

Tutorial Letter 202/2/2014

Internal Auditing: Theory and Principles

AUI2601

Semester 02

Department of Auditing

This tutorial letter contains important information about your module.

Bar code

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1 BRIEFING

This tutorial letter contains the solutions to Assignment 02 for this semester. Your 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 against those provided in this tutorial letter.

You are required to 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 solve 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 make you fail.

Marking your answers should enable you to identify any problems you may be experiencing. Your marks for this assignment will indicate your knowledge level of the module 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 helped you with your examination preparation. Should you encounter any difficulties regarding this internal auditing module, please do not hesitate to contact us.

Lecturer: AUI2601

2 KEY TO ASSIGNMENT 02/2014 (SECOND SEMESTER)

QUESTION 1

15 marks

Question	Correct answer	Study guide reference
1.1	B	Study Unit 2.2 and 9.1

This question required you to understand the dual relationship that internal audit has with executive management and the executive committee, as well as the steps in the audit process.

Option B is correct as it listed the progressive steps performed during an internal audit engagement. The chief audit executive reports functionally to the board and administratively to the organisation's chief executive officer, facilitating organisational independence (Practice Advisory 1110-1).

Option A is incorrect as this is not the responsibility of executive management.

Option C is incorrect as internal auditors do not work under the control of the audit committee.

Option D is incorrect as the report must always be discussed with executive management before it is tabled before the audit committee.

Question	Correct answer	Study guide reference
1.2	D	Study unit 8.1.4

Option D is correct since this is the function of working papers. Working papers document the information obtained, the analyses made, and the support for the conclusions and engagement results. Internal audit management reviews the prepared working papers. (Practice Advisory 2330.A1-1)

Option A is incorrect. While working papers are the property of the organisation, they should be made available only to authorised personnel. "Engagement records or working papers are the property of the organization. The internal audit activity controls engagement working papers and provides access to authorized personnel only" (Practice Advisory 2330.A1-1).

Option B is incorrect. Although it is allowed for internal auditors to grant access of working papers to external auditors, the working papers are the property of the organisation.

Option C is incorrect. "The chief audit executive (CAE) must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent regulatory or other requirement." (IIA Standards 2330.A2). The Standards does not prescribe the length of time working papers should be retained. This can only be established by the CAE's professional judgment in consultation with the organisation's legal counsel.

Question	Correct answer	Study guide reference
1.3	C	Study Unit 1.1.3

External and internal audit differ as a result of a difference in objectives. This question required you to select the alternative that described the objectives of internal audit.

Option C is correct as from the definition of internal auditing it is apparent that the objective of internal audit is to assist management and the board to manage the organisation efficiently, by assisting them in the achievement of the objectives.

Option A is incorrect as this refers to one of the steps within the internal audit process.

Option B is incorrect as this is an external audit objective.

Option D is incorrect as it is management's responsibility to implement controls and not that of internal audit. The internal audit activity will never develop and implement internal controls as part of the internal audit work because this would impact on the internal audit activity's objectivity and independence. As part of the consulting activity internal audit can assist management by compiling internal controls but they will not implement the internal controls.

Question	Correct answer	Study guide reference
1.4	B	Study Unit 8.1.4

Option B is correct. Engagement working papers generally:

- Aid in the planning, performance, and review of engagements.
- **Provide the principal support for engagement results.**
- Document whether engagement objectives were achieved.
- Support the accuracy and completeness of the work performed.
- Provide a basis for the internal audit activity's quality assurance and improvement program.
- Facilitate third-party reviews. (Practice Advisory 2330-1)

Option A is incorrect as the final or interim audit reports (not the working papers) normally provides a place for the auditee to give responses to audit recommendations.

Option C is incorrect since overall audit recommendations are properly summarised in the audit report. Individual test conclusions are documented in the working papers.

Option D is incorrect since the working papers are not an exhibit appended to the audit report.

Question	Correct answer	Study guide reference
1.5	D	Study Unit 3.1.3

Option D is correct. "Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives;
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied;
- Adequacy and effectiveness of governance, risk management, and control processes;
- **Probability of significant errors, fraud, or noncompliance;** and

- Cost of assurance in relation to potential benefits”. (IIA Standards 1220)

Option A is incorrect as “infallibility” cannot be achieved.

