

PAPER 6F: MULTIDISCIPLINARY CASE STUDY

Case Study – 3

REVENUE RECOGNITION AND AUDITORS' REPORTING

➤ Background of the Company

ABC Ltd. (hereinafter referred as ABC) is engaged in two types of business activities:

- Advertisement business – The business of providing services in respect to advertisement, publicity and promotion of products of other companies.
- Manufacturing business – The business is to manufacture plastic containers which have multi-utility. These containers are mainly used in kitchen for storage, microwave, etc.

ABC is a phase II company as per the notification issued by MCA dated 16 February 2015 and is required to comply with (Indian Accounting Standards) Rules, 2015 in preparation of its financial statements for the year ended 31 March 2018.

XYZ Ltd. has appointed ABC as its advertising agency on a non-exclusive basis subject to terms and conditions contained therein.

ABC generates approx. 99% of its revenue from XYZ Ltd. Each year the company enters into an agreement with XYZ which is effective from calendar year January to December and is renewed every year.

ABC hires other companies (third party vendors) to provide advertising services to XYZ. The charges for the third party vendors are paid by the ABC and not XYZ. The Company's gross cash inflows from XYZ include the expenses paid to the third party vendors. Thus, the Company charges XYZ for two items – one, charges paid to the third party vendors and two, its commission/service fee.

The relevant terms and conditions of the agreement entered into between ABC and XYZ Ltd. are as follows:

- Notwithstanding anything contrary in this Agreement, nothing herein shall be construed as authorising ABC to act, register, or otherwise represent itself as an Agent of XYZ. The relationship between XYZ and ABC shall be on a principal to principal basis only.
- ABC shall be responsible for creating/conceptualizing the advertisement content, preparation of advertisement and publicity materials including artwork and designing for print advertising, photographs, transparencies, slides, cinematography films, television films, sound recordings, audio-visuals, editing, printing of positives, bromides & CD for releasing advertisement in newspapers, magazines, etc. (hereinafter collectively referred to as "Work"). It may also be noted that the company is responsible for incurring costs for execution of the entire contract initially. Thereafter, it would add its commission/service fee on such costs and would raise an invoice on XYZ.

The above clauses have been inserted into the agreement due to the peculiar nature of the business and the amount of expenditure involved. The involvement of XYZ is essential since it involves crucial decisions which may impact the business and image of XYZ. For example, it is essential to take approval from XYZ while deciding the actor who should be involved in the advertisement, the media company which should be further involved in rendering of services. The above clauses seem protective in nature.

In practice, the auditor has also informed that the initial price negotiations, etc. with third party vendors are carried out by the company. XYZ approves the price and the third party for execution of the work for which the company is responsible. Getting the work executed remains the responsibility of the company.

It may also be noted that the ABC would be entitled for advance payments only if the quotations submitted by the company have been accepted by XYZ.

- ABC shall act through the media agency and media partners designated by XYZ, for placement and release of advertisements in all media, including but not limited to newspapers, magazines, films, cinema slides, outdoor and transport media, radio, television, internet, satellite/ cable TV, television sponsored programs, direct mailers, brochures, booklet, annual reports, calendars, diaries, presentation items, etc. (hereinafter collectively referred to as "Media").

- ABC shall obtain written approval from XYZ's authorized personnel before executing the Services. ABC shall execute the Services assigned to it based on the specific written approval received from XYZ's authorized personnel and on the terms and conditions/specifications/format, indicated therein. If there is no such specific written approval, a letter duly signed and issued by XYZ's authorized personnel and/or minutes of the meeting duly signed by both Parties to the effect that the Services had been assigned by XYZ to ABC, would construe the prior approval for the purposes of this Clause.
- ABC shall also obtain the prior written approval of XYZ whenever a third party is engaged by ABC to render any part of the Services as contemplated under this Agreement.
- ABC shall submit invoices to XYZ for claiming the consideration and should be accompanied/supported by relevant third-party invoice & challans.
- XYZ shall make advance payment to ABC, provided the quotation submitted by ABC is acceptable to XYZ, in the following manner:
 - i) if the film production/still photo shoot is performed outside India, 75% of the production cost excluding travel, boarding & lodging, agency commission and taxes.
 - ii) If the Film production/still photo shoot is performed within India, 50% of the production cost, excluding travel, boarding & lodging, agency commission and taxes
- ABC shall involve XYZ in all negotiations with third parties for the Services under this Agreement.
- In case the undisputed portion of the bills remains unpaid beyond the due date by XYZ, ABC is entitled to claim interest at the rate of ten (10%) interest per annum on the outstanding undisputed portion of the bills beyond the stipulated credit period. Further, in case of film production, if the cost exceeds as to what was estimated and agreed with XYZ, the company would be liable to bear the differential costs and make

payments to third parties. Similarly, in case of flex printing, display, sports marketing and events, the company is responsible to bear the variability in the costs, though in practice this situation does not arise.

