Tutorial Letter 202/1/2017

AUI3704

THE INTERNAL AUDIT PROCESS: MANAGATING THE INTERNAL AUDIT ACTIVITY

Semester 1

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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CONTENT

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: AUI3704

2 KEY TO ASSIGNMENT 02/2017 (FIRST SEMESTER)

QUESTION 1 20 marks

Violation of the code of ethics
References: Code of ethics
Study guide, study unit 1.2.2

a) The principle of integrity has been violated. (1) The rule of conduct states that internal auditors "shall observe the law and make disclosures expected by the law and the profession." (2) The auditor should have reported his finding to the correct channels. (1)

b) The principle of confidentiality has been violated. (1) The rule of conduct states that internal auditors "shall be prudent in the use and protection of information acquired in the course of their duties." (2) The CAE should not have discussed the observations and recommendations with another CAE and should not conduct such acts in the future. (1)

c) The principle of competency has been violated. (1) The rule of conduct states that internal auditors "shall only engage in those services for which they have the necessary knowledge, skills and experience." (2) The internal auditor should not have conducted the interrogation as he/she does not have the knowledge equivalent to that of a person whose primary responsibility is to detect and investigate fraud. He should not conduct such behaviour in the future. (1)

d) The principle of objectivity has been violated. (1) the rule of conduct states that internal auditors "shall not participate in any activity or relationship that may impair or be presumed to impair unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organisation." (1) The internal auditor should not have accepted the position and he should now resign from the position as it is a conflict of interest. (1)

e) The principle of objectivity has been violated. (1) The rule of conduct states that internal auditors "shall disclose all material facts known to them that, if not disclosed, may distort the reporting activities under review." (2) The internal auditor should report the director and disclose all the facts to the necessary channels. (1)

QUESTION 2 40 Marks

You are required to critically evaluate Bulle (Pty) Ltd's corporate governance and compliance with the requirements of King III based on the information

presented in the scenario.

References: King III

1. In terms of Principle 2.1 the board should act as the focal point for and custodian of corporate governance. This principle is not being adhered to. (1)

   By his own admission Hennie Meyer (the chairman) does not know too much about “that stuff” (corporate governance and King III). (1) As chairman of a large company he should. He should also be providing leadership to the board and ensuring its role as the focal point of corporate governance. (1)

2. It appears that the board has met only twice for the financial year 2016. (1) In terms of Principle 2.1 the board should meet preferably at least four times a year or as often as is required to fulfil its duties. (1)

   The duties of the board are diverse and far reaching and it is difficult to see how the board can meet its responsibilities meeting only twice a year. (1)

   Furthermore, this meeting lasted 1 hour and thirty-five minutes only. It is impossible to deal with strategic matters, operational performance, risk evaluation, stakeholder’s needs and expectations etc. in this short period of time. (1)

3. In terms of Principle 2.21 the board should be assisted by a competent company secretary. Victor Hatfield’s competency can be questioned. (1)

   The minutes of the meeting are poorly constructed and certain matters do not seem to have been dealt with e.g. confirmation of the prior meetings minutes, matters arising. (1)

4. In terms of Principle 2.14 the directors should act in the best interests of the company (1)

   Whilst there is no problem with Bulle (Pty) Ltd extending a contract with a non-executive director it is poor corporate governance for Akon Ndungane to have voted on the decision. He should have recused himself and not taken part in the consideration or approval of the contract. (1)

   Both the company secretary and the chairman should have been aware of these requirements. (1)

5. In terms of sound corporate governance, reports and documentation for meetings should be given to directors well in advance so that they can properly prepare themselves to make sound decisions. (1) A number of reports were tabled at the meeting and virtually no discussion appears to have ensued. (1)

6. In terms of principle 2.16 the board of Bulle (Pty) Ltd should elect (have elected) a chairman who is:

- an independent non-executive director and (1)
- the role of chairman should not be filled by the chief executive officer (1)

In this instance Hennie Meyer fills both roles. (1)

