Symptoms of Accounting Misstatements in context of PSU Audits – A Case based Discussion

Universally, Technical Professionals engaged in rectification of faults begin their investigations from any apparent symptoms of the underlying problems. These symptoms are clues guiding for specific examinations and facilitate fast diagnosis of the ultimate problems. In the absence of such clues, problem detection is time consuming and tougher. At times, Auditors engaged in assurance services are hard-pressed to meet various statutory deadlines as to the completion of jobs. An audit involves correction of material accounting faults which today demands fast detection and rectification / reporting. If the financial statements or accounting records disclose any obvious symptoms of misstatements (clues), the detection and correction of the same is faster as pointed out above. This article highlights such a symptom-based primary inquiry in an assurance audit situation, with the help of a few illustrations and cases on audit qualifications. Read on to know more……..

CA. Jiss Morris

The author is a member of the Institute who may be contacted at jisfca@yahoo.co.in

Audit intention

Expression of opinion as to true and fair view of financial statements is the basic intention of audit. If the reported financial statements include significant accounting misstatement, the auditor surely has to report the same and its probable impact. The expectations of stakeholders are also on similar lines. Hence, detection and correction / reporting of material financial misstatements is a prominent responsibility of the auditor while carrying out the annual audit assignments.

Non-disclosure by the management

A business enterprise carries out diverse transactions on day-to-day basis, resulting in the generation of huge mass of financial data over the year, leading to preparation of annual financial performance statements. If the audited financial statements contain material misstatements, that straightly points towards ineffective audit. It is true that management is primarily responsible for preparing and maintaining error-free accounts. Even so, in actual practice it is interesting to notice that the management (i.e., representatives of shareholders) rarely discloses voluntarily to any auditors the existence of any misstatements in accounts whether known to them or not. It may be due to fear of reporting or for some other reasons. In effect, detection of material misstatements & true and fair financial reporting is the headache of auditor to a good extent.

How a physician's or technicians Client discloses?

At this stage, it is fascinating to notice the attitudes of an audit client and clients of a physician or an engineering technician. The physician's client i.e, the patient makes a full and frank disclosure of his physical troubles to the physician. These are symptoms, based on which the physician makes further tests, diagnoses the problem and curative action is taken. Unless the patient voluntarily reveals his apparent problems, the physician's job goes more investigative. He may examine the patient for apparent symptoms and he will have to conduct several tests and procedures to detect the real health problems. In such a case, chances of non-detection is also higher. To be safer, he then proceeds with such tests and procedures to assure that his client is free from a list of critical illnesses (say cancer, cardiac problems *etc.*) and a Medical report may also be issued accordingly. Here, a materiality (criticality) based approach is adapted. Any subsequent detection of a very rare illness may not point towards physician's gross negligence.

A technician's client also discloses to him the apparent problems and malfunctioning of say, a technical installation. Based on such disclosure, trouble shooting is done by the technician. In the absence of such disclosures by the client, trouble shooting may involve detailed procedures as stated in physician's case above. He may in such case, issue a test certificate for the installation based on common and major fault conditions which he has examined.

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General realities on fault rectification

It can be observed in the above instances that, once the symptoms (Leads), are readily disclosed, detection and correction of the underlying problems are easy and time saving.

Hence, if the symptoms are not readily available, it is better to examine for the existence of any apparent symptoms so that problem detection is easier.

In a situation of complete absence of such symptoms, the generic approach is to test and deal with frequently found significant (i.e, serious) problems first. The primary approach gives a better coverage in lesser time and adds a good degree of comfort towards reasonable professional assurance, as it considers all pervasive problems.

Lead Generation in Commercial Audits

Likewise, in the audit scenario, if primary investigation is towards detection of apparent symptoms of frequently occurring misstatements, recognition of the underlying material misstatement is quicker. Here, a symptom or red signal is just an indicator of a probable financial misstatement and is apparent in the financial statements or in the books of accounts. For the auditor, these are 'leads' towards fast detection of misstatements. These leads can be based on commonly occurring and other serious misstatements in relation to items of Balance Sheet and Revenue Statements pertinent to the type of industry under audit. The intention is to ensure that there is no inadvertent audit omission of (a) material misstatements where the symptoms are "visible" in financial statements or books, (b) Other "serious" misstatements, the occurrence of which is "common" in relation to financial statements generally and specific to a particular industry. The underlying presumption is that any subsequent discovery of a material but ordinary kind of misstatement may be viewed as a serious audit omission compared to misstatement of an extra ordinary kind (Say, one involving interpretation of an Accounting Standard).

