

Tutorial Letter 201/2/2017

INTERNAL AUDIT PROCESS: SPECIFIC ENGAGEMENTS AND REPORTING

AUI3703

SEMESTER 2

Department of Auditing

IMPORTANT INFORMATION

This tutorial letter contains important information about your module.

BAR CODE

CONTENTS

1	BRIEFING.....	3
2	KEY TO ASSIGNMENT 01/2017.....	4

1 BRIEFING

This tutorial letter contains the solutions to Assignment 01 for this semester. The lecturer has marked a selection of the questions in this assignment. The marks you received for your answers to these questions will constitute your mark for this assignment and will contribute towards your year mark. You need to assess your answers to the other questions yourself by comparing your answers to those provided in this tutorial letter.

Use the marking plan as a guide to award yourself marks for your answers. Take care not to mark the same concept more than once just because it appears more than once, perhaps in different words or in a different format.

After you have marked your own answers, please reflect carefully on your result to determine why you could not allocate full marks to your answers. Please ensure that you allocate marks only to valid answers. It is imperative that you identify your problem areas now, while you can still do something about them. If you do not solve all your problems as soon as you have identified them, you may repeat the same mistakes in the examination, and that could prove very costly. Marking your answers should enable you to identify any problems you may be experiencing. Your marks for this assignment will be an indication of your level of knowledge of the module content at this stage. You should still have enough time left to revise the work and solve the identified problem areas before the examination.

We trust that you have found the assignment both interesting and informative and that it has served as an aid for your examination preparation. Should you encounter any difficulties regarding this module in internal auditing, please do not hesitate to contact us.

Ms Carter-Brown

AUI3703

2 KEY TO ASSIGNMENT 01/2017

QUESTION 1

15 marks

1. B
2. D
3. D
4. C
5. A
6. A
7. B
8. C
9. A, B or C
10. C

1.1 The purposes of the Standards include all of the following **except ...**

B. guiding the ethical conduct of internal auditors.

Answer (A) is incorrect. Establishing the basis for the evaluation of internal audit performance is one of The IIA's stated purposes of the Standards. **Answer (B) is correct.** Guiding the ethical conduct of internal auditors is the purpose of the Code of Ethics, not the Standards. **Answer (C) is incorrect.** Delineating basic principles that represent the practice of internal auditing is one of The IIA's stated purposes of the Standards. **Answer (D) is incorrect.** Fostering improved organizational processes and operations is one of The IIA's stated purposes of the Standards.

1.2 Engagement information is usually considered relevant when it is ...

D. consistent with the engagement objectives.

Answer (A) is incorrect because whether sampling is appropriate and the results are valid are issues related to the determination of sufficiency and reliability rather than relevance. **Answer (B) is incorrect** because objectivity and lack of bias do not assure that information will support observations and recommendations and be consistent with the engagement objectives. **Answer (C) is incorrect** because sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the internal auditor. **Answer (D) is correct.** Information should be sufficient, reliable, relevant, and useful to provide a sound basis for engagement observations, conclusions, and recommendations. Relevant information supports engagement observations, conclusions, and recommendations and is consistent with the objectives for the engagement

- 1.3** An inexperienced internal auditor notified the senior auditor of a significant variance from the engagement client budget. The senior told the new internal auditor not to worry because the senior had heard that there has been an unauthorised stoppage that probably accounted for the difference. Which of the following statements is most appropriate?

D. The senior should have aided the new internal auditor in formulating a plan for accumulating appropriate information.

Answer (a) is incorrect. The Standards provide that the extent of supervision should vary with the proficiency of the auditor. It is not inappropriate for an inexperienced auditor to refer this to the senior. Answer (b) is incorrect. The Standards provide that the extent of supervision should vary with the proficiency of the auditor. It is not inappropriate for an inexperienced auditor to refer this to the senior. Answer (c) is incorrect. The variance does need explanation and the rest of the audit can continue. Answer (d) is the correct answer. The IIA Standards provide that unexpected results from applying analytical auditing procedures should be investigated since unexplained results could indicate a potential error or irregularity. The variance was not adequately investigated or explained.

