Project	**Revenue Recognition**
Topic	**Presenting revenues for performance by third parties**

Purpose of this paper

1. Entities often use other parties to fulfil contractual obligations to customers. For example, the practice is common for internet retailers and other entities that do not hold inventory of goods but arrange for other parties to deliver goods, as well as many service providers.

2. The objective of this paper is to help the boards decide what amounts an entity should recognise as revenue when other parties are involved in providing goods and services to the entity's customer. In other words, whether in some cases an entity should recognise revenue as the gross amount billed to the customer, or the net amount retained by the entity after paying those other parties.

3. The issue is principally one of presentation—ie net income generally would not differ whether the company recognises revenue as the gross amount billed to the customer, or the net amount retained by the entity. Nonetheless, the issue is significant because of the importance that some investors appear to attach to the amount of revenues that an entity recognises.

4. In considering that issue, this paper focuses on the identification of performance obligations rather than on their satisfaction and measurement.

5. The paper is structured as follows:

(a) Staff recommendations (paragraph 6);

(b) Applying the Boards' preliminary views (paragraphs 7–22);

(c) Requirements of existing standards (paragraphs 23–26);

(d) Determining whether an entity is obliged to provide goods and services to a customer or to arrange the provision of goods or services on behalf of another party (paragraphs 27–35);

(e) Transferring a performance obligation to another party (paragraphs 36–37);

(f) Disclosure (paragraphs 38–44).

Recommendations

6. The staff recommend that

(a) the identification of performance obligations should determine what amounts an entity recognises as revenue;

(b) the revenue recognition standard should provide indicators to assist entities in identifying performance obligations when it is not clear what goods or services an entity is obliged to transfer;

(c) if an entity transfers a performance obligation to another party it should not recognise revenue with respect to that obligation;

(d) an entity disclose separately revenues in the same line of business from (a) providing goods and services on its own account and (b) arranging for the provision of goods and services;

(e) an entity disclose the basis for its assessment and any significant judgement when determining whether it is obliged to provide goods and services to a customer or to arrange the provision of goods and services on behalf of another entity.

Applying the Boards' preliminary views

7. Consider the following two simple examples:

> **Example 1**
>
> ConCo is a constructor specialising in building offices. Council contracts with ConCo to build it new offices. Council has some high security needs, requiring specialist installations, which amount to 10% of the total cost of the building. ConCo bills Council CU1,000,000 to build the building. Council makes all payments to ConCo.
>
> ConCo subcontracts with SecureCo to install the security features. SecureCo bills ConCo for the work done.
>
> What amount should ConCo recognise as revenue?
>
> **Example 2**
>
> IntCo is an internet retailer that markets goods on behalf of third party sellers.
>
> IntCo's website states that customers purchasing goods are entering into a contract with a third party rather than IntCo. When a customer buys a good, IntCo sends the order details to the seller, collects payment from the customer and remits 80% of the amount collected to the seller. The seller delivers the good directly to the customer and is responsible to the customer for all post delivery obligations (eg returns and any disputes over the quality of the good).
>
> Suppose Customer buys a book from BookCo for CU10 via IntCo's website.
>
> What amount should IntCo recognise as revenue?

8. The staff think that the boards' proposed model determines what amount an entity should recognise as revenue by requiring the entity to identify its performance obligations in its contract.[1] Specifically, an entity must determine whether its performance obligation is

   (a) to provide goods and services itself, or

   (b) to arrange for another party to provide those goods or services.

9. If an entity's performance obligation is to arrange for another party to provide goods and services, the entity often collects payments for those goods and services on behalf of that other party. In such cases, the entity recognises a monetary liability for those payments rather than a performance obligation. Settlement of that liability does not transfer goods and services to the customer and, hence, does not result in revenue recognition (apart from any revenue the entity generates for providing the service of acting as an intermediary).

10. Consider example 1 above. Applying the approach discussed in paragraphs 8–9, ConCo must identify its performance obligations in its contract with Council. ConCo's performance obligation is to build an office building, including the required security features, according to Council's specifications. To put itself in a position to satisfy that performance obligation, ConCo contracts with SecureCo to install the specialised security features. Because Council and SecureCo do not have a contractual relationship, SecureCo cannot be obliged to provide the security features to Council. That suggests that ConCo has the performance obligation for the security features rather than an obligation to arrange for SecureCo to provide those services to Council.