7. To compound this problem the deputy chairperson is also an executive director. This means that for any decisions for which the chairman is "conflicted" (not independent) there is no lead independent non-executive director to act as chairman. There are no independent directors. (1)

8. In terms of principle 2.18, the board should comprise a balance of power with a majority of non-executive directors, and the majority of the non-executive directors should be independent (1)

   There is no balance of power, executive directors are in the majority (five of eight directors) (1)

   There are no independent non-executive directors
   - Akon Ndungane is in a business relationship with Bulle (Pty) Ltd (1)
   - Barry Botha is the company's major supplier and (1)
   - Pieter Spies is a shareholder. (1)

   Therefore, all of them have a relationship with the company which would be seen to interfere with their capacity to act independently. (1)

9. In terms of principle 2.18 the board should have a suitable diversity of race and gender. (1) This does not appear to be the case, particularly with regard to gender – no females. (1)

10. The attendance of only one non-executive director at the meeting suggests that the other non-executive directors do not attach much importance to their roles. Attending two meetings is not very onerous and they have failed to fulfil their responsibilities. (1)

11. Although it is positive that there is an audit committee, it is not properly constituted which reduces its effectiveness. (1)

    All members should be independent non-executive directors – none of the members are (1)
    - Barry Botha is non-executive but not independent (1)
    - Wynand Nel is the chief financial officer (1)
    - Hennie Adams is not a director – he is the internal audit manager (he should report functionally to the audit committee, not be part of it). (1)

    It should be chaired by an independent non-executive director – and definitely not the financial director, Mr Wynand Nel. (1)

    With a financial director and internal audit manager on the committee, it would appear that collectively the audit committee has the necessary knowledge, but its total lack of independence negates this positive characteristic. (1)

12. A significant related issue is that the scope of work carried out by the internal audit department is determined by Wynand Nel, the financial director and chairman of the audit committee. The internal auditor carries out the assignment and then as a member of the audit committee evaluates his own report. (1)

13. In terms of Principle 7.1 the board should ensure that there is an effective risk based internal audit and audit plan (1)

    At present internal audit activities are compliance based – there is no mention of any risk based planning and limited to systems selected on a random basis determined by the financial director. (1)

14. Principle 4.1 requires that the board be responsible for the governance of risk and that an ongoing risk management policy and plan be implemented to identify risk, measure its potential outcome and activate what is necessary to manage the risk. (1)

    Based on the minutes, there is no evidence that there is a risk management process. With the board meeting only twice a year, it is reasonable to expect that there would be
    - a report from a risk committee (1)
    - discussion/report back on identifying and responding to risk (1)
    - some discussion on the sustainability of the company. (1)

15. Overall sound corporate governance and compliance with King III are severely lacking. As the only independent non-executive director, Mornè Olivier is unlikely to make much difference. (1)

(One mark per a valid point, maximum 40 marks)

QUESTION 3: (12 marks)

3.1 Briefly describe the steps that should be carried out in the risk management process?

References: Study guide, study unit 5.3

The following steps should be followed in the risk management process:

Determine the organisation’s objectives. (1)
Identify the risks that threaten the identified objectives. (1)
Carry out a risk assessment to identify the most important risks. (1)
Decide on a method to manage risks. (1)
Determine whether the chosen method did in fact mange the risk acceptably. (1)
If not, amend the plan. (1)

(One mark per a valid point, maximum 6 marks)

3.2 For each of the controls listed above, identify the risk that the control is mitigating.

References: Study guide, study unit 5.3

Risks identified are as follows:

a. Orders may not be acted upon timeously or at all, resulting in loss of sales and customer goodwill. (1)
b. Orders may be accepted from non-account holders who have not been vetted which could further result in bad debts. (1)
c. A sale can be made to a customer who is not creditworthy, i.e. will not pay resulting in bad debts.
d. Goods may be removed from inventory for fictitious/unauthorised sales. (1)
e. Incorrect items or quantities may be picked. (1)
f. Inaccurate and incomplete delivery notes may be made. (1)

