

Tutorial Letter 103/3/2014

Internal Auditing: Theory and Principles

AUI2601

Semesters 1 and 2

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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“Success is sweet: the sweeter if long delayed and attained through manifold struggles and defeats.”

A. Branson Alcott

Please note / important notes:

1 BRIEFING

Dear Student

In this tutorial letter we provide you with solutions to the additional questions as well as the solutions to the simulated examination provided to you in Tutorial Letter 102/3/2014.

When comparing your solutions to our suggested solutions, please pay close attention to the layout of our solutions and the way in which marks have been allocated. This will be an indication to you of what we will expect of you in the examination.

Where necessary, we have included comments to provide further study guidance. You will only reap the full benefit from this tutorial letter if you first attempt to answer the questions yourself and then compare your answers to the suggested solutions. Doing this will enable you to identify the areas that are not clear in your mind so that you can either refer back to your study material, or contact your lecturer while you still have enough time to do so.

We trust that you will find these exercises both stimulating and instructive. Please do not hesitate to contact us should you encounter difficulties with any part of your studies in this module.

Regards

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2 KEY TO ADDITIONAL QUESTIONS

Topic 1: The definition of internal auditing

Study unit 1.1: Discussion of the definition of internal auditing

QUESTION 1

4 marks

1.1 The main and ancillary objectives of an internal audit

Reference: Study guide, section 1.1.3

The main objective of internal auditing is determined by the needs of the management of an organisation in order to assist them in the improvement of risk management, control and governance processes as well as the effective discharge of their responsibilities.(1) The internal auditor must ensure that these needs are satisfied by the internal audit report addressed to management.

The discovery of errors and fraud are ancillary objectives. (1)

1.2 The two main focus areas of an internal audit

Reference: Study guide, section 1.1.4

The first target area comprises the examination and appraisal of the managerial and operational aspects of an organisation (the consulting services). (1)

The second target area comprises the examination and appraisal of the record-keeping and control systems pertaining to the administrative and financial aspects of an organisation (the assurance services). (1)

Comment

It is important that you know the definition of internal auditing and the main objectives and focus areas. This forms the basis for the Standards and for how you practise internal auditing. This is theory and the only way to remember it, is to study it properly.

Study unit 1.2: The origin and development of internal auditing
QUESTION 2**19 marks****2.1 The main components in establishing the required body of knowledge for internal auditors****Reference:** Study guide, section 1.2.3

1. The identification of the most important disciplines of which internal auditors should have a thorough understanding.
2. The required levels of knowledge in each of these disciplines.

(1 mark each)**Comment**

The objectives and practice of internal auditing have been changing ever since its early beginning, which implies a corresponding development in the theoretical basis of internal auditing. It is necessary to know the two main components that will be the required body of knowledge for internal auditing, because they will be used as the basis for the development of the theory and knowledge for the discipline of internal auditing.

2.2 The development of the practice of internal auditing**Reference:** Study guide, section 1.2.1

Modern internal auditing evolved from an essentially accounting-oriented craft to a management-oriented profession.

Development in the USA

- **Turn of the century:** The company accountant and the external auditor were responsible for the accuracy of the accounting records and financial statements. (1)
- **The period 1900-1920:** Auditors of big concerns were able to justify higher costs for the implementation and maintenance of financial controls. The separation of planning and physical operations also contributed to the improvement of accounting controls. (1)
- **The period 1920-1929:** In addition to reporting on financial controls, the duties of the internal auditor were expanded to include the discovery of fraud and error. (1)
- **The period 1929-1940:** Greater emphasis was placed on the substantiation of the authorisation and accountability of each transaction to prevent the occurrence of fictitious transactions. This was the origin of internal accounting control. Over and above the

discovery of fraud and error, internal auditors had to ensure that every transaction was properly authorised, and correctly documented and accounted for, which meant a further expansion of their responsibilities. (1)

- **The post 1940 period:** Higher standards of business responsibility were set for company management by the public and shareholders. The involvement of company directors in management affairs increased, among others, through audit committees. (1)
- **Recent developments:** During the 1990s, the research foundation of the International Institute of Internal Auditors in the USA conducted extensive research into the functions and responsibilities of internal auditors as well as the knowledge they should possess. This research led to the most comprehensive report on the current nature and function of internal auditing. This report, published in 1999, is entitled *Competency framework for internal auditors* (CFIA) and consists of six volumes (984 pages). (1)

These research results brought about a drastic change of direction in internal auditing, since the emphasis shifted from reactive to proactive internal auditing. (1)

Two other important research reports were published during the 1990s and had an important influence on the practice of internal auditing. To sum up, we can say that the content of these reports shifted the emphasis away from the traditional internal control over the activities of an organisation to the full spectrum of components of control of an organisation, of which internal control over the financial activities of the organisation is only one. (1)

The first of these two reports was published in the USA in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), first in four volumes and then, in 1994, in two volumes. The second report, which took the COSO report further, was published in 1995 by the Criteria of Control Boards of the Canadian Institute of Chartered Accountants (the CoCo report). (2)

In both these reports and in the CFIA, significant emphasis is placed on the identification and evaluation of risk in an organisation. In the first volume of the COSO report, the five components of the control framework, namely, control environment, risk analysis, control activities, information and communication and monitoring are explained, while the evaluation tool which consists of three parts is described in the second volume:

- The first part of the tool gives the focal points of each of the five components of control, but does not provide any examples that describe the focal points.(1)
- The second part consists of a comprehensive reference manual in which the following particulars in respect of all activities of a generic organisation are given:
 - objectives
 - the main type of audit which is appropriate, namely, an operational, financial or compliance audit
 - relevant risks

- focal points for action or control activities. (1)
- The third part is the same as the first, but includes examples of descriptions of or comments on each focal point. (1)

These developments led two other researchers, David McNamee and Georges Selim, to the conclusion that the broad development of internal auditing practice has now moved into the third paradigm phase, namely, the **risk phase**.

This new paradigm rests on three main pillars:

- organisational objectives
- risks associated with the achievement of these objectives
- controls for managing these risks. (1)

The publication of the COSO and CoCo reports and the *Competency Framework for Internal Auditors* laid the foundation for the recent new approach in internal auditing practice, as well as for the new definition of internal auditing and the new framework for professional practice. (2)

Another important internal auditing technique, *control self-assessment*, emerged during this period and has already gained general acceptance. (1)

The most important reason why users of the control self-assessment technique attach great value to it is that it allows them to exercise better general control over the activities of an organisation, both for the management of the organisation and for the internal audit activity. (1)

Development in South Africa

Internal auditing practice in South Africa has had much the same history as the rest of the world. Although great emphasis is still placed on financial matters and records, the auditing of the efficiency and effectiveness of managerial activities is expanding rapidly. The King Report on Corporate Governance makes it a requirement for companies and entities adopting its recommendations to have internal audit activity. The new Companies Act 71 of 2008, although not explicit that companies should have an internal audit activity, implies that companies should be subjected to an internal audit process.

Internal audit is a requirement for public entities and companies that are listed on the JSE Securities Exchange. (2)

Comment

Common mistakes made by students in the past were to discuss the development of professionalism instead of the development of the practice of internal auditing, and to limit the discussion to the USA only. The question specifically required international and local developments. You must read the question and what is required properly to give the most comprehensive solution possible.

QUESTION 3**6 marks****The main characteristics of a profession**

Reference: Study guide, section 1.2.2

1. Specialised knowledge of a subject which should be acquired through formal training.
2. The rendering of a specialised service to society.
3. Admission to the profession must be subject to predefined standards governing professional qualifications and experience.
4. Society must accept and recognise the professional status of the profession, and the members of the profession must in turn acknowledge and recognise their social responsibility in the practice of their profession, that is, through their ethical code.
5. Minimum standards should be set for the behaviour of members of the profession towards clients, colleagues and the public in the practice of their profession.
6. Members must be organised in the context of an association which enjoys statutory recognition.
7. A common body of knowledge must be attached to the discipline and profession.

(1 mark each)

Comment

It is important that, as a future internal auditor, you realise that internal auditing is a profession on its own; and understand what defines a profession. This is a theoretical question.

