



The Southern African Institute of Government Auditors

Qualifying Examination for Registered Government Auditors

Paper 3: Auditing

September 2008

INSTRUCTIONS TO CANDIDATES

- 1 Maximum marks: **160**.
- 2 Total time available **four hours**.
- 3 The marks allocated to each question are an indication of the expected length and required depth of the answer.
- 4 Ensure proper planning and avoid exceeding the time you have allocated for each question as suggested by the number of marks allocated to the question.
- 5 Present your arguments in a clear, well structured manner, using precise language and professional terms, where appropriate.
- 6 No books or notes are allowed in the examination room.
- 7 All working papers must be handed in together with all paper provided for the examination (including unused answer sheets).
- 8 Answers written in pencil will not be marked.
- 9 You are reminded that this examination will be held under the rules set out in the document "RGA-QE Examination Matters & Examination Policy 2008".
- 10 You are required to observe all Examination Instructions on the separate sheet of paper handed to you before commencement of this examination.

QUESTION 1

(80 marks)

You have been an audit partner in CBH Incorporated for the past seven years. CBH has the reputation of being a top accounting and auditing firm, with local and international offices and approximately 250 partners. The audit client base of CBH comprises mainly large, listed entities in the private sector, the majority of which have 30 June and 31 December financial year-ends.

Your audit firm has recently been afforded the opportunity to present a proposal for the 31 March 2008 audit of the Department for Public Ventures, on behalf of the Auditor-General. You have been designated the engagement partner for the potential audit and are currently assisting the team with the preparation of the proposal for the audit. Over the past two weeks you have gained an understanding of the Department's business and operations from various sources, as documented below.

The Department of Public Ventures is the shareholder representative for the government with oversight responsibility for State Owned Ventures (SOVs). The Department ensures alignment between the SOVs' and the government's policy objectives and regulatory requirements, whilst ensuring that SOVs are sustainable businesses that provide economic benefit to the country. The Department also monitors the performance of the SOVs against a range of financial, operational and strategic targets.

The organisation and management structure of the Department is clearly defined, with proper allocation of responsibilities. In addition, it appears that senior management is honest, competent and experienced. Unfortunately, there have recently been allegations in the media of fraudulent payments having been made by the Department to a company under the control of one of the senior managers. The accounting officer and other senior officials have strongly condemned any such actions and are committed to a full and fair investigation, and to taking the appropriate action, should the allegations prove to be true.

The position of chief financial officer has historically been an area of concern as this position has been filled by four different persons over the past five years. The current chief financial officer was appointed in September 2007 and appears to be appropriately qualified and committed to accurate financial reporting. In addition, the majority of the accounting staff has been with the Department in excess of five years.

The internal audit department operates effectively and ongoing reviews are performed. Management responds appropriately to recommendations made by internal audit and you have gathered that the internal control system of the Department is sound and reliable.

The audit committee meets regularly and plays an integral part in the governance of the Department of Public Ventures.

The main item on the balance sheet of the Department is investments in subsidiaries, since the nature of the business is to acquire shares in specific enterprises so as to enable the state to own these entities. Income is in the form of funds received from National Treasury, which are utilised to acquire shares in these companies and to cover the Department's significant expenditure. Other sources of income are insignificant and consist mainly of interest on staff loans and the periodic sale of fixed assets. The Department has a negative cash flow. The financial statements of the Department are prepared on the modified cash basis.

As the Department of Public Ventures is a government department, there are several related party transactions between itself and other government departments.

The Department of Public Ventures is prohibited from obtaining loan finance from financial institutions and other organisations. The Department is 100% financed by the Government and it receives its annual funds from the National Treasury. These funds are used to acquire assets and investments.

The 2007 audit of the Department of Public Ventures was performed by Audit Solutions on behalf of the Auditor-General. With the permission of the Auditor-General and the Department you have been in contact with Audit Solutions and have determined that a good relationship existed between the auditors and the Department and that the Department provided Audit Solutions with their full co-operation. An unqualified audit opinion was expressed in the prior year and few errors were identified.

While obtaining knowledge of the business you started to prepare a draft Overall Audit Strategy to present to the Auditor-General as part of your firm's proposal.

