

# **Tutorial Letter 202/2/2017**

## **The Internal Audit Process: Managing the Internal Audit Activity**

### **AUI3704**

#### **Semester 2**

#### **Department of Auditing**

**IMPORTANT INFORMATION:**

**SUGGESTED SOLUTION TO ASSIGNMENT 02 OF 2017 FOR THE SECOND SEMESTER.**

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## SUGGESTED SOLUTION TO COMPULSORY ASSIGNMENT 02 OF 2017

This tutorial letter provides feedback on compulsory Assignment 02. You need to study the contents of this tutorial letter carefully because it will provide you with valuable insight and assist you with your examination preparation. The study references are provided to assist you. Therefore, please refer to them to obtain a better understanding of the suggested solution.

### QUESTION 1

25 marks

#### 2. Violation of the code of ethics

**References:** Code of ethics  
Study guide, study unit 1.2.2

- 2.1 Yes, the auditor is in violation of the code. (1) The principle that has been violated is objectivity (1) – an internal auditor should not accept anything which may impair professional judgement. (1) The internal auditor should not have accepted the weekend with his family as a gift as he will be auditing the hotel in the coming weeks. (1)
- 2.2 Yes, the auditor is in violation of the code. (1) The principle that has been violated is confidentiality (1) – an auditor must be prudent in the use and protection of information acquired. (1) The internal auditor should not have discussed the sensitive information with the human resource manager. The incident should have been appropriately reported as a red flag for fraud. (1)
- 2.3 Yes, the auditor is in violation of the code. (1) The principle that has been violated is competency (1) – an internal auditor should engage only in those services for which he or she have the necessary knowledge, skills and experience. (1) The chief audit executive should not have assigned the junior internal auditor to the audit and the junior internal auditor should have not accepted the audit. (1)
- 2.4 Yes, the auditor is in violation of the code. (1) The principle that has been violated is integrity (1) – an internal auditor should perform work with honesty, diligence and responsibility. (1) The internal auditor should have performed a detailed risk assessment to identify if there were any new key controls, with regard to credit purchases, before deciding on the tests to be performed. (1)
- 2.5 Yes, the auditor is in violation of the code. (1) The principle that has been violated is objectivity (1) – an internal auditor should not participate in any activity or relationship that may impair unbiased assessment or which is in conflict with the interests of the organisation. (1) The internal auditor should report his relationship with his brother-in-law who is heading the finance function and other auditors should be assigned to complete the audit.

(Marks as indicated, maximum of 15 marks)

**QUESTION 2****0 marks****Ignore this question****QUESTION 3****25 marks****3.1 Discuss the adequacy of the authority of the current internal audit activity**

**References:** Standard 1000  
 Practice advisory 1000-1  
 King III  
 Study guide, study unit 4.1.2

The authority given to the internal audit activity is inadequate (1)

The CAE and staff of the Internal Audit activity should be authorised for the following:

- Unrestricted access to all functions, records, property and personnel without any approval from the line manager. (1)
- Full and free access to the Audit Committee. (1)
- Ability to allocate resources, set frequencies, select subjects, determine scopes of work and apply the techniques required to accomplish audit objectives. (1) This is the responsibility of the Chief Audit Executive and the internal audit activity, not the Board. (1)
- Obtain the necessary assistance from personnel in production without the approval of the line manager. (1)

(Marks as indicated, maximum of 5 marks)

**3.2 Explain the requirements with regard to the supervision of junior internal auditors. Reference to the standards should be made.**

**References:** Standard 2340  
 Study guide, study unit 7.1

The two junior internal auditors should not complete the audit without supervision. (1)  
 According to Standard 2340 on engagement supervision: (1) "Engagements must be properly supervised to ensure objectives are achieved (1), quality is assured (1), and staff is developed." (1)

(Marks as indicated, maximum of 4 marks)

**3.3 Explain the different options available in establishing a structure for the internal audit department and identify the most suitable one.**

**References:** Study guide, study unit 3.2.2

The different options available to establish a structure for the internal audit department are as follows:

Full in-house internal audit section (1)

Co-source the function with the private sector where some of the work is contracted out.

(1)

Outsource the function to the private sector where the entire function is contracted out.

(1)

Share the function with another department, subject to approval by the relevant treasury.

(1)

The option that is best suited for the company is a co-sourced function as the additional resources will complement the existing resources. (1) The additional resources can be obtained at short notice without going through a whole recruitment process. (1)

(Marks as indicated, maximum of 5 marks)

**3.4 Explain how and when can you use the words “conforms with the International Standards for the Professional Practice of Internal Auditing”. Comment on the use of the statement by the current internal audit activity.**

**References:** Standard 2430

The internal audit activity may not use this statement in their reports. (1)

According to Standard 2430, Internal auditors may report that their engagements are “conducted in conformance with the International Standards for the Professional Practice of Internal Auditing”, only if the results of the quality assurance and improvement program support the statement. (2)

(Marks as indicated, maximum of 3 marks)

**3.5 Discuss the benefits that internal auditors and external auditors may receive from a co-ordinated effort.**

**References:** Standard 2050

Reding, p9-13

The internal and external auditors can both benefit from a co-ordinated effort. (1)

The following are the benefits for both respectively:

Benefits for external auditors

- External auditors gain a better insight into client operations in specialised areas in the organisation through the internal auditor’s experience in those areas (1)
- Client relations are improved because of a feeling of involvement through cooperation and coordination of effort. (1)
- External auditors are allowed to concentrate on more significant areas to rotate audit emphasis. (1)

