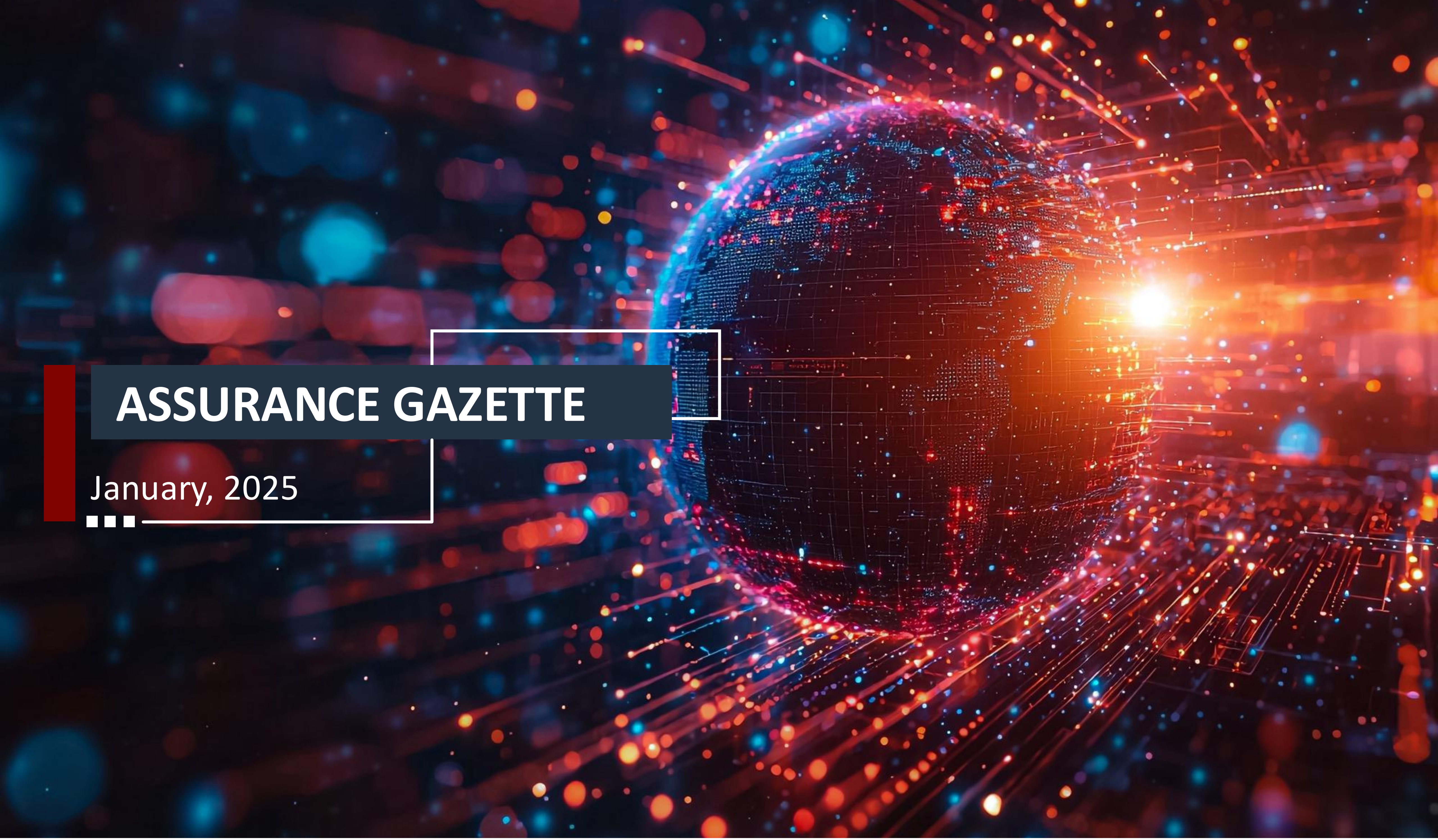

ASSURANCE GAZETTE

January, 2025

NANGIA & CO LLP

CHARTERED ACCOUNTANTS

Contents

Foreword

*Welcome to the **January 2025 Assurance Gazette!***

This article shares insights on enhancing financial reporting reliability and transparency, drawing from NFRA's key findings. It addresses challenges in critical areas like revenue recognition, trade receivables, inventory valuation, and related party transactions, offering guidance for management and auditors to reinforce internal controls, improve audit diligence, and ensure strong compliance practices.