- ABC shall be entitled to get reimbursement from XYZ for the payment made by it to a third party for any part of the Services rendered by the third party pursuant to this Agreement, on submission of original bills raised by such third party. However, XYZ shall have no liability to a third party if it has paid the amount to ABC raised by the third party.

➤ The various activities from which the Company earns its revenue are summarized below -

- **Promotion of products**

This activity consists of the following –

- 1) **Film Production**

This relates to the expenses incurred on developing the advertisement film. An estimate is being entered into with XYZ on the basis of days of shoot and other incidental expenditure. Company then hires a sub vendor to perform the activity. Vendor then carries out the work as per the specification from ABC. Vendor submit the bills to ABC and after adding the commission as per agreement on the total cost incurred ABC raises the invoice on XYZ.

- 2) **Retainership Fees**

The Company has a studio in its office for designing the advertisements and carrying out various other activities. As per the contract, Company charges a fixed amount from XYZ every month for the studio.

- 3) **Printing of brochure**

This is the commission that the Company gets on Printing of Brochures, Banner, Dangler, Poster, Leaflets and show room display kit. Printing activity will be carried out by third party vendor appointed by XYZ under the

recommendation of ABC. Vendor invoices are not received by the company in this case.

Revenue recognition for promotional activities followed by ABC are given below:

Activity	Revenue elements	Cost
Film Production	Vendor bill + Commission	Vendor bill
Retainership Fees	Monthly fixed billing	No direct cost
Printing of brochure	Only commission	No direct cost

- **Outdoor activity**

This activity consists of the following –

1) Flex Printing

The design for hoarding to be printed is selected by XYZ. ABC then selects a vendor for the printing of the flex. After the flex is printed and delivered, vendor raises the bills on ABC and after receiving the vendors bill ABC adds its commission fixed as per agreement and raises the invoice on XYZ.

2) Mounting

The printed flex is then mounted at the selected display area by another vendor. Once the flex is mounted, vendor raises the bills on ABC and after receiving the vendors' bill, ABC raises the invoice on XYZ.

3) Display

With the consent of XYZ, ABC fixes the place for display of the hoardings and accordingly vendor raises monthly bills on ABC. ABC further adds its commission fixed as per agreement and raises the invoice on XYZ.

Revenue recognition for outdoor activities followed by ABC are given below:

Activity	Revenue	Cost
Flex Printing	Vendor bill + Commission	Vendor bill
Mounting	Vendor bills	Vendor bills

	(No commission)	
Display	Vendor bill + Commission	Vendor bills

- **Advertisement activity**

This activity consists of the following –

- 1) **Media Commission**

This is the commission that the Company gets on the commercial that is run or printed on TV or newspaper respectively. Vendors' invoices are not received by the company in this case, and are directly billed to XYZ. Company receive details in excel sheet on monthly basis containing total cost incurred by XYZ and commission income accrued for ABC.

- 2) **Online Revenue**

Commission income on the ads run on various websites like Google, Yahoo etc.

Revenue recognition for advertisement activities followed by ABC are given below:

Activity	Revenue	Cost
Media Commission	Only commission	No direct cost
Online Revenue	Vendor bill + Commission	Vendor bills

- **Sports marketing and events**

ABC organises various events on behalf of XYZ at the time of car launch or otherwise. An estimate is entered into between ABC and XYZ and the activity is decided as well as the area where the events are to be put up. ABC then sub contracts the same to various vendors. The vendors then carry out the work as per the specification from ABC. And after carrying out the work submits the bills which ABC verifies and raises a manual invoice on XYZ by charging the commission as per agreement on the total cost incurred.

