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International
Accounting Standards
Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

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: **May 2007, London**

Project: **Guidance on identifying agency arrangements (Agenda Paper 7)**

Background

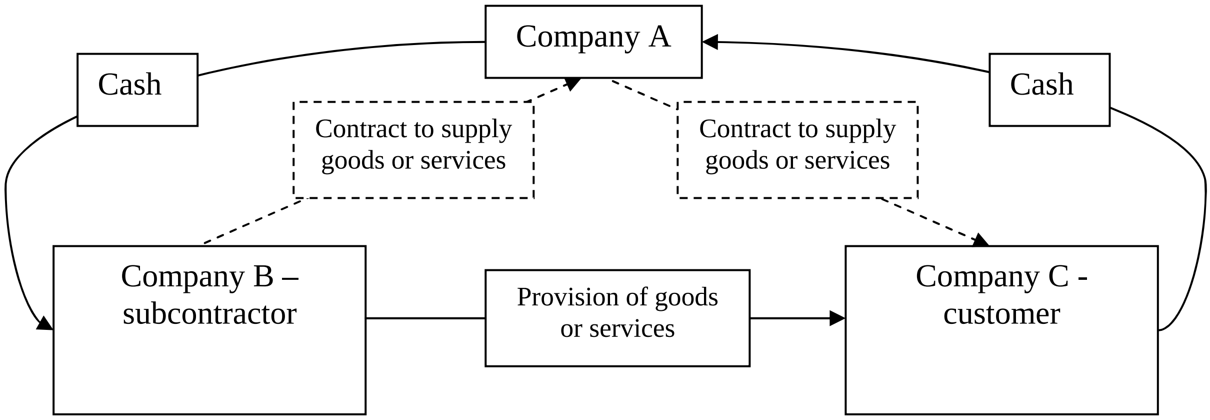
1. In February 2006, the IFRIC received a request for an interpretation of how IAS 18 paragraph 8 should be applied to situations where an entity employs another entity to meet the requirements of a customer under a sales contract. The details included in the request were specific to one contract. However 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 which they were currently undertaking.

3. At its March 2007 meeting, when redeliberating D20, the IFRIC discussed the gross or net presentation in the context of customer loyalty programmes. The IFRIC decided that the Interpretation should address that issue. The staff prepared a new draft Interpretation which incorporates useful guidance in paragraph 8 of the Consensus, Example 2 and BC 17. This guidance highlights the need for management to assess whether the entity has collected (or will collect) the consideration on its own account (i.e. as the principal in the transaction) or on behalf of the third party (i.e. as an agent for the third party) and the respective accounting, but does not provide more detailed guidance.

Issue

4. 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).



5. Company A will typically sell the services provided by Company B to Company C at a profit. Company B will take on substantially all of the work required under the contract but Company A may continue to hold some of the risks, for example credit risk.
6. The issue raised is whether Company A is the principal or is acting as an agent for Company B (who is the principal), and therefore the extent to which Company A should record revenue arising from its sales to Company C.
7. As there is little guidance in IAS 18 on that issue, the IFRIC is asked to develop such guidance.

Staff analysis

Guidance in IAS 18

8. 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 Appendix of IAS 18 include some guidance which is relevant in assessing agency transactions.

9. 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".

10. IAS18 paragraph 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."

11. Example 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".

12. Example 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”.

13. 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) which is passed on to the transport company involved. In other arrangements, where risk and rewards are shared, the answer is not straightforward and need a detailed analysis and exercise of judgement.

Guidance in US GAAP

14. Paragraph 6 of EITF 99-19: *Reporting Revenue Gross as a Principal versus Net as an Agent* states that “This 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.

15. 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

16. 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
17. Examples are presented in Exhibit 99-19A to illustrate the application of the consensus.

Guidance in UK GAAP

18. 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".

Comparison between guidance in US GAAP and UK GAAP

19. 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. US GAAP and UK GAAP appear to be very similar, with one exception: responsibility for fulfilment is quite detailed in the US GAAP guidance, whereas the UK GAAP guidance sets out an indicator for undisclosed agency[1].

20. An entity will usually know whether it is the principal or an agent. An IFRS preparer that is unable to conclude based on IAS 18 whether to recognise revenue gross or net could apply the hierarchy in IAS 8 and refer to the US GAAP and UK GAAP guidance.

Information given in financial statements

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

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[1] Such an agency differs from a disclosed agency in that the customer is not made aware of the arrangement between the principal and its agent. Thus the principal is not a party to the sales contract between the undisclosed agent and the customer; so far as the customer is concerned, the agent is acting as a principal. This has an important effect on the legal position, in that the agent's exposure to risks and rewards is not limited to the amount of its commission.

22. 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".

23. 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."

Inputs from IFRIC members

24. At its July 2006 meeting, 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.

25. After that meeting, the staff asked all IFRIC members if they were aware of significant diversity in the application of IAS 18 to similar circumstances and

asked for real-life examples. The general feed-back from the five responses received is that such diversity does not appear to be significant in practice as most IFRS preparers already use guidance in US GAAP or UK GAAP. One IFRIC member pointed out that there may be some cases where applying one GAAP or the other could lead to different answers but, usually, reasonable solutions could be found. Another IFRIC member believed that any guidance on the issue would be more in the nature of application guidance and, therefore, the IFRIC should not take this item to its agenda.

Staff question

26. The staff is not clear on how to proceed with this project and ask IFRIC members to consider two possibilities:

    View A: The project should be dropped on the basis that:

    - There is no significant diversity in practice
    - Guidance provided in other GAAPs is acceptable for an IFRS preparer
    - Any guidance in this area is more in the nature of application guidance and should not be issued by the IFRIC

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

    - There is significant diversity in practice
    - Guidance provided in other GAAPs is not satisfactory
    - There is a need to issue an Interpretation to assist users and to enhance disclosures

27. The staff is aware that some IFRIC members would be in favour of view A (see paragraph 26 of this paper). The staff support view A.

28. The staff ask IFRIC members which view they support.