

AUI3701

October/November 2016

THE INTERNAL AUDIT PROCESS: PLANNING THE ENGAGEMENT

Duration 2 Hours

100 Marks

EXAMINERS

FIRST

MR BL SHABANGU

SECOND

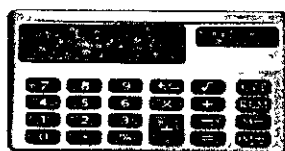
MRS BM VAN WYK

Use of a non-programmable pocket calculator is permissible

Closed book examination

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THIS PAPER CONSISTS OF **EIGHT (8)** PAGES

QUESTION	MAIN TOPIC	MARKS
1	Multiple-choice questions	15
2	Assurance and consulting services	20
3	Aspect of the business environment	19
4	Information systems auditing and controls	12
5	Planning, Risk, Standards, Fraud and audit objectives	<u>34</u>
		<u>100</u>

NOTE

Although the primary purpose of the examination is to test the candidate's knowledge and ability to apply the subject matter, the examiners will also take into consideration his or her ability to organise and present this knowledge in acceptable, written English

QUESTION 1

15 marks

REQUIRED

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

1.1 A

1.2 B

Each question counts 1 marks

- 1 1 Which of the following best describes the purpose of the internal audit activity?
- A To add value and improve an organisation's operations
 - B To assist management with the design and implementation of risk management and control systems
 - C To examine and evaluate the organisation's accounting system as a service to management
 - D To monitor the organisation's internal control system of the external auditor
- 1 2 During an engagement to evaluate the organisation's account payable function, an internal auditor plans to confirm balance with suppliers. What is the source of authority for such contact outside the organization?
- A Internal audit activity policies and procedures
 - B The standards
 - C The code of ethics
 - D The internal audit activity's charter
- 1 3 Independence permits internal auditors to render impartial and unbiased judgements. The best way to achieve independence is through
- A individual knowledge and skills.
 - B a dual-reporting relationship
 - C supervision within the organization
 - D organizational knowledge and skills

- 1 4 Internal auditors must be objective in performing their work. Assume that the chief audit executive received an annual bonus as part of that person's compensation package. The bonus may impair the CAE's objectivity if
- A the bonus is administered by the board of directors or its salary administration committee
 - B the bonus is based on monetary amount recovered or recommended future savings as a result of engagements
 - C the scope of internal auditing is evaluating controls rather than account balances
 - D all of the answers above
- 1 5 An internal auditor most likely will have conflict of interest by providing an assurance service with regard to a
- A financial activity in which the, internal auditor, had been a key employee 5 years previously.
 - B purchasing activity if a major supplier is owned by the internal auditor sister in law
 - C data processing center for which the internal auditor had performed the service three times previously
 - D computer system for which the internal auditor had been the internal audit activity representative on the design system
- 1 6 Due professional care calls for
- A detailed reviews of all transactions related to a particular function
 - B infallibility and extraordinary performance when the system of internal control is known to be weak
 - C consideration of the possibility of material irregularities during every engagement
 - D testing in sufficient details to give absolute assurance that noncompliance does not exist
- 1 7 Control by management is the result of
- A planning, organizing, and directing of organisational activities
 - B ascertaining needs, identifying alternatives courses of action, setting standards for measuring performance, and comparing outcomes with predetermined standards
 - C authorizing and monitoring performance, and comparing actual performance with planned performance
 - D determining efficiency and economy of operations, including whether objectives have been met

- 1 8 The purpose of internal audit activity's evaluation of the effectiveness of existing risk management process is to determine that
- A management has planned and designed so as to provide reasonable assurance of achieving objectives
 - B management directs processes so as to provide reasonable assurance of achieving objectives
 - C the organisation's objectives will be achieved efficiently and economically
 - D the organisation's objectives will be achieved in an accurate and timely manner and with minimal use of resources
- 1 9 Documentation required to plan an internal audit engagement include information that
- A resources needed to complete the engagement were considered
 - B planned engagement work will be completed on time
 - C intended engagement observations have been clearly identified
 - D internal audit activity resources are efficiently and effectively employed
- 1 10 Internal auditors must develop and document a plan for each engagement The planning process should include all of the following except
- A establishing engagement objectives and scope of work
 - B obtaining background information about the activities to be reviewed
 - C identifying sufficient information to achieve engagement objectives
 - D determining how, when, and to whom the engagement results will be communicated

QUESTION 2

20 marks

You are the new senior internal auditor at Question Two PTY (Ltd) The CAE has informed you that, the internal audit activity has been lacking in conducting consulting engagements in the past and that with your arrival, they are hoping to change that

Question Two PTY (Ltd) is a pharmaceutical company engaged in the formulation, manufacture and sale of medications derived from indigenous plants

REQUIRED

Marks

- 2.1 Give 3 (three) examples of each type of consulting engagement (9)
stated below
- Advisory consulting engagement
 - Educational consulting engagement
 - Facilitative consulting engagement
- 2.2 Explain how internal auditors could provide consulting services in (3)
support of the organization's risk management system

- 2.3** Provide steps in planning assurance activities **(8)**

QUESTION 3 **19 marks**

There is a premise in the public equity markets that investors will provide capital to organisations in exchange for the potential return on those investments. To install confidence in the capital markets, investor's needs to be provided assurance that the information they are provided with to evaluate the risks and the potential rewards for their investment is sufficient, reliable and accurate. The board of a company must understand this and focus on the needs of investors and potential investors. This is where corporate governance becomes applicable. The board has a fiduciary responsibility to the organisation's stakeholders. Companies are now under a lot of pressure from a number of their stakeholders to adhere to the King III report.