Some visible Leads of Accounting Misstatements

The fundamental arrangement of items in a statement of financial position is based on Current and Non-current nature of Assets and liabilities. Naturally, the Individual account balance figures and its periodical movements must also reflect such fundamental characteristics in the normal course, which is the basic presumption in a Lead (figure) based inquiry. Any departure of accounting figures from these normal characteristics is a sign of probable misstatement. E.g., normally, Individual balance figures under current assets should vary in the short run, i.e., there must be additions and or deductions. If such figures remain constant over a period, which indicates a deviation i.e, a probable accounting misstatement which ordinarily requires a rectification as shown in Illustration –I.

An individual balance figure of a current liability should vary in the short run. But if it remains constant over a number of years, that indicates its probable time-barred (or non-existent) nature. So current assets and current liability figures are to be "current" and not "fixed".

Similarly, in the normal course, individual balances of Non-current items should be constant in the short run. Deviation hints probable misstatements. E.g., Revenue expenses treated as capital expenditure is indicated by variations in an individual Fixed Assets figure which is supposed to be constant in the short run (except for depreciation).

Also, there are instances of revenue receipts treated as current liabilities where the accounting indication is "only additions in an individual liability balance without deductions". Here also the balance figure violates the basic characteristic of the representing head i.e., a current liability which is to be paid off in the short run. To conclude, irregular movements of accounting figures from its standard movements during a period is *prima facie* considered as a probable misstatement.

Visible indicators of misstatements can be easily compiled in similar lines based on the nature of transactions and balances, (i.e., facts and figures) to the extent possible. Investigation and settlement of all such cases in the primary phase of the audit is a good work because such misstatements are visible irregularities causing the financial statements "handicapped". For the revenue statements, normally the items are to be of recurring nature. Non recurring items appearing in revenue heads or a nonmoving balance indicates that it is either exceptional/extra ordinary or capital nature.

Common Accounting Misstatements

Some cases of most common accounting misstatements in context of PSU audits and related red signals are discussed hereunder. As is known, in PSUs, there is still an element of bureaucracy and consequent administrative & procedural delays that usually results in material accounting misstatements.

I. INVENTORIES

Let us go through the extracts from the original audit qualifications of some Public Sector Undertakings (PSU) of past years to have a look on common accounting misstatements.

1. An Industrial Electronics Company

Inventory included items costing ₹76.81 lakh which were declared surplus several years back due to design change. As the proposals for write off were in process of approval, suitable provision for obsolescence should have been made. Non provision of the same resulted in understatement of provision for obsolescence and over statement of profit to the extent of ₹76.81 lakh.

2. A Company in Telecom Sector

Provisions were understated by ₹15.09 crore on account of non-provision of obsolete and non-moving inventories in nine units of the Company. This also resulted in understatement of administrative, operating and other expenses by ₹15.09 crore with consequent overstatement of profit for the year and reserves and surplus by ₹15.09 crore.

3. A Heavy Equipment Company

Inventories included raw materials and components valued at ₹7.49 crore not moved for more than five years against which the Company had made a provision of ₹4.05 crore. As this inventory could neither be used for the purpose for which it was procured nor for any alternate use for the last five

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years, its usability/realisability was uncertain. Thus, full provision should have been made for obsolescence. Non-provision on this account had resulted in overstatement of inventories and profit by ₹3.44 crore.

Symptoms of obsolescent inventories in financial statements

Non writing down of obsolete and unusable inventory to its net realisable value is a frequently found irregularity. Generally, dead stock shows dead balances in accounts (i.e., no additions or deductions for many years). It is primarily signalled by constant figures of inventory item-wise balances appearing in the schedule of inventories of current year and one or more previous years as illustrated below. At times, such items are transferred to Non current assets. (For convenience, only 3 years' figures are provided. Quantity and rates columns omitted). Here, the apparent abnormality in individual figures (constant figures) pointed out misstatements as reported above.

