The Southern African Institute of Government Auditors

Qualifying Examination for Registered Government Auditors

Paper 3: Auditing

November 2011

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 2011".
10 You are required to observe all Examination Instructions on the separate sheet of paper handed to you before commencement of this examination.

ADVANCING AUDITING AND ACCOUNTABILITY

QUESTION 1 (80 marks)

The Department of Corrections of the South African government is responsible for managing South Africa's prison system. The Department has approximately 43 000 staff members and is responsible for the administration of 263 prisons. The prisons include minimum, medium and maximum security facilities. The Department is headquartered in Johannesburg.

The Department strives to contribute to maintaining and protecting a just, peaceful and safe society by enforcing sentences of the courts, detaining all prisoners in safe custody whilst ensuring their human dignity and promoting the social responsibility and human development of all prisoners and persons subject to community corrections.

Parts A to D of this question relate to the annual regularity audit performed by the Auditor-General South Africa (AGSA) on the annual financial statements of the Department of Corrections for the financial year ended 31 March 2011.

PART A: ACCEPTING AN ENGAGEMENT (6 marks)

In terms of the *Public Audit Act*, the functions of the AGSA can be categorised into *constitutional functions*, which include mandatory, regularity audits and discretionary audits and *other functions*, which includes audit-related services such as agreed-upon procedures.

The Department of Corrections and the National Council for Corrections requested the AGSA to perform certain agreed-upon procedures on statistics of infants and young children in detention with their mothers.

REQUIRED:

Describe three main differences between a *regularity audit*, such as the annual audit performed by the AGSA on the annual financial statements of the Department of Corrections and *audit-related services*, such as the agreed-upon procedures requested by the Department of Corrections and the National Council for Corrections.

PART B: PLANNING THE ANNUAL AUDIT (18 marks)

In terms of *ISA 315 - Identifying and assessing the risks of material misstatement through understanding the entity and its environment*, the auditor is responsible to identify and assess the risks of material misstatement due to fraud and error in the financial statements, through understanding the entity and its environment, including the entity's internal control. *ISA 315* requires that this assessment is done on the financial statement level, as well as at assertion level for classes of transactions, account balances and disclosures.

The audit team assigned to the 2011 audit of the Department of Corrections identified a number of risk factors, in *addition* to those appearing on the Department's *Risk Register*, which may increase the risks of material misstatement. One of the audit team members began to document the additional risks on working paper *D5.5.1 – Risk Summary* (refer to the next page). Apart from the first two risk factors already documented (refer to number 1 and 2 on *D5.5.1*), several other risk factors were identified and their impact on the audit should still be considered and documented on working paper *D5.5.1*. These other risk factors include the risks documented below.

3 There is a high vacancy rate in the finance department.
4 There appears to be inadequate control and management of the termination of services of employees.
5 There are several pending investigations, litigations and claims against the Department.
6 The Department has a complex structure with correctional centres and warehouses in various locations.
7 The audit manager of the 2011 audit and several other audit team members have no prior audit experience with the Department of Corrections as the previous manager resigned and audit staff was reallocated.
8 The current Commissioner of Corrections and other persons in senior positions are under investigation for possible irregularities concerning the process of awarding tenders.

REQUIRED:

Complete working paper *D5.5.1 – Risk Summary* for risks number 3 to 8 as mentioned above. You may present your answer in table or any other form, provided that your answer includes the following in respect of each risk factor:

(a) the possible impact of the risk factor; (7)
(b) whether the risk factor increases risk at the financial statement level and/or risk on the assertion level; (3)
(c) the component(s) of audit risk affected by the risk factor, namely inherent risk (IR), control risk (CR) and/or detection risk (DR); (3)
(d) the assertion(s) affected by the risk factor (if applicable); and (3)
(e) the classes of transactions, account balances and disclosures affected by the risk factor (if applicable). (2)

RISK SUMMARY	**D5.5.1**
Auditee: Department of Corrections	**Year-end:** 31 March 2011
Prepared by: J Daniels 12/06/2011	**Reviewed by:** K Smith 15/06/2011

Risk factors identified	Impact of risk factor (What can go wrong and why?)	Increased risk at financial statement or assertion level?	Component of audit risk affected			Assertion affected, if applicable	Classes of transactions, account balances or disclosures affected, if applicable
			IR	CR	DR		
1. Identifying fraud and addressing the risk of fraud are not seen as a high priority.	There is an increased risk of misstatements due to fraud, as employees do not see any deterrent for committing fraud and theft.	Financial statement level.	✓			N/A – all assertions may be affected.	Not applicable – all transactions, account balances and disclosures may be affected.
2. The prior year audit report was qualified in respect of material overpayments of medical aid contributions paid by the Department, due to system problems which resulted in the incorrect calculation of contributions.	There is an increased risk that the system problems still exist and that medical aid contributions may again be calculated incorrectly which may lead to material errors in the financial statements.	Assertion level.		✓		Accuracy	Employee Cost – Social Contributions
3.							