- 1.4** A primary purpose for establishing a code of conduct with a professional organisation is to ...

C. promote ethical culture among professionals who serve others.

Answer (a) is incorrect. Although this may be a result of establishing a code of conduct, it is not the primary purpose. To consider it so would be self-serving.

Answer (b) is incorrect. A code of conduct may help to establish minimum standards of competence, but it would be impossible to legislate equality of competence by all members of a profession. **Answer (c) is the correct answer.** This is a distinguishing mark of a profession. **Answer (d) is incorrect.** There are situations where responsibility to the public at large may conflict with, and be more important than, loyalty to one's organization.

- 1.5** In the course of their work, internal auditors must be alert to fraud and other forms of white collar crime. The important characteristic that distinguishes fraud from other varieties of white collar crime is that ...

A. fraud is characterised by deceit, concealment or violation of trust.

Answer (a) is the correct answer. This is in accord with the IIA Standards. **Answer (b) is incorrect.** Fraud may be perpetrated against the organization. **Answer (c) is incorrect.** Fraud may be for the benefit of an organization. **Answer (d) is incorrect.** Parts of this statement may or may not be true.

1.6 Which of the following is not considered a red flag?

- A. Management has delegated the authority to subordinates to make purchases under a certain value.**

Answer A is the correct answer. This is an acceptable control procedure aimed at limiting risk while promoting efficiency. It is not, by itself, considered a red flag.

Answer B is incorrect. Lack of rotation of duties or cross-training for sensitive jobs is one of the red-flag list factors. **Answer C is incorrect.** This would be an example of an inappropriate segregation of duties, which is an identified red flag. **Answer D is incorrect.** This is an identified red flag

1.7 Which of the following should the auditor recommend as the most economical point at which to correct input errors in an online system?

- B. Entry of data into each field of a record is completed.**

The most economical point means the point at which it is best to check for errors in the data in a system. **Answer D is incorrect** as it checks for errors when the data is being output. It is best to check for errors on the input of data. Answers A and D are involved in looking at the data at the end of the input process while Answer B checks each field *as it is being typed in*, so **answer B is correct.**

1.8 Rejection of unauthorised modification to applications system could be accomplished through the use of ...

- C. implementation controls.**

Answers A, B and D are application controls that relate to the input of *data* for processing and are therefore incorrect. Answer C, implementation controls, are part of General Controls and the Control Environment and are necessary to prevent unauthorised and untested changes made to the operating system. **Answer C is therefore correct.**

1.9 The following audit procedure was documented in the working paper file: "To determine whether document flow and the provision of management information throughout the delivery department is optimised". This audit procedure will relate to

...

- A. the economy of the process.**
B. the efficiency of the process.
C. the effectiveness of the process.
 D. the financial impact of the process.

The question is a bad one as optimising the provision of information is the sum all three processes... the efficiency, effectiveness and the economy of the provision of the information.

From diagram 7.1 on page 44 of your study guide effectiveness is given as the "results of operations". To ensure that the operations are optimised the information

needs to be useful and timely to management. Efficiency is the “method of operation” and Economy takes the cost of generating the information into account. By maximising all 3 parts the process will be optimised.

1.10 Which of the following statements is true?

- A. Effectiveness is the relationship between planned inputs and actual output.
- B. Economy is the relationship between planned inputs and actual inputs.
- C. Efficiency is the relationship between actual input and actual output.**
- D. Effectiveness is the relationship between planned inputs and actual inputs.