Illustration - I

Schedules of inventory for 3 years (in lakh)

Items	Current year value on 31.03.2016	Prev. year value as on 31.03.2015	2nd prev. year value as on 31.03.2014.
P	12.30	11.70	13.10
Q	**11.86**	**11.86**	**11.86**
R	2.70	3.10	3.50
S	**12.90**	**12.90**	**12.90**
T	13.80	7.90	8.10

Items Q and S show constant balances over several years signalling its probable non moving/ unusable (obsolete) nature commanding a write down, of course, subject to further enquiry with the management. Quantity columns also contain constant figures in such cases. It is probable that there may also be some other obsolete items not having any indications in financial statements as noted above. Here, an easily detected symptom has lead to a conclusion as to a highly probable accounting misstatement.

II. RECEIVABLES

Have a look on some common audit comments of PSUs on Debtors

4. A Company in procurement & sale of food produce

Claims Receivable were overstated by ₹26.14 crore due to inclusion of the following: (i) Irrecoverable/ doubtful claims of railways of ₹23.85 crore, and (ii) Transit shortages of ₹2.29 crore recoverable from Handling and Transport contractors remained unrealised for more than three years at District office, New Port Depot and Port Depot in West Bengal region.

5. A Power Sector Company

Profit for the year was overstated by ₹1.48 crore due to Non-provision of ₹1.48 crore towards insurance claim pending since 20XX for damage to gas insulated switchgear equipment.

6. A Company producing refractories

Non-provision of doubtful debts of ₹92.40 lakh outstanding for a long time against supply of refractory to M/s OX India Limited, the ownership of which had already been transferred to a private party.

Accounting symptoms of uncertainty in collection

As is well known, chances of collectability declines when the debts go older. Inclusion of unrealiable amounts in trade receivables is a frequently found misstatement in corporate financial statements as reported above. Here also, the visible symptom is constant balances of parties in the schedule of debtors continue over years as in the case of inventory illustration-I shown earlier. It is true that other balances may also contain doubtful amounts, but those are not visibly signaled for which other audit checks may be applied, say age-wise receivable statements *etc.*

Non writing back of time-barred payables is a frequently commented audit point. As per the Limitation Act, a liability gets time-barred when it remains unclaimed for 3 years.

Indicators not apparent in Financial Statements/Books

Error signals may not always be apparent in financial statements as discussed above. Quite often, non-financial data (Mainly technical/quantitative data related to Balance sheet and revenue items) signals material financial misstatements. Such data are prepared by persons not related to accounts (say, Transmission division of an Electricity company) and are very much closer to the occurrence of actual events and facts. Hence, these are considered more reliable and independent in financial audit.

III. FIXED ASSETS –

(a) Capitalization of projects.

Audit qualifications of a few PSU heavy weights are stated here under:

7. A Company in Telecom industry

Delay in capitalisation; of subscribers' installations, telephone exchanges, exchange equipment and cables in Delhi unit, resulted in understatement of depreciation by ₹5.28 crore (including prior period depreciation of ₹3.60 crore) and capital work-in-progress by ₹79 lakh. Consequently, gross block and net block of fixed assets were overstated by ₹79.30 lakh and ₹6.07 crore respectively, whereas profit for the year and reserves & surplus were also overstated by ₹16.80 lakh and ₹5.28 crore respectively.

8. A Power Sector Corporation

The Company capitalised T-M transmission line in December 20XX and M-J transmission line in January next year, though these lines were completed and ready for charging in March and November 20XX, respectively. This resulted in overstatement of net block of fixed assets by ₹3.31 crore and understatement of depreciation by ₹94 lakh and overstatement of profit by ₹4.25 crore.

9. A Company holding and managing Airports

Fixed assets as well as depreciation were understated by ₹94 lakh and ₹4 lakh respectively due to: (i) Non-capitalisation of residential building freehold property by ₹94 lakh, resulting in understatement of depreciation by ₹4 lakh.