PART C – PERFORMANCE OF AUDIT PROCEDURES (50 marks)

The following *extracts* from the annual financial statements of the Department of Corrections for the year ended 31 March 2011, relates to the audit of *medical supplies* (refer to Part C1 and Part C2):

ACCOUNTING POLICIES

9. Inventory

All payments for inventories are recognised as an expense in the statement of financial performance when final payment is effected on the system. Inventory purchases are included under Goods and Services.

Inventories on hand as at 31 March 2011 are included in the annual financial statements as a disclosure note. Inventories on hand represent all actual items in stock, regardless of whether payment has been affected or not. Inventories on hand are reflected at cost, using the first-in-first-out valuation method. Damaged or unusable inventories are written down to R nil.

STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 31 MARCH 2011

EXPENDITURE	Note	2010/11 R'000	2009/10 R'000
Current expenditure			
Goods and services	5	3,573,028	3,344,946

NOTES TO THE ANNUAL FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011

	Note	2010/11 R'000	2009/10 R'000
5. Goods and services			
…….		…….	…….
…….		…….	…….
Inventory purchases	5.3	754,565	642,322
…….		…….	…….
…….		…….	…….
		3,573,028	3,344,946

	Note	2010/11 R'000	2009/10 R'000
5.3 Inventory purchases			
Medical supplies		329,510	256,256
Food and food supplies		659,589	589,236
……		…….	……..
……		……	…….
		754,565	642,322

21. Inventories on hand at 31 March 2011

Categories	**R'000**
Medical supplies	89,860
……	……..
……	……..

The following represents an *extract* from the working paper *D7.1.2 - Audit plan for medical supplies* as included in the planning section of the audit file:

Conclusion

Based on the information we have obtained in gaining an understanding of the accounting process and internal controls over medical supplies *(working paper D2.1.4)* and our risk assessment performed at assertion level for medical supplies (*working paper D5.7.7*), we have formulated the following audit plan for the audit of medical supplies:

Medical inventory purchases included as an expense under Goods and Services:

The system of internal controls appears to be operating effectively and our risk assessment did not reveal any specific risks in respect of medical supply purchases. We have decided to follow a control reliance approach for the audit of medical supply purchases and will consequently perform extensive tests of controls and limited substantive procedures.

Medical inventory on hand at 31 March 2011 included in the annual financial statements as a disclosure note:

We have decided that a substantive audit approach will be most effective for the audit of medical supplies on hand at year-end. We will attend the annual stock counts on 31 March 2011 at selected correctional facilities and will perform further substantive procedures to verify the disclosed balance of medical supplies on hand at 31 March 2011.

PART C1: TESTS OF CONTROLS **(20 marks)**

The following represents an *extract* from the system description documented in working paper *D2.1.4 – Understanding the system: Medical Supplies*, specifically relating to the *ordering* and *receiving* of medical supplies:

The Department of Corrections is responsible to provide proper medical care to all prisoners. This duty includes the provision of proper hospital/clinic care, surgical procedures required, external equipment such as hearing aids and medication, including prescription medicines, antiretroviral drugs, vaccines, *et cetera*.

All the correctional centres have on-site access to the services of a full-time registered pharmacist. All medication is kept in the pharmacies for issue to correctional clinics or hospitals and for dispensing purposes.

The Head Pharmacist is responsible for the administration of medicine and must ensure that the correctional centre adheres to laws and regulations regarding the control of medical supplies. All persons employed in the pharmacy that provides services which form part of the scope of functions of a pharmacist, must be registered with the South African Pharmacy Board and must possess a valid membership number and membership certificate. All access to medical supplies is strictly obtained through one of the registered pharmacists. There is only one entrance to the pharmacy which is secured by means of a security gate and an alarm system. The door and security gate are kept locked at all times and only authorised personnel may enter or exit the pharmacy.

The Head Pharmacist is responsible for maintaining the correct inventory levels and for identifying the need to order pharmaceuticals on time. Pre-numbered *Procurement Requests* are automatically generated on reaching the minimum quantity for those items that should be readily available when needed, in other words, medical supplies which always have to be kept in stock. For these and any other items needed, any of the pharmacists complete a pre-printed and pre-numbered *Purchase Request*. The Head Pharmacist signs all *Purchase Requests* as evidence of his/her approval after he/she ensured that the request is valid and necessary.

