



The Southern African Institute of Government Auditors

Qualifying Examination for Registered Government Auditors

Paper 3: Auditing

November 2010

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 2010".
- 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)

The Department of Transport's mission is to lead the development of integrated, efficient transport systems by creating a framework of sustainable policies, regulations and implementable models to support government strategies for economic, social and international development. The Department strives to effectively manage the transportation systems of the country and to provide the public with safe, integrated, regulated, affordable and assessable transportation systems.

PART A: THE AUDIT OF CONSULTANT FEES

(70 marks)

Part A of this question consists of Section 1 to 3 which all relate to the audit of consulting fees incurred by the Department of Transport for the year ended 31 March 2010.

The Department of Transport regularly appoints consultants to assist in a wide range of activities such as policy advice, engineering services, social and environmental studies and feasibility studies, for example, feasibility studies on the viability of introducing new passenger or freight rail services in specific areas.

Detailed below are extracts from the Annual Financial Statements and Trial Balance of the Department of Transport for the year ended 31 March 2010, pertaining to fees paid to consultants.

EXTRACT FROM THE ACCOUNTING POLICIES

Basis of preparation

The financial statements have been prepared on a modified cash basis of accounting, except where stated otherwise. The modified cash basis constitutes the cash basis of accounting supplemented with additional disclosure items. Under the cash basis of accounting transactions and other events are recognised when the cash is received or paid.

Goods and services

Payments made for goods and services are recognised as an expense in the Statement of Financial Performance when the final authorisation for payment is effected.

EXTRACT FROM THE STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 31 MARCH 2010

| | Note | 2009/10 R | 2008/09 R |
|----------------------------|------|--------------|--------------|
| EXPENDITURE | | | |
| Current expenditure | | | |
| Goods and services | 5 | 982,365,879 | 643,547,963 |

EXTRACT FROM THE NOTES TO THE ANNUAL FINANCIAL STATEMENTS

| | | <u>2009/10</u> | <u>2008/09</u> |
|------------------------------|--|----------------|----------------|
| 5. Goods and services | | | |
| Consulting fees | | 569,772,210 | 599,458,523 |
| Other | | 412,593,669 | 44,089,440 |

EXTRACT FROM THE TRIAL BALANCE AS AT 31 MARCH 2010

| <u>Account number:</u> | <u>Account description:</u> | <u>R</u> |
|------------------------|---|--------------------|
| 1250008022 | Consulting fees: Competitive Bidding | 389,442,533 |
| 1250008023 | Consulting fees: Written Price Quotations | 180,329,677 |
| | | <u>569,772,210</u> |

SECTION 1: THE AUDIT PLAN FOR CONSULTING FEES

(20 marks)

Management of the Department has always been committed to accurate reporting. Past audits indicated no major problem areas in fees paid to consultants and no exceptions relating to consulting fees were raised during the prior year audit. Procurement and contract management policies and systems were in recent years extensively evaluated and updated to ensure compliance with legislation and to facilitate accurate recording of consulting fees. Prior year audits indicated that the systems function effectively and that the internal controls adequately address all significant risk areas. The Department has a well-established internal audit department and the internal audit reports prepared during the current financial period included no significant reportable items relating to consulting fees.

REQUIRED:

- (a) Based on the information provided above, assess audit risk on assertion level and the components thereof in respect of the audit of consulting fees for the year ended 31 March 2010. (6)
- (b) Design and formulate the audit plan for the audit of consulting fees for the year ended 31 March 2010. (14)

SECTION 2: THE USE OF AUDIT SAMPLING

(18 marks)

The following sampling worksheet has been prepared for the audit of consulting fees.

| G5.3.6 | |
|--|--------------------|
| SAMPLING WORKSHEET: CONSULTING FEES | |
| <hr/> Auditee: Department of Transport <hr/> | |
| Prepared by: K Els 12/07/2010 <hr/> | |
| <u>Population</u> | <u>R</u> |
| Consulting fees: Competitive bidding | 389,442,533 |
| Consulting fees: Written price quotations | <u>180,329,677</u> |
| Total population | <u>569,772,210</u> |
| Planning materiality | 4,500,000 |
| Tolerable misstatement | 3,375,000 |
| Inherent risk | Low |
| Control risk | Low |
| Risk factor | 0.9 |
| Sample size – Significant items | 104 |
| Sample size – Remainder of population | 48 |
| Method of selection | Haphazardly |

REQUIRED:

- (a) Identify any shortcomings in the working paper. (4)

You need not comment on the adequacy or correctness of the audit work documented in the working paper.