Topic 2: The functional role of internal auditing**Study units 2.1& 2.2: Functions and roles of management and internal audit in the organisation****QUESTION 4****28 marks****4.1 The four functions of management in the organisation****Reference:** Study guide, section 2.1.2 – 2.1.5**1. Planning**

Planning takes into account the main purposes of the organisation and includes both short-term and long-range objectives. (1) It requires knowledge of, or research into, the technological aspects of the trade, the physical and mechanical aids available, and the operating methods, techniques or strategies. (1) This should be reconciled with the nature and objectives of the organisation, and with the formulated policy and staff situation (1) within the limits imposed by the capacity and marketing potential of the products manufactured or traded in, or the service rendered. (1) (Maximum 3 marks)

2. Organising

Organising involves

- the planned grouping together in units, sections or departments of related or reconcilable activities; (1)
- the establishment of a logical flow or trail of activities in which duties and responsibilities are both handed over and taken over at strategic cut-off points; (1) and
- ensuring an uncomplicated but effective achievement of the concern's objectives and compliance with the its policies (1)

Organising actually represents the plan or framework within which all activities must take place. (1) (Maximum 3 marks)

3. Directing

Directing or guidance represents

- communication of organisational or managerial policy to subordinates (especially heads of departments); (1)
- communication of goals and strategies either through procedural manuals, through staff meetings or through the establishment of guidance committees; (1) and
- motivation of staff so that they adhere to managerial policy (1)

(Maximum 3 marks)

4. Control

Control over all forms of delegated duties is not only a managerial aid, but is actually the achievement of efficient and successful management. (1)

Control is associated with

- adherence to managerial policy; ($\frac{1}{2}$)
- the utilisation of all physical, mechanical and supervisory resources; ($\frac{1}{2}$)
- compliance with planned procedures; ($\frac{1}{2}$)
- obeying the rules set for documentation and authorisation; ($\frac{1}{2}$)
- the delimitation of executive powers in the decentralised and delegated areas of authority; ($\frac{1}{2}$)
- the setting of minimum standards of compliance; ($\frac{1}{2}$)
- the measurement of results against expected standards; ($\frac{1}{2}$)
- introducing an efficient system of internal controls; ($\frac{1}{2}$) and
- efficient reporting on all activities ($\frac{1}{2}$)

Management's control functions endorse their involvement and responsibilities regarding the entire undertaking and all its business operations. (1)

(Maximum 3 marks)

(Total of 12 marks)

Comment

This answer is more comprehensive than necessary in order to guide you in your study process. You must ensure that you understand the question and what is required and give the relevant information in your answer. Always look at the marks allocated and ensure that your answer is comprehensive enough to obtain the maximum marks.

4.2 The place of the internal audit activity in the organisational plan of an organisation

Reference: Study guide, section 2.2.1

Standard 1110- Organisational independence

For the purpose of establishing the correct organisational status of the internal audit activity, it is important that the organisational plan of an entity is carefully constructed and that the position of the internal audit activity allows the internal auditors to be independent. (1)

The *Standards* describe how organisational independence should be established within the internal audit activity. (1) They require that the internal auditors enjoy the necessary access to and support from executive management to enable them to carry out their duties free from intervention and to obtain the cooperation of the auditees. (1)

Standard 1110 states that the chief audit executive must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. (1) The chief audit executive (CAE) reporting functionally to the board and administratively to the organisation's chief executive officer facilitates organisational independence. (1) The CAE should report to an individual with sufficient authority to promote independence and ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations. (1)

The internal audit activity should be independent of the activities audited and internal auditors should be objective in performing their work. The fact that internal auditors may be employees of the company does not, of itself, impair their objectivity. (2)

(6 marks)

4.3 The role of the internal auditor as an adviser to the members of the organisation

Reference: Study guide, section 2.2.2.1

As an adviser, the internal auditor examines and reviews the activities of the undertaking with a view to furnishing members of the organisation with advice, information and recommendations that will enable them to discharge their duties effectively.(1) As an adviser, the internal auditor must form an unbiased opinion. (1) As an adviser, he or she merely offers advice, gives information or makes recommendations; the ultimate decision therefore rests with top executive management. (1) The internal audit activity should never possess the organisational power to force top executive management to accept the audit results. (1)

(4 marks)

4.4 The internal audit activity as a control function

Reference: Study guide, section 2.2.2.2

The internal audit activity serves as a detective control in the system of internal control, in other words, it functions as a control over other controls. (1)

The scope of the task of the internal audit activity in an organisation includes the examination and evaluation, by the internal auditor, of the adequacy and effectiveness of risk management, control and governance processes, and the quality of performance in carrying out assigned responsibilities (*Practice Advisory 2100-2130*). (1)

In this capacity, the internal audit activity evaluates the general system of management control and the system of internal control, and keeps top executive management informed about the adequacy of the system. (1)

(3 marks)

4.5 Main factors that directly influence the organisational status of the internal audit activity

Reference: Study guide, section 2.2.1.1

The organisational status of the internal audit activity is directly influenced by the following two factors:

1. The level of responsibility conferred on the internal audit activity in the organisation, which naturally reflects the value management attaches to the work performed by the internal auditors. (1) This is an indication of the degree of acceptance by top management.(1)
2. The level of management to which the chief audit executive reports, which indicates the internal auditor's level of accessibility to top management.(1)

(3 marks)

Comment:

The above topics are discussed in sufficient detail in your study guide. Make sure that you work through the relevant study units and know the content for examination purposes.

Topic 3: Professional matters pertaining to internal auditing

Study unit 3.1: The profession practices framework of the internal auditing profession

QUESTION 5

15 marks

5.1 A professional person

Reference: Study guide, section 1.2.2

A professional person can be described as a person who, within his or her specific profession (under self-determined standards), for his or her own account, but based on service, makes his or her specialised knowledge and expertise available to his or her client on a basis that will be both acceptable and indispensable to his or her client and to society as a whole. (3)

Comment

This question requires you to explain in 'your own words'. Therefore your solution will be different to the solution provided here-in. Your solution should focus on the characteristics and attributes that make a person a 'professional person.' As a future internal auditor, you should ensure that your conduct is professional at all times.

5.2 Minimum standards of conduct as prescribed by the Code of Ethics of the Institute of Internal Auditors

Reference: Study guide, section 3.1.2

Rules of Conduct

1. Integrity

Internal auditors:

- 1.1. shall perform their work with honesty, diligence, and responsibility. (1)
- 1.2. shall observe the law and make disclosures expected by the law and the profession. (1)
- 1.3. shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization. (1)
- 1.4. shall respect and contribute to the legitimate and ethical objectives of the organization. (1)

2. Objectivity

Internal auditors:

- 2.1 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 organization. (1)
- 2.2 shall not accept anything that may impair or be presumed to impair their professional judgment. (1)
- 2.3 shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review. (1)

3. Confidentiality

Internal auditors:

- 3.1 shall be prudent in the use and protection of information acquired in the course of their duties. (1)
- 3.2 shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization. (1)

4. Competency

Internal auditors:

- 4.1 shall engage only in those services for which they have the necessary knowledge, skills, and experience. (1)

- 4.2 shall perform internal auditing services in accordance with the International Standards for the Professional Practice of Internal Auditing. (1)
- 4.3 shall continually improve their proficiency and the effectiveness and quality of their services. (1)

(12 marks)

Comment

This is a theoretical question. As a future internal auditor, you need to understand and abide to the code of Ethics. Therefore you should study this well and be able to apply it in practice.

QUESTION 6**12 marks****Explain whether each of the scenarios is permissible in terms of the Code of Ethics**

Reference: Study guide, section 3.1.2

- 6.1.** Internal auditors shall not accept anything of value from an employee, client, customer, supplier or business associate of their organisation which would impair or be presumed to impair their professional judgement. (Objectivity par 2.2) (1)

Internal auditors shall not be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organisation. (Integrity par 1.3) (1)

Thus: Not permissible. He should not accept the gift. (1) (3 marks)

- 6.2.** Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience. (Competency par 4.1) (1)

Internal auditors shall perform internal auditing services in accordance with the International Standards for the Professional Practice of Internal Auditing. (Competency par 4.2) (1)

Thus: Not permissible. Appoint a more senior member of staff to review and control the work done by Peter. (1) (3 marks)

- 6.3.** Internal auditors shall perform their work with honesty, diligence, and responsibility. (Integrity par 1.1) (1)

Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties. (Confidentiality par 3.1) (1)

Thus: Not permissible. Mr Bergire is guilty of misconduct. (1) (3 marks)

- 6.4.** Internal auditors shall observe the law and make disclosures expected by the law and the profession. (Integrity par 1.2) (1)

Internal auditors shall not knowingly engage in acts or activities which are discreditable to the profession of internal auditing or to their organisation. (Integrity par 1.3) (1)

Thus: Not acceptable. Cooperation between internal and external auditors should be promoted. (1) (3 marks)

Comment

*In a practical question like this, firstly reference should be made to the relevant Code of Ethics requirement. Secondly, the practical scenario should be applied to the Standard or Code of Ethics requirements. Finally, you should **conclude** whether the scenario complies with the Standards or Code of Ethics requirements. Therefore in a practical question like this, just giving the conclusion (even if it is the correct conclusion) will not earn you full marks; you need to provide an analysis.*

QUESTION 7

4 marks

Aspects to consider during the planning of the internal audit

Reference: Study guide, par 3.1.3

In planning the engagement, Dave should consider Standard 2201 – *Planning considerations*:

- The objectives of the activity being reviewed and the means by which the activity controls its performance. (1)
- The significant risks to the activity, its objectives, resources and operations, and the means by which the potential impact of risk is kept to an acceptable level. (1)
- The adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model. (1)
- The opportunities for making significant improvements to the activity's risk management and control processes. (1) (4 marks)

Comment

The questions in this topic demonstrated how you must know and understand the theory and apply it in practice. This module is your introduction to internal auditing. It is crucial for your second year and third year level modules that you know your Standards off by heart and how to apply them. You must be able to differentiate between managing the internal audit activity, which includes annual planning (standard 2000) and planning a specific audit engagement (standard 2200). Furthermore, you must know your code of ethics and be able to identify unethical conduct in a given scenario.