11. Therefore, ConCo allocates CU1,000,000 to its performance obligation to provide the office and recognises revenue of CU1,000,000.

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[1] As a reminder, a performance obligation is a 'promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer'.

12. Now consider example 2. In this case, IntCo's performance obligation is to arrange for BookCo to provide goods to Customer. BookCo is IntCo's customer and IntCo provides the services of recording Customer's order details, passing them to BookCo, and processing Customer's payment, etc. IntCo is not, however, obliged to provide the book to Customer.

13. Therefore, of the total amount of CU10 that IntCo collects from Customer, CU8 relates to BookCo's performance obligations under its contract with Customer, ie to supply Customer with the ordered book. When IntCo collects that amount from Customer, it recognises a liability, but settlement of that liability does not result in revenue. Only CU2 relates to IntCo's performance obligation for the services that IntCo is providing for BookCo. Therefore, IntCo recognises revenue of CU2.

14. The two examples above illustrate that, by identifying an entity's performance obligations in the contract, the entity can determine what amounts to recognise as revenue in the proposed model.

Consequences of applying the boards' proposed model

15. The staff highlight two consequences of the proposed model. First, the focus on the individual performance obligations could mean that although an entity is not obliged to provide a good or service itself, it may nonetheless have a related performance obligation because of some form of 'continuing involvement' in the provision of that good or a service.

16. To illustrate, consider a variant of Example 2 in paragraph 7.

Suppose the case facts are the same except that IntCo provides its customers with a guarantee that it will refund the customer's money if the third-party seller of the goods does not provide the goods.

17. In this case, the existence of the guarantee does not change the conclusion that IntCo is not obliged to supply the ordered book to Customer. But it does mean that IntCo now has another performance obligation in the form of a guarantee to

Customer. IntCo must therefore consider that additional performance obligation when allocating its consideration of CU2. (Whether the guarantee obligation might be so trivial that it can be ignored is not a subject for this paper.)

18. The second consequence of the proposed model is that an entity may have a performance obligation to provide a good itself, even though it controls that good only momentarily. Consider the following example:

> **Example 3**
>
> Distributor purchases some products from a Manufacturer. It owns the products and then sells them to customers. Manufacturer determines the selling price of the products to Distributor's customer. Distributor has the right to return the products without penalty up to the point that it sells them to a customer.

19. In the above example, Distributor's performance obligation is to provide the products to its customer. The Boards will need to re-deliberate the issue of when Manufacturer transfers control of the products to Distributor and, therefore, recognises revenue. Nonetheless, the staff observe that regardless of that conclusion, Distributor's obligation to its customers is to transfer the products. That suggests that it controls the products at some point (even if only momentarily) and, therefore, would recognise revenue for providing the products themselves.

20. Some board members might observe that Distributor's position arguably is similar to another entity that sells the products on behalf of Manufacturer (say out of inventory held on consignment). Nonetheless, that other entity's contracts with its customers are different from Distributor's contracts. Hence, it has different performance obligations from Distributor.

21. Of course, the case facts in these last two examples were clear cut. The staff note that it can be these types of situations that make it difficult to identify the performance obligations. That issue is considered later in this paper.

22. The consequences highlighted above stem from the boards' decision to focus on the *recognition* (and measurement) of revenue in this project, rather than the *definition*

of revenue. The boards could consider other presentation approaches that would be consistent with existing definitions of revenue.[2] However, those approaches would not be as consistent with the boards' proposed recognition model. That is because the proposed model is founded on the notion that satisfaction of a performance obligation to the customer gives rise to revenue—in other words, when the entity derecognises the performance obligation it recognises a corresponding amount of revenue.

Recommendation and question 1
The staff recommend that the identification of performance obligations should determine what amounts an entity recognises as revenue (ie an entity recognises revenue only for the goods and services it is obliged to transfer to the customer). Do you agree?

Requirements of existing standards

23. The staff think that the approach in the proposed model is similar to existing standards. For instance, IAS 18 *Revenue* states that revenue 'includes only the gross inflows of economic benefits received and receivable by the entity on its own account'. Hence when an entity collects amounts on behalf of third parties, as in an agency arrangement, it does not recognise those amounts as revenue. Until recently, IAS 18 did not give guidance on determining when an entity is acting as a principal or an agent. However, as a result of reported diversity in practice, the Appendix to IAS 18 was amended to incorporate some additional guidance based on EITF 99-19 *Reporting Revenue Gross as a Principal versus Net as an Agent*.

