Violation of AS 2: A case study

Authors: Jaison David, Tisa Maria Antony, Sunil N, Leo Prasad V, Tinu Baiju, Anjana Cherian Mathew, Priyanka S, Kushboo Rajpurohit, Sathish E – Research Scholar's, CHRIST (Deemed to be University)
Guided by : Dr. Kavitha Jayakumar, Associate Professor, CHRIST (Deemed to be University)

Abstract: *Window dressing of financial statements is the core issue of any financial statements of any company, misappropriation of stocks is one of those issues, and due to this reason AS 2 gives a clarity for a company on how to evaluate the stocks. In spite of being controlled by the accounting standard and SEBI we could still find many cases in valuation of inventories. From the auditing perspective a fictitious case been formulated and the suggestions been provided with the help of teaching guidelines.*

Keywords: - *valuation of stocks, LIFO, FIFO, AS 2.*

Introduction

Inventory refers to the goods that is being ready for sale or the unsold products that is in the process of production and includes raw material, work in progress and finished goods. Inventories should be valued at cost or net realizable value whichever is lower. The operating performance of the industries is influenced by the valuation of industries. The cost of inventories should be separately calculated and individual cost should be assigned to each items. Inventories can be valued by using FIFO method or Weighted Average Cost method. When it becomes difficult to calculate the cost of inventory, Standard Cost and Retail Cost can also be used to arrive at the accurate value. Inventory Valuation should be done carefully and is of utmost importance to an industry as it influences the current profit, current cash flow and income tax issues.

Accounting Standard-2 specifies about the valuation of Inventories. This standard clearly tells us about the accounting treatment of inventories and also sets the guidelines for which the inventories are to be valued in the financial statements. This standard is of huge importance as it has an impact on the revenues and assets of the company.

Inventory valuation consists of two elements that are price and quantity. Determining this type of fraud is a difficult task and auditors need to be careful while valuating inventory. The common ways to commit this fraud are recording items that do not exist, invalid journal entries, fake shipping and receiving reports, etc. Therefore, the auditor should use different systematic procedures to examine the company's inventory techniques and ensure that the physical goods match with the financial data. It directly effects company's profit and becomes complex when documents are not properly maintained. In order to solve this issue, the auditor can use any of the costing methods i.e. FIFO, LIFO and weighted average method. These methods helps auditor to know the remaining inventory at the end of the year and defines the cost of items and gives proper evidence during inventory audit. Other problem that may occur is timing of the inventory inspection.

Coming to Inventory Audit, Inventory Audit need to be done monthly or quarterly as per the size of business or the amount of transactions involved. Various softwares are being introduced by different IT companies. These help in generating better accuracy and less time involved compared to Physical Inventory system of validating inventory.

Body

In September 2000, Mr. Gautama Shankar acquired a position of salesman with Elite Processing in Karnataka, most successful processed food Production Company in whole of India. With ambition and hard work, he was promoted to the post of general manager of the southern region of Elite Processing. He was wholly responsible to cater to retail outlets in and around south India all the way up to Northern region.

Gautama discovered that managing such a large-scale operation wasn't easy as he thought to be. It was more stressful, tiring and complicated. He was caught by his superiors for poor performance for his region. This began to question the creditors and other clients. Things began to go out of hands when they questioned his authority and responsibilities in meeting the standards and target in sales and turnover (corporatefinanceinstitute.com, n.d.). He began to take matters into his own hands. Gautama began misrepresenting values and figures in the books of accounts by adding fictitious assets and high value inventory items to meet the profit levels as per the superiors. By doing so, he decreased the costs involved and thereby increasing the overall profits.

However, the overall profits did not meet the target met by the company. He had to pool in even larger amounts of assets and inventories to reach the targets and goals set by the company. When things started to go more out of his hands, he admitted of misrepresentation of books to his superiors (isca.org.sg, n.d.). Elite Processing immediately fired him and appointed a special committee to look into the matters. Committee founds out that the company's income has been overstated by 13%.

Gautam disclosed his ways of inflating the books, by adding more content on smaller inventory that no one would arise a suspicion. Also, it was all done in a computerized format in his division.

In 2012, J & D Co Chartered Accountants audited Elite Processing. Thomas Varghese of J & D Co Chartered Accountants served as audit manager. Ram Suman served as the audit supervisor assigned to Elite Processing engagement. They had followed up with SEBI to investigate the audits of Elite Processing. SEBI criticized Thomas and Ram for their roles as auditors and their failure to check for Elite Processing inventory accounts. They should have had a doubt in knowing that 43% of total assets were of inventory. They were also aware of Elite Processing poor internal management control due to lack of communication which led to inventory errors. Also, for a fact that it was in 2010-2012 they saw an increase in rapid growth of inventory levels.

Case Ending

SEBI criticized the auditors regarding their problem to pursue physical inventory levels with that of computerized ones. Gautam criticized that these auditors had looked into such books of accounts on auditing. Auditors failed to follow up. Ram did not notice numerous differences in physical and computerized forms of Elite Processing inventory or chose not to investigate the differences.

Gautam's explanation wasn't complimentary to J & D Co Chartered Accountants. Gautam testified that he made up excuses to account missing or misplaced inventory and auditors never cross examined. Also, Auditors weren't willing enough to count inventory items at Elite Processing.

SEBI required Thomas and Ram to go under several professional courses. Also, the audits conducted by them in future was required to be peer reviewed to find out whether proper audit procedures have been followed. Since Thomas and Ram failed to comply with quality standards, J & D Co Chartered Accountants was not sanctioned by SEBI. Nestle dismissed J & D Co Chartered Accountants and retained KPMG as audit firm. To settle disputes and charges filed against Gautam by SEBI, Gautam signed a consent decree in which he neither admitted nor denied charges but agreed not to violate SEBI laws in future.

Teaching Note

Synopsis

The core issues involved in the case is the manipulation of accounts by misrepresenting values and figures in the books of accounts by adding fictitious assets and high value inventory items to meet the profit levels as per the superiors. The Chartered Accountants that audited the accounts failed to check and verify the inventory accounts. They should have had a doubt in knowing that 43% of total assets were of inventory. The auditors were aware of Elite Processing poor internal management control and the lack of communication which led to inventory errors.

Assignment questions

1. Explain the core issue of the case?
2. Can the activities or the fraudulent practices done by Gautam Prasad be justified? Explain?
3. What can be done to avoid such issues in the future?

Case Positioning and Setting

The case basically deals with Mr. Gautama Shankar, the general manager of Elite Processing acquired a position of salesman with Elite Processing in Karnataka, who began to misrepresent the values and figures in the books of accounts by adding fictitious assets and high value inventory items to meet the profit levels as per the superiors. By doing so, he decreased the costs involved and thereby increasing the overall profits.

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