Topic 4: The qualifications and characteristics of an internal auditor**Study unit 4.1: The qualifications and characteristics of an internal auditor****QUESTION 8****12 marks****8.1 Personal characteristics of an internal auditor****Reference:** Study guide, section 4.1.2

- **Knowledge and competency:** (1) Thorough knowledge of management principles, financial and management accounting, information systems, experience in as great a variety of systems as possible, and complete competency in internal auditing. An internal auditor should be capable of handling any internal audit situation with confidence and assessing the relevant accountability correctly in the light of the prevailing economic and specific business conditions.
- **Awareness of new developments:** (1) An internal auditor should have insight into the technological influences on the applicable disciplines. He or she should also be interested to learn more about new developments or matters with which he or she is not proficient.
- **Good human relations:** (1) An internal auditor should have a pleasant personality, inspire confidence, speak convincingly and act with authority, be able to persuade others to cooperate, be tactful in his or her behaviour, and should enjoy the confidence of both management and his or her colleagues. He or she should therefore be able to maintain excellent human relations.
- **Diligence and patience:** (1) Internal auditors must be able to exercise patience. Repetitive and routine work, although monotonous, should not affect their vigilance and concentration. Whenever necessary, they should be capable of probing deeply into a matter and should never hesitate to ask questions regarding matters about which they are uncertain.
- **Objectivity and confidence:** (1) Internal auditors should have the courage of their convictions and should not hesitate to criticise justly or disclose the truth: they should also not yield to pressure. In other words, they should not hesitate to follow the path of duty in spite of possible conflicting interests. Their conviction, however, must always be supported by facts.
- **Practical approach:** (1) Internal auditors must be practical and should never allow theoretical knowledge, or possible theoretical schemes, to distort their practical judgment, experience or reasoning. They must be considerate towards the auditee and refrain from making demands which will disrupt their employer's business.
- **Professionalism:** (1) Internal auditors should always adhere to their high professional calling and the Code of Ethics which governs the profession, always acting sincerely, honestly and impartially.

- **Independence and sound judgement:** (1) Internal auditors must be completely independent in their external relations with management and the auditee. This requires internal auditors to be free from control and their professional judgement should not be subjected to that of others.
- **Due professional care:** (1) Internal auditors must be intelligent and proficient, and should always display reasonable care and skill. Caution is important at all times.
- **Integrity:** (1) Integrity has to do with uprightness and honesty. An internal auditor's integrity should never be in doubt.
- **Pleasant personality:** (1) It is essential for internal auditors to have a pleasant personality for this will enable them to gain people's confidence. They should be able to speak with authority, be persuasive and tactful, and be trusted by both management and their colleagues.

(1 mark for mentioning each personal characteristic, with a maximum of 12 marks)

Comment

This question asked you to list the personal characteristics of internal auditors. You were only required to list the words in bold in this solution. We added to the listed characteristics by describing how they fit into the practice of internal auditing to help you better understand the impact of these personal characteristics. Should the question have required you to explain or describe the characteristics, you would have to provide this discussion and you would be given additional marks for doing that.

8.2 The requirements for becoming a Certified Internal Auditor

Reference: Study guide, section 4.1.1

A person is entitled to the qualification of Certified Internal Auditor (CIA) when he or she meets the following requirements:

1. A bachelor's degree or equivalent three-year academic qualification with three years internal auditing (or relevant) experience, (1) or an honours degree or equivalent four-year academic qualification with two years internal auditing (or relevant) experience. (1) (Qualifications obtained outside the USA must be submitted to the Board of Regents for approval before the candidates may take the examination.) (1)
2. Good character. (1)
3. A pass mark in a four-part examination set by the International Institute of Internal Auditors. (1)
4. Set requirements for work experience. (1)

Comment

To obtain the required marks for the question, it is only necessary to list the requirements needed to be entitled to the different qualifications. You were not required to discuss the requirements regarding work experience.

Topic 5: The purpose, authority and responsibility of an internal auditor
Study unit 5.1: The powers, responsibilities and liabilities of an internal auditor
QUESTION 9**10 marks****9.1 The duties of an internal auditor towards his or her employer**

Reference: Study guide, section 5.1.1

As part of his or her contractual obligation as an employee, the internal auditor has an obligation towards his or her employer to act in good faith in the fulfilment of his or her duties. (1) The following duties are included in this concept:

The internal auditor

- may not use confidential information obtained in the performance of his or her duties for his or her own gain or impart such knowledge to third parties (1)
- should further the interests of his or her employer's business undertaking (1)
- may not perform acts of dishonesty (fraud, theft) against his or her employer (1)
- may not perform acts which are in competition with his or her employer (1)
- may not perform acts of misconduct while performing his or her duties (1)

(6 marks)**Comment**

This is a theoretical question. As a student or practitioner of Internal Audit, it is important to know and understand the duties of an internal auditor towards the employer. The answer to this question can be obtained from your study guide. Make sure that your answer is complete.

9.2 Definition of a charter

Reference: Study guide, section 5.1.1

A charter is a formal written document that defines the internal audit activity's purpose, authority and responsibility. (1) The charter should (a) establish the internal audit activity's position within the organisation; (1) (b) authorise access to records, personnel, and physical properties relevant to the performance of the engagement (1) and define the scope of internal audit activities. (1)

(4 marks)

Comment:

*This is a theoretical type question. A charter is an important document in internal audit practice. Hence students must be able to explain the **definition** and **elements** of a charter.*

QUESTION 10

25 marks

The powers of an internal auditor

Reference: Study guide, section 5.1.1

Basic powers provided for in the internal audit charter should include the following:

- **Access to the books, records, vouchers and accounts (1)**

The reason for including this power is that the internal auditor must at all times have all the information pertaining to the audit assignment at his or her disposal. This includes the element of surprise visits, because irregularities may be discovered in this manner. (3)

- **Obtaining information and explanations (1)**

It is virtually impossible for an internal auditor to possess all the relevant knowledge. Officials and/or management must therefore furnish the internal auditor with additional information and explanations should he or she require it. If the internal auditor is not satisfied with the explanations he or she receives, he or she should discretely mention this fact in his or her report. (3)

- **Attendance at meetings (1)**

The internal auditor needs to keep abreast of matters concerning planning and policies within the organisation so that he or she is able to perform his or her task. It is therefore necessary for the internal auditor to attend and make a contribution to policy making meetings or at least to receive copies of the minutes of such meetings, although this is not ideal. (3)

- **Believing trusted officials (1)**

The internal auditor is entitled to place reliance on any information supplied to him or her by trusted employees in the organisation. He or she must, however, exercise reasonable care and treat each case on its own merits before accepting as trustworthy all information given to him or her by employees. Should he or she come across anything suspicious, he or she should spare no effort to get to the bottom of the matter. (3)

- **Independence of the internal auditor (1)**

The internal auditor has to be independent of the personnel and the operational activities on which he or she reports to prevent any situation from questioning his or her integrity, findings and recommendations. He or she should also insist on being placed in a position to act independently.

