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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:	**September 2007, London**
Project:	**IAS 18 – *Revenue Recognition* Guidance on identifying agency arrangements (Agenda Paper 3)**

Background

1. At its July 2007 meeting, the IFRIC noted that IAS 18 specifies the accounting for agency relationships. Paragraph 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.' Paragraphs 6 and 18(d) of the Appendix to IAS 18 refer to the substance of the transaction to identify whether the entity is acting as agent or principal.

2. The IFRIC acknowledged that no detailed guidance was given in IFRSs on identifying agency relationships. However, the IFRIC believed that:

   - determining whether an entity is acting as an agent depends on facts and circumstances and that judgement is required;

- any guidance beyond that given in IAS 18 would be more in the nature of implementation guidance than an Interpretation.

3. For these reasons the IFRIC [decided] not to develop an Interpretation and to remove this item from its agenda. In doing so, the IFRIC noted that this issue has widespread and practical relevance and that some constituents might not be aware of the existing guidance that has been issued in some jurisdictions.

4. For these reasons, the IFRIC asked the staff to develop guidance that might be recommended to the Board for inclusion in the Appendix to IAS 18.

Staff analysis

5. The staff performed the following analysis:

   - Proposed guidance for inclusion in the Appendix to IAS 18;
   - Comments on the proposed guidance (principal);
   - Comments on the proposed guidance (agent).

Section 1) Proposed guidance for inclusion in the Appendix to IAS 18

6. The staff propose the following guidance for inclusion in the Appendix to IAS 18:

> Paragraph 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.'
>
> Determining whether an entity is acting, in substance, as a principal or an agent depends on facts and circumstances and requires judgement. An entity is acting, in substance, as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that, individually or in combination, may indicate that an entity is acting as a principal include:
>
> (a) the entity has the primary responsibility for providing the goods or services desired by the customer or for fulfilling the order. Indications that the entity has such primary responsibility include, for example:
>
> (i) the entity modifies the product or performs part of the services;

(ii) the entity has discretion in selecting the supplier used to fulfil an order from a customer;

(iii) the entity is involved in the determination of products or services specifications;

(b) the entity has inventory risk before or after the customer order, during shipping or on return;

(c) the entity has discretion in establishing prices directly or indirectly, such as by providing additional goods or services;

(d) the entity has credit risk.

An entity is acting, in substance, as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature that may indicate that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

Section 2) Comments on the proposed guidance (principal)

2.1 The entity has the primary responsibility for providing the goods or services desired by the customer or for fulfilling the order

7. Paragraph 7 of EITF 99-19 states:

> "**The company is the primary obligor in the arrangement** — Whether a supplier or a company is responsible for providing the product or service desired by the customer is a strong indicator of the company's role in the transaction. If a company is responsible for fulfilment, including the acceptability of the product(s) or service(s) ordered or purchased by the customer, that fact is a strong indicator that a company has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer. Representations (written or otherwise) made by a company during marketing and the terms of the sales contract generally will provide evidence as to whether the company or the supplier is responsible for fulfilling the ordered product or service. Responsibility for arranging transportation for the product ordered by a customer is not responsibility for fulfilment".

8. Examples 4 and 8 of Exhibit 99-19A illustrate the use of this indicator (emphasis added):

> **"Example 4**
>
> A major Chain of athletic shoe stores obtains 60 percent of its seasonal shoes from an overseas source. The lead-time for the order is four months and the

selling season lasts three months. Chain takes title to the products upon delivery and is obligated to pay the Supplier according to typical industry payment terms. Selling prices for the products are determined exclusively by Chain. As long as Chain devotes at least 20 percent of its advertising budget to the Supplier's brands and prices the shoes within 20 percent of the national average price, Chain may return for full credit any unsold shoes and any customer returns within 60 days of the end of the season. Sales to customers are by cash or credit card.

Evaluation: After applying the indicators, Chain concludes that revenue from sales of products from the overseas source should be reported based on the gross amount charged to customers. Indicators of gross reporting are (a) <u>Chain is the primary obligor to the customer, a strong indicator, as Chain is responsible for fulfilment and customer remedies in the event of dissatisfaction</u>, (b) Chain has general inventory risk as a result of taking title and maintaining inventory, although that risk is mitigated through the return provisions with the supplier, (c) Chain has complete latitude to set the prices for the products (even though product pricing may affect Chain's return rights and expose it to greater inventory risk) and the net amount to be earned varies with that selling price, and (d) Chain also has credit risk for credit card transactions (a weaker indicator). No indicators of net reporting are present."

"Example 8

Bank D is a large bank that provides a wide range of services to customers. One popular offering is payroll processing with direct deposit. Bank D provides the interface with its customers but has a contract with a major payroll processing service to handle all aspects of the payroll processing. When a Bank D customer needs assistance with payroll processing, the customer service department of the processor answers the telephone announcing "Bank D Payroll Processing Service." The customer also may directly contact Bank D and the customer's account manager will coordinate with the processor. The customer is aware that Bank D outsources the payroll processing service; however, the contract for the processing establishes Bank D as the obligated party for all aspects of the processing. The processor is not a party to that contract. Bank D has complete discretion in determining the fees to be charged for the payroll processing service.

