

**International
Accounting Standards
Board**

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This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

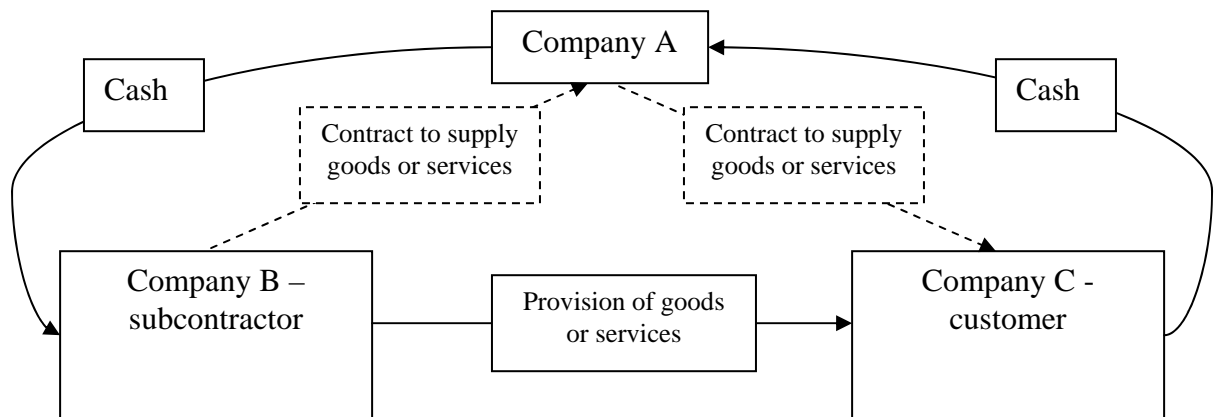
Project: Guidance on identifying agency arrangements (Agenda paper 6)

INTRODUCTION

1. In February 2006, the IFRIC received a request for an interpretation of how IAS18.8 should be applied to situations where an entity employs another entity to meet the requirements of a customer under a sales contract.
2. The details included in the request were specific to one contract. However the request did raise a question as to whether there is a need for more general interpretive guidance in this area.

SUMMARY OF THE ISSUE

3. In many industries, it is common to outsource or subcontract work. In these situations, a company (Company A) may enter into a contract with another entity (Company B) which will supply some or all of the services that Company A is contracted to provide to its customer (Company C).



4. Company A will typically sell the services provided by Company B to Company C at a profit. Company B may take on substantially all of the work required under the contract but Company A will typically continue to hold some of the risks, for example the bad debt risk.
5. IAS 18.8 states that “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.”
6. The issue raised is how Company A should determine whether it is acting as an agent for Company B as a principal, and therefore the extent to which it should record revenue arising from its sales to Company C.
7. It should be noted that this paper considers this issue as it relates to trading relationships between companies. It does not consider the treatment of sales taxes, goods and services taxes, value added taxes or excise duties, which are also discussed in IAS 8.8.

STAFF ANALYSIS

8. The staff considers that, whilst there is little specific guidance in the standard on how agency relationships can be identified, preparers of accounts should first look to apply the general revenue recognition principles in IAS18 to the specific facts and circumstances surrounding a relationship to ascertain whether they should recognise revenue net or gross.
9. In particular, the staff believes that the provisions of paragraphs 8 and 14 include guidance which is likely to be relevant in assessing agency transactions.
10. IAS 18.8 states that “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.” In many arrangements, it will be clear that one entity is collecting amounts on behalf of another, for example a delivery charge which is passed on to the transport company involved.
11. IAS18.14, addressing the sale of goods, states that “revenue shall be recognised when ... the following conditions have been satisfied :
 - The entity has transferred to the buyer the significant risks and rewards of the goods;
 - The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.”
12. In order to recognise revenue under paragraph 14 it is necessary for an entity to transfer the risks and rewards of ownership to its customer, and to cease to have a managerial involvement in or effective control over the product sold. An entity which has never had managerial involvement in or control over a product, and which has never been exposed to the risks and rewards associated with that product will not be able to pass these to a customer and therefore will not be able to recognise revenue arising on the sale of those goods.
13. The staff believes that assessing which parties take on risks and rewards, managerial involvement, and control are therefore good indicators of which parties may be acting as principal or agent in a relationship.