Organisational status and objectivity are the primary means that internal auditors use to ensure their independence from the staff of the organisation as well as its normal business activities. (2)

Constraints

Management can impose constraints on the internal auditor regarding access to records, explanations, independence, and so on. Unlike the external auditor, the internal auditor has no legal recourse in this regard. It is therefore desirable that, where his or her powers are restricted by management, he or she should state in his or her report that the audit was completed within certain constraints, and explain how they affected his or her findings. He or she should, however, persevere in attempting to persuade management not to impose unnecessary constraints on him or her as these prevent him or her from carrying out his or her duties as efficiently as possible. (4)

Comment:

The above topics are dealt with properly in your study guide. Make sure that you work through the relevant study units and know the content thereof for examination purposes.

Study unit 5.2: The internal auditor's responsibility with regards to fraud

QUESTION 11

4 marks

Importance of internal control to management

Reference: Study guide, section 5.2.

- The primary responsibility for the safeguarding of assets and/or income, and for the

prevention of fraud and errors, rests with management. The maintenance of an adequate system of internal control is essential for the proper discharge of this responsibility. (2)

- The protection offered by an efficiently functioning system of internal control against human weaknesses is of the utmost importance. The possibility of fraud and errors being repeated over an extended period of time is decreased by the controlling actions inherent in a good system of internal control. It enables management to have greater reliance on the reliability of the data to be used in management decisions. (2)

Comment:

This is a theoretical question. In order to answer the question you must understand the relationship between Internal Controls and Fraud.

QUESTION 12

12 marks

12.1 Types of fraud company employees may commit

Reference: Study guide, section 5.2.1

- Acceptance of bribes or kickbacks. (1)
 - Diversion to an employee or outsider of a potentially profitable transaction that would normally generate profits for the organisation. (1)
 - Embezzlement, as typified by the misappropriation of money or property, and the falsification of financial records to cover up the act, thus making detection difficult.(1)
 - Intentional concealment or misrepresentation of events or data. (1)
 - Claims submitted for services or goods not actually provided to the organisation. (1)
- (5 marks)

12.2 The internal auditor's responsibility regarding prevention of fraud

Reference: Study guide, section 5.2.2

Internal auditors are responsible for assisting companies to prevent fraud by examining and evaluating the adequacy and effectiveness of their internal control systems commensurate with the extent of a potential exposure within the organisation.

In carrying out this responsibility, internal auditors should, for example, determine whether -

- the organisational environment fosters control consciousness (1)
- realistic organisational goals and objectives are set (1)
- written corporate policies (eg code of conduct) exist that describe prohibited activities and the action required whenever violations are discovered (1)
- appropriate authorisation policies for transactions are established and maintained (1)
- policies, practices, procedures, reports and other mechanisms are developed to monitor activities and safeguard assets, particularly in high-risk areas (1)

- communication channels provide management with adequate and reliable information (1)
- recommendations need to be made for the establishment or enhancement of cost-effective controls to help deter fraud (1)

(7 marks)

Comment:

In question 12.1 you have to illustrate your knowledge regarding fraud. Question 12.2 is a theoretical question. The internal auditor's responsibilities regarding fraud are noted in your study guide. When answering questions on the internal auditor's responsibilities regarding fraud, make sure you are giving the correct responsibilities as per the question.

QUESTION 13**11 marks****13.1 Possible consequences or fraudulent activities****Reference:** Study guide, section 5.2.1

- Using vehicles for unauthorised purposes.
- Using vehicles after working hours for personal use.
- Loss of vehicles due to theft.
- Loss in value of vehicles due to regular breakages (inadequate maintenance).
- Delays in delivering goods to customers.

(5 marks)

13.2 Minimum controls to prevent losses due to employee fraud**Reference:** Study guide, section 5.2.2

- Those responsible for the physical control of vehicles should not be responsible for approving or effecting payment for the maintenance of those assets.
- Those responsible for the custody of assets should not be responsible for maintaining the records of the assets.
- Those responsible for the security at the gate should not be responsible for entries into the log books.
- Those responsible for issuing cheques for expenses relating to vehicles should not also be responsible for reconciling the bank statement to the cashbook.

(1½ each, maximum 6 marks)

Comment:

Question 13 tests your ability to apply the theory on the prevention and detection of fraud, as given in the scenario, in a practical manner.

Topic 6: Internal auditing concepts
Study unit 6.1: Governance, risk management and control
QUESTION 14**14 marks****14.1 Definition of governance, risk management and control**

Reference: Study guide, par 6.1

- **Governance** is the process put in place by an organisation's top management to manage the organisation in the pursuit of its goals. (2)
- **Risk Management** is the management process used in any organisation to manage the risks that impact on the achievement of the organisation's objectives.(2)
- As defined by the Institute of Internal Auditors, **control** is 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. (2)

(6 marks)

14.2 The role of the internal audit activity in risk management with reference to the Gautrain project

- The most difficult part of the risk management process is to *identify* all the risks for the Gautrain project. Thus, during the evaluation process, the definition of internal auditing requires the internal auditor to use a systematic, disciplined approach during the evaluation of risk management. (1) The most critical task for the internal auditor is to ensure that the risk process did in fact identify all the appropriate risks. (1)
- The evaluation of the risk management process by the internal auditor will give management assurance on the success achieved in the risk management process and in the achievement of its goals. (1)
- In doing this, the internal auditor will add value to the Gautrain project as a whole and facilitate the process of continuous improvement by highlighting any deviations from, or shortcomings in, the risk management process, and recommending improvements to the process where appropriate. (2)
- The internal audit activity allows an entity to understand the extent to which potential events might affect objectives. (1)
- It assesses risks from two perspectives:

- Likelihood (1)
- Impact (1)

All risks that face the Gautrain project and that may stop it from meeting or exceeding stakeholders' expectations should be evaluated. (1)

(8 marks)

Comment:

This question, dealing with risk management, is a question that tests your application of theoretical knowledge and the answer was not taken straight from the study guide. You must know the standard as well as the practice advisory to be able to answer this question. You must be able to apply the theoretical knowledge in a practical manner, based on a given scenario.

QUESTION 15

12 marks

Preventative and detective controls to ensure effective and efficient vehicle maintenance and security

Reference: Study guide, section 6.1.4

Preventative

- Locks on gates/fences
- Dogs
- Lighting
- Maintenance schedules for services
- Sign for keys/use of vehicles
- Regular inspections/services
- Gear locks and alarm systems in vehicles

Detective

- Surveillance cameras on site (could also be preventative)
- Alarms
- Logbooks
- Maintenance records

- Delivery reports
- Surveillance via satellite/radio

(1 mark each, with a maximum of 12 marks)

Comment

Note that you were required to “suggest” controls which is similar to “mention” or “list”. No explanation is therefore required. Should you be required to “describe” or “explain” the controls, however, you would have to elaborate on each control.

Topic 7: The Internal audit process

Study unit 7.1: The internal audit process

QUESTION 16

6 marks

16.1 Materiality

Reference: Study guide, section 6.1

Materiality involves the importance/value/influence (1) that a transaction or group of transactions jointly or an operating activity or group of activities jointly or an error or group of errors, (1) of whatever nature, could have on the decision or opinion of the internal auditor in exercising his or her responsibilities. (1) (3 marks)

16.2 Standards with which audit evidence must comply to be acceptable

Reference: Study guide, section 7.1.4, phase 3
Standard 2310 – Identifying information

The sufficiency, reliability, appropriateness and relevance of audit evidence (1) will depend on the nature, timing and scope of the internal audit procedures that are being applied. (1) All audit evidence should be able to pass the test in respect of sufficiency, usefulness, reliability and relevance at all times. (1) (3 marks)

Comment:

Questions 16.1 and 16.2 are theoretical question that test your knowledge on materiality and the Standards relevant to audit evidence.

QUESTION 17**24 marks****17.1 Internal audit procedures****Reference:** Study guide, section 7.1.4

Internal audit procedures are the techniques (1) employed to achieve the set internal audit objectives of every audit. (1) (2 marks)

17.2 Internal audit procedures, observing, questioning and verification**Reference:** Study guide, section 7.1.4

- **Observing**

To the internal auditor, observing means seeing or noticing. It implies taking a careful and knowledgeable look at people's activities and actions in order to obtain information that the internal auditor requires to perform his or her task.