Hints for detection of misstatements

In capital intensive industries like Power, telecommunication *etc.*, non capitalisation/delayed capitalisation of new/expansion projects resulting profit inflation and understatement of depreciation & Fixed assets is a usual misstatement as reported above. Illustration below indicates an internal report (a non financial data) prepared by Planning Dept. of a Telecom Company, but relevant for financial audit.

Old dates of acquisitions appearing in the asset register, Plant & Machineries with high original cost, low rate of depreciation and low WDV *etc.* usually signals it's life expired/obsolescent nature.

Illustration - II

Report on Working lines as on 30.06.2015 (within the audit period)

Exchange details	As on 30.04.2015	As on 31.05. 2015	As on 30.06.2015
Exchange type - A Location – L1	3,500 lines	3,500 lines	**4,500 lines**
Exchange type - A Location – L2	2,000 lines	**2,500 lines**	2,500 lines
Exchange type - B Location – L3	5,000 lines	5,000 lines	5,000 lines
Exchange type - A Location – L4	--	--	**1,000 lines**

The above is a cumulative monthly report showing the actual working capacity of telephone exchanges in terms of telephone lines of a Telecom Company. Here, capacity expansion is evident at locations L1 & L2 in the months June and May 2015 respectively and a new project is functioning at location L4 from June 2015, commanding capitalisation of the respective project costs (i.e, cost of related Equipments, Lines and all incidental expenses including attributable overheads) in accounts with effect from the months reported or earlier when they are ready for use and not any later. In view of the prevalence of misstatements in this area, L1, L2 & L4 signals scope for misstatements in Fixed Asset Register as to the date of capitalisations. Usually, due to administrative delays, project completion reports are either not issued to the Accounts or are delayed resulting Non capitalisation/Delayed capitalizations. As discussed earlier, the signals may not always

indicate a misstatement. Say, in the case above, if the equipment at location L2 has an original installed capacity of 3000 lines, increase in actual working capacity from 2000 to 2500 lines may not require any equipment capitalisation but other expenses may do.

(b) Inclusion of Decommissioned/Obsolete Assets in fixed assets

This is another area of normal audit concern. Some audit comments of PSU are reported hereunder.

10. An Internet/Telecom Service Provider

Fixed assets (Delhi unit) included 38,450 technologically faulty CDMA handsets at a gross value of ₹67.14 crore. However, as per AS-10, these fixed assets should have been eliminated from the financial statement when no further benefit was expected from their use and disposal. This resulted in overstatement of gross block of fixed assets by ₹67.14 crore, net block of fixed assets by ₹43.65 crore and accumulated depreciation by ₹23.49 crore, profit by ₹43.65 crore and understatement of administrative, operating and other expenses (loss of obsolete assets) by ₹43.65 crore.

11. An Oil Refinery

Profit was overstated by ₹3.11 crore due to non-provision of depreciation/ amortisation in respect of plant and machinery, which had been condemned. The equipment under reference had already outlived its life. Hence as per AS-6, 95 % of the original cost of the asset should have been provided as depreciation.

Financial Indicators of Probable Assets obsolescence

Old dates of acquisitions appearing in the asset register, Plant & Machineries with high original cost, low rate of depreciation and low WDV *etc.* usually signals that its life expired/obsolescent nature. In addition, observations in the year end physical verification report of Assets as "Scrapped" "Unusable" "Decommissioned" *etc.* are chances of probable misstatements in financial statements in view of the recurrence of misstatements in this area. Subsequent enquiry with an independent technical staff will confirm the position. Unusable assets are to be deleted from "fixed assets" and written down to its NRV if its net book value is higher as per AS 10.

IV. PAYABLES/CREDITORS

Have a look on some audit qualifications on creditors.

12. An electronic goods manufacturing company

Other long term liabilities / Trade payables include liabilities amounting to ₹120.88 lakh which are outstanding for more than three years and are no longer payable. This was included in our previous year's report. Non writing back of this liability to revenue has resulted in overstatement of other long term liabilities and accumulated losses of the division by ₹120.88 lakh.