Purchase Requests and the related *Procurement Request*, if applicable, are forwarded to the Ordering Clerks in the Supply Chain Management division, who are responsible for the ordering of all pharmaceutical products.

One of the Ordering Clerks captures the *Purchase Request* on the system and then forwards the manual *Purchase Request* and *Procurement Notice*, if applicable, to the Head: Supply Chain Management. The Head signs the *Purchase Request* and *Procurement Notice* as evidence of approval, after verifying the correct capturing of the *Purchase Request* on the system and inspecting the documents for reasonableness, proper completion, the signature of the Head Pharmacists, etc. The Head: Supply Chain Management then approves the *Purchase Request* on the system. The signed *Purchase Request* and *Procurement Notice* are handed back to the Ordering Clerk who creates an *Order* on the system. No *Orders* can be created on the system without reference to a previously approved *Purchase Request* on the system.

The *Orders* are prepared with reference to the approved *Purchase Request* and the database of approved suppliers and prices. This database is maintained and updated each quarter, in terms of the requirements of the Department's procurement policies. The Ordering Clerk selects one of the approved suppliers on a rotation basis and captures the *Order* on the system, after which the Head: Supply Chain Management approves the *Order* on the system, after referring to the already approved *Purchase Request* on the system and the database of approved suppliers and prices.

Once the *Order* has been approved on the system the captured *Purchase Request*, *Order* and a *Supply Receipt* are printed by the Ordering Clerk. The *Order* is handed to the Head: Supply Chain Management for his signature.

The Ordering Clerk sends the supplier copy of the *Order* per registered post to the supplier. It can also be faxed, but the original must still be sent per registered post to the supplier.

Copies of all documentation are forwarded to the Medical Supply Receiver (also a registered pharmacist), who checks the documents, initials them and files them in an *Awaiting Goods File*. Upon delivery of the medical supplies, the Medical Supply Receiver obtains all the relevant documentation from the *Awaiting Goods File*. He or she removes the items from their packaging to check the actual items delivered against the *Order* and the *Supplier Delivery Note* in respect of description and quantity. The expiry dates of items are also checked before accepting the goods. The Medical Supply Receiver then records the correct quantities on the *Supply Receipt*. The Medical Supply Receiver also checks the nature of the items delivered for any special storage instruction, such as cold storage applicable in the case of vaccines, antibiotics, *et cetera*. The Medical Supply Receiver signs the *Supply Receipt* as evidence of receiving the items in good order. Supplies requiring storage in a specific temperature controlled environment are immediately transferred to the pharmacy for shelving at the correct temperatures. All other items must be delivered to the pharmacy within three days of receipt.

No persons other than the pharmacists, assistants and support personnel registered in terms of the *Pharmacy Act* are allowed to handle pharmaceutical products. As such, any pharmaceutical products are delivered directly to the pharmacy from the receiving area by the Medical Supply Receiver. No medical supplies are stored or kept at any other locations or storage areas.

Upon transferring of the items to the pharmacy, the Head Pharmacist inspects the goods and acknowledges receipt thereof by also signing the *Supply Receipt*.

The Medical Supply Receiver creates a *Voucher File* with all the documentation relating to the ordering and receiving of the supplies and forwards the file to the Posting Clerk: Accounting for recording purposes. All system generated documents are issued in number sequence.

REQUIRED:

Design tests of controls to test the effectiveness of the controls of the Department of Corrections over the *ordering* and *receiving* of medical supplies.

Note:
Your solution should not include tests of general and application computer controls nor should your answer include the use of general audit software.

PART C2: SUBSTANTIVE AUDIT PROCEDURES (30 marks)

The Department of Corrections maintains perpetual inventory records and inventory listings for all inventories on hand on a separate system, for control and disclosure purposes. The system includes all categories of inventory, including medical supplies.

The Department conducted inventory counts at head office and all the correctional centres on 31 March 2011. The counts were conducted in terms of the requirements specified in the *Procedure Manual – Inventory Management*.

Proper inventory count instructions were distributed to all personnel involved. These instructions clearly specified the date and time of the count, preparation of the pharmacies for the count, movement of medical supplies during the count, the method of counting and recording quantities, numbering of count sheets, *et cetera*. The instructions also required that all damaged or items past expiry date are recorded in a separate register. Any damaged medication or medication past the expiry date is written down to a nil balance, as they have no resale value.