- (b) Detailed below are certain factors which may affect the sample size for detail testing.

1. The auditor's assessment of the risk of material misstatement.
2. The use of other substantive procedures directed at the same assertion.
3. The level of tolerable misstatement.
4. The amount of misstatement the auditor expects to find in the population.
5. The number of sampling units in the population.

Indicate, with proper motivation, for each of the factors above, the effect that an increase in the factor would have on the sample size. (10)

Your solution should be presented in the following manner:

| Factor | Effect on sample size | Motivation |
|--------|-----------------------|------------|
| 1. | | |

- (c) Apart from haphazard selection of items, identify and briefly explain other methods of selecting items for detail testing. (4)

SECTION 3: AUDIT PROCEDURES FOR CONSULTING FEES (32 marks)

The Department of Transport's policies and procedures and its system of internal control over the procurement of consulting services are described below.

Should the estimated value of the consulting fees exceed R500,000 (including VAT) or the expected duration of the appointment exceeds one year, the consulting services are procured through a *competitive bidding process*. The Department uses the quality-and-cost-based selection method in selecting consultants. The Department's bid documentation includes, inter alia, the terms of reference, the request for proposals and the letter of invitation for bidding. The terms of reference includes matters such as the task directive, objectives, goals and scope of the assignment, time frames, responsibilities, evaluation criteria, cost estimates and the validity period. The request for proposals includes the letter of invitation, information to consultants, the terms of reference and the proposed contract. All the afore-mentioned documents are prepared in accordance with the requirements of National Treasury.

Prospective service providers are invited to submit bids by means of a public advertisement in national newspapers, on the website of the Department and in the government tender bulletin.

Once all proposals have been received at the closing time for submission, the proposals are evaluated by the Department's bid evaluation committee. At the end of the evaluation process, the bid evaluation committee prepares an evaluation report on the quality of the proposals and recommends a service provider to the bid award committee. The bid award committee identifies the preferred supplier which is approved in writing by the chairman of the bid award committee. Once negotiations with the preferred service provider are finalised, a standard contract as prescribed by National Treasury is prepared. All contracts are approved and signed by the Accounting Officer and the Chief Operating Officer.

The Department enters into two types of contracts, namely *fixed price contracts* and *time-based contracts*. With *fixed price contracts* payments are based on clearly specified outputs such as reports, drawings, bills of quantities, etc. The Department is invoiced based on the payment provisions included in the contract, such as amounts to be paid, scheduling of payments and the specified outcomes.

Payments for *time-based contracts* are made at regular intervals as specified in the contract and are based on agreed hourly, daily, weekly, or monthly rates for staff that are named in the contract and on reimbursable items using actual expenses. Consultant's invoices normally clearly indicate the staff members, number of hours worked and relevant rates. Proof of reimbursable expenses is attached to the invoices. Time-based contracts specify a maximum amount of total payments to be made to the consultant.

When the estimated value of the consulting fees is less or equal to R500,000 (including VAT) or the expected duration of the appointment is less than one year, *written price quotation procedures* are followed. Quotations are obtained in writing from at least three different providers whose names appear on the list of accredited service providers as maintained by the Department. This list is established through the competitive bidding process.

Upon receipt of an invoice from a consultant, the appropriate Head of Directorate checks the invoice and supporting documentation and certifies that the services are rendered and the price charged in accordance with the conditions of the contract. The Head of Directorate signs the invoice as evidence of approval. Once a payment request has been prepared, it is approved by the Head of Directorate.

The payment request together with the invoice and other supporting documentation are submitted to senior management for authorisation in terms of the Department's financial delegations.

The approved payment request and all documentation are forwarded to the accounting department where a disbursement clerk captures the payment on the accounting system. The payment is then authorised online by the appropriate authorised officer. An electronic payment is automatically generated and the accounting system is simultaneously updated by debiting the relevant general ledger account.

Two general ledger accounts are maintained for consulting fees, namely one for consulting services procured through competitive bidding and another account for services procured through written price quotations. A payment number is generated which is recorded on the payment request and invoice. The invoice and all supporting documentation are stamped as "paid" and filed according to the payment number.

A contract file is maintained for each contract which includes the signed contract, bid documentation, copies of all invoices received and details of payments made on the contract to date.

