



The Southern African Institute of Government Auditors

Qualifying Examination for Registered Government Auditors

Paper 3: Auditing

November 2016

INSTRUCTIONS TO CANDIDATES

- 1 Maximum marks: **160**.
- 2 **Q1=60 marks, Q2=25 marks, Q3= 25 marks, Q4= 30 marks, Q5 20 marks**
- 3 **Start each question in a new Exam Book (Green)**
- 4 Total time available: **four hours**.
- 5 The marks allocated to each question are an indication of the expected length and required depth of the answer.
- 6 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.
- 7 Present your arguments clearly, using well structured, clear and precise language and appropriate professional terms.
- 8 No books or notes are allowed in the examination room.
- 9 All working papers must be handed in together with all paper provided for the examination (including unused answer sheets).
- 10 Answers written in pencil will not be marked.
- 11 You are reminded that this examination will be held under the rules set out in the document "RGA-QE Examination Matters & Examination Policy 2016".

Question 1

(60 Marks)

Background to EKOM

EKOM is a Schedule 2 Public Entity, and fully adheres to the rules and regulations as set out in the Public Finance Management Act (PFMA), Act 1 of 1999 and the applicable Treasury Regulations. EKOM Annual Financial Statements are prepared in terms of the International Financial Reporting Standard and Companies Act of South Africa 2008. EKOM is a holding company which has several subsidiaries all with a 31 March year end.

EKOM generates approximately 95% of the electricity used in South Africa and approximately 45% of the electricity used in Africa. EKOM generates, transmits and distributes electricity to industrial, mining, commercial, agricultural and residential customers and redistributors. Additional power stations and major power lines are being built to meet rising electricity demand in South Africa. EKOM will continue to focus on improving and strengthening its core business of electricity generation, transmission, trading and distribution. As part of EKOM's strive to improve their service to South Africans a decision was taken to base management's bonuses on ESKOM's profit.

EKOM operates and maintain various plants across South Africa. EKOM strive to support its subsidiaries and their business contacts by sourcing all their procurement needs from these companies first.

EKOM purchased and implemented a new accounting system during the 2016 financial year to assist the accounting department to decrease their financial reporting time. Management of EKOM wants the financial statements by 15 April 2016 as they want to apply for additional finance to expand their business ventures as they are currently struggling with liquidity problems.

During 2016 most South Africa Stated Owned Entities' credit ratings were under review by Moody's, EKOM is faced with a possible downgrade in their credit rating.

Background to the Auditors of South Africa (AOSA)

AOSA is a Chapter 9 institution which has a constitutional mandate to conduct and issue audit reports on all government departments, public entities, municipalities and public institutions.

You are an audit senior at the AOSA. AOSA are the newly appointed auditors of EKOM. You were allocated to the audit of the EKOM.

The audit deadline is 15 April 2016.

The previous auditors gave AOSA the prior years' audit file as per EKOM's request.

The following working papers are provided:

Construction of Medu power station	A1
Subsequent Event	C1

ANNEXURE A

Auditors of South Africa				A1(1 of 2)
Auditee:	EKOM	Period-end:	31-Mar-16	
Preparer:	SW	Reviewer:	SM	
Preparer Date:	01 April 2016	W/P reference:	A1	
Subject	Construction of power plant (Medu)			



Medu is a green-field coal-fired power plant project located west of Lebowakgomo, Limpopo Province, South Africa. Medu is the fourth dry-cooled, base load station built in 20 years by EKOM.

The power station is the fourth largest coal plant in the southern hemisphere, and is the biggest dry-cooled power station in the world. The planned operational life of the station is 50 years. The power station will directly grow SA's gross domestic product (GDP) by approximately 0.35% per year.

EKOM undertook feasibility studies in order to determine the most viable plant location option for availability and accessibility of primary resources. The following were taken into account:

- ability to connect to the existing EKOM network
- environmental acceptability

- cost of production.

Construction commenced in May 2010 and was completed on 31 January 2016. All capital expenditure cost were taken into account and all non-capital cost were expensed.

EKOM had use more steel than the world's tallest building (the Burj in Dubai). EKOM had to import 200 200 tons of structural steel because of limited supply in South Africa. Medu will stand approximately 130 meters in height.

Accounting policy of Property, plant and equipment

Property, plant and equipment are carried at cost, less accumulated depreciation and impairment loss. Depreciation is charged on straight-line basis over the estimated useful life of the assets.