(One mark per a valid point, maximum 6 marks)

QUESTION 4: (28 marks)

4.1 Differentiate between internal quality assessment and external quality assessment.

References: Study guide, study unit 17
Attribute Standard 1300

Internal quality assessments:
- are the ongoing monitoring of the performance of the internal audit activity. (1)
- are periodic reviewing to evaluate conformance with the Definition of Internal Auditing, the Code of Ethics and the Standards. (1)
- may be conducted by the internal audit activity itself or by members of staff within the organisation (1)

External quality assessments must be:
- conducted at least once every five years. (1)
- done by an independent reviewer, which means that there is no real or an apparent conflict of interest: the reviewer is not under the control of the organisation to which the internal audit activity belongs. (1)

(Marks as indicated, maximum 5 marks)

4.2 Describe the benefit of external quality assessments?

References: Study guide, study unit 17

Yes, there is benefits obtained from external quality assessments. (1)

An external quality assessment:

- is an objective independent appraisal of the quality of the internal audit activity's operations to determine effectiveness and efficiency in internal auditing. (1)
- provides data on evaluation whether there is compliance with the charter, plans, policies and procedures and legal requirements. (1)
- supplies information on the considerations of the organisation's expectations. (1)
- assesses the degree of integration of the internal audit activity into the fabric of the total organisation. (1)
- provides information on the tools and techniques employed by the internal auditing profession. (1)
- assesses the degree of value added to the organisation resulting from the internal audit activity. (1)
- supplies information on whether this service is rendered by professional staff whose work meets the criteria set by the standards. (1)
- makes recommendations for improvements. (1)

(Marks as indicated, maximum 7 marks)

4.3 Explain how and when you as the CAE can use the term "conforms with the International Standards for the Professional Practice of Internal Auditing" (IIA Standards)

Reference: Standard 1321

IIA Standard 1321 is applicable. (1) The chief audit executive may state that the internal audit activity conforms to the International Standards for the Professional Practice of Internal Auditing only if the results of the quality assurance and improvement program support this statement. (2)

(Marks as indicated, maximum 3 marks)

4.4 Define an internal audit charter and the purpose thereof

Reference: Standard 1000-1

The internal audit charter is a formal document that defines the internal audit activity's purpose authority and responsibility. (1)

The internal audit charter establishes the internal audit activity's position within the organisation, (1) including the nature of the chief audit executive's functional reporting with the board; (1) authorises access to records, personnel, and physical properties relevant to performance engagements; (1) and defines the scope of internal audit activities. (1) Final approval of the internal audit charter resides with the board. (1)

(Marks as indicated, maximum 5 marks)

4.5 Should the CAE outsource the audit to an external service provider? Provide full reasons in terms of the standards.

Reference: Standard 1200, 1210.A1

The CAE can outsource the audit if she complies with the standards as follows:

- Standard 1200 states: Engagements must be performed with proficiency and due professional care. (1)
- Standard 1210.A1 states: The CAE must obtain competent advice and assistance if the internal auditors lack the knowledge, skills or other competencies needed to perform all or part of the engagement. (1)
- Practice Advisory 1210.A1-1 states: Each member of the internal audit activity needs not be qualified in all disciplines. (1) The internal audit activity may use external service providers or internal resources that are qualified in disciplines such as accounting, auditing, economics, finance, statistics, information technology, engineering, taxation, law, environmental affairs, and other areas as needed to meet the internal audit activity's responsibilities. (1)
- Practice Advisory 1210.A1-1 states: An external service provider may be engaged by the board, senior management, or the chief audit executive (CAE). (1)
- The supervisor should still maintain control/supervision over the quality of the work. (1)

(Marks as indicated, maximum 5 marks)

4.6 Discuss the reasons according to the IIA Standards why audit engagements need to be properly supervised?

References: Study guide, study unit 16

Engagements should be supervised to ensure that:

- Objectives are achieved. (1)
- Quality is assured. (1)
- Staff are developed. (1)

(Marks as indicated, maximum 3 marks)