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Contents

FASB Proposes Amendments to Principal-Agent Guidance in Revenue Standard

The FASB invited constituents to comment on a proposed Accounting Standards Update (ASU) intended to clarify how the principal versus agent guidance in the new revenue standard should be applied to determine whether revenue should be presented gross (as a principal) or net (as an agent).[1] The comment deadline is October 15, 2015.

In July, the IASB issued an exposure draft that includes similar proposed amendments to the principal-agent guidance in its version of the standard.[2]

Key Facts

- An entity would determine the nature of its promise for each specified good or service to be provided to its customer and whether it controls each specified good or service before it is transferred to the customer.
- The FASB's proposed ASU would not amend principal-agent guidance in current U.S. GAAP.[3] However, this legacy guidance will be superseded when the new revenue standard becomes effective.

Key Impacts

- Companies should consider the proposed ASU as they prepare to implement the new revenue standard.
- The FASB's proposed ASU intends to reduce diversity in practice while maintaining substantial convergence between U.S. GAAP and IFRS.

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[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, and FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, both available at www.fasb.org.

[2] IASB Exposure Draft ED/2015/6, Clarifications to IFRS 15, available at www.ifrs.org.

[3] FASB ASC Subtopic 605-45, Revenue Recognition – Principal Agent Considerations, available at www.fasb.org.

Gross versus Net Revenue Reporting

Gross versus net revenue reporting has been a complex issue for years. Arrangements that involve multiple parties within a distribution chain providing goods or services to customers require a reporting entity within that chain to exercise significant judgment in evaluating whether it is a principal (presenting revenue gross) or an agent (presenting revenue net) in the transaction. Current U.S. GAAP includes indicators that should be evaluated for this determination. However, applying these indicators has often been challenging for preparers.

The new revenue standard supersedes existing principal-agent guidance and requires an entity to determine if the nature of its promise is a performance obligation to provide specified goods or services to the customer (principal) or to arrange for another party to provide those goods or services (agent). The standard specifies that an entity is a principal if it controls the goods or services before transferring them to the customer. The standard also provides indicators of when an entity is an agent in the revenue transaction.

Principal versus Agent Considerations

Questions have been raised by the Transition Resource Group (TRG) about how the control principle in the revenue standard interacts with the agency indicators. Some questioned whether the control principle should be applied independently of the indicators (e.g., based on how control is evaluated elsewhere in the revenue standard) or whether the agency indicators are used in the control assessment. Some have suggested that the indicators are confusing because they do not directly answer the question of whether an entity controls goods or services before transfer. Also, some have questioned whether, and if so how, some indicators should be weighted more heavily than others, particularly when the indicators provide contradictory evidence.

Determining whether an entity controls goods or services is particularly difficult in contracts for the transfer of a non-physical item (e.g., a software developer sells its app through another party's website) or the provision of some services (e.g., an entity arranges for its advertising to be placed on another party's website through a virtual advertising platform). In those situations it may not be clear how the control principle interacts with the agency indicators.

The proposed ASU makes it clear that the control principle is the basis for determining the nature of the entity's promise to the customer and whether an entity is a principal or an agent. To facilitate this determination, the proposed ASU includes four key proposed changes to the revenue standard.

Entities Must Identify the Nature of the Specified Good or Service Provided to the Customer. The proposed guidance clarifies that the determination of whether an entity is a principal or agent in a transaction is made for each specified good or service (i.e., each distinct good or service or distinct bundle of goods or services) promised to the customer. An entity could be a principal for some specified goods or services and an agent for others within the same contract. The proposed ASU's objective is to more clearly articulate the unit of account in the principal-agent analysis and link it with the guidance on identifying performance obligations.

Clarify How an Entity Can Control a Service or a Good or Service That Is Combined with Other Goods or Services. The proposed ASU provides more guidance on how to apply the control principle when services are provided and when a good or service is combined with other goods or services.

The proposed ASU states that when another party is involved in providing services to a customer, an entity that is a principal obtains control of a right to a service to be performed by a third party. This gives the entity the ability to direct the third party to provide the service to the customer on the entity's behalf. For example, this would occur when an entity enters into a maintenance services contract with a customer and then engages a third party to perform those services under the entity's direction.

The proposed ASU also specifies that an entity controls a specified good or service if it provides a significant service of integrating goods or services provided by another party into the specified good or service for which the customer has contracted. This would occur when the entity first obtains control of the good or service from the other party and then directs its use to create the combined output for which the customer has contracted.