Observing is a valuable procedure which is used in virtually every assignment and which requires a high degree of skill. Observations are sometimes carried out in a subtle and inconspicuous manner. Information obtained in this way is very valuable because the auditee is often unaware that he or she is under observation and therefore does not behave or carry out procedures aimed purely at satisfying the internal auditor. (2)

Examples of how observation can be used to verify inventory:

- Observe and note areas where high-value items are stored.
- Observe inventories that may be troublesome, such as those types which are difficult to count.
- Observe whether the count is being done competently, conscientiously and in accordance with instructions.
- Observe whether the tags or count sheets are being properly written up.
- Observe whether any deterioration of inventory overlooked at prior sorting is noted by the counter and recorder.
- Observe whether the procedure of checking the count is proceeding according to instruction.
- Observe the manner in which the inventory count is completed
 - to ascertain whether instructions in this regard are properly implemented
 - to witness the return of tags or count sheets to the responsible official
 - to note whether all tags or count sheets are accounted for by checking (or testing) the sequence of tags or count sheets returned (used, spoilt and unused) with the record of those issued

(1 mark each, maximum 2 marks)

- **Questioning**

Questioning is probably the most pervasive technique used by the internal auditor to gather information in the performance of his or her task. Questioning is carried out throughout the audit and may be verbal or written.

Verbal questions are continually asked. To obtain the facts and to do so without upsetting the auditee is sometimes not an easy task. Questions must be phrased in such a manner that they do not sound like a cross-examination, but merely like an attempt to obtain information. (2)

Examples:

Ask management to describe the procedures laid down for testing the inventory records. Ask the storeman how he identifies slow-moving or obsolete inventory items during the inventory count.

(1 mark each, maximum 2 marks)

- **Verification/audit of balances**

Verification consists of checking, examining and/or obtaining satisfactory evidence that all the organisation's assets and liabilities that are, or should be, shown on the balance sheet

(1) do exist

(2) are in fact the property or liability of the undertaking

(3) are shown at a fair valuation

(4) are all disclosed in conformity with generally accepted accounting principles and/or specific legal requirements

It is necessary for internal auditors to satisfy themselves of the preceding facts in respect of every item separately and of the balance sheet as a whole. (3)

Examples:

- Scrutinise sufficient relevant inventory records to be satisfied that required adjustments have been made.
- Note the cut-off point and trace some of the receipts and issues just before and after cut-off, per relevant documents, to the entries on the inventory records to ensure that the dates compare.
- Conduct test counts of items and ensure that the quantities concur with the balances on the relevant inventory records; investigate and clear any differences.

(2)

(Maximum 12 marks)

Comment:

The question also required you to explain each audit procedure, that is, how each procedure can be applied in an inventory count. Always be on the lookout for questions with dual instructions, such as this one, and make sure that you answer all questions completely.

17.3 Audit evidence

Reference: Study guide, section 7.1.4

Audit evidence involves all forms of information which the internal auditor considers necessary in order to achieve his or her audit objective. (1)

Evidence has a wide-ranging and important function in the internal audit process. (1)

The basic task of the internal auditor is to obtain sufficient acceptable audit evidence to enable him or her to carry out his or her responsibilities as efficiently as possible. (1)

There are numerous kinds of audit evidence, (1) all of which are likely to be used at some stage of the audit. Various audit objectives require various kinds of audit evidence or a combination of different kinds of audit evidence. (1) The most common kinds of evidence are physical evidence, oral evidence, documentary evidence and evidence generated by the internal auditor. (2)

Audit evidence must be sufficient, reliable, relevant and useful. (2)

(Marks as indicated with a maximum of 9 marks)

Comment:

The question is a theoretical question that tests your knowledge on the topic of audit evidence. When explaining audit evidence, be as comprehensive as possible (listing the definition, characteristics and kinds of audit evidence).

17.4 Steps to follow in planning the audit of inventory as requested by management

Reference: Study guide, section 7.1.4

- (1) Obtain background information of the audit area. (preliminary survey)
- (2) Identify the audit objective(s) to be achieved.
- (3) Consider the audit risk.
- (4) Decide on the audit approach.

(5) Determine the allocation of engagement resources.

(6) Compile the detailed audit programme.

(1 mark each, maximum 6 marks)

Comment:

The above topics are dealt with properly in your study guide. Make sure that you work through the relevant study units and know the content thereof for examination purposes.

Topic 8: The Internal audit procedures and tools

Study unit 8.1: The internal audit procedures and tools

QUESTION 18

13 marks

18.1 Objectives/benefits of audit working papers

Reference: Study guide, section 8.1.4
Practice Advisory 2330-1

Working papers that document the engagement should be prepared by the internal auditor and reviewed by the management of the internal audit activity. (1) The working papers should record the information obtained and the analyses made, and should support the bases for the observations and recommendations to be reported. (1) Engagement working papers generally:

- Aid in the planning, performance and review of engagements. (1)
- Provide the principal support for the engagement results. (1)
- Document whether the engagement objectives were achieved. (1)
- Support the accuracy and completeness of the work performed. (1)
- Provide a basis for evaluating the internal audit activity's quality assurance and improvement program. (1)
- Facilitate third-party reviews. (1)

(Mark as indicated with a maximum of 8 marks)

18.2 Internal auditing aids

Reference: Study guide, section 8.1.1

Auditing aids are simply auditing instruments which the internal auditor uses while carrying out the audit procedures. (1) They are not in themselves audit procedures. (1) Although they form an

integral part of the audit, they merely aid in establishing the content of the audit opinion or conclusion. (1)

Examples:

- Audit marks
- Audit working papers
- Audit testing or sampling

(1 mark each, limited to 2 marks)

(Total of 5 marks)

Comment:

The above topics are dealt with properly in your study guide. Make sure that you work through the relevant study units and know the content thereof for examination purposes.

QUESTION 19

10 marks

19.1 Audit marks

Reference: Study guide, section 8.1.2

The internal auditor does not make entries in the books of account, but checks, looks over or audits transactions which have already been recorded in the books of account.(1) As in the recording process, the internal auditor also experiences a need to utilise a visible sign to signify the completion of a particular audit function or procedure regarding a specific recorded fact. (1) A distinctive audit mark or tick is therefore placed against every examined entry (in front of, after, under or above) to signify performance of a particular procedure, (1) like routine checking (with its components of casting, transfer, extension, balances carried forward and brought down, etcetera), and vouching and verification. (1) The reason for having different positions for the placing of the marks is simply that one and the same entry may be subjected to more than one procedure or examination function. (1)

(Mark as indicated with a maximum of 3 marks)

Comment:

Remember to state that audit marks are visible signs or distinctive marks or ticks placed against every examined entry. If you do not mention this in your answer, you will lose one mark.

19.2 The purpose and requirements of audit testing or sampling

Reference: Study guide, section 8.1.3

- **Purpose**

Sampling or testing (which is merely an audit tool, not a procedure in itself) is applied for the purposes of

- (1) arriving at an audit opinion rapidly and without delay (1)
- (2) arriving at conclusions on whether the population should be accepted or rejected (1)
- (3) making sure that the conclusions regarding the financial and/or other records are accurate (1)
- (4) using the sampling conclusions as the basis for the reasonableness of the audit opinion, that is, testing the strength of the theory of probability (1)

(Maximum 4 marks)

- **Requirements**

Every sample must comply with the following three requirements:

- (1) It must be adequate, that is, it must contain a sufficient number of items to reveal similar results if other samples of the same size are selected from the same population. (1)
- (2) It must be representative, that is, reveal characteristics similar to all the data in the particular population. (1)
- (3) It must be stable, that is, the results of the sample must remain unchanged even if the sample size is increased. (1)

(Maximum 3 marks)

(Total of 7 marks)

Comment:

*Note that it is important to describe both the **purpose** and the **requirements** of audit testing or sampling to obtain the full marks. This is another example of a question containing dual requirements. You have to discuss both aspects in order to obtain good marks.*

Topic 9: The relationship between internal auditing and related disciplines

Study unit 9.1: The relationship between internal auditing and related disciplines

QUESTION 20

16 marks

20.1 Factors leading to a poor relationship between internal and external auditors

Reference: Study guide, section 9.1.3

- Lack of initiative on the part of both parties.
- Failure on the part of the external auditor to acknowledge the role and experience of the internal auditor.
- The opinion of certain external auditors that internal auditors are not capable and well trained.
- Uncertainty regarding the extent to which external auditors can rely on the work of internal auditors.
- The policy of using internal audit personnel in assisting the external auditor can disrupt the smooth implementation of the internal audit department's own work programme, which is of a continuous and management-orientated nature and is not aimed at year-end audits. This may result in the rescheduling of internal audit planning to make personnel available to the external auditor.
- Internal auditors are perhaps not motivated to help external auditors. They may feel that they are being used as "second-class" auditors performing work beyond their actual work environment that the external auditor does not want to do himself or herself.
- No or insufficient communication between the two parties.

