SOLUTIONS TO QUESTION TWO -audit

PRAXY LTD

SECTION A

Question 1

To : Mr. Percy Bwalya, Quality Control Partner Date: 16 May 2011
From : Kelvin Shondo, Audit Partner
Subject : Briefing notes on ethical and professional issues and related money laundering Issues

The purpose of these briefing notes is to comment on the ethical and professional issues, including possible money laundering issues, arising from the following matters:

- Incorporation of Praxy Ltd
- Tax investigation
- Security consultancy services

a) Incorporation of Praxy Ltd

Before accepting appointment to audit Praxy Ltd, ethical and professional requirements require that we carry out the following procedures relating to money laundering:

(i) Client identification

- Review the identity of the Praxy Ltd and its business activities by reviewing documents relating to its incorporation.
- Consider whether the commercial activities makes business sense and that Praxy is not just a front for other perhaps illegal activities
- Obtain and reconfirm the current list of principal shareholders and directors and make enquiries as to their involvement in other businesses

(ii) Client understanding

- Given the recent events, pre-engagement communication should now be considered to explain to Praxy Ltd directors the nature and reason for client acceptance procedures
- Best practice recommends that the engagement letter should also include a paragraph outlining the our responsibilities in relation to money laundering

This is especially significant in view of the liquidation of Tinto Banking Services in which Mr Fisho Mwale was a director.

b) Tax investigation

Praxy Ltd is a relatively new client. Before accepting to act as professional advisers on matters such as taxation, we should carry out customer diligence. As PMK we should therefore have sufficient knowledge and understanding of Praxy to be aware of any suspicions that the tax authorities might have. As the investigation has come as a surprise, it is possible that, for example:

- The tax authorities suspicions are unfounded
- We may be seen to have failed to recognise suspicious circumstances

In addition to reviewing its client acceptance procedures, we should now review any communication from the predecessor auditor obtained in response to its professional inquiry (for any professional reasons why the appointment should not be accepted). In addition, we should now seriously consider that a second partner review of the opinion should be undertaken before issuing our final opinion.

If Praxy is found guilty of under-declaring income for tax purposes, this is tax evasion and is illegal. In addition, this may also be construed as a money laundering offence. As a firm, our reputation risk will be increased if implicated because we knew (or ought to have known) about Praxy's activities. We may also be liable if found to have been negligent in failing to detect any material misstatement arising in the March 2011 financial statements.

Praxy's audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by Praxy or error overlooked by us. Tax advisory work should have been undertaken and/or reviewed by a manager/partner not involved in the audit work. As tax advisors, we could soon be making disclosures of misstatements to the tax authorities on behalf of Praxy Ltd. We should encourage Praxy to make necessary disclosure voluntarily.

Potentially, we may find ourselves being confronted with the following threats:

- Advocacy threat – supporting client's taxation position
- Self interest threat – protecting income from provision of other services
- Self review threat – auditing its taxation work

a) Security consultancy services

As compared with the issue on tax investigation, there is no obvious tax issue. Praxy Ltd is not overstating expenditure for tax purposes. We should consider our knowledge on import duties, etc in the destination country before recommending a course of action to Praxy Ltd.

The payments being made for security consultancy services may amount to a bribe. Corruption and bribery (and extortion) are designated for money laundering offences. If this is a bribe, Praxy Ltd clearly benefits from payments as it receives income from the contract with the major customer. This is criminal property and possession of it is a money laundering offence

WE should seriously consider the seriousness of the disclosure made by the chief executive in the context of domestic law. We may guilty of a money laundering offence if the matter is not reported to the Anti-Corruption Commission (ACC). If a report to the ACC is considered, we should encourage Praxy Ltd to make voluntary disclosure. If Praxy Ltd does not, we will not in breach of client confidentiality for reporting knowledge of a suspicious transaction.

I trust that the above has provided sufficient briefing on the subject matter.

Thank you.