In this issue we also bring The Expert Advisory Committee's analysis of the company's share in the property to be classified as Inventory or Investment Property under Ind AS 2 or Ind AS 40 respectively. It captures the Committee's conclusion that the property aligns with Inventory classification as the primary intent of the business to meet criteria under specified standard.

Classification of the Project as Inventory or Investment Property under Ind AS framework-EAC Opinion

Facts of the Case

The Company, a PSU under the Ministry of Housing & Urban Affairs, achieved Navratna status in 2014 and operates in PMC(Project Management Consultancy), Real Estate, and EPC Engineering, Project and Construction) segments. It developed a joint real estate project with AMC (‘A’ Municipal Corporation) (76.98% Company, 23.02% AMC) at J Place, intending to sell it post completion.

Despite multiple sale attempts from 2008 to 2014, the property could not be sold due to lack of interest and missing statutory approvals. In the interim, it was temporarily rented out to government entities, with income shared as per the ownership ratio.

The Occupancy Certificate was obtained on Jan-24, and the Company plans to launch the sale soon after completing RERA and other requirements.

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The Company seeks the Expert Advisory Committee's opinion on whether its share of assets in the J Place property should continue to be classified as 'Real Estate Inventory', reclassified as 'Investment Property', or treated differently under applicable Ind AS.

Points considered by the Committee

Analysis of Inventory Classification Under IND AS 40

The primary issue is whether the company’s share of assets in the J Place Property project should be classified as **‘Inventory’** or **‘Investment Property’**. The analysis focuses exclusively on this classification and does not address other accounting or legal considerations.

Key Points from IND AS 40 and IND AS 2:

1. **Definition of Investment Property (Ind AS 40):**

   Property held to earn rentals, for capital appreciation, or both, rather than:

   - Use in production/supply of goods or services.
   - Sale in the ordinary course of business.

   Examples of investment property include:

   - Land held for capital appreciation.
   - Buildings leased out under operating leases.
   - Property being constructed for future investment purposes.

   Property held for **sale in the ordinary course of business** is explicitly excluded from being classified as investment property.

2. **Definition of Inventories (Ind AS 2):**

   Assets held for:

   - business.
   - Production for such saSale in the ordinary course of le.

3. **Judgment Required:**

   Classification depends on the primary intended use of the property. Entities must develop criteria for consistent judgment and disclose the basis when classification is difficult.

Facts of the Case:

The company and AMC jointly developed the property under a 2005 MoU. Key points from the MoU:

- The project was intended to generate maximum revenue through **sale of property**.
- A professional marketing agency was engaged for selling the property.
- Sale proceeds were to be shared after deducting equity contributions.

- **Attempts to Sell the Property:**
  Despite efforts (advertisements, consultants, etc.), the sale was delayed due to missing Occupancy Certificates and pending RERA formalities.
- **Temporary Rentals:**
  The property was leased out temporarily to government authorities to generate rental income until statutory requirements for sale could be completed.
- **Management's Intention:**
  The primary intention remained to sell the property, as evidenced by actions and recent receipt of the Occupancy Certificate.

Committee's Conclusion:

The developed property is **intended for sale in the ordinary course of business**, aligning with the definition of inventory under Ind AS 2. The temporary rental income does not change its classification. Therefore, the property should be classified as **Inventory**, not **Investment Property**.

Audit Oversights and Financial Reporting Deficiencies: Strengthening Controls and Compliance

A recent analysis by NFRA (National Financial Reporting Authority) reveals significant shortcomings in financial reporting, including gaps in audit procedures, inadequate documentation practices, and non-compliance with accounting standards. These persistent issues, spanning areas such as revenue recognition, inventory valuation, impairment calculations, etc. emphasize the urgent need for robust internal controls, heightened auditor diligence, and a stronger commitment from both management and auditors to uphold accounting integrity. Below is a summary of the key recurring observations by NFRA:

1. Failing to Identify/Assess ROMM Related to Revenue

Issue:

Failure to identify and assess risks of material misstatement related to revenue, including ignoring revenue shortfalls and insufficient documentation.

