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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2007, London**

Project: **IAS 18 *Revenue* – Guidance on identifying agency arrangements (Agenda Paper 3)**

Background

1. In February 2006, the IFRIC received a request for an interpretation of how IAS 18 paragraph 8 should be applied to situations in which an entity employs another entity to meet the requirements of a customer under a sales contract. The details included in the request were specific to one contract. However, the request raised a question as to whether there is a need for more general interpretive guidance in this area.

2. At the July 2006 meeting, the IFRIC discussed whether to take on a project to develop interpretive guidance on how to identify whether an entity was acting as an agent in a selling arrangement and so should recognise revenue net in accordance with IAS 18. The IFRIC considered that the guidance included in IAS 18 was not sufficiently detailed and that this may be leading to some diversity in practice and agreed to take the issue onto its agenda. In taking the

issue onto its agenda, the IFRIC asked the staff to give the project a lower priority than the other projects that they were currently undertaking.

3. At the May 2007 meeting, the staff asked IFRIC members whether they were aware of such diversity in practice that an Interpretation was needed. Some IFRIC members noted an indicator of diversity was that some national standard-setters and audit firms had issued guidance. Those IFRIC members supported issuing an Interpretation as it would reduce diversity and give useful guidance for preparers of financial statements. One IFRIC member pointed out that EITF 99-19 *Reporting Revenue Gross as a Principal versus Net as an Agent* provides useful indicators that include responsibility for fulfilment, in addition to indicators on risk and rewards. Another IFRIC member was not in favour of issuing an Interpretation because providing a list of indicators would not reduce diversity. This member believed that apparent differences in financial reporting actually reflect differences in circumstances that vary from industry to industry and from jurisdiction to jurisdiction. The IFRIC asked the staff to analyse existing guidance, including that issued by the audit firms, to determine whether such guidance was consistent and could be used to help to assess the level of diversity in practice.

Staff analysis

4. The staff performed the following analysis:

   (a) Existing guidance in IFRSs and national GAAP;

   (b) Guidance issued by audit firms;

   (c) Information given in financial statements;

   (d) Assessment of diversity in practice.

(a) Existing guidance in IFRSs and national GAAP

Guidance in IAS 18

5. The staff considers that, whilst there is little specific guidance in IAS 18 on how agency relationships can be identified, an entity should apply the general revenue recognition principles in IAS 18 to the specific facts and circumstances

surrounding a relationship to ascertain whether it should recognise revenue net or gross. In particular, the staff believes that the provisions of paragraphs 8 and 14 and the Appendix of IAS 18 include some guidance that is relevant in assessing agency transactions.

6. IAS 18 paragraph 8 states that "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".

7. IAS18 paragraph 14, addressing the sale of goods, states that "revenue shall be recognised when … the following conditions have been satisfied:

   (a) The entity has transferred to the buyer the significant risks and rewards of the goods;

   (b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold" […]

8. Paragraph 6 in the Appendix of IAS 18 states that "Revenue from [sales to intermediate parties, such as distributors, dealers or others for resale] is generally recognised when the risk and rewards of ownership have passed. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale".

9. Paragraph 18 (d) in the Appendix of IAS 18 states about franchise fees: "Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor acting as agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no profit. Such transactions do not give rise to revenue".

10. The staff believe that, to determine whether an entity acts as a principal or an agent in respect of the sale of goods, the management should normally assess

whether the entity has ever been exposed to the primary risks and rewards of ownership of the goods. A similar rationale should be applied to transactions involving the rendering of services. In many arrangements, it will be clear that one entity is collecting amounts on behalf of another, for example a delivery charge (a service) that is passed on to the transport company involved. In other arrangements, when risks and rewards are shared, the answer is not straightforward and needs a detailed analysis and exercise of judgement.

Guidance in US GAAP

11. Paragraph 6 of EITF 99-19: *Reporting Revenue Gross as a Principal versus Net as an Agent* states that "The Task Force reached a consensus that whether a company should recognize revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee is a matter of judgment that depends on the relevant facts and circumstances and that the factors or indicators set forth below should be considered in that evaluation."

12. From paragraph 7 to 14, the EITF provides the following indicators of gross revenue reporting:

    - The company is the primary obligor in the arrangement
    - The company has general inventory risk (before customer order is placed or upon customer return)
    - The company has latitude in establishing price
    - The company changes the product or performs part of the service
    - The company has discretion in supplier selection
    - The company is involved in the determination of product or service specifications
    - The company has physical loss inventory risk (after customer order or during shipping)
    - The company has credit risk

13. From paragraph 15 to 17, the EITF provides the following indicators of net revenue reporting:

- The supplier (not the company) is the primary obligor in the arrangement
- The amount the company earns is fixed
- The supplier (and not the company) has credit risk

14. Examples are presented in Exhibit 99-19A to illustrate the application of the consensus.

Guidance in UK GAAP

15. The UK FRS 5 'Reporting the Substance of Transactions' includes Application Note G 'Revenue Recognition'. Paragraphs G63 to G66 state:

"G63 The general principles of the standard require that, in order for a seller to account for exchange transactions as principal, it should normally have exposure to all significant benefits and risks associated with at least one of the following:

(a) Selling price: the ability, within economic constraints, to establish the selling price with the customer, either directly or, where the selling price of an item is fixed, indirectly by providing additional goods or services or adjusting the terms of a linked transaction; or

(b) Stock: exposure to the risks of damage, slow movement and obsolescence, and changes in suppliers' prices.