Option B is incorrect as again the internal auditor performs audit tests on a sampling basis which will never provide absolute assurance as not all the transactions are tested.

Option C is incorrect as an internal auditor can never provide absolute assurance because audit tests are conducting on a sampling basis.

Question	Correct answer	Study guide reference
1.6	B	Study Unit 9.1.5

This question required you to determine the **most important** benefit that audit committees provide to the internal auditor.

Option B is correct as audit committees, due to its composition and the legislative requirements in respect of audit committees hold a lot of authority within the organisation and with third party stakeholders.

Options A, C and D are incorrect as these are not functions of the audit committee.

Question	Correct answer	Study guide reference
1.7	C	Study Unit 9.1.3

The question dealt with a benefit of coordination between internal audit and external audit. You were required to select the option that best described a coordinated effort between internal and external audit.

Option C is correct because exchanging of audit reports assists in coordinating work between internal and external audit.

Option A is incorrect because presentations to management are not a supportive action and do not provide a benefit to either party.

Option B is incorrect as discussions of general economic growth and market direction are not a supportive action and will not benefit either party.

Option D is incorrect because dual use of audit trainees is not a supportive action and will not benefit either party.

Question	Correct answer	Study guide reference
1.8	B	Study Unit 7.1

Option B is correct since analytical information results from analysis and verification and includes computations and comparisons (the calculations of average travel expenses are analytical information). The travel expense receipts are documentary evidence.

Options A, C and D are incorrect since physical evidence (which is information obtained by

observing people, property and events) and testimonial evidence (which is information that consists of letters or statements in response to inquiries or interviews), are not included in the scenario.

Question	Correct answer	Study guide reference
1.9	A	Study Unit 5.1.1

Option A is correct since the charter should establish the internal auditor's position within the organisation in order to fulfil his or 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	Correct answer	Study guide reference
1.10	A	Study Unit 8.1.4

Option A is correct. "The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent **regulatory or other requirements**" (IIA Standards 2330.A2). Thus the legal requirements should be adhered to.

Option B is incorrect as retention policies need not be approved by the external auditor.

Option C is incorrect because it is the responsibility of the chief audit executive to develop retention policies.

Option D is incorrect. Working papers should not be retained for an arbitrary period. The duration of retention is based on usefulness and legal considerations.

(1½ marks each)

QUESTION 2

20 marks

2.1 Definition of Internal Auditing, the Code of Ethics, and the International Standards for the Professional Practice of Internal Auditing (Standards) auditing definition and services provided

Reference: Study guide, sections 1.1 and 3.1

- a) The Definition of Internal Auditing states the fundamental purpose, nature, and scope of internal auditing. (1)
*Internal auditing is an **independent, objective assurance and consulting** activity (1) designed to **add value** and **improve** an organization's **operations** (1). It **helps** an*

organization **accomplish its objectives** by bringing a systematic, disciplined approach to **evaluate** and **improve** the effectiveness (1) of **risk management, control, and governance** processes.(1)

(Maximum 4 marks)

- b) The Code of Ethics states the **principles and expectations governing behaviour** of individuals and organizations in the conduct of internal auditing. (1) It describes the **minimum requirements** (1) for conduct, and behavioural expectations (1) rather than specific activities.

The Code of Ethics consists of principles and rules of conduct (1). It describes the principles of integrity, objectivity, competency and confidentiality (1).

(Maximum 3 marks)

- c) *Standards* are principle-focused and provide a framework for performing and promoting internal auditing (1). The *Standards* are **mandatory requirements** (1) consisting of: Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of its performance (1). The requirements are internationally applicable at organizational and individual levels.

The Standards consists of:

Attribute Standards that address the **characteristics** of organizations and parties performing internal audit activities (1); and

Performance Standards that describe the **nature of internal audit activities** and provide **criteria** against which the performance of these services can be evaluated. (1)

(Maximum 4 marks)

Comments:

This is a theoretical question that basically tests your knowledge on the mandatory elements of the International Professional Practices Framework (IPPF).

