ACCOUNTANCY TRAVELOGUE : FACING REVERSE GEAR

by **Kameswara Rao Challa,** FCA, DISA

It is a long time I could not meet you. I am sorry for having missed you all. In this period the global economy has slowed down and the responsibility of the Chartered Accountant has increased tremendously. Though the economy is in reverse gear, we have to move forward. At the 59th Annual Function of the Institute of Chartered Accountants of India Mr. Anurag Goel, Secretary in the Ministry of Corporate Affairs, said ***"the auditing profession must rise to the occasion as one and meet the new challenges with conviction".*** Each one of us agrees with this statement in toto. So let's see how we shoulder the onerous responsibility of marching forward when the economy is traveling in the reverse gear. These are my personal feelings which I wish to share with you all. I welcome your valuable feedback in our common endeavour.

In discharging attest function an auditor has to be alert in respect of the following risk factors to ensure that financial statements (FS) present a true and fair view.

1. **Window Dressing**
2. **Paint Red**
3. **Cover up activity**
4. **Revaluation of assets**
5. **Loans & Advances**
6. **Change in Accounting policy or method of valuation**
7. **Following Standard Auditing Practices**
8. **Compliance with AS.**

1. **Window Dressing:** By window dressing FS management wish to show rosy picture of financial health of an organisation to mislead (a) existing or prospective investors, (b) bankers and financial institutions. By resorting to window dressing organisation may over-state their turnover, profits or assets. Another mode of window dressing is understatement of expenditure, provisions or liabilities. An auditor shall be watchful for the possible window dressing of FS by taking care of the following.

   a) **Overstatement of Turnover and Receivables:** Not many third party documentation is involved in respect of turnover. As such an organisation may artificially try to inflate its turnover and the resultant affect on receivables or debtors. This may be done by any of the following modes.

      i) **Turnover to related parties:** Organisations may artificially increase turnover by means of rotation of turnover between subsidiaries and holding companies, sister concerns or other group entities related directly, indirectly or

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remotely. The relationship need not be formal as enunciated under various laws e.g. listed in the register under section 301 or Schedule-1A of the Companies Act, 1956, under Income Tax or Excise laws. Auditor may use the audit tool of depth checking to satisfy that the turnover is real and does not result in window dressing.

ii) **Mirror images:** One organisation may sell its products to a second company; the first organisation may also purchase goods or services from the second company. As a result both sales and purchases are overstated. The debits and credits (i.e. amount due from and due to the second company) may get squared up in the books of account. The auditor has to thoroughly satisfy that these transactions are not only properly documented, but satisfy that they are genuine.

iii) **Quick turnover:** The auditor has to throw special light in respect of year-end turnover which has been returned at the beginning of the succeeding year. For this purpose the auditor will have to travel beyond the cut-off date (i.e. by verifying transactions of the succeeding year). Apart from Sales Returns, the auditor will have to verify the Credit Notes for possible write off in the form of breakages, damages, rate differences, discounts etc. He has to verify them along with Excise and VAT returns in the month of the sale as well as the period of Return, Write off or Credit Note.

iv) **Realisation:** Under accrual system of accounting revenue is recognized at the time of sale. In normal times, it is expected that debtors will be realized in due course of business, subject to normal risk of bad debts. However in recession times realization plays a vital role for survival of business. A business organisation has to take care for realization of its debtors in time. In case turnover is overstated, the enterprise will not be in a position to realize the overstated debtors. Hence auditor will have to pay attention with regard to realization of debtors. For this purpose, he will do well to obtain confirmation of balances or account copies from debtors. Further, in respect of exports, the auditor will have to verify whether the company has realized in terms of LC in its favour or Foreign Bill Discounting has been honoured or the realization is within 180 days in terms of Foreign Exchange Management Act.

b) **Overstatement of Assets:** In the accountancy travel there lays a rich wardrobe for window dressing FS by overstatement of assets through following methods.

i) **Receivables:** We have already discussed a few techniques by which debtors may be overstated as a result of overstating turnover. Other means by which receivables may be overstated are: (a) Not writing off insolvent or disappearing debtors; (b) Not making adequate provision in respect of sick debtors; (d) Not making provision for export debtors where LCs have devolved, material rejected (and it is not practicable or uneconomical to import the material e.g. perishable goods, cost of import being more than the cost of goods) or amounts outstanding for a long period; (c) Inadequate provision as per RBI guidelines for receivables in respect of banking and finance companies. Auditors need to obtain confirmation of balances or account copies to satisfy that receivables are stated correctly.

