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Purpose

1. Some stakeholders informed the staff that there may be multiple interpretations of the application of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard") about determining and accounting for whether the entity is a principal or an agent to contracts for certain intangible goods or services. This paper incudes a summary of the potential implementation issues that stakeholders reported to the staff. The staff plan to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition for their input about those potential implementation issues.

Background

2. In recent years, there has been an emergence of new types of intangible (sometimes referred to as virtual) goods and services arrangements through the use of the internet, including social networking websites and mobile "app" stores. Examples of the types of arrangements include hosted application software (for example, online games), website advertising space distributed through advertising

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exchanges,[1] e-tickets or vouchers for events or travel services, and electronic gift cards. The following are two specific examples of arrangements that exist in practice:

(a) Publishers of online games may sell virtual goods to players to enhance their game playing experience. Generally, the players are given access to an online game for free and revenue is largely generated through the sale of virtual goods. Virtual goods under this scenario are nonphysical items represented within the game by images, animations, or three dimensional objects (for example, items such as clothing, equipment, weapons, speed, power, or health). Oftentimes the virtual goods are sold through an intermediary, such as a social networking website or a mobile "app" store. The game publisher provides the intermediary with, or the intermediary retains (in instances in which the intermediary collects payment from the customer), a portion of the sales proceeds from the players.

(b) A web-based entity (the "originator") collects data related to its users. In exchange for a fee, the originator provides third parties with access to that data. A third-party service provider may bundle the service from the originator with its own services and sell the package to another entity (the "customer"). The customer remits a combined fee for access to the originator's service and the third party's services to the third party. The third-party service provider remits the originator's fee, net of the agreed-upon commission, to the originator. The customer is aware of the component of the combined fee that is related to the originator's service.

3. The types of transactions included in the two examples above have the following characteristics:

(a) The good or service received by the end customer is a nonphysical item.

(b) Oftentimes the cash received by the originator is net of an amount retained by the intermediary.

[1] Advertising exchanges are technology platforms that facilitate the bidded buying and selling of online media advertising inventory.

(c) The difficulty in determining what amount of revenue to record (for example, a gross amount that includes amounts retained by the intermediary or the net amount of cash received) is generally with respect to the party on the front end of the transaction (that is, the originator).

(d) It is not always apparent who the customer is in the transaction (for example, whether the originator's customer is the intermediary or the end customer).

Accounting Guidance

4. The new revenue standard includes several items of guidance that are applicable to the potential implementation issues described in this paper. The following is a summary of some of that guidance.

Definition of a Customer

5. Paragraph 606-10-15-3 (IFRS 15, paragraph 6) defines a *customer* as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities."

Principal versus Agent

6. Paragraphs 606-10-55-36 through 55-40 (IFRS 15, paragraphs B34-B38) include items an entity should consider in determining whether it is the principal in providing a good or a service to a customer or whether it is an agent of another entity. Under this guidance, an entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for the other party to provide those goods or services (that is, the entity is an agent).

7. An entity should determine who controls the goods or services before the transfer to the customer. A principal controls the goods or services before they are transferred to customers. When an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred.

8. In contrast, an entity is an agent if its performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

9. Paragraph 606-10-55-39 (IFRS 15, paragraph B37) includes the following indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer):

   (a) Another party is primarily responsible for fulfilling the contract.

   (b) The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return.

   (c) The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.

   (d) The entity's consideration is in the form of a commission.

   (e) The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

Consideration Payable to a Customer

10. Paragraphs 606-10-32-25 through 32-27 (IFRS 15, paragraphs 70-72) include guidance on consideration payable to a customer. Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the

customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

Constraining Estimates of Variable Consideration

11. Paragraph 606-10-32-11 (IFRS 15, paragraph 56) states that an entity should include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 (IFRS 15, paragraph 53) only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

12. Paragraph 606-10-32-12 (IFRS 15, paragraph 57) includes a list of factors (not all-inclusive) that could increase the likelihood or the magnitude of a revenue reversal. The factors included in the new revenue standard are:

    (a) The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

    (b) The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

    (c) The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

    (d) The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) The contract has a large number and broad range of possible consideration amounts.