(1 mark each, maximum 7 marks)

20.2 Actions that could be conducive to good cooperation and coordination between the external and internal auditors

Reference: Study guide, section 9.1.3

- A uniform evaluation methodology, that is, both groups of auditors would use similar auditing procedures and standardised audit working papers in the performance of the financial audit processes.
- Direct support in that working papers and audit personnel are at each other's disposal. External auditors, specifically, will not be inclined to release their working papers in order to assist the internal auditors, because of considerations of confidentiality. Furthermore, it is doubtful whether internal and external auditors would agree to work under each other's authority.
- Joint training programmes and/or participation in each other's training programmes.

These actions are only useful if they occur selectively and deal mainly with matters of mutual interest.

- Exchange of audit reports on matters of mutual interest, and the follow-up of suggestions and recommendations by the other party.
- The sharing of responsibilities in that internal auditors accept responsibility for tasks delegated to them by the external auditors; teamwork in performing certain tasks, and supportive presentations to company officials and management.
- The evaluation by internal and external auditors of the effectiveness of each other's work and the reporting on this to management. External auditors have an interest in the effectiveness with which the internal audit activity is performed, because it falls within the normal scope of their responsibility to report to management on the effectiveness of the internal control system as a whole. Although internal auditors do not have a similar responsibility, a sound and objective evaluation of each other's effectiveness may serve as an incentive to improve the quality of both the internal and external audit functions.
- Planning could be undertaken by the two groups with each other's audit plans at their disposal, and joint audit plans could be developed. The reciprocal availability of audit plans should, however, not enjoy high priority, in the light of the need of the external auditor to maintain the element of surprise and objectivity, which is in keeping with external auditing. It is, however, necessary to develop a joint audit plan in respect of those areas in which the external auditor intends to use the services of the internal auditor.
- Periodic meetings where aspects of mutual interest regarding their audit responsibilities are discussed.
- A professional attitude towards each other and mutual respect for each other's professional responsibilities.

(1 mark each, maximum 9 marks)

Comment:

The above topics are discussed in detail in your study guide. Make sure that you work through the relevant study units and know the content thereof for examination purposes.

QUESTION 21

10 marks

21.1 Relationship between internal auditing and general management

Reference: Study guide, section 9.1.1

In order to perform their duties professionally, internal auditors should use the principles of efficient management of an organisation as their point of departure and frame of reference when evaluating the efficiency of the organisation's management. (1)

Any evaluation process requires us to compare the actual state of affairs or expected developments to relevant standards and practices. (1) This implies that internal auditors should use the same approach in their evaluations as would managers at all levels of the enterprise. (1)

The achievement of suitable standards of economy, efficiency and effectiveness should be the goal of all managers if they want to discharge their responsibilities towards their organisations to the best of their ability. (1) The relationship between general management and internal auditing is a close one; the two disciplines are to all intents and purposes inseparably intertwined because managers and internal auditors are largely required to think in the same way. (1)

This means that the internal auditor should evaluate every normal management function of an organisation into its component elements and evaluate them against generally accepted management practices. (1)

(Marks as indicated with a maximum of 6 marks)

Comment:

Students sometimes fail to give enough detail to obtain the full marks. Make sure that your answer covers all the aspects contained in the suggested solution and that you will be able to answer a similar question in the examination.

21.2 Relationship between internal auditing and financial and management accounting

Reference: Study guide, section 9.1.2

To be able to evaluate (audit), the auditor must know the techniques, procedures, principles and practices of accounting. (1) He or she must firstly have the knowledge and skills of an accountant before he or she can act as auditor, but the accountant/ management accountant does not necessarily have to possess the knowledge and skills of an auditor. (1)

Accounting is a creative process and auditing is a critical process. (1)

Accounting information is measurable by criteria such as adequacy, understandability, the ability to be substantiated, neutrality, timeliness, comparability and completeness. (1)

Independence and objectivity are the most important attributes of the audit function (internal and external), because conflict of interest between the compiler and the user drives the need for an audit. (1) Conflict of interest can cause misrepresentation as a result of partiality.

Accounting information must be capable of being substantiated before it can be subjected to an audit. (1)

(Marks as indicated with a maximum of 4 marks)

Comment:

*Remember to discuss the relationship **between** internal auditing and financial and management accounting and **not** the similarities.*

QUESTION 22**16 marks****The effect of cooperation between the internal and external auditors on the interrelationship between the two disciplines**

Reference: Study guide, section 9.1.3

- **Mutual confidence**

Because both groups share certain objectives and certain areas of work, (1) it is in both their interests to promote a cooperative relationship in order to render a more cost-effective and efficient service. (1)

In their attempts to promote better relations, the parties must bear the following in mind:

- (1) Their interaction must have as its object the optimum utilisation of audit aids. (1)
- (2) The role and responsibilities of both groups of auditors differ substantially, because internal auditors report to management and external auditors to the owners. (1)
- (3) The external auditor may decide not to disclose certain suspicious or confidential matters to the internal auditor. (1) (5 marks)

- **Nature and advantages of a good relationship**

The relationship between the external auditor and the internal auditor must promote interaction which is necessary to ensure economical auditing. (1)

A good relationship between the external and internal auditors will result in the following three advantages for the parties and the undertaking concerned:

- Firstly, it creates an opportunity for interaction which is advantageous to the external auditor, the internal auditor and the undertaking, because time and money are saved in this way. (1)
- Secondly, the external auditor can reduce the extent of his or her audit procedures and audit tests if he or she intends to rely on the work of the internal auditor. (1)
- Thirdly, it gives the internal auditor the assurance that an independent person is evaluating the internal audit activity and that he or she will provide objective recommendations. (1) This review by the external auditor enables the internal auditor to evaluate the results obtained in the past by the internal audit activity, and the review can also serve as a guideline for future action and improvements. (1)

(4 marks)

• **Limitations and dangers in connection with the work of the internal auditor**

The results of the external auditor's evaluation of the efficiency of the internal audit activity, the factors concerning the materiality of the areas or items which are to be audited, the audit risk involved and the level of judgment required of him or her will all directly influence the degree to which he or she will make use of the internal auditor's services in his or her evaluations. (1) However, before relying on the work of the internal auditor, the external auditor should consider certain restrictions and dangers which exist. (1)

These restrictions and dangers can be summarised as follows:

- (1) The employer/employee relationship places restrictions on the objectivity and independence of the internal auditors, because they are responsible to management and this determines the objectives and scope of the internal audit activity. (1)
- (2) External auditors are primarily concerned with the fairness of the financial statements and their tests must be performed in accordance with generally accepted auditing standards. (1) Internal auditors, on the other hand, are primarily concerned with the wider concept of operational or managerial effectiveness. (1)
- (3) The external auditor cannot delegate responsibility for his or her professional opinion. (1) He or she must not rely excessively on the internal audit activity, regardless of its quality and scope. (1) If the internal auditor becomes too closely involved, the external auditor's insight and judgment could be detrimentally affected. (1)
- (4) The decision to make use of internal audit time in order to reduce external audit time loses its value if the external auditor has to perform additional tasks to determine whether his or her reliance on the internal auditor is justifiable. (1) Audit efficiency is not fully utilised if the external auditor has to test a substantial part of the work performed by the internal audit activity in key areas. (1)
- (5) The reliance placed by external auditors on the work of internal auditors has not yet enjoyed the attention of the courts.(1) As no definite standards have as yet been developed to regulate the relationship between the external auditor and the internal auditor, it can be assumed that the onus will rest on the external auditor to prove(1)
 - (a) the extent to which he or she relied on the work of the internal auditor (1); and
 - (b) that he or she had taken due care (1)

(Marks as indicated with a maximum of 7 marks)

Comment:

The answers to the questions are obtainable directly from your study guide. Make sure, however, that your answers are complete and cover all the important aspects.

3 KEY TO AND COMMENTS ON SIMULATED EXAMINATION

QUESTION 1: (15 marks)

- | | | |
|------|---|----------------------------|
| 1.1 | C | Study guide, section 4 |
| 1.2 | B | Study guide, section 7.1.4 |
| 1.3 | C | Study guide, section 5.2 |
| 1.4 | A | Study guide, section 6.1.4 |
| 1.5 | D | Study guide, section 8.1.4 |
| 1.6 | B | Study guide, section 7.1.4 |
| 1.7 | A | Study guide, section 5.1.1 |
| 1.8 | B | Study guide, section 5.1.1 |
| 1.9 | A | Study guide, section 3.1 |
| 1.10 | A | Study guide, section 2.1 |

(1½ marks each)

Comments

Question 1 – C

The audit staff should include members who are proficient in applying internal auditing standards, procedures, and techniques. Option C is correct since when hiring an entry-level audit staff, the most likely predictors of the applicant's success as an auditor would be the ability to organise and express thoughts well.