KS

Question 2

Possible reasons why it may not be appropriate to rely on the work of the internal auditors at **Praxy Ltd.**

According to professional requirements, the external auditor should only consider relying on the work of internal audit if specific corporate governance requirements are met. In relation to Praxy Ltd, these requirements are not met as explained below:

a) **Organisational status:** Internal auditors will need to be free to communicate fully with the external auditor. In the ideal situation, the internal auditor should report to the highest level of internal management (Audit committee). At Praxy Ltd, the internal auditor occupies a managerial position and reports to the executive director. This does not provide an acceptable level of independence.

b) **Scope and function:** The nature and extent of internal auditing assignments performed. Does management act on their recommendations? Although many of the functions undertaken by internal audit at Praxy are relevant to financial statements, management does not seem to act on their recommendations given the number of queries still outstanding from previous audits. The shortfall in the budgetary allocation also suggests less than full commitment and support from management.

c) **Technical Competence:** Whether internal audit is performed by persons having sufficient technical training and proficiency. At Praxy Ltd, the internal audit department is headed by Mrs Bwembya. Although fully qualified and experienced in matters of management accounting, there is little evidence to confirm that she is has sufficient experience in matters of internal auditing.

d) **Due professional care:** Whether internal auditing is properly planned, supervised, reviewed and documented. The existence of adequate professional qualifications is important For the internal audit at Praxy ltd, there appear to be no specific objectives for the work planned and the work appear not be reviewed on a timely basis. This level of due professional care may not be considered adequate for the PMK to rely on the work of internal auditors.

Overall the internal audit at Praxy Ltd does not seem to measure up to the corporate governance requirements for internal audit and therefore it is not appropriate that it should be relied upon.

Question 3

Letter to Mr. Chola containing your recommendations for good internal control procedures for:

a) Cheque payments

b) Petty cash

12 June 2011

Mr. Peter Chola
The Finance Director
Praxy Ltd
Plot 128, Luanshya Road
LUSAKA

Dear Mr. Chola

RE: INTERNAL CONTROL RECOMMENDATIONS FOR CHEQUE PAYMENTS AND PETTY CASH

You recently requested that we should advise you on good internal controls over payments and petty cash. We should like to make the following recommendations

The main objectives of control over payments are to ensure that payments are made only in respect of valid transactions and that they are suitably authorised. In particular, the following controls will contribute toward attaining these objectives:

Cheque payments

- Cheques should be raised only on the basis of authorisation, for example, a purchase invoice which has been suitable authorised

- Cheques should be signed by two people, other than those who approve invoices

- There should be two independent signatories for each cheque, for instance, two directors might act as signatories. Signatories should inspect the documents supporting the cheque to ensure that the details agree. They should also mark the documents so that the documents cannot be reused

- Cheques should be restrictively crossed

- Unused should be under sequential control and all numbers should be accounted for. Spoilt cheques should therefore be retained.

- When cheques have been signed, they should be despatched immediately.

Petty cash

- Petty cash payments should be made only on the basis of suitably authorised vouchers which should be under sequential control. All vouchers should be retained for subsequent references. Where independent evidence is also available, for example invoices and receipts, this should also be retained.

- An imprest system should be used to control petty cash. This means that the petty cash float is maintained at a specific amount and is reimbursed at regular intervals on the basis of vouchers showing payments which have been made. It is suggested that the float should be kept at a constant level of say K6 million and should be reimbursed once exhausted.

- The petty cash float should be subject to a periodic surprise count by a senior separate person not involved with the petty cash system. The balance on hand should be reconciled to the imprest account by reference to the vouchers not yet reimbursed.

- The size of individual payments out of petty cash should be subject to a maximum to be agreed by directors

- Staff should not be allowed to cash personal cheques or borrow from petty cash.

I hope the above information is useful to you in designing your systems of internal control. If you require any more information, please let me know.

