

# **Tutorial Letter 202/1/2018**

## **Internal Auditing: Theory & Principles**

**AUI2601**

### **Semester 1**

### **Department of Auditing**

This tutorial letter contains important information about your module.

Bar code

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## 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 results 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: AUI2601**

## 2 KEY TO ASSIGNMENT 02/2018 (FIRST SEMESTER)

Note the following in the comments below:

The **Standards** refers to the International Standards for the Professional Practice of Internal Auditing

**CAE** stands for the chief audit executive

**IAA** stands for the internal audit activity

Question	Correct answer	Study guide reference
1.1	3	Learning unit 15.4
1.2	1	Learning unit 3
1.3	3	Learning unit 14.4
1.4	2	Learning unit 13.3
1.5	3	Learning unit 1.2
1.6	3	Learning unit 5.1.3
1.7	2	Learning unit 12.3
1.8	4	Learning unit 15.4
1.9	4	Learning unit 7.2
1.10	1	Learning unit 4
1.11	1	Learning unit 7.2
1.12	2	Learning unit 6
1.13	1	Learning unit 13
1.14	2	Learning unit 7

(1½ marks per question)

**Question 2****30 Marks****2.1 Difference between external and internal auditing****Reference: Learning Unit 1.5**

Factor	Internal audit	External audit
Organisational structure	Internal audit can be an external contractor <b>or</b> an in-house function. (1)	External audit is an external contractor, never an employee of the company. (1)

<b>Factor</b>	<b>Internal audit</b>	<b>External audit</b>
Objectives	Internal audit forms an opinion on the adequacy and effectiveness of systems of risk management and internal control, many of which fall outside the main accounting systems. (1)	External audit seeks to provide an opinion on whether the accounts/financial statements present a true and fair view of the organisation. (1)
Audit coverage	Internal audit covers all the organisation's operations. (1)	External audit works primarily with those financial systems that have a bearing on the final accounts. (1)
Audit timeframe	Internal audit performs audits throughout the year. (1)	External audit tends to be a year-end process, even though some testing may be carried out during the year. (1)
Staff structure	Staff consists of Chief Audit Executive (CAE), seniors and managers, junior internal auditors. (1)	Staff consists of partners, managers, seniors and trainees. (1)
Staff	Competent persons trained in internal auditing. (1)	Qualified CAs and partly qualified accountants. (1)
Methodology	Risk-based audits – assurance and consulting services. (1)	Vouching and verification and some use of risk-based systems approach. (1)
Certification	Certified Internal Auditor (CIA) (1)	Chartered Accountant (CA) (1)
Membership affiliation	Institute of Internal Auditors (IIA) (1)	South African Institute of Chartered Accountants (SAICA) (1)
Legislation	Legally required in the public sector, encouraged in private sector. (1)	Legally required for all registered companies and the public sector (small companies may have exemptions). (1)

(1 mark each, maximum 12 marks)

## 2.2 Personal characteristics of an internal auditor

### Reference: Learning Unit 10

- Knowledge and competency
- Awareness of new developments

- Good human relations.
- Diligence and patience.
- Objectivity and confidence.
- Practical approach.
- Professionalism.
- Independence and sound judgement.
- Due professional care.
- Integrity.
- Pleasant personality

(½ mark each, maximum of 5 marks)

### 2.3 Internal auditing concepts

#### Reference: Learning Unit 13

(a) It is the uncertainty of an event occurring that could have an impact on the achievement of objectives. (1) Risk is measured in terms of consequences and likelihood. (1)

(b) 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. Management plans, organises and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved. (2)

(c) It is the process put in place by an organisation's top management to manage the organisation in the pursuit of its goals. In this way, the needs of all the stakeholders involved with that specific organisation are balanced. (2)

(Mark as indicated – Maximum 6 marks)

### 2.4 Internal auditors' assistance to management

#### Reference: Learning Unit 4.3.1

The internal audit activity can assist management in:

- **Monitoring activities top management cannot monitor itself.** (1) Every year the chief audit executive prepares a schedule of proposed audits that specify 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 are 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 state. (1)
- **Helping managers manage** – the internal auditors can generally find problems and suggest corrections. (1)

(Mark as indicated – Maximum 6 marks)

### Question 3

**13 Marks**

#### 3.1 Advantages and disadvantages reporting to audit committee

Reference: Learning Unit 4.2.1.