The audit teams reviewed the instructions and were satisfied that it complied with the *Procedure Manual* and included all the necessary aspects required to ensure that the inventory counts are properly performed. The audit teams attended the inventory counts at selected correctional facilities as per the audit plan documented in working paper *D7.1.2 - Audit plan for medical supplies*.

REQUIRED:

(a) Describe the procedures that the various audit teams should have performed *during and at the conclusion* of the physical inventory counts of medical supplies on hand at year-end. (17)

(b) Formulate the substantive audit procedures that should be performed, *in addition to the procedures performed during the inventory count*, to ensure that *all* assertions in respect of medical supplies are tested and that medical supplies on hand at 31 March 2011, as disclosed in note 21 to the annual financial statements, are therefore fairly stated. (13)

Note:
Your answer should not address any general or specific analytical procedures or the use of computer assisted audit techniques.

PART D: CONCLUDING AND REPORTING **(6 marks)**

The final materiality figure for the 2011 audit of the Department of Corrections was set at R150 million.

During the audit of Capital Assets the AGSA identified misstatements in the valuation of major moveable tangible assets.

The financial reporting framework for Departments requires a Department to record assets on receipt of the item at cost of acquisition. Where the cost cannot be determined accurately, the asset should be stated at fair value. Where fair value cannot be determined, the asset should be included in the asset register at R1. The Department of Correction's major movable tangible assets as disclosed in disclosure note 35.1 to the financial statements did not in all instances reflect the cost or fair value of the assets and consequently assets were overvalued by R193 million.

REQUIRED:

Discuss, with reference to *ISA 705 – Modifications to the opinion in the independent auditor's report*, the effect of the misstatement identified on the audit opinion of the AGSA.

QUESTION 2 **(25 marks)**

You are a Registered Government Auditor (RGA) employed by the Auditor-General South Africa (AGSA). You are the auditor in charge of the annual audit engagement at the Government Information Technology Agency (GITA), a national South African public entity. GITA was established in 1999 to facilitate all government's information technology (IT) resource needs in order to ensure a more economical acquisition of IT resources. The organisation employs over 800 business analysts and programmers to meet the IT system development needs of all government institutions.

The systems development director, Ms Jane Kizane informed you that GITA is currently busy with 32 systems development projects over all three spheres of government. She presented you with the current project planning memorandum. Inspection of the memorandum revealed that almost half of these projects should have been completed by now. After you discussed this fact with your audit manager, it was decided that the audit engagement will commence with a general and application control review of the systems development methodology. You decided to select one of the overdue projects that is close to completion to perform a complete walk-through of the project.

You randomly selected project number 2010-16, a new matriculation result management programme that is being developed for a provincial department of Education. According to Ms Kizane, this project will be implemented within the next two weeks. You determined the following based on the project planning memorandum:

- ☐ The project should have been completed a month ago.
- ☐ The purpose of the system is to capture matriculation results based on each candidate's 10-digit examination number, in such a manner that the results can be easily posted on the Department's website on the day the results must be published.
- ☐ Once the system is operational the Department plans to capture the examination number, first name, surname and subjects selected of each registered candidate for that calendar year by the end of July.
- ☐ Marks awarded for each paper must be captured by markers on a separate pre-numbered mark allocation sheet (MAS) for each subject.
- ☐ MASs will then be captured unto the system by the Department's data capturers as soon as they are received during November and December.

REQUIRED:

(a) Prepare an engagement work programme, listing the engagement procedures you would follow to perform the above-mentioned project walk-through. (10)

(b) Discuss the specific application controls that should be present in the matriculation result management program to ensure the validity, accuracy and completeness of the capturing of matriculation results. (15)

QUESTION 3 **(25 marks)**

You have been appointed as the performance management auditor at the Department of Education. Your portfolio of responsibilities includes performance audits and the audit of pre-determined objectives. You recently attended a course on performance auditing and know one of the first steps would be to gather as much knowledge about the business as possible.

As part of the information gathering process you extract information published in the media on the Department of Education. One of the media reports is very critical about the professional development of teachers. Some of the challenges highlighted by the report include a lack of access and opportunities to quality Teacher Education and Development; a mismatch between the provision of and demand for teachers of particular types; the poor pass results in schools; and inefficient and poorly monitored funding mechanisms. The media report concluded that the quality of learning across all grades and phases of the basic education sector is less than satisfactory and this poor performance is most prevalent in poor communities.