REQUIRED:

- (a) Indicate the various sources from which CBH Incorporated can obtain an understanding of the business of the Department of Public Ventures. (10)

- (b) Discuss the factors, in terms of *ISA 300 – Planning an audit of financial statements* and *ISA 220 - Quality control for audit of historical financial information*, which CBH Incorporated needs to consider *before* accepting the appointment as the auditor of the Department of Public Ventures for 2008. (26)

- (c) Explain the term “audit risk” and the various components thereof in terms of *ISA 200 – Objective and General Principles Governing an audit of financial statements*. (6)

- (d) Assess the risk of material misstatement of the annual financial statements of the Department of Public Ventures at the overall financial statement level. In other words, assess the risk of material misstatements that relate pervasively to the financial statements as a whole, and that have the potential to affect many assertions.

(14)

Please note: You do not need to distinguish between the various components of audit risk. Your answer should, however, distinguish between the factors increasing and decreasing audit risk and should also contain a conclusion on the acceptability of the engagement.

- (e) Explain the purpose of the *Overall Audit Strategy* and set out the general audit approach you would follow, should the audit of the Department of Public Ventures be awarded to your firm. Your solution should include a conclusion on the levels of the different components of audit risk, as well as an indication of the nature, timing and extent of your planned audit procedures.

(10)

- (f) Explain when information is considered *material* as well as the relationship between audit risk and materiality. Provide an outline of how you would determine planning materiality for the 2008 audit of the Department of Public Ventures.

(14)

QUESTION 2

(25 marks)

You are a member of the audit team for the Provincial Department of Education. As auditor, you review the contract files for the procurement of primary school text books. You note that a contract for R5.8 Million has been awarded to ABC School Supplies CC. The contract was awarded on the strength of a tender process which was finalised in October 2007. On review of all of the tender submissions, you make the following observations:

- 21 entities submitted their tenders;
- the price of the tenders ranged from R5.8 Million to R11.6 Million;
- ABC School Supplies CC submitted the cheapest tender; and
- all of the required tender registers appear to be in order.

You obtain the tender file for your review. On inspection of the individual tender submissions, however, you observe that the tender submissions of 20 entities have two sets of staple holes in the top left corner, but ABC School Supplies CC's tender document has only a single set of staple holes. On closer inspection, you note that in all the other 20 tender submissions, page 10, which represents the pricing schedule, has a single set of staple holes. You are also convinced that the paper used for page 10 of the 20 unsuccessful tenderers is different from the rest of their document packs, but identical to each other.

You are convinced that this little detail represents a red flag of fraudulent activity and extend your tests.

REQUIRED:

- (a) Explain the significance of your discovery and state the type of fraud this represents. Explain the modus operandi used by the fraudster. (7)
- (b) List the further audit steps you would undertake as a result of this review. (18)

QUESTION 3

(30 marks)

The Kwalngwe Metropolitan Council, one of the largest metropolitan councils in the country, has been using the SPA integrated application system for the past three years. The SPA system is an application that merges all sub-applications into a single organisation-wide system. One of these sub-applications is the Human Resources (HR) application, used to capture and process all information related to the council's more than 5 000 employees.

As a senior auditor on the annual audit of Kwalngwe, you obtained the following information:

The HR system is used, *inter alia*, to add new employees to the employee master file, change details of current employees (including remuneration), and to remove employees from the system. The HR system has a direct interface with the payroll system and forms the basis for monthly payroll processing.

The following table summarises the HR-specific actions associated with key people in the department:

Action → Job description ↓	Authorise user creation / removal from the system	Data entry	Output and user profile reviews	Authorisation of processing errors for resubmission	Creating new users on the system	Performing the monthly back-up of the system
Data Entry Clerks		X				X
Assistant Director: HR		X		X		
Systems Administrator	X		X		X	
Director: HR	X	X				

X – indicates the person currently performing the task or with the ability to perform the task.

Notes on the above:

- There are four authorised users on the system; two data entry clerks, the assistant director and the director. All four users have full read and write access to the system. A temporary data entry clerk was employed for two months during the past year to assist with capturing information associated with renegotiated employee benefits for all employees. This temporary clerk's contract has since expired, although her user name and password still appear on the system's access table.
- Source documents form the basis for most transactions. Examples of such documents include appointment letters, resignation letters, and employee contracts. All of these are signed by the HR assistant director or director before being captured into the system. Should source documents contain

errors and be rejected by the system for any reason, the assistant director authorises the document for re-entry by overriding the error message. To save time the assistant director would usually enter the transaction himself.