Evaluation: Bank D concludes that it should report the fees from payroll processing gross. <u>Bank D is primarily responsible to the customer for providing the service, a strong indicator of gross reporting, even though Bank D outsources certain processes to an unrelated party</u>. Bank D has complete control over the fees charged to customers and discretion at any time to engage any of a number of payroll processors to perform the service, both indicators of gross revenue reporting. Bank D has credit risk; however, fees for payroll services are debited to a customer's account at the time payroll is distributed, providing weak, if any, support for gross reporting. No indicators of net reporting are present."

9. In other guidance, this indicator takes the following form:

- "Where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal" (FRS 5-Application Note

G). Further, the Discussion Paper on revenue recognition of the ASB explains:

> Such an agency [undisclosed agency] differs from a disclosed agency in that the customer is not made aware of the agreement 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. Although it will receive or retain no more than its commission if the transaction proceeds successfully, it is potentially exposed to the full amount paid by the customer.

- [Sentence omitted from observer notes];
- [Sentence omitted from observer notes].

10. The staff believe that the proposed indicator "the entity has the primary responsibility for providing the goods or services desired by the customer" is similar to the indicator "the company is the primary obligor in the arrangement" set out in EITF 99-19. However, the term "responsibility" is more broadly used in IFRSs than "obligor"[1] and the general notion of responsibility encompasses responsibility through an arrangement or otherwise.

11. In addition, the staff believe that the following indicators set out in EITF 99-19 should be presented as sub points for item (a) in the proposed guidance rather than indicators on their own:

    - The company changes the product or performs part of the service (see paragraph 10 of EITF 99-19);
    - The company has discretion in supplier selection (see paragraph 11 of EITF 99-19);
    - The company is involved in the determination of product or service specifications (see paragraph 12 of EITF 99-19).

[1] The term "obligor" is only used in IAS 39 paragraph 59(a).

2.2 The entity has inventory risk before or after the customer order, during shipping or on return

12. This indicator encompasses two indicators set out in paragraph 8 and 13 of EITF 99-19:

   - "**The company has general inventory risk (before customer order is placed or upon customer return)—**Unmitigated general inventory risk is a strong indicator that a company has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross based on the amount billed to the customer. General inventory risk exists if a company takes title to a product before that product is ordered by a customer (that is, maintains the product in inventory) or will take title to the product if it is returned by the customer (that is, back-end inventory risk) and the customer has a right of return. Evaluation of this indicator should include arrangements between a company and a supplier that reduce or mitigate the company's risk level. For example, a company's risk may be reduced significantly or essentially eliminated if the company has the right to return unsold products to the supplier or receives inventory price protection from the supplier. A similar and equally strong indictor of gross reporting exists if a customer arrangement involves services and the company is obligated to compensate the individual service provider(s) for work performed regardless of whether the customer accepts that work."
   - **"The company has physical loss inventory risk (after customer order or during shipping)—**Physical loss inventory risk exists if title to the product is transferred to a company at the shipping point (for example, the supplier's facilities) and is transferred from that company to the customer upon delivery. Physical loss inventory risk also exists if a company takes title to the product after a customer order has been received but before the product has been transferred to a carrier for shipment. This indicator may provide some evidence, albeit less persuasive than general inventory risk, that a company should record revenue gross based on the amount billed to the customer."

13. Example 12 of Exhibit 99-19A illustrates the use of this indicator (emphasis added):

   "Example 12

   Consolidator negotiates with major airlines to obtain access to airline tickets at reduced rates compared with the cost of tickets sold directly by the airlines to the public. Consolidator determines the prices at which the airline tickets will be sold to its customers and markets the tickets through advertisements in newspapers and magazines as well as the Internet. The reduced rate paid to an airline by Consolidator for each ticket sale is negotiated and agreed to in advance. Consolidator agrees to buy a specific number of tickets, and must pay for those tickets regardless of whether it is able to resell them. Customers pay for airline tickets using credit cards, and Consolidator is the merchant of record. Although credit card charges are pre-authorized, Consolidator incurs occasional losses as a result of disputed charges. Consolidator is responsible for the delivery of an airline ticket to the customer and bears the risk of physical loss of that ticket while in transit (although the airline has procedures for refunding lost tickets). Consolidator also facilitates resolutions of complaints by its customers regarding service provided by airlines; however, once a customer receives a ticket, the airline is responsible for fulfilling all obligations associated with the ticket.

Evaluation: After applying the indicators, Consolidator concludes, based on the qualitative weight of the gross and net indicators, that revenue from the sale of tickets should be reported for the gross amount billed to customers. <u>General inventory risk exists for the tickets purchased by Consolidator, a strong indicator of gross reporting</u>. Ticket pricing also points to gross reporting as Consolidator has complete latitude to set sales prices for tickets and, as a result, the amount Consolidator earns will vary. Weaker indicators of gross reporting are also present for physical loss inventory risk (loss of tickets during delivery) and credit risk for collecting customer credit card charges. The fact pattern seems to indicate that the airlines are the primary obligors, as only the airlines can fulfill the air travel transportation of a customer, an indicator of net reporting. However, Consolidator assists customers in resolving service complaints, a function associated with the primary obligor role."