Corporate governance involves a set of relationships between board, management, the company's shareholders and other stakeholders. The board and management must set the tone for and promote integrity, ethical values and competence. They must also set the philosophy regarding risk management. Management must then ultimately ensure that key controls are in place to reduce risks associated with critical business objectives.

Internal auditors are expected to assess and make appropriate recommendations for improving the governance process. To perform effective assurance and consulting services, it is imperative that internal auditors have sufficient understanding of the organisation's objectives and operations.

REQUIRED		Marks
3.1	What are internal auditor's objectives in improving the governance process?	(4)
3.2	Briefly describe 6 (six) examples of activities that internal auditors should refrain from doing in order to safeguard against impairment of their objectivity and independence with regards to risk management	(6)
3.3	Describe the common examples of key controls	(9)

QUESTION 4 **12 marks**

Question Four PTY (Ltd) has a recently converted its payroll and purchasing cycle from a manual process to an online computer system. The process of conversion has not run smoothly with challenges both experienced during the conversion process itself as well as with the running of the system thereafter. What has transpired is that the application controls are inadequate and therefor the output of the system is mostly inaccurate. This has resulted

in the delays of operation as the information produced by the system has to be reviewed each time. The project manager of the conversion was the in house IT manager who has since left the organization.

At the time of the conversion the company was under financial constraints and short staffed hence could not hire sufficient officials. For that reason a lot of the officials had to perform more than one role. The IT manager had to act as the systems analyst, programmer and file librarian.

On enquiry with the CEO, the CEO admitted that the company had failed to implement certain IT Governance and management controls. This has resulted in the system not contributing to the achievement of objectives. The CEO is worried about the implications of a malfunctioning system.

Marks

REQUIRED

- 4.1** Briefly discuss **five (5)** IT standards that should be present to ensure that the IT systems are designed adequately and operate efficiently. **(10)**
- 4.2.** What do the IIA standard say about the proficiency of internal auditors when they have to audit IT systems. **(2)**

QUESTION 5

34 marks

- A** You are the internal auditor at Question Five PTY (Ltd). You are currently planning on conducting an internal audit at the company. The company is a manufacturing company and a subsidiary within an industrial conglomerate. The following information pertains to the company:
- 1 The financial director has been very evasive in answering questions, generally displaying a very dismissive attitude to the auditors.
 - 2 Some of the products manufactured by the company have not kept up with the market requirements.
 - 3 In prior years directors' annual bonuses were based upon earnings reflected in the audited annual financial statement. This policy has been abandoned and directors' monthly salaries have been increased.
 - 4 The company is contemplating retrenching its internal auditors in a cost cutting exercise, the holding company internal auditors will be available if required.
 - 5 Close to the end of the year a number of complex entries relating to asset revaluations were put through.
 - 6 For the six weeks prior to year-end, the credit controller was absent from work due to ill health. During the period a number of employees in the section took over his duties, e.g., authorizing credit terms, passing credit notes.
 - 7 Management is regarded by staff as being very dictatorial as certain members of management will frequently override controls. Some staff members have expressed the view that the holding company puts too much pressure on management to perform.

8 Numerous transactions take places with other companies within the group

REQUIRED **Marks**

- 5.1** What steps would you follow to schedule and prepare for an interview with the company's financial director **(5)**
- 5.2** Discuss the risks you would consider when planning to conduct an internal audit assignment on the financial statements of the company **(3)**

For questions 5.3, 5.4 5.5 and 5.6 do not consider the scenario given above.

Ballpen PTY (Ltd) is a company that recently got a big contract with the government to supply stationery. The company is looking to move into bigger office buildings and hire new people in order to be able to produce and supply more of its product. With new people coming, the company will require more office furniture and equipment. The company is situated in Pretoria central. To save cost the company prefers trading with other suppliers who are in and around Gauteng.

- 5.3** Identify the audit objectives for the audit assignment on the obtaining of tenders/ quotations activity in the purchasing process **(4)**
- 5.4** Which the questions should be considered by the internal auditors when evaluating the adequacy of process design **(4)**
- 5.5** Identify the parties who should be involved in a fraud risk assessment and state the role of each **(4)**

Below is an extract of annual financial statements of Question Five PTY (Ltd)

Account	Amount
Cash	10 000
Debtors	11 000
Short term investments	12 000
Current liabilities	32 000
Gross profit	15 000
Net profit	1 000
Turn over	25 000

- 5.6** Using the information above calculate the following ratio (round off your answer to the nearest second decimal place) **(8)**

- Current ratio
- Acid test ratio

- Gross profit ratio
- Net profit ratio
- Profitability ration

B Question Four Two (PTY) Ltd CEO asked you as the internal audit activity to conduct an operational safety audit of the production facility's metal drill press unit. More specifically, the internal audit function was asked to determine how well the metal drill press equipment and equipment operators comply with company safety policies.

Upon enquiry of the CEO by the CAE it was discovered that the company's safety policies include the following:

- Operators are required to wear safety glasses, ear plugs, and protective gloves.
- The drill presses are required to have a clear, plastic safety shield and protected channel to safely feed the metal through the press.
- The drill is operated by a knee switch. The operator engages and disengages the drill by shifting his or her right knee.

On further inspection by internal auditors it was discovered that the equipment was in relatively poor condition with little evidence of regular maintenance. Drill bits were not replaced as they became dull, and broken bits often were used because new bits were not kept in supply. Two of the 10 drill machines were missing safety shields. Five of the 10 machine operators were using protective ear plugs at the time of inspection of the plant and six were wearing safety glasses. Four of the knee switches were found to be sticking occasionally in both the off and on positions. The auditors perceived a general sense of negligence – negligence by production management, drill press equipment operators, and maintenance employees.

- 5.7 Based on the scenario presented above, state the possible internal audit engagement objectives (4)
- 5.8 What is meant by scope of the audit engagement? (2)