24. EITF 99-19 provides guidance to help an entity determine whether it is acting as principal or an agent by means of specified indicators. Those indicators include whether the entity is the primary obligor in the arrangement, which party holds

[2] For instance, the boards could decide that an entity should recognise revenue only with respect to activities that it undertakes itself.

general inventory risk, whether the entity can set prices for the products or services being sold and whether the entity bears any customer credit risk in the transaction.

25. UK GAAP's FRS 5 *Reporting the Substance of Transactions,* Application Note G *Revenue Recognition* requires an entity to determine whether it is acting on its account for the supply of goods and services (ie as a principal) or is acting as an intermediary, earning a fee for arranging the provision of goods and services on behalf of a principal. It provides indicators to assist an entity in determining whether it is acting as principal or agent.

26. The Appendix to this paper provides further details of those and other standards.

Determining whether an entity is obliged to provide goods and services to a customer or to arrange for another party to provide those goods or services

27. When applying existing standards, entities sometimes reach different conclusions on similar fact patterns about whether they should recognise revenues on a gross or net basis. That inconsistency may result from the different ways that entities apply the indicators of existing standards, in particular whether they are applied to the arrangements as a whole or to the individual obligations. It may also result because it can be difficult to determine what an entity is obliged to do under the contract.

28. The staff think the boards' proposed model provides a clear *objective* for addressing the issue of whether an entity reports revenue for performance by others. However, it might be difficult to determine what the entity is obliged to do in some three-party contractual arrangements.

29. Some argue that in such three-party arrangements determining the nature of the entity's performance obligation is a matter of fact—the entity should look to its contract with its customer and determine whether it is legally responsible for a particular obligation. They observe that even though two entities may appear to share responsibility for a performance obligation, most shared liabilities are ranked, ie one party is primarily obliged and the other is the guarantor.

30. However, the staff understand that the indicators in EITF 99-19 are commonly relied upon in current practice, not only for those entities applying US GAAP. The recent amendment to the Appendix of IAS 18 and the guidance in FRS 5 (2003) further indicate that existing application guidance in this area is considered necessary and useful in practice.

31. There are pros and cons of providing guidance in the form of indicators. On the one hand, guidance may reduce diversity in practice. On the other hand, indicators sometimes are used as a checklist that entities might use to structure different accounting results for similar economic circumstances.

Recommendation and question 2
The staff recommend that the revenue recognition standard should provide indicators to assist entities in identifying performance obligations when it is not clear what goods or services an entity is obliged to transfer. Do you agree?

Possible indicators to assist in applying the objective

32. As discussed above, to apply the proposed model an entity needs to determine whether its performance obligation is to provide goods and services to a customer, or whether its performance obligation is to arrange for another party to provide the goods or services.

Indicators that the entity may have a performance obligation to provide a good or service to a customer

33. The staff have analysed the characteristics of an entity that is obliged to provide the goods or services itself to the customer in the light of the indicators in existing standards. It is important to note that these are indicators only. For instance, the fact that an entity does not have inventory risk does not mean that it could not have an obligation to provide a good—the entity could have arranged its supply chain so that it bears virtually no inventory risk.

Indicators	**Commentary**
Primary responsibility for fulfilment The entity is primarily responsible for fulfilment of the order. Therefore, within the range of requirements imposed by the contract with the customer, the entity can determine the product or service specifications, has discretion in supplier selection and may change the product or perform part of the service itself.	The focus in the proposed approach is on the contract between the entity and its customer, and the performance obligations an entity has to that customer. The proposed revenue recognition model does not consider revenue transactions from the customer's point of view. However, what the customer believes it is getting from which party may help to identify an entity's performance obligations where a third party is involved in the transaction.
Inventory risk The entity has inventory risk before or after the customer order, during shipping or on return, including physical loss or damage to the inventory and obsolescence.	Inventory risk is an indicator that an entity may have control over a good prior to transferring it to the customer. If the entity's performance obligation is to provide a good (rather than to arrange the provision of that good by another party), the entity would need to have controlled that good.
Discretion in establishing prices The entity has discretion or latitude in establishing prices directly or indirectly, such as by providing additional goods and services, or adjusting the price of a linked transaction.	If an entity is obliged to provide a good or service, it would typically have the ability (subject to market constraints) to set the selling price with the customer.
Customer credit risk The entity bears the customer's credit risk in the transaction.	An entity that is obliged to provide a good or service would typically bear the credit risk of the amount due from the customer. Nonetheless, an entity arranging for the provision of a good or service could bear credit risk if it is responsible for collecting consideration from the customer, but must

	settle fully with the third party regardless of whether the consideration is collected. Credit risk is considered a weaker indicator than the other indicators discussed in EITF 99-19, and it is considered an 'additional factor' in FRS 5.