2.2 Scenarios permissible in terms of the IIA Code of Ethics

Reference: Study guide, section 3.1

2.2.1

This activity is a violation of the IIA Code of Ethics. (1)

Code of Ethics

Rules of Conduct

Objectivity

Internal auditors:

- shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organisation.
- shall not accept anything that may impair or be presumed to impair their professional judgment. (1)

Preparing a personal tax return for a divisional manager for a fee falls under this prohibition, since the auditor's objectivity would be impaired. (1)

(Maximum 3 marks)

2.2.2

This activity is a violation of the IIA Code of Ethics. (1)

Code of Ethics Confidentiality

Principles

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so. (1)

Rules of Conduct

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

This auditor had no legal or professional obligation to give out that information and therefore did not protect the information acquired in the course of his duties. (1)

(Maximum 3 marks)

2.2.3

This action is permissible under the IIA Code of Ethics. (1)

Code of Ethics Rules of Conduct Integrity

Internal auditors shall observe the law and make disclosures expected by the law and the profession.) (1)

Thus, the internal auditor is legally bound to respond to a court order. The requirement not to use information in any manner detrimental to the legitimate and ethical objectives of the company does **NOT** override the legal obligation to respond to a court order. (1)

(Maximum 3 marks)

Comments:

*This is an application-type question and tests your understanding of the Code of Ethics: The Principle 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, then determine if there has, or has not been, a violation. Next, if you are stating it is a violation, you should explain why. Be clear about your reasons because 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.*

QUESTION 3**10 marks****3.1 Advantages and disadvantages of reporting to the Audit Committee****Reference: Study guide, sections 2.2****Advantages**

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

Disadvantages

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

(Maximum 3 marks)

Comments:

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

3.2 Advantages and disadvantages of reporting to the CEO**Reference: Study guide, sections 2.2****Advantages**

- Reporting to the CEO appears good because internal audit has guaranteed access to an official at a high level; (1) who has a reasonable measure of independence (in a big organisation the CEO is not normally responsible for a particular department). (1)
- Management may feel less threatened because the accessibility of the internal auditor is to a lower level than if he or she were to report to the Board of Directors. (1)

Disadvantages

- The influence and authority of the internal auditor may be affected if such audit matters receive the attention of the CEO to the detriment of other management matters, the efficiency of management will suffer and distrust might increase. (1)

- The CEO is usually quite a busy official, therefore the Chief Audit Executive may find that he or she does not receive the guidance and support necessary to perform his or her task effectively. (1)

(Maximum 3 marks)

Comments:

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

3.3 Recommended reporting lines as per IIA Standards

Reference: Study guide, section 2.2 and IIA Standards 1110

The chief audit executive must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. (IIA Standards 1110) (1)

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

(Maximum 4 marks)

Comments:

*This is a theoretical and application question. You need to use the **IIA Standards** as your reference to guide you in determining the recommended reporting lines.*

QUESTION 4

25 marks

4.1 The internal auditor's responsibility in the governance process according to IIA Standards 2110 – Governance

Reference: Study guide, section 6.1 and IIA Standards 2110

The internal audit activity must **assess** and **make appropriate recommendations** for improving the governance process in its accomplishment of the following objectives:

- promoting appropriate ethics and values within the organization; (1)
- ensuring effective organizational performance management and accountability; (1)
- communicating risk and control information to appropriate areas of the organization; (1)
- coordinating the activities of and communicating information among the board, external and internal auditors, and management. (1)
- **2110.A1** – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities. (1)

- **2110.A2** – The internal audit activity must assess whether the information technology governance of the organization supports the organization’s strategies and objectives. (1)

(Maximum 6 marks)

Comments:

*This was a purely theoretical question. The answer can be found, as is, in the study guide and the IIA Standards. You have to specifically state the **nature of the internal auditor’s work** regarding these two processes. The main point IIA Standards 2110 is what internal audit does. Look at the bold words that indicate exactly what IA does.*

4.2 Role of internal auditors as a control function in the organisation

Reference: Study guide, sections 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, 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*). (2)

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 regarding the adequacy of the system. (1½)

The **aim of evaluating the adequacy** of the governance, risk management and control processes is to determine whether the established system provides reasonable assurance that the objectives and goals of the organisation will be achieved efficiently and economically. (1½)

The **aim of evaluating the effectiveness** of the governance, risk management and control processes is to determine whether the system is dependable, i.e. whether the objectives and goals are being accomplished in an accurate and timely fashion with minimal use of resources. (1½)

(Maximum 7 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide.