Auditors of South Africa			A1(2 of 2)	
Auditee:	EKOM	Period-end:	31-Mar-16	
Preparer:	SW	Reviewer:	SM	
Preparer Date:	01 April 2016	W/P reference:	A1	
Subject	Construction of power plant (Medu)			

During the planning phase of the audit the following information was obtained from the previous auditors and management from EKOM.

Audit approach for auditing the line item: Medu

Through discussions with the previous auditors and management it was noted that management and the accounting department strive to implement and adhere to good internal controls especially regarding property, plant and equipment. Property, plant and equipment is a very material balance on EKOM's financial statements and includes a large number or transactions. The previous auditors also commented that EKOM maintains a good audit trail through their excellent filing system of their supporting documentation and that the auditors are welcome to inspect all assets at any time.

ANNEXURE B

Auditors of South Africa			C 1
Auditee:	EKOM	Period-end:	31-Mar-16
Preparer:	AT	Reviewer:	MM
Preparer Date:	09 April 2016	W/P reference:	C 1
Subject	<i>Subsequent events</i>		

The following conversation between one of the trainee auditors and the financial managers were recorded:

Trainee auditor: Hi Sebuwa, how are you?

Financial manager: Hi Mapitso, I am fine thanks and you?

Trainee auditor: I am well thanks. Thank you for your time.

Financial manager: No problem.

Trainee auditor: Was there any event that happened after the reporting date, which might affect the financial statements?

Financial Manager: Yes, our biggest plant caught fire on 5 April 2016. This incident is going to have an effect in our energy supply, as a result we expecting 51% down fall in our sales and profits because already we phasing supply challenges due to our economic challenges.

Trainee auditor: Yes, we also determined that EKOM's going concern assumption are appropriate, however you still need to disclose the material uncertainty.

Financial manager: I will **not disclose** this information in the financial statements it because it will raise unnecessary attention to our stakeholders.

NB: ASSUME THAT THE AMOUNT IS ABOVE THE MATERIALITY AMOUNT.

REQUIRED:

1 Please refer to the information contained under the following headings:

- Background to EKOM; and
- Background to the Auditors of South Africa (AOSA)

Describe the risk of material misstatement of EKOM at the overall financial statement level for the financial year ended 31 March 2016. **(9)**

Communication skills: Clarity of expression **(1)**

2 Please refer to the information contained in **Annexure A, Working Paper A1**, and describe the risk of material misstatement at the assertion level regarding the Property, plant and equipment balance as at 31 March 2016.

(12)

Note: One (1) mark will be awarded for each correctly described risk and half a mark (0.5) for the correct assertion.

3 Please refer to the information contained in **Annexure A, Working Paper A1**, describe what the audit team's response to the assessed risk of material misstatement for the Property, plant and equipment balance as at 31 March 2016 will be.

(9)

Communication skills: Presentation **(1)**

4 Formulate the substantive procedures that Auditors of South Africa (AOSA) should perform on the opening balances of EKOM for the year ended 31 March 2016. **(5)**

5 Please refer to the information contained in **Annexure A, Working Paper A1**, formulate the substantive procedures that Auditors of South Africa (AOSA) should perform to ensure the **Accuracy, valuation and allocation** of the **Property, plant and equipment** of EKOM for the year ended 31 March 2016. **(12)**

Communication skills: Presentation **(1)**

6 Based on the information provided in **Annexure B, Working Paper C1**, discuss whether the subsequent event as noted in the working paper should be adjusted or not and indicate the effect of this event on the audit opinion.

(10)

QUESTION 2-**(25 marks)**

You are a Registered Government Auditor (RGA) employed by the Auditor-General of South Africa (AGSA), and have been assigned to the annual audit engagement at the National Department of Tourism Services (NDTS). The NDTS recently developed and implemented a new budget management system to manage actual income and expenditure against budgeted income and expenditure. As numerous complaints have been received regarding this new system, you decided to review some of the general and application controls within the NDTS information technology (IT) environment.