Options A, B and D are incorrect as the least likely predictors are grades achieved on university internal auditing modules, ability to fit well socially into a group and the level of detailed knowledge of the company.

Question 2 - B

Audit evidence should be sufficient, relevant, competent and useful.

Option B is correct as this is a quality of useful audit evidence.

Option A is incorrect as this does not relate to the quality of audit evidence.

Option C is incorrect as this is a quality of relevant audit evidence.

Option D is incorrect as this is a quality of sufficient evidence.

Question 3 – C

This question tests your understanding of the internal auditor's responsibility regarding prevention of fraud. You are required to select the **incorrect** statement.

Option C is correct as the internal auditor is not responsible for acting as an insurer of guarantor against fraud.

Option A is incorrect as internal auditing is responsible for evaluating the organisation's control consciousness.

Option B is incorrect as internal auditors should be aware of activities where fraud is likely to occur.

Option D is incorrect. Deterrence of fraud is the responsibility of management; evaluating the effectiveness of management efforts is the responsibility of internal auditing.

Question 4 – A

Option A is correct since a preventative control is a control that deters undesirable events from occurring. In this case the undesirable event would be buyers favouring certain suppliers in placing orders for personal gain.

Option B is incorrect since a corrective control is a control that corrects errors or irregularities that have been detected; in this case no error has occurred.

Option C is incorrect since a detective control is a control that detects undesirable events, in this case no undesirable event has occurred yet.

Option D is incorrect since internal controls can be detective, corrective, or preventive by nature, there is no monitoring control.

Question 5 – D

Option D is correct. It is a professional requirement that all internal auditors work in a methodical manner and keep written records of their procedures and findings.

Option A is incorrect as the CAE is responsible to establish work paper policies.

Option B and C are incorrect because the audit committee and executive management of the auditee rarely look at audit working papers.

Question 6 – B

Option B is correct since this is the definition of competent evidence.

Option A is incorrect since documentary evidence consists of evidence in the form of letters, invoices, shipping notes, and so forth.

Option C is incorrect since relevant evidence supports the engagement observations and recommendations and should be consistent with the objectives for the engagement.

Option D is incorrect since sufficient evidence is evidence that is convincing enough for a prudent person to reach the same conclusion.

Question 7 – A

Option A is correct since the charter should establish the internal auditor's position within the organisation in order to fulfil his/her obligations and responsibilities.

Option B is incorrect since the internal audit activity should not specifically identify what activities will be audited.

Option C is incorrect because the internal auditors are obligated to make all needed disclosures to the audit committee.

Option D is incorrect since access to the external auditor's working paper cannot be guaranteed in the charter.

Question 8 – B

This question requires you to identify which power the internal auditor is exercising in the scenario.

Option B is correct as the internal auditor exercised his authority of access to books, records, vouchers and accounts by requesting the fixed asset register.

Option A is incorrect as the internal auditor is requesting information but not explanations.

Options C and D are incorrect since the scenario does not speak of attendance at any meetings or interactions with officials.

Question 9 – A

This question tests your knowledge of the separate categories (mandatory and recommended) of the International Professional Practices Framework (IPPF).

The Institute of Internal Auditors (IIA) developed the IPPF which consists of **mandatory** guidance (the definition of internal auditing, the International Standards for the Professional Practice of Internal Auditing (Standards) and the Code of Ethics) and the **recommended** guidance (Practice Advisories, Practice Guides and Position Papers).

Option A is correct as it contains all the components of mandatory guidance.

Option B is incorrect as it contains only two of the components of mandatory guidance

Option C and D are incorrect as they contain components of the recommended guidance.

Question 10 – A

This question required you to know the four functions of management and select the option that was **not** a function of management.

Option A is correct as reviewing is not a function of management. Reviewing forms part of control.

Options B, C and D are incorrect as planning, organising, directing and controlling are the four functions of management.

QUESTION 2:**(61 marks)****PART A****(28 marks)****2.1 Internal auditing definition and services provided**

Reference: Study guide, sections 1.1.2 & 6

2.1.1 Assurance and consulting

By focusing on assurance and consulting work, this conveys a more proactive, customer-driven approach ✓ with a role to play in the control, risk management and governance activities. ✓ (2)

2.1.2 Adding value

In the process of obtaining data in order to understand and assess risk, internal auditors develop significant insight into operations and opportunities for improvement that can be extremely beneficial to the organisation. ✓ This valuable information can be in the form of consultation, advice, written communications or presented through other means. (2)

2.1.3 Risk management process

The internal audit activity should assist the organisation in managing risk. ✓ Assistance is provided by identifying and evaluating the organisation's exposure to risk, assessing risk during the course of engagements, and improving the risk management process. ✓ (2)

2.1.4 Control process

The internal audit activity should evaluate the organisation's control process ✓ to determine its effectiveness and efficiency. ✓ (2)

2.1.5 Governance process

The internal audit activity should assist the organisation in achieving its goals. It does this by evaluating and improving the process through which goals and values are established and communicated, by monitoring whether goals have been achieved, ensuring accountability, and safeguarding values. ✓✓ (2)

Comment

This is a theoretical question. The question basically tests your knowledge on the definition of internal auditing.

2.2 Tasks performed by internal audit

Reference: Study guide, section 6 & 1.1.2

- (I) Internal audit should NOT take on this task or responsibility.√ The bank reconciliation is a routine accounting procedure that is the responsibility of the accounting department.√

The performance of the reconciliation is, in itself, an internal control which may from time to time be “internally audited” to determine whether the control is operating as it was designed to.√

- (II) Internal audit should carry out this procedure√ because a surprise cash count is not part of the normal internal control over cash, but an independent audit procedure designed to determine whether controls are working.√

- (III) Again, internal audit should not be part of the monthly internal control routines such as inventory counts.√

Internal audit should attend and observe cycle counts and indeed perform a sample of test counts, but this would be to evaluate the company's inventory controls.√

- (IV) Internal audit should not be involved in “head hunting”, because this is a human resource function.√

At a later stage they (IA) might be required to audit work performed by the person they had “head hunted”; doing the “head hunting” themselves would impair their independence. √

- (V) Internal audit could certainly take responsibility for this review.√

It can be conducted as a compliance audit.√

- (VI) At most, internal audit could assist in drafting this set of procedures, since human resources is not the internal audit's area of expertise. √

The nature of an internal audit is one of “evaluation” and “review” rather than one of creating systems.√

(Marks as indicated, to a maximum of 2 marks per function and a total of 12 marks)

Comment

This is a theoretical and application question in which you are required to state to whom the responsibilities of each of the processes are attributable in question 2.1. Take care to answer the whole question, you should state whether or not the process is the internal audit's responsibility and the reason for your statement.

2.3 Independence

Reference: Study guide, sections 1.1.2 & 2.2.1

Independence in relation to the internal audit function means that the department must be independent of the systems, departments, individuals etc on which they perform their audit/assurance activities.√

Independence means that internal auditors:

- Must not be involved or be responsible for any performance matters within an activity being audited. ½
- Must be able to develop audit programmes without being influenced. ½
- Must have full access to all evidence and members of staff wherever this is required for the purposes of the audit. ½
- Must be objective when collecting and evaluating information and evidence. ½
- Must be able to prepare audit reports on any matters they consider necessary. ½

If this is the case, internal auditors will be able to perform their functions objectively.√

This will result in internal audit evaluations, opinions and judgments that are impartial and unbiased.√

(Marks as indicated, maximum 2 marks)

Comment

This was a purely theoretical question. The answer can be found, as is, in the study guide. Note that a maximum of 2 marks were awarded. Use the mark allocation to assist you in deciding on how much to write in your solution.

2.4 Organisational status of internal audit

Reference: Study guide, sections 2.2.1 & 2.2.2

How the internal audit department and its members are perceived by the departments which they audit (auditees) will be influenced by the organisational status the department is given. √

If the internal audit department is given little status and power within the organisation, and is obliged to report to the financial controller and has no direct access to the audit committee/board/chairperson, it will be regarded as just another department doing what it is told to do.√

If the internal audit department is given suitable power and is recognised as an important part of the organisational structure reporting directly to the chairperson/audit committee, it will be perceived to be independent.√

The following two factors influence the organisational status of the internal audit activity:

- the level of responsibility conferred on the internal audit activity in the organisation ✓
- the level of management to which the chief audit executive reports which indicates the internal auditor's level of accessibility to top management ✓

(Marks as indicated, maximum 4 marks)

Comment

This is a two-part question. The first part required you to discuss how the internal audit activity's "organisational status" can enhance its independence. The second part of the question required you to state two factors that will influence the organisational status of the internal auditing activity.