14. In other guidance, this indicator takes the following form:

- "Stock: exposure to the risks of damage, slow movement and obsolescence, and changes in suppliers' prices" (FRS 5 App G, paragraph G63(b));
- [Sentence omitted from observer notes];
- [Sentence omitted from observer notes].

15. The staff believe that giving a single indicator on inventory risk would be more efficient than the two indicators of EITF 99-19 set out in different places.

2.3 The entity has discretion in establishing prices directly or indirectly, such as by providing additional goods or services

16. Paragraph 9 of EITF 99-19 states:

"**The company has latitude in establishing price—**If a company has reasonable latitude, within economic constraints, to establish the exchange price with a customer for the product or service, that fact may indicate that the company has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer."

17. Example 8 of Exhibit 99-19A illustrates the use of this indicator (see paragraph 8 of this paper).

18. In other guidance, this indicator takes the following form:

- "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;" (FRS 5 App G, paragraph G63(a)). This indicator is presented in the first position in the UK guidance. With stock, this is one major indicator: FRS 5 App G paragraph G63 states "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 […]; or (b) Stock […]."

- [Sentence omitted from observer notes];
- [Sentence and example omitted from observer notes].

2.4 The entity has credit risk

19. Paragraph 14 of EITF 99-19 states:

"**The company has credit risk—**If a company assumes credit risk for the amount billed to the customer, that fact may provide weaker evidence that the company has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross for that amount. Credit risk exists if a company is responsible for collecting the sales price from a customer but must pay the amount owed to a supplier after the supplier performs, regardless of whether the sales price is fully collected. A requirement that a company return or refund only the net amount it earned in the transaction if the transaction is cancelled or reversed is not evidence of credit risk for the gross transaction. Credit risk is not present if a company fully collects the sales price prior to the delivery of the product or service to the customer (in other words, before the company incurs an obligation to the supplier). Credit risk is mitigated, for example, if a customer pays by credit card and a company obtains authorization for the charge in advance of product shipment or service performance. Credit risk that has been substantially mitigated is not an indicator of gross reporting."

20. In other guidance, this indicator takes the following form:

- Among "additional factors which indicate that a seller may be acting as principal include […] (b) assumption of credit risk" (FRS 5 App G, paragraph G65);
- [Sentence omitted from observer notes];
- [Sentence omitted from observer notes].

21. The staff believe that the proposed indicator "the entity has credit risk" is consistent with existing guidance. However, this indicator is the last indicator of the list of EITF 99-19 and is also viewed as a weaker indicator. In its proposed

indicators, the staff did not intend to give a relative weight to the various indicators but preferred leaving room to judgement.

Section 3) Comments on the proposed guidance (agent)

22. In paragraph 6 of this paper, the staff proposed the following guidance:

An entity is acting, in substance, as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature that may indicate that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

23. Paragraphs 15 to 17 of EITF 99-19 state:

"15. **The supplier (not the company) is the primary obligor in the arrangement—**Whether a supplier or a company is responsible for providing the product or service desired by a customer is a strong indicator of the company's role in the transaction. If a supplier (and not the company) is responsible for fulfillment, including the acceptability of the product(s) or service(s) ordered or purchased by a customer, that fact may indicate that the company does not have risks and rewards as principal in the transaction and that it should record revenue net based on the amount retained (that is, the amount billed to the customer less the amount paid to a supplier). Representations (written or otherwise) made by a company during marketing and the terms of the sales contract generally will provide evidence as to a customer's understanding of whether the company or the supplier is responsible for fulfilling the ordered product or service.

16. **The amount the company earns is fixed—**If a company earns a fixed dollar amount per customer transaction regardless of the amount billed to a customer or if it earns a stated percentage of the amount billed to a customer, that fact may indicate that the company is an agent of the supplier and should record revenue net based on the amount retained.

17. **The supplier (and not the company) has credit risk—**If credit risk exists (that is, the sales price has not been fully collected prior to delivering the product or service) but that credit risk is assumed by a supplier, that fact may indicate that the company is an agent of the supplier and, therefore, the company should record revenue net based on the amount retained.."

24. In other guidance, this indicator takes the following form:

- 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. (FRS 5 App G, paragraph G66)

- [Sentence omitted from observer notes].

25. Given the proposed indicators of an entity acting as a principal, the staff do not believe that it is useful to repeat them for the purpose of determining whether an entity is acting as a agent. Instead, the staff believe it would be more useful to remind the general principle about risks and rewards and put forward the indicator on fixed earnings.

Questions for IFRIC

26. Do you agree with the staff proposal to provide general guidance together with a set of indicators that are generally consistent with EITF 99-19?

27. Do you have any suggestions about the proposed indicators?

28. The staff does not believe that providing some examples would be very useful as circumstances vary from industry to industry and jurisdiction to jurisdiction. Do you agree that the general guidance is sufficient?