You have decided to commence by examining the complaints that users have raised with regard to the system. The following are regarded as the main complaints:

1. Most personnel complained that the new system was not necessary and that the previous budget management application was more efficient.
2. The system is not user-friendly. The finance personnel are struggling to operate the system.
3. After the system was implemented six months ago, some of the previous information regarding vote numbers was erased from the database.
4. Because of the lost information, no transactions could be processed for two weeks, resulting in delayed processing and backlogs. Personnel did not know what to do and the information could not be recovered.
5. The database administrator allegedly committed fraud by purposefully changing amounts allocated to certain vote numbers.

According to the financial manager, the budget management system functions as follows:

- The main purpose of the system is to manage actual income and expenditure against budgeted information. The system is therefore linked to the income and revenue IT applications as well as the procurement and payment applications.
- After the approval of the budget, designated finance officials capture the amounts budgeted for each vote number on the computer by entering only vote numbers and amounts.
- Vote numbers consist of eight digits. The first four digits indicate the division as well as whether it is an income or expenditure vote number, for example a vote number starting with "0902" indicates that the vote number belongs to division no "09" and it is an expenditure vote number ("01" is allocated to income and "02" to expenditure). The second four digits indicate the type of account, for example "1001" is allocated to "Stationary". Vote number "0902-1001" will therefore belong to the stationary expenditure account of division no 09.
- The NDTS consists of 11 divisions. Some divisions have both income and expenditure vote numbers, while others only have expenditure vote numbers.

The database contains roughly 30 income vote numbers and 570 expenditure vote numbers.

- Directors and managers in all divisions can access their budgeted-compared-to-actual-information anytime if they wish to determine what amounts are still to be collected on specific income vote numbers in order to meet budgeted income amounts or available amounts on specific expenditure vote numbers to ensure that no over or under expenditure take place.

REQUIRED:

- 1 For each of the five complaints listed below, discuss two general controls that would most likely have prevented the complaint. **(10)**
- 2 Discuss the specific application controls that you expect to be in place with regard to the new budget management system. **(15)**

QUESTION 3**(25 marks)****Question 3.1****(4 marks)**

Auditor Y is a new member on your audit team who has never performed the audit of performance information (previously predetermined objectives). Auditor Y is already aware that the auditor needs to express an audit conclusion on the usefulness and reliability of the reported performance information.

Required:

Describe to auditor Y how the audit criteria for consistency are tested when conducting the audit of performance information (predetermined objectives) at a department.

(4 marks)**Question 3. 2****(16 Marks)**

Municipality of Do Good has a strategic objective that relates to the delivery of basic services with the following indicators:

- Provide 2200 households with water
- Provide 1600 households with electricity.

Management has confirmed that there are no formal documented standard operating procedures that describe how the information is collected, collated, processed, monitored and reported for these services. However, the municipal manager has communicated the processes that need to be followed for managing and reporting on these services to his staff via email. These processes communicated via email provide detail in relation to the following:

Identification of the person responsible for collecting information and consolidating the information on a monthly basis. The same person is also responsible for monitoring the information on a quarterly basis as this person is familiar with the process.

An automated information system is not used as it is too costly. All information in this regard is captured manually.

A definition of what constitutes a "household" i.e. it is house that has been built and is occupied.

The evidence supporting the reported achievements against the planned targets of 2200 households with water and 1600 households provided with electricity is identified as the monthly report produced on households provided with water and electricity.

Question 3.2.1.

Based on the information provide above, explain which audit criteria are affected and why?

(10 marks)

Question 3.2.2.

Based on the information provided above, document any risks/control deficiencies that may exist in relation to the reliability or reported performance achievements by the municipality of Do Good.

(6 marks)

Question 3.3

(5marks)

You are the audit manager responsible for the audit of Department X. You have selected programme 2 for audit which constitutes 4 indicators and targets. In planning for the audit, the audit team has performed an assessment of the indicators against the materiality considerations to determine if they are material or not material.

Details of the assessment of the indicators are included in the table below.

Indicator Number	Assessment of the indicator
Indicator 1	This indicator is a customised sector indicator, however, based on discussions with management, the department does not have any sufficient funding to deliver on services in relation to this indicator
Indicator 2	This indicator is linked to primary functions of the department and is also linked to the Medium Term Strategic Framework (MTSF) outcomes and priorities. This indicator is therefore a
Indicator 3	This indicator constitutes 33% of the total budget allocation. This
Indicator 4	This indicator is linked to the primary functions of the department.

You are currently reviewing the assessment of the material indicators. Discuss with clear reasons why you agree/disagree with the assessment of the indicators.