PART B

(23 marks)

2.5 Internal audit planning process

Reference: Study guide, section 7.1.4

- Obtain background information of the audit area (preliminary survey). ✓
- Identify the audit objectives to be achieved. ✓
- Consider the audit risk. ✓
- Decide on the audit approach. ✓
- Determine the allocation of engagement resources. ✓
- Compile the detailed audit programme. ✓

The internal auditor is currently busy with obtaining background information. ✓

(Maximum of 7 marks)

Comment

This is a theoretical and application question in which you are required to state the steps in the internal audit planning process and what step is currently happening in the scenario. Therefore this question requires you to have a strong understanding of the phases in the internal audit process and the activities performed in each of the phases and sub-phases.

2.6 Internal control questionnaire

Reference: Study guide, section 6.1.4 & 7.1.4

(l) A written authorised order means that:

- it can be ascertained who placed every order (isolation of responsibility). ✓ $\frac{1}{2}$
- the supplier knows precisely what to supply and any disputes for incorrect delivery (quantity, description and possibly price) can be settled by reference to the order itself. ✓ $\frac{1}{2}$
- unauthorised orders will be harder to initiate (most suppliers require written order and an order number). ✓ $\frac{1}{2}$

- the receiving department has a document which authorises it to receive goods and tells it what should be accepted.√½

(1½ marks for a valid reason, maximum of 1½ marks)

(II) Documentary evidence, from a department that is independent of stores, exists about the goods received.√½

- The signature establishes accountability on the part of the recipient.√½
- A record of exactly what was received is created, against which the suppliers invoice can later be checked for accuracy and completeness.√½

(1½ marks for a valid reason, maximum of 1½ marks)

(III) This control means that payments are only made for purchases that were:

- properly authorised.√½
- received.√½
- properly invoiced, with correct quantities and prices as agreed.√½

(1½ marks for a valid reason, maximum of 1½ marks)

(III) Cancellation of supporting documentation makes it far more difficult to present the same documentation a second time in support of an invalid payment (theft). √½

(1½ mark for a valid reason, maximum of 1½ marks)

Comments:

This was an application question where you have to understand the concept of internal control. By understanding the concept of internal control, you will be able to describe its importance and relevance in any scenario.

2.7 Fraud elements

Reference: Study guide, sections 5.2.1

The elements of legal fraud or deceit (as it was called in the common law) are as follows:

- a false representation of a material fact or, in some cases, an opinion made by an individual or an organisation. √
- made with the knowledge that it is false or without sufficient knowledge on the subject to warrant a representation. √
- a person relies on the untrue representation and acts upon it √
- to his or her disadvantage/damage √

(Marks as indicated, 4 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide. Just be careful not to confuse it with white-collar crime.

2.8 Examples of fraud

Reference: Study guide, section 5.2.1

1. Theft is not fraud, as there is no misrepresentation.√√
2. Negligence is not fraud, as there is no misrepresentation.√√
3. Possible corruption if the voucher for the spa weekend is not disclosed and approved by Ms Tinkerbelle's manager. It is not fraud.√√

(2 marks for each clearly substantiated description of whether or not the example is fraud, maximum of 6 marks)

Comments:

This is an application question. The question tests your knowledge of fraud. In this question, you should read each scenario and check it against the elements of fraud. In your answer, you should show this working / thought process so that we can see what you are comparing the scenario against and your conclusion.

PART C

(10 marks)

2.9 Request from audit committee

Reference: Study guide, study unit 3.1.2

Competency: √

Internal auditors:

- Shall engage only in those services for which they have the necessary knowledge, skills and experience.√
- The CAE cannot accept this request by the audit committee because no one in the internal audit department has the necessary knowledge, skills and experience.√
- The request can be outsourced to a skilled third party.√

(Marks as indicated, maximum 4 marks)

Comments:

This is an application-type question and tests your understanding of the Code of Ethics: The Principles and the Rules of Conduct, and how to apply these to the scenarios in the question. Read each scenario carefully and think of the ethical behaviour that the scenario is depicting. Based on what the rules and the principles state, then determine if there has, or has not, been a

violation. You should then explain why you are stating it as a violation, be clear about your reasons since we need to determine whether you really understand the Code of Ethics and its Rules of Conduct. Do not just state it is a violation; explain **how** the objectivity, competency, integrity or confidentiality has been violated.

In answering this question, you need to determine whether there was a violation and if so, only then can you suggest a recommendation. You should answer it as follows:

1. State the relevant Code of Ethics requirement, for example internal auditors shall engage only in those services for which they have the necessary knowledge, skills and experience (competency).
2. Apply the Code of Ethics requirement to the scenario.
3. Conclude whether, according to the Code of Ethics requirements, compliance was followed.
4. If there was non-compliance, then suggest a recommendation that would be in compliance with the Code of Ethics.

2.10 Internal audit relationship with audit committee

Reference: Study guide, section 9.1.5

- The CAE should have the following dual-reporting responsibilities:
 - Functionally to the audit committee ✓
 - Administratively to the chief executive officer ✓
- The CAE should have ready access to the audit committee. ✓
- The CAE should have direct and regular communication with the audit committee. ✓
- The CAE should attend audit committee meetings. ✓
- The CAE should meet privately with the audit committee on a regular basis. ✓
- The audit committee should approve the appointment and removal of the CAE. ✓
- The audit committee should be advised by the CAE on his or her relationship with the external auditors and how the internal and external audits are progressing. ✓

(Marks as indicated, maximum 6 marks)

Comments:

This is a theoretical question. The answer did not require you to apply any knowledge. The answer can be found, as is, in the study guide.

QUESTION 3:**(24 marks)****3.1 Interaction between internal and external auditors****Reference:** Study guide, section 9.1.3

- **Preventing fraud**

The internal auditor is responsible for assisting with the prevention or deterrence of fraud by examining and evaluating the adequacy and effectiveness of actions taken by management to fulfil the obligation regarding control, commensurate with the extent of the potential risk or exposure in the various segments of the organisation's activities. √√

- **Detecting fraud**

The internal auditor's responsibility to detect fraud arises from the requirement that internal auditors should exercise due professional care and competence in the performance of every engagement. Practice advisory 1210.A2-2 clearly shows the internal auditor's responsibility to detect fraud as:

The detection of fraud consists of identifying indicators of fraud sufficient to warrant recommending an investigation. These indicators may arise as a result of controls established by management, tests conducted by auditors, and other sources both within and outside the organisation. √√

(Marks as indicated with a maximum of 4 marks)

Comment

This is a theoretical question. This question requires you to be able to identify the relevant Standard and Practice Advisory that relates to the role of the internal auditor regarding fraud. The question is straightforward and it is simple to earn marks, provided you know the Standard and Practice Advisory to which the question was referring. Therefore, you must have a solid understanding of the International Standards for the Professional Practice of Internal Auditing (Standards).

3.2 Fraud risk**Reference:** Study guide, section 5.2

Nr	Increase or decrease	Motivation
I.	Decrease√	Adherence to these principles requires management to implement sound internal controls, create a sound control environment and monitor the business closely.√½
II.	Increase√	The directors may be inclined to intentionally misrepresent financial results to increase their personal income.√½

Nr	Increase or decrease	Motivation
III.	Increase✓	The managing director is likely to get his way if he is forceful and autocratic. This way, for example, result in the overriding of controls.✓½
IV.	Decrease✓	Control over the business will be improved hence reducing the opportunity for fraud.✓½
V.	Increase✓	The company's financial employees realise that there is little regard for the external auditors then any deterrent provided by being audited will be lost.✓½
VI.	Decrease✓	By simplifying its structure the company are provided with less opportunity to perpetrate and hide fraudulent transactions/ deals.✓½
VII.	Increase✓	Computerisation, if not thoroughly controlled can easily result in the perpetration of fraud, e.g. if adequate access and other controls are not implemented, data can be invalidly accessed, amended or deleted, unauthorised electronic funds transfer can be made.✓½
VIII.	Increase✓	In this type of environment fraudulent business practices may creep in e.g. bribes may be offered for contracts, controls may be overridden, misappropriation of financial information.✓½

(Marks as indicated with a maximum of 20 marks)

Comment

This is a two-part question. The first part requires you to determine whether the scenario increases or decreases the risk of fraud. The second part of the question requires you to justify your answer by explaining why the scenario would increase or decrease the risk of fraud. Merely repeating the scenario does not indicate whether you understand the concept of fraud. You have to explain the consequences of the occurrence in the scenario and the impact (negative or positive) on fraud for each of the scenarios.