G64 Where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal.

G65 Additional factors which indicate that a seller may be acting as principal include:

(a) performance of part of the services, or modification to the goods supplied;

(b) assumption of credit risk; and

(c) discretion in supplier selection.

G66 In contrast, where a seller acts as agent it will not normally be exposed to the majority of the benefits and risks associated with the exchange transaction. Agency arrangements will typically include the following characteristics:

(a) the seller has disclosed the fact that it is acting as agent;

(b) once the seller has confirmed its customer's order with a third party, the seller will normally have no further involvement in the performance of the ultimate supplier's contractual obligations;

(c) the amount that the seller earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer; and

(d) the seller bears no stock or credit risk, other than in circumstances where it receives additional consideration from the ultimate supplier in return for its assumption of this risk".

(b) Guidance issued by audit firms

16. The staff analysed existing guidance issued by the big four (see appendix 3 for a summary). This guidance is consistent as each audit firm has developed its own guidance based on EITF 99-19 and/or FRS 5.

17. The staff also found it interesting that some audit firms included examples dealing with "severance taxes" or "excise taxes and goods and services taxes", illustrating the need for such guidance in this area.

(c) Information given in financial statements

18. The staff reviewed about ten financial statements in various industries, considering revenue recognition policies and gross or net presentation.

19. Information about whether an entity acts as a principal or an agent is usually disclosed in the note on accounting policies. For example an IFRS preparer states: "Revenue recognition in respect of [Company A] concession contracts depends on the nature of the transaction: in the case of contracts where [Company A] acts as the principal, sales are recognised in Revenue; in the case of contracts where [Company A] acts as an agent, only concession commission received is recorded in Revenue".

20. In rare cases, the staff found disclosures discussing the criteria applied in assessing whether a company acted as principal or agent and whether the gross or net basis is applied:

Company B, an IFRS preparer, states: “Revenue-sharing arrangements are recognised gross, or net of content or service provider fees when the provider is responsible for the service rendered and for setting the price to be paid by the subscribers. Revenues from the supply of content are also recognised gross, or net of amount due to the content provider when the latter is responsible for the service content and for setting the price to subscribers.”

Company C, a US GAAP preparer, states: “We evaluate the criteria of Emerging Issues Task Force (EITF) Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, in determining whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned as commissions. Generally, when we are the primary party obligated in a transaction, are subject to inventory risk, have latitude in establishing prices and selecting suppliers, or have several but not all of these indicators, revenue is recorded gross. If we are not primarily obligated and amounts earned are determined using a percentage, a fixed-payment schedule, or a combination of the two, we generally record the net amounts as commissions earned.”

21. Overall, information disclosed seems satisfactory. The staff note that US GAAP and UK GAAP encourage preparers acting as agent to disclose more information:

EITF 99-19 paragraph 20:

Some Task Force members observed that the voluntary disclosure of gross transaction volume for those revenues reported net may be useful to users of financial statements. Task Force members observed that such disclosure could be made parenthetically in the income statement or in the notes to the financial statements. However, if gross amounts are disclosed on the face of the income statement, they should not be characterized as revenues (a description such as "gross billings" may be appropriate), nor should they be reported in a column that sums to net income or loss

FRS 5 app G paragraph G72:

Where a seller acts as agent, it is encouraged, where practicable, to disclose the gross value of sales throughput as additional, non-statutory information. Where such disclosure is given, a brief explanation of the relationship of recognised turnover to the gross value of sales throughput should be given.

(d) Assessment of diversity in practice

22. The guidance in both US GAAP and UK GAAP relies on the approach that the principal should normally have exposure to the significant risk and rewards associated with the transaction.

23. The guidance issued by some international audit firms is consistent with the guidance in US GAAP and UK GAAP.

24. IAS 18 is also based on a risks and rewards approach.

25. Therefore, exiting guidance is consistent and there should not be significant diversity in practice.

Staff recommendation

26. The staff ask IFRIC members to consider two possibilities:

View A: The project should be removed from the IFRIC agenda (see appendix 1 for a proposed wording for such decision) on the basis that:

- existing guidance, including that issued by some international audit firms, is consistent. Apparent differences in financial reporting actually reflect differences in circumstances that vary from industry to industry and from jurisdiction to jurisdiction. Issuing an Interpretation will not reduce this apparent diversity;
- under IAS 8 GAAP hierarchy, an IFRS preparer may wish (although it is not obliged to do so) to consider other guidance.
- any guidance in this area is more in the nature of implementation guidance and should not be issued by the IFRIC;

View B: The IFRIC should proceed with its work on this project on the basis that:

- the issue is widespread and has practical relevance;
- whereas the guidance in US GAAP and UK GAAP is useful outside of their respective jurisdiction, it is likely that some preparers around the world may not be aware of it;
- an Interpretation should be issued based on this existing guidance and it should not be difficult for the IFRIC to reach a consensus on this issue on a timely basis (see appendix 2 for proposed guidance).

27. The staff support view A and ask IFRIC members which view they support.

Appendix 1
Proposed wording for a tentative agenda decision

[Appendix removed from observer notes].

Appendix 2
Proposed guidance that could be issued by the IFRIC

[Appendix removed from observer notes].

Appendix 3
Guidance issued by audit firms

[Appendix removed from observer notes].