QUESTION 4

(30 Marks)

Please note that the case study for the qualifying examination is consistent with the case study used for the formal assessment, but further information has been provided.

Mr Adam Brown has served as Headmaster to a well-known and prestigious school since 2005. He is well-known and respected for his strong stance on leadership and integrity and is generally recognised for the "wonderful things" he did for the school.

In November 2015 he announced to the School Governing Body that, as he is reaching 55 years of age, he will take early retirement and travel abroad. The School Governing Body agrees that he will officially retire at the end of the second term of 2016. As he has a lot of accumulated leave, it is agreed that his last official duties will be at the end of the first term, with him taking leave for the remainder of his employment.

The Deputy Principal is appointed as acting Headmaster, effective from 20 March 2016.

You are a practicing forensic accountant. You receive a call from the newly appointed Chairman of the School Governing Body during the first week of April, seeking an urgent meeting. It seems that the Headmaster, Mr Brown, has not been entirely honest and has misappropriated large sums of money from the school by submitting fraudulent claims to reimburse him for school expenses he allegedly incurred on behalf of the school.

You are appointed by the School Governing Body to investigate and to report on the matter.

After a detailed investigation, covering a period of six years, you submit your report where you identified more than 1 000 transactions where Mr Brown allegedly defrauded the school for almost R2 million.

Mr Brown is arrested by the police and released on R50 000 bail. The court case is remanded for 6 months pending further investigation.

The entire school community is shocked. Parents, scholars and teachers alike talk about their disbelief of these revelations. The school's Facebook page get hundreds of hits, where people speculate on how this could have happened and go undetected for so many years. Many ask why the school has not been audited before.

During your investigation you interviewed all members of the finance department. The Bursar, Mr Charles, is a retired school inspector, aged 70, who quickly admits that "he is not really a numbers person" and that he placed complete reliance on the Headmaster. He says he will work at the school up to mid-year and then officially retire.

His assistant, Mrs Delphine, is also well past normal retirement age (at 65) and she admits that she is very pleased to have the opportunity to work at the school as her government pension is only R8 000 per month. She said she only has a Standard 8 (tenth grade) school qualification, but claims that "in those days it was enough". She has no accounting qualifications. She is, however, well versed in an antiquated accounting system which only she knows how to operate. She expresses her displeasure that the School Governing Body "forced her" to start using Pastel accounting from the beginning of this year.

The outgoing chairman of the School Governing Body, Mr Elroy, stated that his job was easy, as the Headmaster, Mr Brown, was a workaholic who was always at school and hardly ever took leave. He stated that there was very little for him to do as Mr Brown took care of most tasks.

You are also told that Mr Brown would dominate the weekly finance meetings and was prone to ridicule and bully those who disagreed with him. Many committee members claimed later that they were not aware of many of the transactions you identified during your investigation. They also say that Mr Brown was a master at juggling budgets.

No monthly management accounts are prepared. The school does not have any internal auditors.

The method applied by Mr Brown was to submit claims to pay himself either in cash or by electronic transfer, which he would approve himself. He attached falsified supporting documentation (invoices etc.) which he had assigned to various cost centres.

In the investigation you find that the majority of Mr Brown's claims were either not approved by any other party, or signatures of the bursar were forged. Mrs Delphine, who is the only signatory on the bank account, claims that she is a "processor" and not an "authoriser".

On further investigation you find that a significant portion of the claims Brown submitted relate to personal home improvements, where he claimed to have spent the money on the school premises. As Brown's house was on the market at the time of the investigation, you find many photos on the estate agents' advertisement, which demonstrate Brown's standard of living, seemingly beyond that of his and his wife's standard of living.

During your investigation, you engage with many of Brown's colleagues. Several of them mention that Brown's wife was very demanding and insisted "on only the best" for their home. They also mention that Brown always borrowed money from petty cash at the school as he seemed financially "embarrassed". You confirm in your investigation that there were a very large number of "IOUs" Brown had taken from the school which were offset from his "claims". His colleagues also mention that Brown often referred to how much he would have earned if this was a private school.

You interview the external auditor. The engagement partner, Mr Fitzgerald, advises you that he has been the auditor of the school for the last 15 years and that he

knows the school environment so well that he can perform his audit cheaply (which he was pressurised to do anyway) and that most of the audit work was done by the ladies in the finance office, at the instruction of the Headmaster. He says he has the greatest respect for, and relies heavily on, the integrity of Mr Brown.