##### Advantages

- This level of reporting gives the internal audit activity a high degree of organisational independence and accessibility because it is reporting to a body with more authority than top executive management. (1)
- The majority of members in the audit committee are not involved in the operational matters of the company (executive functions). (1)

(Maximum 2 marks)

##### Disadvantages

- The audit committee does not meet frequently enough; the members do not have time to support the internal audit activity (IAA) on a day-to-day basis as an independent reporting facility. (1)
- Because of its function, the audit committee by its very nature is apart from the main stream business activities. As a result, the internal auditor does not always receive necessary information and directives which might enable him or her to function effectively. (1)

(Maximum 2 marks)

#### 3.2 Recommended reporting structure according to IIA Standards

Reference: Learning Unit 4.2. and IIA Standards 1110

To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship (Interpretation of Standards 1100 – Independence and Objectivity) (1) in which the CAE reports functionally to the Audit Committee (1) and administratively to the CEO. (1) Therefore **dual reporting** is advised for independence purposes. (1)

(Maximum 2 marks)

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

#### Reference: Learning Unit 16.5

- The chief audit executive should have the following dual-reporting responsibilities:
  - functionally to the audit committee (½), and
  - administratively to the chief executive officer. (½)
- 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)
- The audit committee should ensure that internal audit function has the necessary resources, budget, standing, authority within the company. (1)

(Maximum 7 marks)

#### Question 4

16 marks

#### 4.1 Classification of controls and audit procedures

##### References: Learning unit 13.4

Control activity	Type of control (1 mark)	Audit procedure (1½ marks)
1	Preventive control (1)	Obtain leave register from HR and check that for each person that has taken leave there is a leave form which was completed and signed off before the person could go on leave. (1½)
2	Detective control (1)	Obtain the copies of the reconciliation and check that they are signed off by the preparer (accounting clerk) and the reviewer (normally the supervisor) (1½)
3	Preventive control (1)	Review the IT policy of the company to check that computer users are required to use a password. Physically attempt logging-on to a computer to check if it will require a password. (1½)
4	Directive control (1)	Obtain the procedure manual and review it to determine that it is comprehensive to guide the activities of the finance department (1½)

## 4.2 Audit evidence

### References: Learning unit 14.4

**Physical evidence** – is obtained by directly observing people, property and events. It can take on the following forms: attendance at a physical stock count and at wage payouts. (1½)

**Oral evidence** – is gathered in the course of interviews or enquiries. Generally, this type of evidence must be supported by documentation or other evidence. (1½)

**Documentary evidence** – Documentary evidence comprises the documents of the auditee which relate to the auditee's business. This type of evidence may be internal or external. External documentary audit evidence originates outside the undertaking and includes letters or memoranda received by the auditee, suppliers' invoices, credit notes received, bank statements and packing sheets. Internal documentary evidence originates within the undertaking and includes sales invoices, paid cheques, credit notes issued and copies of outgoing correspondence. (1½)

**Evidence generated by the internal auditor** – This type of evidence is related to analysis and confirmation. The sources of such evidence are calculations, comparisons with imposed standards, completed operations, similar operations and the combining of information in context. (1½)

(Maximum 6 marks)

## Question 5

20 marks

### Scenarios permissible or not according to the IIA Code of Ethics

Reference: Learning 6

	Permissible/not permissible (1 mark)	Reference to IIA Code of Ethics (2 marks)	Reasons (1 mark)
5.1	Not permissible (1)	<b>Integrity</b> (1) Internal auditors shall observe the law and make disclosures expected by the law and the profession. (Rule of conduct 1.2) (1)	The internal auditor is legally bound to respond to a court order. The requirement not to use information in any manner detrimental to the legitimate and ethical objectives of the company does NOT override the legal obligation to respond to a court order. Therefore he/she has violated the IIA Code of Ethics. (1)

5.2	Not permissible (1)	<b>Competency (1)</b> 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)
5.3	Not permissible (1)	<b>Objectivity (1)</b> 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 organisation. (Rule of conduct 2.1) (1)	Auditing an activity for which his uncle is responsible may impair his unbiased assessment due to their relationship and would cause a conflict of interest. (1)
5.4	Permissible (1)	<b>Objectivity (1)</b> Shall 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)	Since the CAE believed that it was a finding that was unacceptable to the organisation and he had also discussed it with senior management with no resolution, he was correct in reporting it to the board. (1)
5.5	Not permissible (1)	<b>Competence (1)</b> Shall engage only in those services for which they have the necessary knowledge, skill and experience. (Rule of conduct 4.1) (1)	The internal auditor and the IAA collectively do not possess the required knowledge or experience to accept to perform the audit. This is therefore not allowed. (1)

(Maximum 20 marks)

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