4.3 Different types of control and examples of each type

Reference: Study guide, section 6.1.4

Preventive control – a control to deter undesirable events from occurring. (1)

Detective control – a control to detect and correct undesirable events that have already occurred. (1)

Directive control – a control to cause or encourage a desirable event to occur. (1)

Examples		
Preventive (1 mark per example)	Detective (1 mark per example)	Directive (1 mark per example)
Personnel access cards	Reconciliations to be done	Procedure manuals
Cabinet/ locks/keys	Control accounts to be balanced	Company policy
Security areas/cameras	Exception reports	Prescribed standards

(Or any other valid control)

(Maximum 6 marks)

Comments:

This is a two-part question. The first part requires you to define the different types of control. The second part requires you to give an example of each control.

4.4 Internal auditor's role in deterrence of fraud

Reference: Study guide, study unit 5.2

Internal audit is responsible for assisting in the 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 exposure/risk in the various segments of the entity's operations. (2) This includes recommending improvements (1).

(Maximum 2 marks)

Comments:

This is a theoretical question that did not require you to apply any knowledge. The answer can be found, as is, in the study guide. Just ensure that you are giving the correct responsibility.

4.5 Steps that internal auditor can take in his or her responsibility in the deterrence of fraud

Reference: Study guide, section 5.2

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 (e.g. 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) and
- recommendations need to be made for the establishment or enhancement of cost-effective controls to help deter fraud. (1)

(Maximum 4 marks)

Comments:

This is a theoretical question that did not require you to apply any knowledge. The answer can be found, as is, in the study guide. Just ensure that you are giving the correct responsibility, do not confuse it with prevention of fraud.

QUESTION 5**10 marks****5.1 Formal requirements before CIA designation can be awarded****Reference: Study guide, section 4.1****A person is entitled to the CIA designation if he or she meets the following criteria:**

- A Bachelor degree or equivalent three (3)-year academic qualification, OR an Honours degree or equivalent four (4)-year academic qualification .(1)
- A good character reference, as attested to by a CIA or IIA member. (1)
- Successfully passed all four parts of the CIA examination set by the IIA. (1)
- Have the required relevant work experience - three (3) years internal auditing (or relevant) experience if he or she has a Bachelor's degree/ equivalent three (3)-year academic qualification OR two (2) years internal auditing (or relevant) experience if he or she has the Honours/ four (4)-year academic qualification. (1)

(Maximum 4 marks)

Comments:

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

5.2 Personal characteristics that would assist the internal auditor to effectively discharge his duties**Reference: Study guide, section 4.1**

An internal auditor should possess the following personal characteristics:

- **Good interpersonal relationships (½)** – An internal auditor should have a pleasant personality, inspire confidence, speak convincingly and act with authority. He/she should be able to persuade other to cooperate, be tactful in his/her behaviour and should enjoy the confidence of both management and colleagues. (1)
- **Diligence and patience (½)** – Internal auditors should be able to exercise patience. Repetitive and routine work, although monotonous, should not affect their attention and

concentration. Whenever necessary, they should be capable of probing deeply into a matter and should never hesitate to ask questions about matter about which they are unsure. (1)