Indicators that the entity may have a performance obligation to arrange the provision of goods or services on behalf of another party

34. Again, note that the following are indicators only. The absence of one or more of these characteristics would not necessarily mean that the entity is providing the goods and services to the customer on its own account.

Indicators	**Commentary**
Consideration is predetermined The entity earns a predetermined fee, which is either a fixed fee per transaction or a or percentage of the amount billed to the customer	Where an entity is responsible for arranging a transaction between other parties, it typically earns a fixed fee for this activity.
No continuing involvement The entity has no further involvement in the performance of the supplier's contractual obligations	Once the entity has transferred the order details to the supplier, it typically has nothing further to do. As mentioned above in the example in paragraph 16 however, the entity may offer some after-sale guarantees to the customer.

35. FRS 5 considers whether the entity has disclosed its agency status to the customer. It states that if the entity is acting as an agent, but has not disclosed this to the customer, there is a rebuttable presumption that the entity is acting as a principal. That is because the customer is not aware that it is transacting with a party other than the entity and therefore the entity is obligated to that customer. The staff believe that this presumption in FRS 5 was driven by legal requirements in the UK. The staff have not researched whether similar legal requirements exist in other

jurisdictions. The recently amended Appendix to IAS 18 does not include this point to assist in determining whether the entity is an agent or a principal, and the staff are inclined to be consistent with that.

Question 3
Do you agree with the staff's proposed indicators?

Transferring a performance obligation to another party

36. One other point to consider is how an entity would recognise revenue if it transferred a performance obligation to another party after contract inception (ie if it laid off that obligation).

37. Some note that the entity has satisfied its obligation by transferring it (even though the obligation continues to exist). Therefore, they would argue that the entity should recognise revenue. However, in this paper the staff recommend that an entity should recognise revenue only with respect to its *own* performance obligations. Hence, if an entity transfers a performance obligation to another party, the staff think that that entity should not recognise revenue for that performance obligation. That is because at the time it is satisfied it is no longer an obligation of the entity and, hence, the other party's performance of the obligation would not give rise to revenues for the entity.

Recommendation and question 4
The staff recommend that if an entity transfers a performance obligation to another party it should not recognise revenue with respect to that obligation. Do you agree?

Disclosure

38. The staff note that US GAAP and UK GAAP encourage entities acting as agent to disclose more information supporting the net presentation of revenue. Paragraph 20 of EITF 99-19 states that voluntary disclosure of gross transaction amounts for

those revenues presented net may be useful—it suggests that this disclosure be made on the face of the income statement or in the notes to the financial statements. However, if the amounts are disclosed on the face of the income statement, they should not be described as revenues, but described rather as ‘gross billings’.

39. Application Note G of FRS 5, paragraph G72, states that if a seller acts as an agent, it is encouraged to disclose the gross value of sales as additional information, including a brief explanation of the relationship of recognised turnover to the gross value of sales throughput.

40. The staff understand that, historically, some users preferred revenue to be presented gross, to avoid any potential information loss about transactions the company is engaged in.

41. The boards have previously indicated that standards should not contain statements that encourage, but do not require, particular disclosures. Therefore, they need to decide whether disclosure of the information encouraged by EITF 99-19 and FRS 5 would be sufficiently useful to justify its mandatory disclosure.

42. The proposed model establishes a principle for the amounts of revenue an entity should recognise, namely for the goods and services that it is obliged to provide. If the entity’s performance obligation is to arrange for another party to provide goods and services rather than to provide them itself, then it has fee or commission revenues for arrangement services. Requiring disclosure of the gross amounts involved in the arrangement is in effect requiring the entity also to report revenues of other parties in the arrangement and seems to inconsistent with the boards’ principle. Therefore, the staff do not think that the boards should require disclosure of the amounts collected by the entity on behalf of other parties. Furthermore it seems strange to single out one particular class of transactions (agency) for more detailed disclosure about transaction volume, when there are many other revenue transactions for which volume data would be as, or more, useful.