Key Learnings for Management:

- Implement and monitor effective revenue recognition controls.
- Identify and address revenue discrepancies promptly, supported by detailed records and reconciliations to prevent misstatements.

Key Learnings for Auditors:

- Perform in-depth risk assessments specific to revenue streams.
- Ensure sufficient evidence is obtained for revenue transactions, addressing occurrence, accuracy, completeness, cut-off, and classification thoroughly.

2. Incorrect Audit of Trade Receivables

Issue:

Reliance on unverified debtor information and inadequate alternative procedures, leading to unreliable audit outcomes.

Key Learnings for Management:

- Maintain up-to-date and accurate records of trade receivables.
- Cooperate with auditors for external confirmations or provide valid alternatives to support trade receivable balances.

Key Learnings for Auditors:

- Conduct external confirmations and, if unsuccessful, design robust alternative procedures to verify the accuracy and existence of trade receivables.

3. Incorrect Inventory Valuation Method

Issue:

Incorrect valuation of finished goods inventory, failing to consider the lower of cost and net realizable value.

Key Learnings for Management:

- Ensure that inventory is valued appropriately under applicable standards.
- Use reliable methods and regular market assessments to determine net realizable value.

Key Learnings for Auditors:

- Verify that inventory valuation methods comply with accounting standards.
- Analyze whether the lower of cost and net realizable value has been appropriately applied.

4. Improper Handling of Writing Back of Liabilities

Issue:

Miscalculation of liabilities and improper reversal of liabilities or assets, impacting profitability and lacking proper justification.

Key Learnings for Management:

- Maintain accurate records of liabilities.
- Ensure justifiable, well-documented decisions for writing back liabilities or assets, with full disclosures.

Key Learnings for Auditors:

- Verify the rationale behind writing back liabilities and assets.
- Scrutinize calculations and related documentation to ensure accuracy and compliance with standards.

5. Failing in Disclosures Regarding Related Party Transactions

Issue:

Inadequate documentation and verification of share allocations and insufficient transparency in related party disclosures.

Key Learnings for Management:

- Ensure all related party transactions are identified, authorized, and fully disclosed.
- Maintain detailed documentation for all such transactions in compliance with accounting standards.

Key Learnings for Auditors:

- Assess risks associated with related party transactions and verify their authenticity and disclosure.
- Obtain sufficient evidence to ensure transparency.

6. Erroneous Revenue Recognition Policy

Issue:

Use of an incorrect revenue recognition policy leading to discrepancies between reported revenue and actual outcomes.

Key Learnings for Management:

- Implement and adhere to a revenue recognition policy aligned with applicable accounting framework.
- Regularly monitor revenue recognition to ensure accuracy and compliance.

Key Learnings for Auditors:

- Assess the appropriateness of the revenue recognition policy.
- Validate its implementation with sufficient evidence to ensure accurate reporting.

7. Incorrect Impairment Calculation Related to Financial Assets

Issue:

Inaccurate impairment calculations for loans and receivables, leading to unreliable financial statements.

Key Learnings for Management:

- Establish effective impairment calculation processes in compliance with applicable accounting framework.
- Conduct regular reviews to ensure accurate measurement and recording of impairments.

Key Learnings for Auditors:

- Examine management's impairment calculations and validate compliance with applicable accounting framework.
- Obtain sufficient audit evidence to confirm the accuracy of recorded impairments.

Nangia’s Take

To establish greater reliability and trust in stakeholders' financial reporting, and in line with NFRA's recent orders, targeted measures are required for both management and auditors. Management must focus on strengthening internal controls, conducting a comprehensive review of accounting policies, and ensuring robust documentation processes to uphold transparency and compliance. Meanwhile, auditors should enhance their diligence through rigorous training and adopt more comprehensive auditing practices. These efforts collectively will play a pivotal role in fostering long-term stakeholder confidence and safeguarding the integrity of financial reporting.

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