Yours sincerely,

K. Shondo

Question 4

The audit implications, if any, of the unwillingness of Mr. Chola to participate in the cheque signing procedures and petty cash function

Mr Chola presumably feels that involvement in cash and cheque controls will be time-consuming, and that he is too busy to be involved in it. He may feel that he does not want to play a direct part in the petty cash function. Because of the small amounts involved, he may wish to delegate this function to another person in the accounts department. He should appreciate; however, that involvement at least in the authorisation of cheque payments would help to ensure that he is aware of major transactions in his business. He might consider the possibility of authorising cheques in excess of a given amount. This would minimise the demands on his time, while exercising control and keeping him informed of significant outgoings from the business

Auditors may wish to consider whether Mr. Chola's lack of involvement may be symptomatic of insufficient attention being given to financial matters by the directors.

SECTION B

Question five

To	**:**	**Audit senior**	**Date: 16 May 2011**
From	**:**	**Kelvin Shondo, Audit Partner**	
Subject	**:**	**Briefing notes on matters affecting our opinion relating to the financial statements of Praxy Ltd for the year ended 31 March 2011.**	

I refer to your working paper (PRX/203/2011), in which you have raised the following matters for my attention:

- Going concern problems
- Change of accounting policy
- Property rental

I comment below on the suitability or otherwise of your proposals, including audit modifications that I consider necessary.

a) Going concern problems

If a letter of support had not been received, then a qualified opinion on the grounds of disagreement (about the appropriateness) of the going concern would be required. As the matter is likely to be pervasive, and adverse opinion would be appropriate (ISA 570 *Going Concern)*

However Praxy Ltd has received a letter of support from its parent company to the effect that it will enable Praxy ltd to continue trading. If this evidence (together with other evidence such as management's representation) is considered to be sufficient to support the appropriateness of the going concern presumption, a qualified opinion will not be necessary provided that the support is adequately disclosed in a note to the financial statements. If the evidence is sufficient, but the disclosure inadequate, an 'except for' opinion would be required.

If the letter of support does not provide sufficient evidence (e.g. if there are doubts about Bantu Investment's ability to provide the required finance), the significant uncertainty arising should be disclosed in an emphasis of matter paragraph in the auditor's report. This would result in a qualified opinion.

Accordingly, your proposal is unsuitable. The auditor's report should be unmodified (assuming that disclosures are adequate)

b) Change of accounting policy

In order to show fair presentation, in all material respects, the financial statements of an entity should contain not only accurate figures, but also sufficient disclosure in relation to those figures in order to allow the user to understand them as required by IAS 1 Presentation of Financial Statements, items should be treated on a consistent basis from year to year. If this is not the case, then the change, together with the financial impact of this change, will need to be disclosed in a note to the financial statements.

Failure to disclose the reasons for change in policy (i.e. to comply with IFRS 3 Business Combinations) and its effects (impact of change from FIFO to weighted average) means that the financial statements do not comply with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* A qualified opinion is therefore required on the grounds of disagreement on disclosure (IAS 1 and IAS 8). Assuming the matter to be material (but may be not pervasive), an 'except for' opinion should be expressed.

The main purpose of an emphasis of matter paragraph is to describe a matter of significant uncertainty which has been taken into account in forming the audit opinion – it does not qualify that opinion. Such a paragraph highlights a note in the financial statements that more extensively discusses the matter. An emphasis of matter paragraph cannot therefore be used to 'make good' a lack of disclosure.

Accordingly, your proposal is again unsuitable. Unless all aspects of the change (including reason and effect) are adequately disclosed an 'except for' qualification will be required on the grounds of disagreements.

c) Property rental **(7 marks)**

The audit opinion states whether the financial statements:

- Are presented fairly, in all material respects (or give a true and fair view) in accordance with the financial reporting framework, and
- Comply with statutory requirements (where appropriate)

The directors' report is not part of financial statements prepared under International Financial Reporting Standards (IFRS). However, as auditors we have a professional responsibility to read other information in documents containing audited financial statements (e.g. the directors' report in an annual report) to identify material inconsistencies with the audited financial statements (or material misstatement of fact).