Allocating the Transaction Price

13. Paragraph 606-10-32-28 (IFRS 15, paragraph 73) states that the objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

14. Paragraphs 606-10-32-36 through 32-38 (IFRS 15, paragraphs 81–83) discuss allocation of discounts. An entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

    (a) The entity regularly sells each distinct good or service in the contract on a standalone basis.

    (b) The entity also regularly sells on a standalone basis a bundle of some of those distinct goods and services at a discount to the standalone selling prices of the goods or services in each bundle.

    (c) The discount attributable to each bundle of goods or services in (b) is substantially the same as the discount in the contract, an analysis of the goods or services in each bundle provides observable evidence of the performance obligation to which the entire discount in the contract belongs.

Contract Combinations

15. Paragraph 606-10-25-9 (IFRS 15, paragraph 17) states that an entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

    (a) The contracts are negotiated as a package with a single commercial objective.

(b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

(c) The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 (IFRS 15, paragraphs 22 through 30).

Potential Implementation Issues Reported by Some Stakeholders

Issue 1: Application of the agency indicators in paragraph 606-10-55-39 (IFRS 15, paragraph B37)

1a: Interaction of the agency indicators with the principle that a principal controls the good or service before its transfer to the customer

1b: Application of the agency indicators to some types of contracts (specifically, those for intangible goods or services and those for which the indicators provide contradictory evidence)

16. Under the new revenue standard, an entity is the principal to the transaction if the nature of its promise is to provide specified goods or services to a customer. An entity is an agent to the transaction if the nature of its promise is to arrange for another party to provide those specified goods or services. In assessing whether it is a principal or an agent, an entity should evaluate which party is the entity's customer with respect to each promise in the contract. If the entity is the principal, its customer typically is the party that obtains control of the good or receives the service (which may be an intermediary to the overall transaction). If the entity is an agent, it might determine that its customer is not the party that will obtain the good or receive the service, but rather the party that will *provide* the good or service, because the entity's performance obligation is to arrange for that customer to be able to sell its good or provide its service.

17. The principal-agent assessment under the new revenue standard is based on an evaluation of which entity controls the promised good or service before it is transferred to a customer. The standard also provides a list of indicators that an entity is an agent. The staff has been informed that stakeholders have different

views of how the notion of control and indicators relate. Furthermore, the staff has been informed of some different views about how to evaluate the agency indicators, specifically as it relates to the inventory indicator and whether or not some indicators are more important than others in the evaluation.

Issue 1a

18. The new revenue standard states that an entity is the principal if it controls a promised good or service before the entity transfers the good or service to a customer. Paragraph BC382 states that "the nature of the entity's promise may not always be readily apparent. For that reason, the Boards included indicators to help an entity determine whether the entity controls the goods or services before transferring them and thus whether the entity is the principal or agent." Some stakeholders therefore think that the indicators complement the notion of control and are relevant to all principal-agent evaluations. These stakeholders assert that the indicators help to establish whether the entity controls the good or service before it is transferred to the customer and that an entity cannot be the principal to the transaction without controlling the good or service.

19. In contrast, others think that if an entity determines that it controls the good or service before transfer to the customer (based on the definition of control in paragraph 606-10-25-25 (IFRS 15, Paragraph 33) and the associated indicators present in paragraph 606-10-25-30 (IFRS 15, Paragraph 38)), it is the principal and it would not need to consider the indicators in paragraph 606-10-55-39 (IFRS 15, paragraph B37). Those stakeholders assert that control is assessed independently of the agency indicators, which then serve to establish whether the entity is a principal or agent when control cannot be definitively established. This is principally because they question whether all of the indicators have a direct correlation to the notion of control (discussed further below). Those stakeholders additionally cite that while the implementation guidance explicitly states that if an entity is a principal if it controls a good or service (606-10-55-37/IFRS 15, paragraph B35), it does not explicitly state that if an entity does *not* control a promised good or service before its transfer to a customer that it is automatically an agent to the transaction. They assert that when control is not first established, agency is then assessed through a series of indicators such that an entity *could* conclude that it is a principal

to the transaction based on its evaluation of the indicators without determining that it controls the good or service before its transfer to the customer.