REQUIRED:

- (a) Design audit procedures to verify that suppliers appearing on the list of accredited service providers which are used when consulting services are procured through written price quotations, are not fictitious. (7)
- (b) Design a combination of detail substantive tests and compliance procedures/tests of controls to determine whether *consulting fees procured through competitive bidding procedures*, as per the trial balance as at 31 March 2010 (account number 1250008022), is fairly stated and incurred in accordance with the Department's policies and procedures for the procurement of consulting services through competitive bidding procedures. (25)

You need not distinguish between compliance and substantive procedures.

PART B: OTHER INFORMATION IN THE ANNUAL REPORT

(10 marks)

The following represents the contents page of the Annual Report of the Department of Transport for the 2010 financial year.

The Auditor-General South Africa (AGSA) is required to express an opinion on the annual financial statements included under part 5 in the Annual Report.

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REQUIRED:

In terms of *International Standard on Auditing 720: The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statement*:

- (a) Describe the auditor's responsibility in respect of part 1 to 4 of the annual report of the Department of Transport. (2)
- (b) Part 1 to 4 of the annual report may contain inconsistencies and/or material misstatement of facts that could undermine the credibility of the financial statements included in part 5. Distinguish between an *inconsistency* and a *misstatement of fact*, in terms of *ISA 720*. (2)
- (c) Describe the actions to be taken by the AGSA should a material inconsistency or a material misstatement of fact be identified *prior* to the date of the audit report. (6)

QUESTION 2

(30 marks)

The Luwero District Municipality includes three towns, various smaller settlements and a large rural area in South Africa. The council employs 483 full-time employees and uses the latest information technology in pursuit of meeting its service delivery targets.

The district council's information technology environment includes a comprehensive integrated system that includes a database that stores both application programs and data files. A client/server environment allows users to access the needed application programs and data files to perform their duties. The system's access controls plays an important role to ensure that only authorised users obtain access to the programs and data files needed for their job descriptions. As an example, only the head of human resources and a single senior human resource manager have read and write access to the employee master file.

As part of the annual audit of the district council, you have been asked to take responsibility for the information technology (IT) aspects of the audit. Your first focus area is auditing the payroll of the Luwero District Municipality. All employees are salaried and the payroll is processed on a monthly basis with reference to the employee master file. **Refer to the next page** for an example of the employee master file and some of the human resources policies of the council. After payroll processing both an error report and an exception report are generated for review by the head of payroll.

You have the latest Generalised Audit Software (GAS) package available with full data extraction and manipulation functions. The council also gave you a copy of the employee master file as at year end.

REQUIRED:

- (a) Discuss both the logical and physical access controls that should be applied to ensure that only authorised employees gain access to programs and files on the database through the client/server environment. (12)
- (b) Describe the difference between an exception report and an error report and give an example of a possible payroll transaction that could appear on each of these reports. (6)
- (c) Describe the difference between a field size test and a limit test and give an example where each could be applied in the payroll system with reference to the fields shown in the master file on the next page. (4)
- (d) Explain how you will use your generalised audit software package to investigate the following:
 - i. Correct allocation of annual leave in the employee master file. (3)
 - ii. Possible duplicate existence of the same employee on the master file. (3)
 - iii. The existence of possible ghost employees at the council. (2)

EXTRACT OF FIELDS AND RECORDS FROM THE EMPLOYEE MASTER FILE:

| Employee number | Surname | ID number | Date engaged | Gender | Level | All inclusive annual package R | Income tax number | Cost centre | Bank account number | Annual normal leave allowed |
|-----------------|----------|---------------|--------------|--------|-------|--------------------------------|-------------------|-------------|---------------------|-----------------------------|
| 23584676 | Apple | 6512085052080 | 02/02/1980 | M | C | 169,871 | 1108144641 | 02-125 | 1062654896 | 30 |
| 23587580 | Porter | 5805184096035 | 01/11/1984 | F | D | 267,965 | 1107657364 | 03-564 | 23366475 | 32 |
| 23607183 | Shabangu | 6903156985647 | 01/01/1988 | F | C | 157,658 | 1154324654 | 02-325 | 455651456 | 30 |
| 23831428 | Moloi | 8208144573364 | 01/04/2001 | M | C | 163,654 | 1136254154 | 02-125 | 215675646 | 30 |
| 23854693 | Botes | 7711035689478 | 01/09/2002 | F | E | 365,842 | 1154775664 | 06-231 | 16545564 | 35 |

Note: The above extract DOES NOT contain all the fields included in the master file.

