

## ELECTIVE PAPER 6F – MULTIDISCIPLINARY CASE STUDY

### SUGGESTED SOLUTION – CASE STUDY 3

#### Multiple Choice

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1. Answer (a)
2. Answer (d)
3. Answer (d)
4. Answer (a)
5. Answer (d)
6. Answer (d)
7. Answer (c)
8. Answer (d)
9. Answer (b)
10. Answer (d)

#### Descriptive / Numerical

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11. (1) The issue 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 party) or on a net basis (i.e. commission/service fee received) as its revenue. The query relates to the services provided such as film production, flex printing, display, and sports marketing and events. The company is entitled for various kinds of fees in the following manner:
- Cost plus commission (at an agreed rate)
  - Fixed amount on a monthly basis
  - Commission.

#### Technical literature

- (2) The issue is to evaluate whether the company is acting as a principal or an agent of XYZ for the services of the third party vendors. This issue is particularly important from revenue recognition

angle. If an entity acts as a principal in its service contracts, it earns revenue from the rendering of services and records revenue equal to the amount charged/chargeable from customers (gross presentation). If it acts as an agent, it earns revenue in the form of a commission or fee from its principal, who is the real service provider. Revenue recorded by an agent is limited to the commission or fee that it earns (net presentation).

Ind AS 18 defines revenue as, "Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."

Under Ind AS 18 also provides that:

"8 Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its **own account**. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission." [Emphasis added]

Indicators that an entity is acting as a principal include that it:

- has primary responsibility for providing the goods and services to the customer or for fulfilling the order;
- has inventory risk before or after the customer order, during shipping or on return;
- has discretion in establishing prices (directly or indirectly); and
- bears the customer's credit risk for the amount receivable from the customer.

*An indicator that an entity is acting as an agent is that it performs services for compensation on a commission or 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.*

### **Principal vs agent**

3. On the basis of the combined reading of the clauses of the agreement and the literature, the following points emerge:

- The company is responsible for creating the entire content and releasing advertisements in newspapers and magazines. The agreement has been entered into between company and XYZ and hence, for XYZ, the primary obligor is the company.
  - The risk of inventories does not arise since production begins on request to product of an advertiser.
  - The pricing for the work carried out by the company including the work done by the third parties (to which work has been sub-contracted by the company) and it is agreed/accepted by XYZ. The media agencies (third party vendors) are chosen by the company and XYZ provides its acceptance.
  - The credit risk lies with the company to the extent there is a variability in the cost incurred on rendering of services. Further, the company is liable to make the payments to third parties which are involved in execution of work.
4. The mere fact that the company is entitled to cost plus commission in various cases and the company needs acceptance from XYZ while involving third parties, etc. does not make the company an agent of XYZ. Thus, based on our understanding of the agreement between the company and XYZ, it indicates that the company provides complete advertising, publicity and promotional services to XYZ on its own account and that it is acting in its own capacity and not as an agent of XYZ. The above facts indicate that the company bears the risks and rewards of a principal in the transaction and has the overall responsibility for the work performed, i.e. the company is the primary obligor for providing the services to XYZ. The other companies (third party vendors) are acting as a sub-contractor to the company. Further, as per the agreement, the credit risk lies with the company. Thus, in revenue (commission/service fee and related costs paid to the 3<sup>rd</sup> party vendors) should be recorded on a gross basis.
12. As part of the current year audit, the auditors has not been able to obtain the required documentary evidence regarding the payment to four contractors for handling of materials, cleaning, packaging etc, payment of certain statutory dues related to contracted labour and salaries and wages.
1. The auditors should carry out procedures as required by SA 500, Audit evidence to the extent possible on the concerned matters to obtain the required audit evidence. Paragraph 6 of SA 500 states as below:
- “6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.”*

*Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.*

*Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.*

2. The auditors should also involve forensic team to:
  - perform additional procedures in respect of the four contractors and other vendors of the company and
  - perform a high level fraud risk assessment for salaries and wages at one of the company's plants in Noida.

3. SA 240, The Auditor's Responsibilities Relating to Fraud states in Para 12, 13, 35 and 37 as below:

*"12. In accordance with SA 200, the auditor shall maintain an attitude of professional skepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance."*

*"13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further."*

*“35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.”*

*“37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)”*

*“A52. SA 450, “Evaluation of Misstatements Identified during the Audit”, and SA 700, “The Independent Auditor’s Report on General Purpose Financial Statements”, establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor’s opinion in the auditor’s report.”*

*Thus, SA 240 requires an auditor to refer to SA 700 for determining the reporting obligations.*

4. SA 700, Forming an Opinion and Reporting on Financial Statements, which is applicable for audits of financial year upto 31 March 2018 state in its para 16 and 17 as below:

*“16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*

*17. If the auditor:*

- (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705.”