14. If an entity is unable to conclude which party in an arrangement is the principal after having applied the principles of IAS 18, the hierarchy in IAS 8 requires that the entity consider applicable sections of the Framework and then recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards.
15. The staff notes that other standard setters have issued more detailed guidance in this area, which does not conflict with the existing IAS. In particular, the staff note that US GAAP includes detailed guidance on identifying agents in agency relationships in EITF 99-19 “Reporting revenue gross as a principal versus net as an agent” which states that “the [SEC] staff considers whether the registrant :
- Acts as principal in the transaction
 - Takes title to the products
 - Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
 - Acts as an agent or broker (including performing service, in substance, as an agent or broker) with compensation on a commission or fee basis.”

Consideration of whether the issue should be accepted onto the IFRIC agenda

Existence of significantly divergent interpretations

16. In a number of industries, business arrangements are becoming ever more complex, and determining whether an entity is acting as a principal in an agency arrangement is not always straightforward. With no clear guidance as to how this should be determined, differing interpretations may develop which may result in significantly divergent accounting treatments. If divergent treatments occur they may give rise to materially different revenue trends and margin percentages in businesses.
17. Some national standard setters have felt that this is an area where divergence can occur and have issued guidance in their local GAAPs. For example, EITF 99-19 cited above, states that “Diversity exists regarding whether an entity should report revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of goods or services or (b) the net amount ... because it has earned a commission or fee.” Similarly, in the UK, Application Note G to FRS5, *Reporting the Substance of Transactions* was issued

“in response to the need for clarity in respect of questions that arise concerning the treatment of revenue...” The issuance of this guidance resulted in the restatement under UK GAAP of the 2003 turnover of House of Fraser, a department store, from £963.5m to £703.5m after it concluded that it was acting as an agent in certain arrangements.

18. In instances where the treatment may require judgement, the staff believes that companies currently refer to other existing guidance (for example EITF 99-19) to interpret specific examples.
19. Whilst the staff considers that the existing guidance does not contradict IFRS, and application of this guidance has not resulted in significant divergence in practice, the staff believes that the lack of formal guidance within IAS 18 may lead to divergence in the future.

Practical and widespread relevance

20. The use of outsourcing or subcontracting is extremely widespread, and, whilst in the majority of cases the guidance included in IAS18 supplemented, if necessary, by reference to the IAS8 hierarchy will be sufficient to conclude on whether an agency arrangement exists, any guidance issued in this area is likely to have widespread relevance.

Relation to a Board project

21. This issue has been considered by the Board in the context of developing a conceptual definition of revenues. “The Board tentatively decided that an entity should not recognise revenues for the performance by third parties of its obligations to deliver goods or render services to customers if those obligations are legally assumed by those third parties.” The staff believes that this tentative decision gives a good guide as to the Board’s view, but notes that the tentative decision is not authoritative literature. The staff also notes that the decision was developed during the Board’s deliberations on the revenue recognition project rather than as an interpretation of IAS 18. It is unlikely that the Board’s deliberations on revenue recognition will result in the issuance of a revised revenue standard in the near future.

Timeliness of a consensus view of the IFRIC

22. The issue is relatively self-contained and there is no reason why, in principle, the IFRIC could not reach a consensus and issue guidance on a timely basis.

CONCLUSION

23. Whilst the staff does not believe that there is currently widespread divergence in this area, the lack of guidance within IAS 18, and the widespread existence of potential agency arrangements means that divergence may come to exist in the future. The staff therefore recommends that the IFRIC take on a project to develop guidance at the level of general principles on identifying whether an entity is acting as an agent in an agency relationship.
24. Appendix 1 to this document details the staff's proposed approach to developing this guidance including details of the amount of research and development which will be required to complete this work.
25. The staff notes that, whilst the issuance of this guidance would be helpful to users, the Agenda Committee has recommended that it be given a lower priority than other projects on the IFRIC agenda.