On further enquiry you established that the Department of Education is not able to report on the total amount of spending on professional development of teachers. You have done a rough estimation of the total spending on professional development across all of its sources of funding to determine if this should be a focus area for the audit and estimated the total spending on professional development for teachers at more than R200 million per year.

During the interview with the Chief Operating Officer she informs you that the Department of Education has assembled considerable evidence of the characteristics of effective professional development for teachers. During your scrutiny of the website of the Department of Education you are also not able to identify any type of Strategic Framework for teaching and development in South Africa.

You also studied the Strategic Plan and documented the following important information from the Strategic Plan:

Vision: Our vision is of a South Africa in which all our people will have access to lifelong learning, education and training opportunities which will, in turn, contribute towards improving the quality of life and the building of a peaceful, prosperous and democratic South Africa.

Mission: Working together with provinces, our mission is to provide relevant and cutting edge quality education for the 21st century.

Strategic Objectives

Strategic Objective 2.1	Improve teacher capacity and practices
Objective statement	To incentivise teacher adoption of e-Education by means of substantial increase in the availability of learning and teaching resources, including through the internet.
Baseline	The current availability of e-Education resources, and capacity to make use of resources that exist, are severely limited.
Justification	Substantial expansion of e-Education in particular amongst the most disadvantaged, depends to a large degree on the buy-in to new technologies and educational media amongst teachers.
Links	Computer literacy, which is a natural outcome of e-Education, is known to have large positive knock-on effects in terms of economic development and employment.

You also studied the Annual Performance Plan 2011/2012 and the following is an extract from the Annual Performance Plan related to the objective included in the Strategic Plan:

Strategic objective	**Programme performance indicator**	**Audited/ Actual performance**			**Estimated performance**	**Medium-term targets**		
		08/09	**09/10**	**10/11**		**12/13**	**13/14**	**14/15**
Improve teacher access to e-Education tools	The number of educators that use and apply ICT (Information and Communication Technology) in their classrooms	-	-	-	1600	1800	2000	2300
	The number of educators who attended ICT training courses	11500	13310	14900	16690	18690	20900	23000
	The number of schools connected to ICT infrastructure and services				900	1025	3000	6000

You conduct research on best practices as part of the process to develop performance audit criteria. During your research you identify the need for an Integrated Strategic Planning Framework. The Plan must address the career of a teacher through a number of phases from recruitment through to retirement including:

- ☐ Recruitment of potential teachers.
- ☐ Preparation of new teachers.
- ☐ Induction into the world of work.
- ☐ Career-long (continuing) professional learning and development.

REQUIRED:

(a) Explain the meaning of performance audit and the audit of pre-determined objectives with specific reference to the information provided in the question. (8)

(b) Explain the difference between an entity-specific performance audit and a transversal performance audit. (2)

(c) Identify three factors that can be used by you after evaluating the information collected and the symptoms identified to assist with selecting and motivating the most suitable focus area. (3)

(d) The Auditor-General South Africa (AGSA) uses nine sub-criteria to audit information on pre-determined objectives. For the main criteria of usefulness, identify the three sub-criteria used by the AGSA and explain the sub-criteria. (6)

(e) Assess the information included in the Strategic Plan and Annual Performance Plan against the criteria of consistency, measurability and relevance. (6)

QUESTION 4 **(30 marks)**

REQUIRED:

Please answer the following short questions.

QUESTION 4.1 **(5 marks)**

As auditor, you must always be alert to the risk of fraud or error. Explain and discuss the key differences between these terms and indicate how these would impact on the auditor's approach when considering these risks.

QUESTION 4.2 **(5 marks)**

Most fraud surveys identify procurement fraud and corruption as the most common form of abuse. In South Africa, the constitution dictates that when an organ of state in the national, provincial or local sphere of government, or any other institution identified in local legislation, contracts for goods or services, it must do so in accordance with a system that is **fair**, **equitable**, **transparent**, **competitive** and **cost-effective**. You are required to explain how procurement fraud undermines these principles contained in the constitutional prescripts.

QUESTION 4.3 **(10 marks)**

Identify and briefly discuss ten practical differences between a forensic audit vs. a traditional audit.

QUESTION 4.4 **(5 marks)**

In a recent fraud survey, 83% of the respondents indicated that they had been subjected to economic crime in the preceding two years. 17% of them indicated that they were not. Discuss these results and express your views (based on your understanding of fraud) why the latter 17% indicated that they did not experience economic crime.

QUESTION 4.5 **(5 marks)**

Fraud generally refers to the unlawful and intentional misrepresentation by a person to the actual or potential prejudice of another. Discuss the concept of "potential" prejudice and indicate what "prejudice" includes.