Answers A and D are incorrect. Effectiveness is the relationship between actual outputs and planned outputs. **Answer B is incorrect.** Economy is the relationship between planned inputs and actual inputs in terms of unit cost. **Answer C is correct.**

QUESTION 2:

(64 marks)

Study unit 1 Answer to activity 1.1 (3 marks)

Complying with the code of ethics is what distinguishes an auditor – a professional – from the general public. The code of ethics assumes trustworthiness. It assumes that the auditor is skilled and knowledgeable. When you, as an internal auditor, shed these qualities by failing to comply with the code of ethics, even if it only happens once, you will lose the trust of the people who rely on you to do your job. In future they will have no confidence in your ability to do your job properly.

Study unit 1 Answer to activity 1.2 (6 marks)

In your answer you need to mention the following principles of the code of ethics: integrity, objectivity, confidentiality and competence. You also need to discuss each of these concepts by explaining its meaning. You need to make a detailed study of the code of ethics.

Study unit 2 Answer to activity 2.1 (1½ marks)

Correct alternative is (3): There is no violation of either the Code of Ethics or the Standards. See options (1) and (2). Option (1) is incorrect. The auditor is not withholding information because he or she has passed the information along to the CAE. The information may be useful in a subsequent audit in the marketing area. Option (2) is incorrect. The auditor has documented a red flag that may be important in a subsequent audit. This does not violate the Standards. Option (4) is incorrect. Option (3) is the only correct answer. This refers to the Code of Ethics, namely the objectivity rule of conduct.

Study unit 2 Answer to activity 2.2 (1½ marks)

Correct alternative is (1): Proficiency in the application of the Standards is required. Option (2) is incorrect. An appreciation of, and not proficiency in, accounting and computerised information systems is required. Option (3) is incorrect. Proficiency in, not an understanding, of audit techniques is required. Option (4) is incorrect. Proficiency in, not a broad understanding of, accounting principles is required when auditing financial records.

Comments

These activities above are typical application of the theory in a practical situation. You will be requested to analyse a practical situation in which an ethical principal is questioned.

Study unit 4 Answer to activity 4.1 (7 marks)

Fraud auditing involves assisting management in creating an environment that encourages the detection and prevention of fraud in commercial transactions. This may involve helping to set the standard for the organisation by establishing an appropriate code of conduct and conflict-of-interest policy.

During a financial audit, an auditor looks for evidence relating to the reliability and integrity of financial information, the information that is normally intended to be used by management for internal decision-making purposes. Financial audits normally include both a review of the accuracy and completeness of the numbers themselves and an evaluation of the adequacy and effectiveness of the controls that management have implemented to safeguard assets.

Comments

This is a theoretical question and you will be able to find the information in the Studyguide.

Study unit 6 Answer to activity 6.1 (18 marks)

Reider's definition of performance auditing reads as follows: Operational auditing is an audit of operations performed from a management viewpoint to evaluate the economy, efficiency and effectiveness of any and all operations, limited only by management's desires.

The elements of this definition are as follows:

1. An audit of operations

Performance auditing can be carried out in all functional areas of an organisation, such as marketing, sales, production and human resources. Performance auditing concentrates on the evaluation of policy, procedures, division of authority, quality of management, effectiveness of methods, special problems and other aspects of an organisation's operations.

2. From a management point of view

The principal focus of performance auditing is the achievement of management's objectives in the most economical, efficient and effective manner. For this reason it is important that a performance auditor should understand the way of thinking, objectives and concerns of top management in particular and focus on the aspects that are important to top management.

3. Evaluation of economy, efficiency and effectiveness

During an audit of economy and efficiency, the auditor looks at the optimum balance between costs and results. In an audit of effectiveness, the auditor determines whether an operation is fulfilling the purpose for which it was established.

4. Any and all operating systems within an organisation

A performance audit can focus on any component of an organisation, whether it is an operating unit, a functional area, a department or an activity within a department, where the audit objective amounts to reviewing the economy, efficiency and effectiveness with which management is achieving its goals.

5. Only the needs of management restrict the scope of operational auditing

As previously mentioned, performance auditing should focus on the aspects that are important to management. The freedom of the internal audit function to evaluate all the activities of an organisation should be incorporated in the internal audit mandate.