Benefits for internal auditors

- The training of internal auditors is enhanced through an interchange of new and different audit techniques, procedures, ideas and information. (1)
- Areas of further internal audit work and procedures for accomplishing that work are identified. (1)
- Internal auditors gain a better understanding of independence, audit standards, and audit objectives and are encouraged to become more professional. (1)
- The external auditors’ appraisal of the effectiveness of internal audit functions can be helpful. (1)

(Marks as indicated, maximum of 8 marks)

**QUESTION 4****9 marks****4.1 Describe six (6) risks that may be attributed directly to the objective of the speedy delivery of goods requested by the manufacturing staff.**

**References:** Study guide, study unit 2.2  
King III / IV

The following procurement risks may be identified:

- Inferior raw material may be purchased when regular quality raw materials are not immediately available.  $\sqrt{1/2}$
- Raw materials may be purchased from an unapproved supplier who can deliver more quickly.  $\sqrt{1/2}$
- Excessive prices may be paid for raw materials to ensure fast delivery.  $\sqrt{1/2}$
- Unnecessary raw materials may be purchased simply to ensure that the procurement function can always supply the requested raw materials needed for manufacturing.  $\sqrt{1/2}$
- Buyers may make mistakes when placing orders because of the long hours they have to work.  $\sqrt{1/2}$
- Dissatisfied or demoralised staff can make more errors in their day-to-day execution of the job responsibilities when buying goods.  $\sqrt{1/2}$
- The requirement to speedily purchase raw materials could lead to staff buying raw materials in a manner that contravenes the existing policies and procedures.  $\sqrt{1/2}$
- The requirement to purchase raw materials rapidly can lead to the initiation of a purchase without considering whether adequate budgetary provision has been made for the purchase.  $\sqrt{1/2}$

(1½ marks for each appropriate risk, maximum of 9 marks)

**QUESTION 5****34 marks****5.1 Provide clarity with regard to the composition of the board in accordance with King III principles.**

**References:** King III / IV

The board should be composed so as to assure a balance of power and with a majority of non-executive directors. (1)

The majority of non-executive directors should be independent. (1)

(Marks as indicated, maximum of 2 marks)

**5.2 Describe the criteria that should be applied when selecting a director in accordance with King III principles.**

**References:** King III / IV

There are three dimensions that need to be considered, namely:

The knowledge and experience required to fill the gap on the board. (1)

The apparent integrity of the individual. (1)

The skills and capacity of the individual to discharge his duties to the board. (1)

(Marks as indicated, maximum of 2 marks)

**5.3 Is the practice of meeting for times a year in violation of the code?**

**References:** King III

This is not in violation of the code. The board is required to meet at least 4 times a year. (1)

(Marks as indicated, maximum of 1 marks)

**5.4 Discuss the appointment of the audit committee chairman in accordance with King III principles.**

**References:** King III

The audit committee should be chaired by an independent non-executive director. (1)

The board should appoint the chairman of the audit committee. (1)

(Marks as indicated, maximum of 2 marks)

**5.5 Indicate the steps with regard to the scope of risk management.**

**References:** King III

Study guide, study unit 2.2.3

The scope of risk management can be assessed by looking at key areas or dimensions and by carrying out the steps listed below:

Identify the risks or threats that affect the organisation's objectives adversely. (1)

Identify the context or level of importance of each risk for that organisation. (1)

Carry out a risk analysis that shows the potential impact on the organisation of all the risks identified.

Select the risk management objectives.

Choose risk management methods that will address the risk management objectives. (1)

(Marks as indicated, maximum of 5 marks)

**5.6 Discuss how risk management can be continually monitored.**

**References:** King III

Study guide, study unit 2.2.

The following monitoring measures should be performed:

- Measuring risk management performance against risk indicators; the risk indicators should be periodically reviewed for appropriateness. (1)
- Periodically measuring progress against, and deviation from, the risk management plan. (1)
- Monitoring changes in the external and internal environments; (1)

- Determining the impact of environment changes on the strategic risk profile of the company. (1)
- Ensuring that risk responses are effective and efficient in both design and operation. (1)
- Tracking the implementation of risk responses. (1)
- Analysing and learning lessons from changes, trends, successes, failures and events (including near-misses). (1)
- Identifying emerging risks. (1)

(Marks as indicated, maximum of 8 marks)

### 5.7 Discuss the objectives of a risk-based audit plan.

**References:** King III  
Study unit 2.2.4

The objectives of a risk-based internal audit are to provide independent assurance to the board that:

- The risk management process that management has put in place in the organisation is operating as intended. (1)
- These risk management processes are of sound design. (1)
- The responses that management has made to risk they wish to treat are both adequate and effective in reducing those risks to a level acceptable to the Board. (1)
- A sound framework of controls is in place to sufficiently mitigate those risks that management wishes to treat. (1)

(Marks as indicated, maximum of 4 marks)

### 5.8 Discuss the benefits of a combined assurance plan and if it is wise or not to have one.

**References:** King III  
Study guide, study unit 2.3

It is definitely a wise decision for a company to have a combined assurance plan. (1)

The benefits of combined assurance is as follows:

- Better understanding of the organisation's focus. (1)
- Reducing the likelihood of assurance risks "falling through the cracks". (1)
- Enhancing the control environment as well as awareness and discipline. (1)
- Better coordination between assurance providers. (1)
- Reducing assurance fatigue in business. (1)
- Controlling the regulatory environment instead of reacting to it. (1)
- Provides for an extensible information model that can handle the "next big initiative". (1)
- Better utilisation and deployment of assurance resources which could ultimately result in cost-savings. (1)

- Increased executive management and audit committee confidence – a single picture of assurance is formed. (1)

(Marks as indicated, maximum of 10 marks)

## **Conclusion**

It is important to review the feedback contained in this tutorial letter and compare it with your own answers.

You are welcome to contact us should you have any queries.

We wish you every success in your studies.