ii) **Inventories:** Inventories may be overstated by any of the following ways: (a) By including non-moving and obsolete items as part of stock; (b) By including third party stock as part of inventories; (c) By including insurance spares (i.e. compulsory spares to be maintained in relation to critical machinery - generally accepted accounting practice is to capitalise insurance spares along with the value of machinery).

iii) **Investments:** Window dressing FS is easy by overstatement of investments. This is particularly possible in the case of bank and finance companies. Investments may be overstated by means of: (a) Not writing off Z-Category or vanishing companies; (b) Not writing down investments in the wake of stock market crash; (c) Overstatement of investment in group companies.

c) **Understatement of Expenses :** An entity may window dress FS by applying anti-aging techniques, i.e. by understatement of its expenses. One way of understatement is by not recognizing expenses on

accrual basis, e.g. not accounting royalty, franchisee fee, copy right fee or patent fee. Another way of understatement is by not disclosing the tax liability where assessment is completed or other demand was raised by tax authorities. A third method is by not sharing the common expenditure in the case of a group company. A fourth practice is where the entity does not account for purchases which are received or goods-in- transit. By understatement of expenses the company also understates its liabilities, as a result net worth is artificially inflated.

d) **Understatement of Liabilities :** There is no dearth of costumes for window dressing FS by understatement of its liabilities - (a) by mis-statement of ascertained liabilities as contingent liabilities; (b) suppression of devolved Bank Guarantees and Letters of Credit; (c) by not recognizing claims from customers or third parties.

2. **Paint Red:** By painting red the management shows a gloomy picture of the organisation. In case of a sick unit, by painting red the management may kill the organisation prematurely. This may be resorted in circumstances where - (a) to hush up diversion of funds by the management; (b) with an intention to cause loss to investors, banks, financial institutions or employees; (c) Intentionally to make the company sick or insolvent an old company and promote a new company for availing subsidies and other benefits. An organisation may be painted red by understatement of turnover, profits or assets. Another mode is overstatement of expenditure, provisions or liabilities. An organisation may be painted red by techniques quite opposite to window dressing as discussed above in detail. The auditor should be alert to this technique to see that the FS are neither misleading nor mis-stated.

3. **Cover up Activity:** Management might have resorted to 'window dressing' of its FS in the previous years. It may wish to take advantage of economic recession and reverse the position wholly or partly. When the auditor comes across this situation, he should insist for adequate disclosures in FS in the form of prior year income/expenditure or in the form of suitable notes to accounts. In addition the auditor shall be required to report the same in his report.

4. **Revaluation of Assets:** By revaluation of assets, the management may wish to improve the net worth of the company. For one or more of the following reasons, an organisation may revalue its business or assets. Revaluation is another way of window dressing FS. During the recession times, upward revaluation of assets is not justified. Hence the auditor has to qualify his report where the company has revalued its assets or business.

a) **Overstate assets:** Disclosure of assets at a higher value is not in the interest of the company. They merely overstate the assets than at realistic values. Though auditor is not a valuer, he has to critically evaluate the valuation report to ascertain whether revaluation is justified. If he is not satisfied he has to qualify his report.

b) **Erosion of capital:** Where capital of a company is eroded due to losses in the current year or accumulated losses, management may try to cover up this position with revaluation. It should be distinctly brought to the notice of the management by the auditor that the position cannot be cured through revaluation of assets. He will have to suitably qualify the report where the management does not adhere to his professional advice.

c) **Recognize intangible assets:** Intangible assets may consist of Goodwill, Technology, Value of Patent, copy right or trade mark, Human Resource Value, etc. In the course of revaluation, management may try to recognize intangible assets in the FS. Auditor should bring it to the notice of the management that revaluation of intangible assets in recession times is not healthy and their recognition in the books may be in violation of Accounting Standard-26 'Intangible Assets'. Where the situation warrants, the auditor will have to suitably qualify his report in this regard.

We will continue our travel as to how we can march forward in our profession while **'Facing Reverse Gear'** by analyzing other risk factors.

- Loans & Advances - u/s 301
- Change in Accounting policy or method of valuation
- Compliance with AS.
- Following Standard Auditing Practices
  - Prudent accounting policies
  - Impaired assets
  - Intangible assets
  - Discontinued business
- Rendering prudent advise to the audit to enable face the slow down ■