5. SA 705, Modifications to the Opinion in the Independent Auditor’s Report, which is applicable for audits of financial year upto 31 March 2018 state in its para 7 as below:

*“Qualified Opinion*

7. The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.”

The table below illustrates how the auditor’s judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

<b><i>Nature of matter giving rise to modification</i></b>	<b><i>Auditor’s judgment about the materiality and Pervasiveness of the effects or possible effects on the financial statements</i></b>	
	<b><i>Material but not pervasive</i></b>	<b><i>Material and pervasive</i></b>
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

The term ‘pervasive’ referred to above is not defined in SA 700. However, SA 705, Modification to the Opinion in the Independent Auditor’s report defines pervasive as under:

*“(a) Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor’s judgment:*

- (i) Are not confined to specific elements, accounts or items of the financial statements; If so confined, represent or could represent a substantial proportion of the financial statements; or*
- (iii) In relation to disclosures, are fundamental to users’ understanding of the financial statements.”*

The team should assess the impact of the adjustments discussed below to determine whether the impact is pervasive.

6. Reference needs to be also made to SA 710, Comparatives. As per paragraph 12 of the standard
- “12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor’s report on the current period financial statements, modified with respect to the corresponding figures included therein.”*

### **Contractual manpower/job work charges**

From the given facts, it seems that the auditors have not been able to obtain the required audit evidence to establish the linkage with the output of the contracted labour and the validity and appropriateness of the payments and whether the arrangements can be in potential non-compliance with the requirement to pay certain statutory dues.

The auditors should consider the available facts and information to determine whether the current case is one where:

- (a) there are strong indicators of fraud and that there is a high risk of the related expense being largely overstated or
- (b) the overstatement of the related expense is expected to be limited in its impact though it would still be material or
- (c) there are definite internal controls weaknesses, particularly relating to proper documentation, attendance monitoring etc. but the related expense is not overstated to a material extent.

In reaching the above decision, the auditor should consider the results of all audit and forensic procedures including analytical review.

While this is a judgement which the auditor has to make on the basis of their detailed knowledge of the facts and circumstances, if the situation is that of 7(b), a qualification would be called for both with regard to the expense items and the contingent liability for the impact of the matter on the statutory dues.

The auditors should also strongly advise the management about the weaknesses in controls which need to be addressed, the need for further investigation in the matter and that immediate rectification measures. As per the team, while they have not carried out specific procedures on comparatives, but since the arrangements are the same as in the previous years, it is of the view that the matter raises an issue even for the previous year’s figures. Thus, to this extent, the audit opinion on the comparative figures will also have to be modified.

13. Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 (“the 2013 Act” or “the Act”) requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The auditor's objective in an audit of internal financial controls is to express an opinion on the effectiveness of the company's internal financial controls and the procedures in respect thereof are carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the date specified in management's assessment. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

The Company did not have an appropriate internal control system for authorization and validity of expenses which could potentially result in the Company recognising inappropriate expenses in the books of account.

Therefore the auditor should modify its report on internal financial controls under Section 143(3)(i) of the Companies Act, 2013.

Further, Section 143(12) of Companies Act, 2013 states as below:

Under sec 143(12) of the *Companies Act, 2013*, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

With regard to the above, rule 13 of the Companies (Audit and Auditors) Rules, 2014 provides that in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the central government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below:

- (i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days
- (ii) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations.

- (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time
- (iv) the report needs to be sent to the Secretary, MCA in a sealed cover by registered post with acknowledgement due or by speed post followed by an e-mail confirmation.
- (v) the report should be on the letter head of the auditor containing postal address, e-mail address and contact details and be signed by the auditor with his seal and his membership number
- (vi) the report shall be in the form of a statements as specified in Form ADT-4.

Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been amended by the Companies (Audit and Auditors) Amendment Rules, 2015 issued in December 2015. The amended provisions require inter alia:

- Reporting by statutory auditor to central government only for frauds which involve/expected to involve individually an amount of INR 1 crore or above
- In case of fraud involving lesser than the above amount, statutory auditor to report matter to the audit committee/board of company instead of central government but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:
  - Nature of fraud with description;
  - Approximate amount involved and
  - Parties involved.

Therefore, if the amount of fraud is expected to involve an amount of INR 1 crore or above, the auditor should report to Central Government as prescribed. However, if the amount involved is less than INR 1 crore, then auditor should report to the board or audit committee.

Further, it may be noted that Paragraph 4 of SA 240 states and clarifies that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In the context of the 2013 Act, this position is reiterated in Section 134(5) which states that the Board report shall include a responsibility statement, inter alia, that the directors had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities. Based on the above, it may be considered that Section 143(12) envisages the auditor to report to the management and thereafter the Central Government an offence involving fraud/suspected fraud against the company by its officers or employees only if he is the first person to identify/note such instance in the course of performance of his duties as an auditor.