- The monthly back-up is performed by copying all information on the system to disks. These disks are kept in the HR department's fire safe.
- Access and transaction logs are generated by the system once a quarter. These logs are printed by the systems administrator and handed to the assistant director for review.
- Employee number is used as the primary key to access all information on the system. The payroll application also uses employee number to access master file information to enable the monthly payroll run. An example of a systems generated employee number is 753829.

REQUIRED:

- (a) Discuss all the control weaknesses in the above information and make appropriate recommendations for each. (22)
- (b) List and describe all the input validation tests you would expect to be programmed for the employee number field in both the HR and the payroll systems. (8)

QUESTION 4**(25 marks)**

The Auditor-General commissioned a transversal audit on the acquisition and utilisation of consultants in 2003. The results of the performance audits were consolidated and a transversal performance audit report was issued and presented to parliament. You are the Audit Manager at the Department of Health. As part of the audit plan it is a requirement that one performance audit is conducted for the year under review. You are of the opinion that it would be a good idea to conduct a performance audit on the acquisition and utilisation of consultants to evaluate if there has been improvement in the management of consultants.

Consultant expenditure represents 10% of total expenditure. The main categories of expenditure on consultants are included in the table below:

Expenditure on consultants in different categories

Main category of work	Number of appointments	Percentage of total appointments
Information technology	4	20%
Human Resource Management	12	60%
Training, development and education	6	15%
Financial Resource Management	2	5%

One of your interviews revealed that in many cases consultants have been appointed on a basis which is permanent in nature.

You have also read a newspaper article about one consultant firm planning litigation against the Department on the grounds of the unfair award of tenders.

As part of your documentation review you scrutinised the minutes of the EXCO meetings. In the minutes you noticed that a request was made to review the performance management system, and that it had been adopted. In subsequent minutes you read that a review was conducted by a consultant firm at an approximate cost of R1.5 million. You asked one of your staff members to compile a list of all consultants authorised by the Tender Procurement Committee and notice that the appointment of the consultants to review the performance management system were not included on the list.

You asked your audit staff member to compile a short system description on the appointment of consultants. The system notes indicated the following:

The organisation follows a variety of approaches for the appointment of consultants, but the most commonly applied is the following:

A project is defined and one of the Executive Managers has to approve the project definition and plan, including the detail of project objectives and deliverables, and a budget estimate. If the Executive considers it necessary the procurement goes out

on tender and has to be approved by the Procurement Tender Committee. The Executive Manager is responsible for the management of the consultants in terms of delivery on time, within budget and at the right quality and quantity. Payments are made by the creditors section, based on the Executive Manager's signature on the cheque request.

A preferred list of service providers exists. However, users of the services of consultants have indicated that information on the current database has been found to be largely outdated and irrelevant to their needs for specialised services in certain areas.

One of your review notes attached to the system description prepared by the staff member, requested clarification as to whether an officially approved policy for the procurement of services existed, and if so, did it also ensure the economical procurement of a service provider, especially with regards to the quality and cost of procurement. The staff member replied to the review note by stating such a policy did not exist.

Another review note required a copy of the contract with the consultant hired to review the performance management approach. The staff member replied that no evidence of a contract could be found.

You also tried to obtain management information on the procurement and utilisation of consultants but could only find payment information on the financial system.

REQUIRED:

- (a) Provide three reasons why a performance audit on consultants should be performed. (3)
- (b) Explain the difference between entity-specific performance audits and transversal performance audits. (4)
- (c) Using the information in the question, identify five symptoms indicating specifically for each whether it is uneconomic acquisition, an inefficient and ineffective utilisation of resources, or an inadequate management measure. (5)
- (d) Based on the information provided in the question, identify three possible focus areas for a performance audit to be conducted on. (6)
- (e) Based on the symptoms identified in (c) above define two relevant performance audit criteria for the procurement and utilisation of consultants. (2)

- (f) Evaluate the performance indicator presented below, using the criteria for a good performance indicator described in the Framework for Managing Programme Performance Information. (5)

Measurable objective	Output	Indicator	Target	Actual Performance Information
Through the appointment and utilisation of consultants, improve service delivery.	Appoint consultants. Utilise consultants.	Number of consultants appointed.	Appoint 100 consultants.	120 consultants appointed.