Revenue recognition for sports marketing and other events organized by ABC are given below:

Activity	Revenue	Cost
Events	Vendor bill + Commission	Vendor Bill

Audit of financial statements for the year ended 31 March 2018

ABC prepared its financial statements for the year ended 31 March 2018 as required by Section 129 of the Companies Act, 2013. While carrying out the audit of the financial statements, the statutory auditors appointed under Section 139 of the Companies Act, 2013 had a detailed discussion with the CFO of the company on the accounting treatment for the various activities described above and the revenue recognised from such activities.

The issue discussed is whether the company should account for the revenue from the specified sources on a gross basis (i.e. commission/service fee plus charges paid to the third parties) or on a net basis (i.e. commission/service fee received) as its revenue.

Audit report issues

In addition to the above, while carrying out the audit of ABC, the auditors noted that certain expenses for the services is recorded by the Company under the head contractual manpower charges.

During the audit, the auditors observed that a few invoices for such expenses appeared similar. The explanation provided by management for this similarity was that the rates agreed to with different parties is the same and this was corroborated by the contract terms with these parties.

As a matter of professional skepticism, the auditors decided to increase the extent of the audit procedures in respect of these parties and other vendors of the Company.

The auditors carried out inquiries and obtained addresses of the parties to ascertain the genuineness of such transactions. They also visited few parties basis the address mentioned on their invoices. They noted that three out of the four parties were employees of the Company and the fourth one was a third party.

When the auditors discussed this matter with the management, they confirmed that three of their contractors are also employees of the Company. and that the Company has been following this practice since the earlier years.

To corroborate management's version and to verify the adequacy of this expenditure, the engagement team performed the following procedures:

- Verified the contractor agreement entered by the Company with the four parties identified by the statutory auditors
- Verified that the monthly invoices raised are based on rates as per the agreement with these parties
- Reconciled the quantity mentioned in the invoice with the production quantity as per excise records
- Verified that payment made to the above parties was through the bank by scrutinizing the bank statements of the Company.
- Verified the bank statements of the parties made available to the auditors for review by management to verify the receipt of payment in their respective accounts.
- Verified that TDS has been deducted on the above payments (verified Form 16A as well).
- Verified from the Income tax web site that the PAN number against which TDS has been deducted belongs to these parties only.
- Verified that the address as per PAN is same as per employees records of the Company for three employees.
- Verified that the address as per bank statement is same as that of mentioned in employees records of the Company for three employees.
- Asked management to provide the auditors with relevant records that can substantiate the movement of contract workers in and out of the factory premises and any other

information available with management to support the appropriateness/ adequacy of this expenditure.

- Enquired from management regarding its liability in respect of statutory dues payable for the contractual manpower operating from its premises.

Audit Observations – Communication to those charged with governance as required by SA 260

- Management mentioned the audit team that they do not maintain updated records that can validate the movement of workers in and out of the factory premises. The engagement team also observed that there is no internal control mechanism in place for tracking the attendance of workers at various locations on daily basis.
- Sufficient and appropriate evidence was not available to substantiate the actual work carried out by the contractual manpower and its trail in the entire production process.
- Management does not possess sufficient information in respect of the status of statutory dues (PF, ESI etc.) payable by the contractor in respect of such labour and consequently on whether there is any obligation on part of the Company to discharge these dues.

QUESTIONS

Multiple Choice (2 marks each)

1. Who is the primary obligor in the current arrangement?
 - (a) ABC Ltd.
 - (b) XYZ Ltd.
 - (c) Vendor or third parties.
 - (d) Both ABC Ltd. and XYZ Ltd.

2. The factor which indicate that a company is acting as a principal in transaction include:
- (a) The customer understands that the company is acting as the primary obligor in the arrangement
 - (b) The company has inventory risk
 - (c) The company has or assumes the credit risk associated with the transaction.
 - (d) All of the above
3. Under Ind AS 18, an indicator that an entity is acting as an agent is that it performs services for compensation or a commission or a fee basis, which is fixed in terms of either an amount of currency or a percentage of the value of the underlying goods or services provided by the principal. Given the current facts, what is the consideration to which ABC is entitled to receive from XYZ:
- (a) Cost plus commission for various services
 - (b) Fixed amount on a monthly basis
 - (c) Commission and reimbursement from XYZ for payment made by ABC to third party for any part of the services rendered by third party to XYZ.
 - (d) All of the above.
4. Who is responsible for credit risk in this arrangement?
- (a) ABC Ltd.
 - (b) XYZ Ltd.
 - (c) Vendor or third parties.
 - (d) Both ABC Ltd. and XYZ Ltd.
5. ABC's auditors are required to report as to whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. Due to absence of internal control mechanism in place to for track the attendance of workers at various locations on daily basis, the reporting implications may be as below:

- (a) Give a detailed note in the financial statements stating about absence of internal control and there is need for improvement
 - (b) Qualify the audit report in accordance with Standards on Auditing
 - (c) Qualify the separate report on internal financial report
 - (d) Qualify both the audit report and report on internal financial report.
6. What are the reporting obligations of the auditor in case it is unable to obtain sufficient appropriate audit evidence?
- (a) The auditor should carry out alternate audit procedure to obtain sufficient appropriate audit evidence
 - (b) The audit report should be qualified under SA 705, Modifications to the Opinion in the Independent Auditor's Report.
 - (c) The audit report should include an Emphasis of matter paragraph under SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
 - (d) Both (a) and (b) above
7. If the entity is collecting the consideration on behalf of the third party (i.e., as an agent for the third party), the entity measures revenue :
- (a) at the gross amount it collects from the customer excluding taxes collected on behalf of government
 - (b) at the net amount it retains on its own account
 - (c) at the net amount it retains on its own account (the consideration received less the amount paid to the third party and to government, if any)
 - (d) at the gross amount it collects from the customer excluding taxes collected on behalf of government and also recognizing all the expenses incurred on gross basis
8. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters to.

- (a) the management
 - (b) those charged with governance such as audit committee or oversight committee
 - (c) central government subject to thresholds prescribed in the rules
 - (d) All of the above
9. Excise duty will be applicable from April 01, 2017 till June 30, 2017 for ABC and GST will be applicable for the period from July 1, 2017. How should revenue be presented by ABC in financial statements for the year ended March 31, 2018?
- (a) Revenue for the period prior to the applicability of GST should be shown as net of excise duty and that post GST becoming applicable should be shown as gross of GST.
 - (b) Revenue for the period prior to the applicability of GST should be shown as gross of excise duty and that post GST becoming applicable should be shown as net of GST.
 - (c) Revenue for the period prior to the applicability of GST and that post GST becoming applicable should be shown as gross of excise duty and GST.
 - (d) Revenue for the period prior to the applicability of GST and that post GST becoming applicable should be shown as net of excise duty and GST.
10. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should:
- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
 - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted

- (c) Seek a legal advice depending on the facts and circumstances
- (d) All of the above.

Descriptive/Numerical

11. As per the given facts, ABC Ltd. is providing advertisement services to XYZ Ltd., one of its primary customer. ABC has entered into an agreement with XYZ which is effective from calendar year January to December and is renewed every year. Determine whether ABC Ltd. is acting as a principal or an agent in this arrangement and whether the presentation of revenue from the below mentioned activities should be made on gross basis (cost plus commission) or net basis.

- Film Production
- Flex Printing
- Display
- Online Revenue
- Sports marketing and events

Identify factors for your determination by referring to the guidance given in the standard and the terms of the arrangement. **(10 Marks)**

12. If you are the auditors of ABC, then how would you address the matter related to similar invoices for expenses incurred on contractual manpower charges in the conduct of the statutory audit? Also evaluate the implications for the auditor's inability to obtain insufficient appropriate audit evidence on the auditor's report required to be issued under Companies Act, 2013 in case the ? Whether there will be any impact on the previous year numbers considering that management has been following the same practice since earlier years and this issue has not been highlighted by the auditors in earlier audit reports. The auditors are continuing auditors for the past four years.

Elaborate by including your audit approach, audit procedures and reporting implications by giving references of auditing standards. **(10 Marks)**

13. The auditor is also required to report auditors' report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. Identify the control weaknesses in the internal controls in case of ABC and explain how should the auditor address this matter while issuing the auditor's report under Section 143(3)(i) of the Companies Act, 2013?

Further, also evaluate, whether any reporting is required to be made to the Central Government under Section 143(12) of the Companies Act, 2013? If yes, identify the steps for such reporting and how should the auditor address this in the audit report. **(10 Marks)**