

## QUESTION TWO

### PRAXY LTD

#### 1. BACKGROUND

Praxy Ltd is wholly owned subsidiary of Bantu Investments Ltd and operates in the furniture retail trade. The company has expanded rapidly in the last five years and has opened several retail outlets in every major town and city of Zambia. The scale, diversity and complexity of activities have grown with the number of employees increasing from 80 to 100.

Over the last three years, the Board at Praxy have recognised the need for assurance advice in specialist areas such as health and safety, regulatory and legal compliance and environmental issues. This is especially significant given the dynamic environment in which Praxy Ltd operates. The environment has been characterised with increased susceptibility to risk due to a wide range of unexpected occurrences.

In order to improve its control environment, the Praxy board set up an internal audit department two years ago. The department is headed by a manager, Mrs Joyce Bwembya. Until recently, Mrs Bwembya has been the management accountant for Praxy Ltd. Mrs Bwembya is a fully qualified chartered accountant with four years' post qualifying experience as a management accountant.

#### 2. INTERNAL AUDIT DEPARTMENT: role and organisation status

At Praxy Ltd, internal auditing is regarded as an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems. In addition to corporate governance and internal control and risk management, the internal audit department is also expected to undertake:

- a) Value for money audits: **A value for money audit is concerned with obtaining the best possible combination of services from the least resources. It is the evaluation of the three (Economy, Efficiency, Effectiveness)**
- b) Information technology (IT) audits: **An information technology audit is a test of control in specific area of the business, the computer systems**
- c) Financial audits: **The financial audit is internal audit's traditional role, which is involved reviewing all the available evidence (usually company's records as pre and post-audit) to substantiate information in management and financial reporting.**
- d) Procurement audits: **Procurement is the process of purchasing for the business. A procurement audit will therefore concentrate on the systems of the purchasing department.**
- e) **Marketing audits:** Marketing is the process of assessing and enhancing demand for the company's products. Marketing and its link with sales is very important for the business, and internal auditor.
- f) **Human Resources Management:** The human resources department one hand procures human resource (employees) for the operation of the business and on the other hand supports those employees in developing the organization.

A query sent to finance director on the role and status of internal auditor came back with the reply,

*“As the corporate governance structure is relatively new, the board is of the opinion that the position of the chief internal auditor should start at the management level before being elevated to that of a director. In addition, the internal audit manager presently reports to the executive director, pending the full formation of an internal audit committee.”*

Your review of recent working papers on capital expenditure audit provided that:

- The annual internal audit plan for the year ended 31 March has been prepared and approved. However, only 50% of the budget required was provided during the year.
- There appear to be no specific internal audit objectives in relation to cheque payments and petty cash transactions planned for internal audit review during the year.
- The work done by assistants five months ago has not yet been reviewed by the internal audit manager
- There are still a number of queries pending management comment and action from the last years' internal audit work.

### **3. APPOINTMENT OF AUDITORS AND PROFESSIONAL ADVISORS**

Your name is Kelvin Shondo, a partner in PMK & Partners. Your firm PMK & Partners is a firm of accountants and consultants registered with the Zambia Institute of Chartered Accountants (ZICA). Your firm has been appointed and accepted to audit the financial statements of Praxy Ltd for the second year running, including acting as professional advisers on such matters as taxation.

In accepting this appointment for the audit of financial statements for the year ended 31 March 2011, you carried out all the usual acceptance procedures including client screening and assessing the ability of PMK & Partners to provide the services required.

There are a few matters arising from the client acceptance procedures summarised in working paper (PRX/200/2011)

### **4. WORKING PAPERS**

The following working papers have been prepared by your audit team highlighting matters requiring your attention:

- a) Client acceptance procedures
- b) Cheque payments and petty cash transactions
- c) Reporting and completion
- d) Restructuring

#### **4.1. Client acceptance procedures – matters arising (Working paper PRX/200/2011)**

As part of your client screening and acceptance procedures, the following matters were identified as requiring special attention:

##### **a) Incorporation of Praxy Ltd**

Praxy Ltd is a relatively new company incorporated by Fisho Mwale. Fisho Mwale is the executive chairman of the Bantu Investments Ltd. You have also become aware that Fisho Mwale used to be a director in Tinto Banking services, a bank that has recently been put under compulsory liquidation by the Bank of Zambia.

##### **b) Tax investigation**

As tax advisor to Praxy Ltd, you have recently learned that the Zambia Revenue Authority have launched an investigation into the affairs of Praxy Ltd on suspicion of under-declaring income in relation to the financial statements for the year ended 31 March 2010, on which you issued an unmodified opinion

**c) Security consultancy services**

The finance director of Praxy Ltd, Mr. Peter Chola has asked for advice on the accounting treatment and disclosure of payments being made for security consultancy services. The payments which aim to ensure that consignments are not impounded in the destination country of a major customer, may be material to the financial statements for the year ended 31 March 2011. Praxy Ltd does not treat these payments as tax deductible.