APPENDIX 1 – Approach to developing guidance on identifying agency arrangements

INTRODUCTION

1. This paper sets out the staff’s proposals for the approach to be adopted to the development of interpretive guidance on how to identify whether an entity is acting as an agent in a selling arrangement. The paper is intended to assist the IFRIC in assessing how much resource would be required to add this item to the agenda.
2. The paper does not seek to consider the result of developing such guidance, or the principles that may be developed but instead considers the sources of information that may be used in developing guidance, and the process to develop and test interpretive guidance in this area.

PROPOSED APPROACH

Form of the guidance

3. The staff considers that interpretive guidance in this area could be issued in three forms :
 - a) Principle based guidance
 - b) Rule based guidance.
 - c) Examples to demonstrate good practice (for example “if entity A sells stock to entity B, and entity A has had exposure to obsolescence risk, the risk of damage, the risk of malfunction, etc, then entity A may recognise revenue in respect of a sale of those goods to entity B”).
4. In accordance with the IFRIC’s goal of providing principle based guidance, the staff proposes that it pursue an Interpretation based primarily on identifying the key principles to be applied. The staff does not propose including in this guidance detailed rules unless they are required to resolve any specific issues or inconsistencies that may arise.
5. Furthermore, since the identification of agency arrangements is dependent on the facts and circumstances relevant to a specific arrangement, the staff does not propose including examples which, by their nature, will be simplistic and may be applied by preparers to

situations which are superficially similar but for which the details may differ in key respects.

Source of the guidance

6. In developing the principles, the staff anticipates that its work will be primarily focused on:
 - IAS 18.8, which states that amounts received by an agent on behalf of a principal are not revenue;
 - Paragraphs 92-93 of the Framework, which consider the recognition of revenue;
 - IAS18.14, which gives a number of conditions that must be met in order to recognise revenue from the sale of goods.

7. The staff notes that IAS 18.14 considers only the sale of goods. Since there is no equivalent guidance for the provision of services, the staff proposes that it first develop guidance for identifying agency arrangements in the case of the sale of goods and then extend this guidance to apply to the provision of services.

Principles identified

8. The staff identified three key principles that could be derived from IAS18.14:
 - in order to recognise revenue an entity must have been exposed to the significant risks and rewards associated with the goods provided;
 - an entity must have managerial involvement in the supplying of the goods or services provided under an arrangement in order to recognise revenue in relation to that arrangement;
 - to recognise revenue, an entity must first have had effective control over the goods sold or services provided under the arrangement.

7. The staff anticipates that any guidance issued is likely to develop further these principles.

Testing of the principles

8. Once it has developed high level principles to form the basis of the interpretive guidance, the staff proposes to test these principles against examples which exist in practice to ensure that they are sufficiently robust and that they are broad enough to cover the potentially difficult areas which exist in practice.
9. The staff does not propose that testing be applied merely to provide a rationale to support existing practice. Instead the testing will be used to identify any gaps in the principles identified for which further clarification may be required.
10. The staff proposes that a review be carried out of examples and situations described in:
 - US EITF 99-19 and EITF 01-14;
 - UK GAAP Application note G (in particular paragraphs G69A – G71A);
 - the UK ASB discussion paper on revenue recognition; and
 - guidance developed by the large accounting firms.

Process and timing

11. The staff proposes that once this ‘testing’ has been completed, it should prepare a presentation to the IFRIC detailing the principles developed and how they have been derived, along with examples which can be used to illustrate how the staff believe that the principles should be applied in practice.
12. Assuming that the IFRIC concur with the principles developed, the staff will then continue to develop an Interpretation.

13. Given the desire that the development of this guidance take a lower priority than current projects, the staff proposes that work on this project proceed only when resource is available.