Issue 1b

20. *If* control is not established, some stakeholders question how an entity should evaluate and/or weight certain indicators, particularly in contracts for some intangible goods or services, where establishing which party *controls* those goods or services is less intuitive. In scenarios where entities cannot initially determine which party controls the good or service, the analysis of the indicators is a crucial part of their principal-agent assessment.

21. Application questions also exist for those scenarios in which the indicators provide contradictory results. For example, assume that a publisher of online games (the originator) is responsible for fulfilling an order for a virtual good. The intermediary sets the price of the virtual good to the end customer, the consideration the originator will receive for the good is fixed, and the intermediary bears the credit risk of the end customer. The originator's lack of pricing latitude, lack of exposure to credit risk, and receipt of a fixed fee are indicators that the entity is an agent, while the fact that the entity is primarily responsible for fulfilling the contract indicates that the entity is the principal with respect to transferring the virtual good. Some question how the intermediary can be anything other than an agent when the originator is the party providing the good or service. Others question whether the intermediary is the principal because it controls the benefits that can be derived from the good or service by virtue of its ability to price the good or service at whatever the market will bear.

22. First, with respect to specific issues on applying the agency indicators, some stakeholders have different views about whether the inventory risk indicator is applicable in intangible goods or services arrangements. Some think that the inventory risk indicator would apply only to transactions that involve physical goods that will be sold to customers (that is, what is typically thought of as inventory), and therefore, would not affect the principal-agent evaluation in these arrangements. Others think that the concept of inventory risk may be applicable more broadly than solely with respect to these goods.

23. For example, some think that the inventory risk indicator should be considered in contracts for virtual goods or services by considering whether the contract is cancellable or non-cancellable (for example, if an intermediary makes a non-refundable purchase from the originator, it is at risk for that minimum amount). Examples 47 and 48 in the new revenue standard may be consistent with this view. Those examples assess the inventory risk indicator related to airline tickets (the right to fly) and restaurant vouchers (a voucher that entitles a customer to future meals at a restaurant). The conclusion in Example 47 is that the entity has inventory risk because it purchased the airline tickets without recourse (that is, if the tickets are not subsequently sold to end customers, it will lose the fee paid to the airline). The conclusion in Example 48 is that the entity does *not* have inventory risk because the restaurant vouchers are not purchased before being sold to end customers.

24. Additionally, some think that the concept underlying the inventory risk indicator should, by analogy, be applied beyond inventory to the risks incurred by a seller or service provider in building or procuring other productive assets, possibly including assets that are not separately recognized (for example, an assembled workforce). For example, an online game developer would generally be responsible for the maintenance of servers and other assets to be able to deliver a virtual good to the end customer and to provide the end customer with continuing access to the online environment where the virtual good exists. In addition, the entity may have capitalized software development costs for software that is used to operate the online gaming environment. Although the game publisher does not have risk associated with physical inventory that it will directly sell to a customer, it does have the risk that if it does not sell sufficient online subscriptions and virtual goods, it will incur a loss because of its ongoing costs to maintain the online environment, or an impairment of its productive assets (for example, its capitalized software). Some think that the risk of loss in those scenarios is similar to the risk involved in producing tangible inventory that the entity may not be able to sell or may have to sell at a loss.

25. Second, with respect to application of the indicators, some stakeholders assert that certain of the indicators are more important than others in assessing whether an

entity is a principal or an agent when different indicators suggest different outcomes. They submit that the underlying concept in the implementation guidance is that the principal to the transaction controls the good or service before its transfer to the customer, and that certain of the indicators, if *not* met, suggest that the entity controls the good or service. They assert that indicators that suggest the entity controls or does not control the good or service should be more determinative than other indicators that may not directly establish control.

26. Some assert that the following indicators are more closely aligned with the concept of control and should be more determinative to the principal-agent evaluation than other indicators if there are indicators providing contradictory evidence:

    (a) Another party is primarily responsible for fulfilling the contract.

    (b) The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return (this would include a more expansive view of inventory risk, as discussed above).

    (c) The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.