<b>4.2. Cheque payments and petty cash transactions (Working paper PRX/201/2011)</b>
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During your preliminary planning, you identified potential weaknesses relating to the signing of cheques and operation of petty cash system. Mr. Peter Chola, the finance director requested that you review the internal controls over cheque payments and petty cash.

Mr. Chola is not willing to be a cheque signatory as he feels that such a procedure is an inefficient use of his time. In addition to Mr. Chola, the company employs 20 personnel including four other directors, and approximately 300 cheques are drawn every month.

The petty cash account normally has a working imprest of about K6 million and total petty cash expenses amount to about K20 million each month. Mr. Chola has again indicated that he is unwilling to participate in any internal control procedures which would ensure the efficient operation of the petty cash account

<b>4.3. Reporting and completion – matters arising (Working paper PRX/203/2011)</b>
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You are currently reviewing the audit working paper files and audit senior's recommendations for the auditors' reports. Details are as follows:

**a) Going Concern Problems**

Praxy Ltd is a subsidiary of Bantu Investments Ltd. Serious going concern problems have been noted during this year's audit. Praxy Ltd will be unable to continue operating for the foreseeable future unless it continues to receive financial support from the parent company. Praxy Ltd has received a letter of support (conform letter) from Bantu Investments Ltd. The audit senior has suggested that due to the seriousness of the situation, the audit opinion must at least be qualified "except for"

**b) Change of accounting policy**

Praxy has changed its accounting policy for inventories during the year from First In First Out (FIFO) to weighted average. No disclosure of this change has been given in the financial statements. The carrying amount of inventories in the statement of financial position as at 31 March 2011 is approximately the same as at 31 March 2010. The audit senior has concluded that a

qualification is not required but suggests that attention can be drawn to the change by way of an emphasis of matter paragraph

**c) Property rental**

The directors' report of Praxy Ltd states that the investment property rental forms a major part of revenue. However, a note to the financial statements shows that property rental is only 1.6% of total revenue for the year. The audit senior is satisfied that the revenue figures are correct. The audit senior has noted that an unqualified opinion should be given as the audit opinion does not extend to the directors' report

<b>4.4. Restructuring (Working paper PRX/204/2011)</b>
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The audit has been completed and reviewed and you are due to issue the audit report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 31 March 2011 of K30 billion, net profit of K6 billion, and total assets at the year end are K160 billion. The finance director of Praxy Ltd Peter Chola telephoned you this morning to tell you about the announcement yesterday of a significant restructuring of Praxy Ltd, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation from Ndola to Lusaka. There will be some redundancies and the estimated cost of closure is K500 million. The financial statements have not been amended in respect of this matter.

<b>SECTION A</b>
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- 1) **With regard to your acceptance to become the auditor of Praxy Ltd for the year ended 31 March 2011, prepare briefing notes for Mr. Percy Bwalya, your quality control partner that comments on the ethical and professional, including possible money laundering issues referred to in working paper (PRX/200/2011) relating to:**
  - a) Incorporation of Praxy Ltd (5 marks)
  - b) Tax investigation (5 marks)
  - c) Security consultancy services (5 marks)
- 2) **Discuss possible reasons why it may not be appropriate to rely on the work of the internal auditors at Praxy Ltd. (10 marks)**
- 3) **With reference to working paper (PRX/201/2011), prepare a letter to Mr. Chola containing your recommendations for good internal control procedures for:**
  - a) Cheque payments (10 marks)
  - b) Petty cash (8 marks)
- 4) **Discuss the audit implications, if any, of the unwillingness of Mr. Chola to participate in the cheque signing procedures and petty cash function (7 marks)**

<b>SECTION B</b>
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- 5) **With reference to working paper (PRX/203/2011), the following matters have been noted for your attention. For each situation, prepare briefing notes addressed to your audit senior, commenting on the suitability or otherwise of the audit senior's proposals for your firm's final report. Where you disagree, advise what audit modification (if any) should be given instead**
  - a) Going concern problems (8 marks)
  - b) Change of accounting policy (5marks)
  - c) Property rental (7 marks)
- 6) **With reference to working paper (PRX/204/2011), regarding restructuring:**
  - a) Comment on the financial reporting implications of this matter, and advise further audit procedures to be performed (15 marks)
  - b) Recommend the actions to be taken by your firm if the financial statements are not amended (10 marks)
  - c) Assuming that this event took place after the annual general meeting had approved the financial statements, how would this change you recommended actions in (b) above? (5 marks)