13. Company dealing in food produce

Sundry creditors for other finance (₹283.08 crore) were overstated by ₹3.60 crore due to non writing back of liabilities no longer required to be paid to HR under centrally sponsored program and SFP scheme resulting understatement of net profit to that extent.

14. A Warehousing Company

Liability amounting to ₹120 lakh created during earlier years on account of customs staff which was no longer required was not routed through prior period adjustment account, but straightly written back in violation of disclosure provisions of AS-5.

Visible indications for time-barred payables

Non writing back of time-barred payables is a frequently commented audit point. As per the Limitation Act, a liability gets time-barred when it remains unclaimed for 3 years. Similar to our illustration – I, scrutiny of schedules of creditors/payables for 3 previous years reveals signals of time-barred liabilities subject to other provisions of limitation act.

V. SIGNIFICANT ACCOUNTING POLICIES AND NOTES TO ACCOUNTS

Review of the same at the commencement of the audit gives an overall insight towards probable misstatements in accounts. A few selected instances are reported here.

Case – 15: In the Annual Report of a Company one of the accounting policy regarding customs duty, provides as below: "Custom Duty payable on raw material, stores and spares and machinery are accounted for on clearing of the goods from Custom Warehouse."

(As per AS 2, the company is required to create a provision for customs duty payable on the goods lying in the warehouse and include the said amount in cost of respective inventories.)

Case – 16: Accounting policy of a company provided that Excise duty on the finished goods lying in factory premises and not cleared from excise bonded warehouse on 31st March, has not been provided and hence not included in inventory valuation.

(It may be noted that as per AS 2, Valuation of Inventories, the cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.)

Case – 17: As per the accounting policy of a company regarding Foreign Currency Transactions, imports and exports were recorded by the company at the pre-fixed rates.

(It may be noted that as per AS 11, a transaction in a foreign currency should be recorded in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.)

Case – 18: A Company accounting policy stated that finished goods are valued at lower of cost or net realisable value; costs include depreciation, interest (excluding interest on discounting of bills) and direct expenses to the point of stocking, excise duty but excludes administration and selling expenses."

(But AS 16, Borrowing Costs provides that those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Accordingly, as per AS 16, no borrowing cost (interest) can be capitalised as a part of cost of inventory.)

VI. BOARD MINUTES

Board minutes are an important source of information on significant events and managerial decisions having direct impact on financial statements. It contains information on many transactions which are clues to the auditor for further provisioning for expenditures, details of write off proposals, capital commitments, contingent liabilities *etc.*

These are only a few of the irregularities selected for our discussion. Based on the most common significant errors, a list of misstatements industry wise and account head wise can be spelt out and its probable signals be identified. An in-depth audit of the accounts targeting such symptoms and simple generic misstatements as a primary investigation of the audit process is more productive, efficient and safe for the auditor on the grounds that:

1. Any subsequent (after audit) detection of an ordinary and reasonably detectable accounting misstatement is more indicative of gross negligence (say, overstatement of cash as in Sathyam case) than an extra ordinary type misstatement (say, which involving interpretation of accounting standard or a rare type fraud).

2. Since all the generic misstatements related to financial statements are detected and pointed out at the initial audit stage, the management gets more time to take corrective actions.

3. Since all serious and visible misstatements have been covered in the primary stage itself, the auditor can comfortably proceed to more complicated errors whose occurrence is not so common and the detection of which is time consuming.

Materiality is a generic and very broader concept which is widely considered in audit situations in terms of size of figures relevant to financial statements from its user's point of view of sensitiveness in decision making. In addition to this, practically, Materiality can be more specifically applied if it is also considered in terms of prevalence or pervasiveness of misstatements in relation to the kind of Industries / financial statements under review from point of view of audit effectiveness. Precisely, an audit omission is more material in relation to an accounting misstatement to the extent it is ordinary in nature and is reasonably detectable. Naturally, Non detection of such misstatement is material in deciding professional negligence in auditing unlike an extra ordinary misstatement in view of the fact that audit gives only a reasonable assurance.

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