Re-frame Indicators to Provide Evidence of When an Entity Controls a Specified Good or Service. The indicators of when the entity is an agent would be replaced with indicators of when an entity controls a specified good or service as a principal. It further reinforces the control principle by noting that an agent does not control the specified good or service before it is transferred to the customer. Although the proposed ASU does not provide guidance on how to weight the indicators, it states that certain indicators may be more or less relevant or persuasive based on facts and circumstances. The proposed ASU even states that some indicators may be present even when an entity is an agent. The indicators are not intended to be all-inclusive.

Proposed Indicators of When an Entity Controls a Specified Good or Service

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service.
- The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer (e.g., on return).
- The entity has discretion in establishing the pricing for the specified good or service. However, an agent can have discretion in establishing prices in some cases.
- The entity is exposed to credit risk for the amount receivable from the customer in exchange for the specified good or service. However, in some cases, an agent may choose to accept credit risk as part of its overall service of arranging for the provision of the specified good or service.

Revised Examples. The proposed ASU would revise some examples in the revenue standard and add new examples that are specifically focused on linking the principal-agent conclusion to the notion of control and illustrating how the indicators should be used to support the evaluation of control.

In several retail transactions a retailer obtains title to its inventory only momentarily at the point of sale (referred to as flash title). Under current U.S. GAAP the retailer would generally report these sales gross. The proposed ASU does not include an example related to these types of transactions. The FASB and IASB believe these contracts are often unique, and changes in facts and circumstances could result in a different conclusion.

Estimating Gross Revenue

In some arrangements in which another party is involved in making an entity's goods or services available to a customer, the entity may be the principal but does not know the price paid by the end customer to the intermediary. For example, an app developer sells its products through a social media intermediary. The intermediary pays the app developer a fixed amount for each download of the app. However, the intermediary does not report to the app developer what the end customers paid because its users buy apps with a virtual currency or because the intermediary offers coupons and discounts to its users.

In current practice, some companies report the amount received from the other party as revenue. Other companies report the estimated amount charged to the end customer as revenue and the difference between the estimated amount and the amount received as a selling cost. The FASB decided not to revise the standard to address this issue because it was a narrow-scope issue. The FASB thought that any additional standard setting would cause further divergence from the IASB's proposed amendments to its standard.

No guidance on this topic is included in the proposed ASU. However, the Board stated in the Basis for Conclusions that:

- in situations where the principal is unaware, and expects to remain unaware, of the transaction price charged to the customer, and
- the principal does not receive from the intermediary a fixed percentage of a stated price,

then the transaction price of the principal does not include the difference between the amount that the entity is entitled to receive from the intermediary and the amount charged by the intermediary to the end customer.[4]

Conversely, the Basis for Conclusions in the IASB's exposure draft does not specifically express a view for a similar situation; therefore, more judgment may be applied.[5] These differences could lead to diversity in practice.

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[4] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), paragraph BC36, August 31, 2015, available at www.fasb.org.

[5] IASB Exposure Draft ED/2015/6, Clarifications to IFRS 15, paragraphs BC53 – BC56, available at www.ifrs.org.

Example 1: Revenue Is Net Amount Remitted

Company A is a principal that is entitled to receive $3 for each good sold by an intermediary. The intermediary may sell the good for a range of prices from $3 to $5, but the amount remitted by the intermediary to Company A will be $3 for each good sold on Company A's behalf.

Company A does not know and will not know the price charged by the intermediary to the end customer. As a result, Company A's transaction price for each good is $3.

Example 2: Revenue Is Gross Transaction Price

Company B is a principal that is entitled to receive 80 percent of the $10 list price for each good sold by an intermediary. Regardless of whether the intermediary sells the good for $8, $10, or another amount, the amount remitted by the intermediary will be $8 for each good sold on Company B's behalf.

Company B knows the list price. Therefore, any incremental discount offered to the end customer by the intermediary is attributed to the intermediary. Company B's transaction price for each good is $10.

The situations illustrated in these two examples may exist more broadly than the circumstances contemplated by the Board.

Next Steps

The proposed ASU makes clarifications to address some of the implementation concerns and questions that have been raised. However, the proposed amendments do not eliminate the significant judgment that may need to be applied in many fact patterns. The principal-agent determination will continue to be challenging. Companies should evaluate the FASB's proposed amendments and consider submitting a comment letter by the October 15, 2015, deadline.

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