EXTRACT OF POLICIES AND PROCEDURES: HUMAN RESOURCES

- All new employees are allocated a unique employee number consisting of eight characters and used as primary key in both the employee master file and the payroll transaction file.
- When an employee retires or resigns, his or her record is deleted from the master file and the employee number cannot be used for a different employee in future.
- All employees are salaried, and must provide an income tax number for the deduction of income taxes.
- Each employee can only be allocated to one cost centre.
- All salaries are paid electronically on the last working day of each month.
- Remuneration and leave is based on an employee's post grade. Salary ranges are allocated within each level, but annual leave is fixed per level.
- Examples of the salary ranges include:

| Level | Range for all inclusive package: |
|-------|----------------------------------|
| C | R125,000 – R185,000 p.a. |
| D | R185,000 – R285,00 p.a. |
| E | R285,000 – R385,000 p.a. |

QUESTION 3**(25 marks)****QUESTION 3.1****(5 marks)****REQUIRED:**

Please answer the following short questions:

3.1.1 Do you agree with the following statement? Please motivate your answer. (2)

“Performance auditing and the audit of pre-determined objectives are both independent audit processes that the Auditor-General South Africa (AGSA) is mandated to conduct on an annual basis”.

3.1.2 Explain the difference between an outcome and an output and give an example of each. (2)

3.1.3 Why is it necessary to define the baseline within the performance management process? (1)

QUESTION 3.2**(20 marks)**

The following are extractions from the Strategic Plan and the Annual Report of the Department: Government Communication and Information System.

Strategic Plan

Programme 7: Government Publication

Strategic Objective:

Continuously communicate and inform the public on the policies and programmes of government to improve their lives.

Learn and explore communication methods and practices to enhance communication.

| Sub-Programme | Output | Measure/ Indicator | Target 2010/11 |
|----------------------|--------------------------|--|--|
| <i>Vuk'uzenzele</i> | Printing of the magazine | Regular publication of target number of the magazine in all official languages | Every second month with a print run of 1.6 million and two million for the March edition |

Annual Report

| Sub-Programme | Output | Measure/Indicator | Target 2010/11 | Actual Performance |
|---------------|-----------------------|---|---|--|
| Management | Printing the magazine | Regular publication of target print run of the magazine | Every second month with a print run of two million for the March edition and 1.6 million for the other editions | In total 10 million copies were printed as follows: five editions with a print run of 1.6 million copies each and one edition with a print run of two million copies |

REQUIRED:

- (a) Identify the AGSA *sub-criteria* to test the main criteria of compliance of reporting requirements of performance information and explain what is meant by the sub-criteria. (6)
- (b) Evaluate the extractions included above against the main criteria of usefulness and the sub-criteria of measurability, relevance and consistency. (10)
- (c) List two factors that you would take into account to select a material programme to be tested and motivate your answer. (2)
- (d) Describe the audit procedures you would conduct on the actual performance information described in the table above to test for validity, accuracy and completeness. (2)

QUESTION 4**(25 marks)****QUESTION 4.1****(15 marks)**

In a landmark case in the United Kingdom (Kingston Cotton Mill – 1896) the judge ruled that the auditors were not liable for damages suffered by a company attributable to a fraud the auditors failed to uncover. The judge stated “[the Auditor] is a watchdog but not a bloodhound”. In the current environment, the auditor is required to “maintain an air of professional scepticism” constantly assessing the risk that he/she may be deceived by the client to conceal a material misstatement. The industry also responded with the advent of the “Forensic Auditor / Accountant” who effectively became the “bloodhound” referred to above. Although the forensic auditor relies on his/her knowledge and experience in auditing, his/her approach to the audit is significantly different in some areas.

REQUIRED:

Highlight 15 areas where the approach of the forensic auditor deviates from the standard audit approach as it relates to the following criteria, presented in tabular form:

| Criteria | General audit | Forensic audit |
|--|----------------------|-----------------------|
| Mandate and scope | | |
| Materiality | | |
| Interpretation of the term “evidence” | | |
| Relevant experience i.r.o. fraud investigation | | |
| Who performs fieldwork | | |
| Approach to assignment | | |
| Disciplines of team members | | |
| Target audience of the report | | |
| Budget | | |
| Understanding of Judicial environment | | |
| Sampling and extrapolations | | |
| Core disciplines applied / relied on | | |
| Level of scepticism | | |
| Reliance on representations made | | |
| General attitude to clients’ staff | | |

QUESTION 4.2**(10 marks)**

The fraudster may attempt to deceive or to manipulate the auditor to render him/her less effective or less likely to identify a fraud.

REQUIRED:

Briefly discuss five different manners in which the fraudster might attempt to manipulate the auditor.