A material inconsistency exists when other information contradicts information contained in the audited financial statements. Clearly, 'major' is inconsistent with 1.6%. If the inconsistency is resolved (e.g. because the directors' report is corrected to state '.....major part of other income...') an unmodified auditor's report will be given

If the inconsistency is not resolved, the audit opinion on the financial statements cannot be qualified (because the inconsistency is in the director's report). In this case, an emphasis of matter paragraph may be used to report on this matter that does not affect the financial statements (ISA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements)*

Accordingly, an unqualified opinion on the financial statements is appropriate. If, however, the inconsistency is not resolved, it should be reported as an emphasis of matter paragraph, after the opinion paragraph.

Question six

a) Comment on the financial reporting implications of this matter, and advise further audit procedures to be performed

Financial implications

The announcement of a restructuring after the reporting date is a non-adjusting event after the reporting date, according to IAS 10 Evens After the Reporting period. This is because the event does not provide evidence in relation to a condition that existed at the year end.

Materiality calculations in respect of the cost of closure are as follows:

Based on revenue	:	500/3,000,000	= 1.67%
Based on profit	:	500/6,000,000	=8.3%
Based assets	:	500/160,000,000	=Less than 1%

Therefore this amount is material to the statement of comprehensive income. Per IAS 10, a note should be provided to the financial statements, which describes the nature of the event, and provides an estimate of the financial effect.

Further audit procedures

- Review any potential note to the financial statements which should disclose the non-adjusting event, providing a brief description of the event, and an estimate of the financial effect.

- Discuss the reason for the restructuring with a member of key management personnel, and read minutes of board meetings where the plan was discussed, in order to gain an understanding about the reason for the restructuring

- Verify the approval of the plan itself, and the approval of the announcement of the plan, which can be preformed through a review of board minutes.

- Confirm the date on which the plan was approved, and also the date of the announcement, using supporting documentation such as press release, letters sent to employees, internal meetings held with employees, etc

- Obtain a copy of the announcement and review for details, particularly a description of the exact nature of the restructuring, including the number of employees to be affected.

- Agree the K500 million potential cost of closure to supporting documentation, including a schedule showing the number and grade of staff to be made redundant, which should be supported by payroll/contract details

- Using the results of the discussion with management, assess the planned restructuring in the context of the auditor's knowledge of the business, considering whether any further costs are likely to be incurred.

b) Recommended actions to be taken by your firm if the financial statements are not amended

If no note is provided to the financial statements, then there is a breach of IAS 30. In this case there is insufficient disclosure provided in the notes to the financial statements regarding a material non-adjusting event after the reporting date.

According to IAS 705 Modifications to the Opinion in the Independent Auditor's Report, in cases where the auditor is in disagreement with management regarding the application of a financial reporting standard and where the consequent misstatement is material to the financial statements, the auditor should express a qualified or adverse opinion. Here the material may be considered material but not pervasive to the financial statements, so a qualified opinion expressed as an "except for" would be appropriate.

The audit report should contain a paragraph which explains the reason for the qualification, specifying the breach of accounting standards, and stating the relevant financial amount. It would also best practice for the auditor to clarify that the profit for year is not affected by the breach of accounting standards, and the misstatement is solely due to inadequate disclosure in the notes to the financial statements.

The auditor should ensure that the matter, and the potential consequence for the audit report, has been made known to those charged with governance. This will allow the highest level of management and directors the opportunity to discuss the matter, having reference to tall relevant facts of the disagreement and implications thereof.

Finally, the auditors could choose to raise this issue at the annual general meeting, where the matter leading to the qualified audit opinion should be explained to the shareholders in the company.

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

The auditor has no obligation to make enquiries regarding financial statements that have been issue. However, if the auditor becomes aware of a fact which existed at the date of auditor's report and which, if known at that date, may have caused the auditor's report to be modified, the auditor should:

- Consider whether the financial statements need revision
- Discuss the matter with management; and
- Take appropriate action (e.g. issuing a new report on revised financial statements)