- **Objectivity and confidence (½)** – Internal auditors should have the courage of their convictions (convictions should always be supported by facts). They should not hesitate to criticise justly or disclose the truth, nor should they yield to pressure. (1)
- **Practical approach (½)** – Internal auditors must be practical and never allow theoretical knowledge to distort their practical judgement, experience or reasoning They must be considerate towards the auditee and refrain from making unreasonable demands that will disrupt the auditee’s business. (1)
- **Professionalism (½)** – Internal auditors should always adhere to their high professional calling and ethical code that governs the profession, always acting sincerely, honestly and impartially. (1)
- **Independence and sound judgement (½)** – Internal auditors must be completely independent, mentally and in their external relations with management and the auditee. This requires the internal auditor to be free from control and their professional judgement should not be subject to that of others.(1)
- **Integrity (½)** – Integrity implies uprightness and honesty. The internal auditor’s integrity should never be in doubt. (1)
- **Inquisitive awareness of new developments (½)**– Internal auditors should have insight into the technological influences and developments in the applicable discipline, together with an interest in learning more about matters with which they are not proficient or new developments. (1)

(Maximum 6 marks)

Comments:

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

QUESTION 6

20 marks

6.1 Considerations when planning an audit engagement

Reference: Study guide, section 7.1.4

Standard 2201 – Planning Considerations

In planning the engagement, internal auditors must consider:

- 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) and
- The opportunities for making significant improvements to the activity’s risk management and control processes. (1)

(Maximum 4 marks)

Comments:

This was a purely theoretical question. The answer can be found, as is, in the study guide and the IIA Standards.

6.2 Different kinds of audit evidence with example of each kind

Reference: Study guide, section 7.1.4

Physical evidence (½)	Examples: attendance at a physical stock count and attendance at wage payouts. (1)
Oral evidence (½)	Examples – written and signed evidence of oral interview or minutes. (1)
Documentary evidence (½)	Examples include letters or memos received by the auditee, suppliers' invoices, credit notes received, banking statements and packing sheets. Examples are sales invoices, paid cheques, credit notes issued and copies of outgoing correspondence. (1)
Evidence generated by the internal auditor (½)	Examples include the use of total control system, the environment in which the organisation is active, general economic conditions, the interrelationships of activities and data, analogy, calculations, comparison with imposed standards, completed operations, similar operations and the combining of information in context (1)

(Maximum of 1 ½ marks for each type of evidence: ½ mark for type of audit evidence and 1 mark for an example. Maximum 6 marks)

Comments:

This is a theoretical question. It requires you to list and give examples of types of audit evidence.

6.3 Format of audit finding

Reference: Study guide, section 7.1

- a. Condition. Audit tests showed that only some of the new accounts received, were reviewed. This item shows what is **currently** happening. (1)
- b. Effect. The bad debts loss increased by R 78 000 during the last financial year. This item shows the result and impact of the finding. (1)
- c. Criteria. Credit department policy requires the review of credit references for all new accounts. Since this show what is required, it is the standard procedure. (1)

d. Cause. According to the new credit manager, strict adherence to established credit policy is not necessary. This item gives the reason for the current situation. (1)

(Maximum 4 marks)

Comments:

This is a two-part, application question. The first part requires you to identify the element of the finding given in the scenario. The second part requires you to give a reason for your selection. In the second part of the question, use the definitions of the terms (criteria, condition, cause or effect) and compare them to the items in the scenario.

6.4 Quality of information

Reference: Study guide, section 7.1

6.4.1 (c)	Accurate information is ... c) free from errors and distortions and faithful to the underlying facts. (1)
6.4.2 (g)	Sufficient information is ... g) factual, adequate and convincing so that a prudent person would reach the same conclusion as the auditor. (1)
6.4.3 (d)	Concise information is.... d) to the point and avoids unnecessary elaboration, superfluous detail, redundancy and wordiness. (1)
6.4.4 (h)	Complete information ... h) lacks nothing that is essential to the target audience and includes all significant and relevant information and observations to support recommendations and conclusions. (1)
6.4.5 (a)	Relevant information ...a) supports engagement observations and recommendations and is consistent with the objectives for the engagement. (1)
6.4.6 (b)	Objective information is... b) fair, impartial, and unbiased and presents the result of a fair-minded and balanced assessment of all relevant facts and circumstances. (1)

(Maximum 6 marks)

Comments:

This is a theoretical question. It requires you to match the definition with the relevant term. The answers can be found in the study guide and the IIA Standards.