Comments

This is a theoretical question and you will find the answer in the Studyguide.

Study unit 7 Answer to activity 7.1 (10 marks)

Audit objectives for assessing the economic and efficient functioning of DWARF's mechanical plant

1. To determine whether the organisation's policy on purchases will ensure the most economical and effective utilisation of resources
2. To determine whether the stock holding is economical without jeopardising the effectiveness of the mechanical plant
3. To determine whether losses and waste in the mechanical plant are minimised
4. To determine whether the activities of the mechanical plant are grouped in logical, feasible processes or tasks
5. To determine whether document flow and provision of management information throughout the mechanical plant are efficient

Comments

In this question you had to apply your theoretical knowledge about economy and efficiency and use that knowledge to formulate audit objectives. A general problem is that students formulate audit objectives that do not refer to the economy or efficiency component. For this question write down all the aspects that relate to economy and efficiency and then formulate an audit objective that relates to each of these aspects, taking into account the information provided in the question. For example, efficiency addresses the efficiency of documentation flow. An audit objective would be as follows:

“To determine (formulation of audit objective) whether document flow and the provision of management information (theoretical knowledge regarding efficiency) throughout the delivery department of DWARF (application to question) are optimised”

Note: No marks will be awarded if the audit objectives are not correctly formulated

Study unit 7 Answer to activity 7.2 (5 marks)

The meaning of mission in the context of organisational performance and the relationship between mission and performance objectives

The mission of the organisation/department/activity is the reason for its existence gives expression to what the organisation/department/activity wants to achieve.

An organisation’s mission can be seen as its primary performance objective. All the performance objectives must be achieved if the organisation wants to achieve its mission.

If a single performance objective is not achieved, the organisation’s mission is not fully achieved either. If we compare the organisation’s mission to a completed puzzle, then the puzzle pieces are the performance objectives and the puzzle will only be complete if all the pieces are in place.

Comments

This question covers the theory of the mission statement and performance objectives of an organisation that is discussed in detail in your study guide. You had to start by explaining what a mission statement is and then link it to performance objectives. Ensure that you study all your theoretical work in detail!

Study unit 7 Answer to activity 7.3 (12 marks)

Economy

Interview senior staff members to determine whether the purchasing department gathers information on prices and suppliers on a frequent basis, in order to determine whether materials are purchased at the lowest prices.

1. Examine the procedures followed to determine whether purchasing conditions are agreed upon and followed in such a way that purchases fall within the budget, all possible discounts are obtained and payments are made on terms that are most beneficial to the organisation.
2. Reperform the calculation of minimum inventory levels and most economic purchase quantities to ensure that they are correctly calculated.
3. Confirm the accuracy, reliability and relevance of information used to determine minimum inventory levels and economic purchase quantities.

Efficiency

1. Through observation and discussion determine whether the correct number of people have been assigned to purchasing materials on behalf of the pencil plant to avoid causing unacceptable backlogs or idle time.
2. Evaluate whether it is efficient for the finance department to handle purchases on behalf of the pencil plant.
3. Obtain evidence that all information saved on computer is backed up as necessary, and that the computer system is properly maintained in order to ensure that the information on which order requisitions are based is accurate, and that these notices are processed on a regular basis.
4. Investigate the procedures followed as well as the time from the moment the notice for an order is printed on computer until the order is placed, and ensure that there are no unnecessary delays

Effectiveness

1. Ensure that meaningful, realistic and measurable objectives have been set for the pencil plant in respect of, for example, profit margins, output, manufacturing costs and productivity.
2. Evaluate the planning of the plant to ensure that it is directed at achieving these objectives.
3. Examine whether the criteria used to measure the achievement of the overall objectives, for example quality of output, output quantities, spoilage levels, application of materials, direct costs, throughput manufacturing rate, are realistic and meaningful.
4. Evaluate the effectiveness of the pencil plant by measuring the performance of the plant in terms of the formulated objectives and criteria.