Question 4.1

(20 marks)

Briefly explain the concepts of Donald Cressey's Fraud Triangle. Name the three components, briefly describe them, explain Cressey's theory and apply his theory to the case study at hand by listing which facts could be relevant to the three fraud triangle components.

Question 4.2

(10 marks)

Define and briefly explain the key elements of fraud.

QUESTION 5

(20 marks)

You are the Senior Manager on the audit of Department XYZ for the 2016/17 financial year end.

Background information

Department XYZ received an adverse audit opinion for the last three financial years.

This department has a huge staff turnover and as a result key finance and supply chain management positions were vacant in the financial year under review. As a result, the department's leadership appointed consultants to provide CFO support and assist with addressing the qualification areas over the next three years.

The department has an annual budget of R7.5 billion. The department consists of head office and 6 district offices. The following functions are decentralised at a district office level:

- Procurement of goods and services
- Processing of payments
- Asset management

No formal training on LOGIS, BAS and PERSAL functionalities are provided to officials appointed to any finance and supply chain positions.

The procurement of infrastructure assets is done by Department ABC on behalf Department XYZ. On completion of the infrastructure assets it gets transferred from Department XYZ to Department ABC as custodian of all infrastructure assets.

The department (head office and district offices) does not utilise the ordering system (LOGIS) properly. When goods and services are ordered, the orders are raised late on the system and/or the delivery thereof isn't necessarily updated on LOGIS. The department follows a manual process to compile a listing of outstanding invoices and orders. Payments for goods and services received are sometimes paid against a sundry account and not a specific order number and consequently orders are not de-committed on LOGIS. A register of all invoices received are not maintained.

The electronic system used to manage infrastructure projects (storage of project contracts, bid documentation, variation orders, payment certifications, etc) are not maintained and updated regularly. Projects are also not allocated unique project identification numbers at inception. The department lacks a comprehensively documented and implemented infrastructure portfolio oversight process. Over-reliance on manual reconciliation and reporting processes.

PERSAL is not timeously updated with all terminations and annual leave taken. The department has no policy and procedures for irregular and fruitless and wasteful expenditure. The register for irregular expenditure identified is not updated and maintained.

The department has no asset management policy and procedures, consequently asset verifications and additions are not done on a regular basis.

Extracts from the 2015/16 audit report

Basis for adverse opinion: *Irregular expenditure, fruitless and wasteful expenditure, movable tangible assets, employee benefits, payables, accruals, commitments, immaterial misstatements aggregated*

Accruals

The department did not have adequate systems to maintain records for goods and services received but not yet paid for. I was unable to obtain sufficient appropriate audit evidence for the amounts disclosed as accruals. I could not confirm accruals by alternative means. Consequently, I was unable to determine whether any adjustment to accruals stated at R136.8million (2014: R120.5 million) in the financial statements was necessary.

Extracts from the 2015/16 annual financial statements

Accruals

Accruals are not recognised in the statement of financial position as a liability or as expenditure in the statement of financial performance, but are included in the notes to the financial statements.

Accruals and payables not recognised

Accruals

Listed by economic classification	R'000	R'000	R'000	R'000
	30 Days	30+ Days	Total	Total
Goods and services	60 000	5000	65 000	60 000
Transfers and subsidies	-	35 000	35 000	50 000
Capital assets	6 800	30 000	36 800	10 500
Total	66 800	70 000	136 800	120 500

Extracts from 2016/17 Audit Improvement Plan (AIP)

- Develop and implement policies and procedures for irregular and fruitless and wasteful expenditure
- Restate accruals to address the qualification area

Required

(a) Based on the information above, list all the risks of material misstatement at assertion level. Use the headings in the table below to populate your answer.

(10 Marks)

No	Risk	Class of transaction, account balance or disclosure impacted	Assertion(s)
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(b) The department indicated in their AIP that they will be restating accruals to address the qualification area. List the key procedures/steps that you would expect to be included in their correction process/methodology to address the risk of **completeness**. **(10 Marks)**

Hint: The above requirement could also be seen as the substantive procedures you would perform to gain the required assurance on the completeness of this disclosure note.

Document any assumptions made below your answers.

END OF PAPER