43. However, in borderline cases, in which it is difficult to identify the nature of an entity's performance obligations, additional disclosure might be helpful to users. That is because there are accounting consequences that flow from making that determination. Framing such a disclosure requirement is difficult because a disclosure requirement based solely on where the determination is difficult is rather vague and open-ended. One approach (such as adopted in IAS 1 *Presentation of Financial Statements*, ED 10 *Consolidated Financial Statements* and IAS 40 *Investment Property*) would be to require an entity to describe the basis for its assessment and any significant judgment if it has concluded that it is obliged to arrange for the provision of goods and services even though the transaction has many of the characteristics of one that requires the entity to provide those goods and services on its own account, or vice versa.

44. The staff also think that an entity should separately disclose revenue when, in the same line of business, it is both providing goods and services to its customers and arranging for goods and services to be provided. The staff think it is important for the user to be able to distinguish between the different nature of the revenues. Furthermore, providing such disclosure would create greater comparability between periods where there has been a change in volume of either activity. The staff notes that this requirement could be dealt with as an example of a general requirement to disclose different classes of revenue when the boards develop the disclosure requirements for the standard.

Recommendation and question 5

The staff recommend that an entity

- disclose separately revenues in the same line of business from (a) providing goods and services on its own account and (b) arranging for the provision of goods and services

- disclose the basis for its assessment and any significant judgement when determining whether it is obliged to provide goods and services to a customer or to arrange the provision of goods and services on behalf of another entity.

Do you agree?

APPENDIX

Extracts from existing standards

Guidance in IFRS

IAS 18 *Revenue*

A1. Paragraph 8 of IAS 18 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 service 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 in behalf of the principal are not revenue. Instead, revenue is the amount of commission'.

A2. 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.'

Appendix to IAS 18

A3. Example 21 of the Appendix provides guidance on determining whether an entity is acting as a principal or as an agent, per the 2009 amendment. It states that 'An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services.' It goes on to suggest 'features that indicate that an entity is acting as a principal include:

a. the entity has the primary responsibility for providing the goods or services to the customer, or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;

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

c. the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and

d. the entity bears the customer's credit risk for the amount receivable from the customer.'

A4. It states further that 'An entity is acting 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 indicating 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.'

Guidance in US GAAP

EITF 99-19 *Reporting Revenue Gross as a Principal versus Net as an Agent*

A5. Paragraph 6 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 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 of 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.'

A6. 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

A7. 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

A8. Examples are presented in Exhibit 99-19A to illustrate the application of the consensus.

Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*

A9. Paragraphs 58 and 59 state the following:

> .58 One problem peculiar to cost-type contracts involves the determination of the amounts of reimbursable costs that should be reflected as revenue. Under some contracts, particularly service-type contracts, a contractor acts solely in the capacity of an agent (construction manager) and has no risks associated with costs managed. This relationship may arise, for example, if an owner awards a construction management contract to one entity and a construction contract to another. If the contractor, serving as the construction manager, acts solely as an agent, his revenue should include only the fee and should exclude subcontracts negotiated or managed on behalf of the owner and materials purchased on behalf of the owner.

.59 In other circumstances, a contractor acts as an ordinary principal under a cost-type contract. For example, the contractor may be responsible to employees for salaries and wages and to subcontractors and other creditors for materials and services, and he may have the discretionary responsibility to procure and manage the resources in performing the contract. The contractor should include in revenue all reimbursable costs for which he has risk or on which his fee was based at the time of bid or negotiation. In addition, revenue from overhead percentage recoveries and the earned fee should be included in revenue.

Guidance in UK GAAP

FRS 5 *Reporting the Substance of Transactions* Application Note G *Revenue Recognition*

A10. 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: 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.'

A11. Paragraph G64 states 'Where the seller has not disclosed that it is acting as an agent, there is a rebuttable presumption that it is acting as principal.'

A12. Paragraph G65 lists additional factors which indicate that a seller may be acting as a principal, including

a. performance of part of the services, or modification to the goods supplied;
b. assumption of credit risk; and

c. discretion in supplier selection.

A13. Paragraph G66 provides characteristics of typical agency arrangements:

(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.