Comments

In this question you had to apply the theoretical knowledge you have about economy, efficiency and effectiveness and use that knowledge to formulate audit procedures. A general problem is that students formulate audit procedures that do not refer to economy, efficiency or effectiveness. For this question write down all the aspects that relate to economy, efficiency or effectiveness and then formulate an audit procedure that relates to each of those aspects, taking into account the information provided in the question.

For example, effectiveness addresses the achievement of results. An audit procedure would be:

“To identify (formulation of audit procedure — can also use “to evaluate”, “to inspect” or “to identify”) factors that impeded the achievement of results (theoretical knowledge regarding effectiveness) throughout the manufacturing department of ABC Ltd (application to question)”

Note: No marks will be allocated if the audit procedures are not correctly formulated!

QUESTION 3:**3.1 Identify the weaknesses in the distribution department's operating procedures, that would encourage fraudulent behaviour and for each weakness, briefly describe why this would be the case.****Reference:** Study guide, section 4.3

1. Drivers are appointed on a contract basis and paid a fixed rate per hour.
They work a lot of overtime and there is little time for oversight.
Staff may put in claims for more hours than they have actually worked.
2. Little time for manager-employee interviews and oversight.
Staff may be paid for unproductive hours.
3. The company doesn't advertise for new programmers, as they have a pool of friends and family of existing staff members to select from.
Staff may be appointed without proper vetting being done, leading to the employment of dishonest staff.
4. The culture of the company is trusting with very few rules. A new person starting there, only have to sign an agreement that they have a valid driver's license.
No clear policies setting out the tone at the top and acceptable staff behaviour.
5. A staff member got fired recently, but although the reason was rumoured to be fraudulent behaviour, nobody really knew the reason.
Lack of communication between management and staff may lead to similar incidents in future.

(Two marks each, maximum 10 marks.)

3.2 Eight (8) audit procedures that can be used to determine whether the new delivery vans has been economically procured**Reference:** Study guide, sections 3.2.2

1. Analyse the purchasing policy of ReadAlot with regard to the purchase of new delivery vans and ensure that the policy is such that the new vans can be economically procured.

2. Evaluate the procedures followed when purchasing the delivery vans and ensure that the procedures followed are in line with the purchasing policy and that the vans purchased was purchased at the best price. Specifically note the tender procedures, specification of the delivery vans etc.
3. Discuss the amount spent on procuring the vans with management and ensure that there are valid reasons for the purchase of the delivery vans.
4. Ensure that cost-benefit studies were completed before the vans were purchased.
5. Analyse the finance terms of the purchased delivery vans, for example was it bought on a hire-purchase agreement, for cash or with a loan. Ensure that the finance method used is the most beneficial for the company.
6. Review the capital usage schedules and ensure that vehicles will be used optimally.
7. Ensure that the replacement policy provides for the economical use of delivery vehicles.
8. Ensure adherence to the purchasing and replacement policy.

(1½ mark each, maximum 12 marks.)

3.3 Indicate how the tasks of an internal auditor during a fraud investigation would differ from the tasks performed during a performance audit of the distributions department.

Reference: Study guide, section 4.3

A fraud investigation is geared to detection. (1) During a fraud investigation the internal auditor's tasks involve the following:

- looking for evidence supporting an identified irregularity,(1)
- determining the particulars of the irregularity,(1)
- quantifying the loss or scope of the problem and the period in which it took place, the method used and the persons involved, (1)
- acting as a gatherer of information and evidence. (1)
- recommendations to prevent the fraud from happening again. (1)

In a performance audit, the auditor's tasks consist of the following:

- looking for symptoms that indicate that problems may exist with economy, efficiency and effectiveness, (1)

- looking for weaknesses in the system, or susceptibility of the system to problems, (1)
- making recommendations for improving efficiency, economy and effectiveness, (1)
- reassuring management, (1)
- emphasising compliance with developed procedures and controls and improving them. (1)

(Marks as indicated. Maximum 10 marks)

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