance objectives must be achieved if the organisation wants to achieve its mission.

If a single performance objective is not achieved, the organisation's mission is not fully achieved either. If we compare the organisation's mission to a completed puzzle, then the puzzle pieces are the performance objectives and the puzzle will only be complete if all the pieces are in place.

### Comments

This question covers the theory of the mission statement and performance objectives of an organisation that is discussed in detail in your study guide. You had to start by explaining what a mission statement is and then link it to performance objectives. Ensure that you study all your theoretical work in detail!

**Study unit 7 Answer to activity 7.3 (12 marks)****Economy**

Interview senior staff members to determine whether the purchasing department gathers information on prices and suppliers on a frequent basis, in order to determine whether materials are purchased at the lowest prices.

1. Examine the procedures followed to determine whether purchasing conditions are agreed upon and followed in such a way that purchases fall within the budget, all possible discounts are obtained and payments are made on terms that are most beneficial to the organisation.
2. Reperform the calculation of minimum inventory levels and most economic purchase quantities to ensure that they are correctly calculated.
3. Confirm the accuracy, reliability and relevance of information used to determine minimum inventory levels and economic purchase quantities.

**Efficiency**

1. Through observation and discussion determine whether the correct number of people have been assigned to purchasing materials on behalf of the pencil plant to avoid causing unacceptable backlogs or idle time.
2. Evaluate whether it is efficient for the finance department to handle purchases on behalf of the pencil plant.
3. Obtain evidence that all information saved on computer is backed up as necessary, and that the computer system is properly maintained in order to ensure that the information on which order requisitions are based is accurate, and that these notices are processed on a regular basis.
4. Investigate the procedures followed as well as the time from the moment the notice for an order is printed on computer until the order is placed, and ensure that there are no unnecessary delays

**Effectiveness**

1. Ensure that meaningful, realistic and measurable objectives have been set for the pencil plant in respect of, for example, profit margins, output, manufacturing costs and productivity.
2. Evaluate the planning of the plant to ensure that it is directed at achieving these objectives.
3. Examine whether the criteria used to measure the achievement of the overall objectives, for example quality of output, output quantities, spoilage levels,

application of materials, direct costs, throughput manufacturing rate, are realistic and meaningful.

4. Evaluate the effectiveness of the pencil plant by measuring the performance of the plant in terms of the formulated objectives and criteria.

### Comments

In this question you had to apply the theoretical knowledge you have about economy, efficiency and effectiveness and use that knowledge to formulate audit procedures. A general problem is that students formulate audit procedures that do not refer to economy, efficiency or effectiveness. For this question write down all the aspects that relate to economy, efficiency or effectiveness and then formulate an audit procedure that relates to each of those aspects, taking into account the information provided in the question.

For example, effectiveness addresses the achievement of results. An audit procedure would be:

“To identify (formulation of audit procedure — can also use “to evaluate”, “to inspect” or “to identify”) factors that impeded the achievement of results (theoretical knowledge regarding effectiveness) throughout the manufacturing department of ABC Ltd (application to question)”

Note: No marks will be allocated if the audit procedures are not correctly formulated!

### QUESTION 3:

(25 marks)

- 3.1 List eight (8) warning signs given in the information that could have aroused suspicion that the warehouse manager was involved in fraudulent activities.

Reference: Study guide, study unit 13

Warning sign	Recommendation
No access controls and manager trusts employees fully.	Access cards should be issued to all employees and access should be monitored.
Major differences between inventories on hand and the system. No reconciliations are performed.	Monthly reconciliations should be performed on differences between inventories on hand and inventories noted on the system.
The warehouse manager could not provide reasons for the differences during the stock take. He was not concerned at all.	Reasons for all differences should be obtained and followed up on a monthly basis.
There are no policies and procedures in the warehouse.	Policies and procedures should be implemented to improve the controls of the warehouse.

Various vacant positions not filled.	All vacant positions should be advertised and filled as soon as possible.
No segregation of duties as the manager is performing all the main duties.	An organogram should be completed, all vacant positions should be completed and duties should be segregated between the employees.
The warehouse manager sells the geysers for cash and it is against the organisation's rules.	These cash transactions should be investigated and the necessary steps should be taken against the manager.
Changes in lifestyle of the warehouse manager.	These lifestyle changes should be investigated.
Warehouse manager does not take leave and go to the warehouse every weekend.	A leave policy should be implemented and management should ensure that all employees take their annual leave.

(1 mark for each warning sign listed and 1 mark for each valid recommendation.

Maximum of 16 marks)

### 3.2 Briefly describe the tasks of the internal auditor during a fraud investigation.

**Reference:** Study guide, study unit 13

- Looking for evidence supporting an identified irregularity.(1)
- Determining the particulars of the irregularity.(1)
- Quantifying the loss or scope of the problem and the period in which it took place, the method used and the people involved. (1)
- Acting as a gatherer of information. (1)

(Marks as indicated. Maximum 4 marks.)

### 3.3 The key principles for managing fraud risk.

**Reference:** Study guide, study unit 13

- A fraud risk management programme should be in place.
- Fraud risk exposures should be addressed periodically by the organisation.
- Prevention techniques should be established.
- Detection techniques should be established.
- A reporting process should be in place to ensure potential fraud is addressed appropriately.

(One mark for each principle listed. Maximum of 5 marks)