27. The stakeholders that have this interpretation note the other indicators appear to have a less direct correlation with the control notion; and therefore, should be weighted less heavily in the principal-agent evaluation than the indicators that they think more closely correlate with the control principle. For example, those stakeholders assert that exposure to credit risk of the end customer or the structure of payment (that is, in the form of a commission or not) would seem to less directly affect whether the entity obtains control of the good or service prior to its transfer to the customer.

28. With respect to weighting indicators, other stakeholders assert that the guidance does not establish any one or more of the indicators as more conclusive than any other indicators. They cite the rationale in BC382 which states "[t]he nature of the entity's promise may not always readily be apparent. For that reason, the Boards included indicators in paragraph 606-10-55-39 to help an entity determine whether the entity controls the goods or service before transferring them and thus whether

the entity is a principal or an agent." Based on this language in the Basis for Conclusions, those stakeholders assert that BC382 provides evidence that the Boards' intention was *not* to assign weighting to the indicators and that all of the indicators were developed with the intent to help establish which party controls the good or service before its transfer to the end customer.

Issue 2: If an entity determines that it is the principal, which typically results in gross revenue, what amount of revenue should the entity recognize if it received a net amount of cash and does not know the gross amount?

29. In some contracts that include an intermediary, an entity might conclude that the intermediary is solely an agent to the transaction and, therefore, that its customer is the end customer (that is, rather than the intermediary). However, the entity may be unaware of the price paid by the end customer to the intermediary for the goods or services. In those circumstances, it may be difficult for the entity to determine the transaction price because:

    (a) The end customer remits payment for the entity's goods or services to the intermediary, rather than the entity.

    (b) The intermediary remits only the amount owed to the entity under the terms of the contract.

    (c) The intermediary has discretion over the price that the end customer pays for the goods or services.

    (d) The intermediary does not report to the entity the amount it charges the end customer.

30. The staff is aware of the following different stakeholder interpretations of the new revenue recognition standard in the scenarios described above:

    (a) *View A - The entity's performance obligation is to transfer the good or service to the <u>intermediary</u>, not the <u>end customer</u>.* Some stakeholders think that if the intermediary controls the pricing of the goods or services to the end customer, has the credit risk of the end customer, and receives an amount of consideration that can vary per good or unit of service sold, it should be considered the principal to the transaction with the end

customer. Those indicators each suggest that the intermediary is the principal and the fact that the entity does not even have the ability to know the price charged to the end customer, further indicates that it does not control the good or service, but rather that the intermediary has the ability to direct the use of and obtain substantially all the remaining benefits from the good or service. In that case, the entity's customer is the intermediary and the transaction price should reflect the net amount of consideration to which it is entitled from the intermediary.

(b) *View B - Variable consideration with no constraint.* Others think that the entity's customer in this transaction is the end customer (and therefore, that the intermediary is solely an agent) where it is primarily responsible for fulfilling the contract and where it has other risks associated with the good or service (for example, if one were to apply a more expansive view of inventory risk, as discussed above). In this case, the amount to which the entity is entitled is the amount paid by the end customer, which may be considered to be variable where the price the intermediary charges the end customer for the same good or service fluctuates. Therefore, an entity would estimate the amount of variable consideration to which it expects to be entitled in accordance with the guidance in the new revenue standard. Some think the constraint on variable consideration does not apply in these scenarios (or it would not limit the amount of variable consideration included in the transaction price) because there would *never* be a risk of a significant revenue reversal. This is because the entity would never adjust the variable consideration amount to the actual amount charged to the end customer as the intermediary does not report to the entity the prices it charged to end customers and no additional consideration is exchanged between the parties.

(c) *View C - Variable consideration with constraint.* Similar to View B, under this approach it is assumed that the consideration to which the entity is entitled for transferring the good or service to the end customer is variable. However, stakeholders supporting this view assert that the constraint on variable consideration *should* apply because most of the

factors in paragraph 606-10-32-12 (IFRS 15, paragraph 57) are relevant in these transactions. Under this interpretation, the constraint on variable consideration should be applied because:

(i) The amount of consideration to which the entity will be entitled is highly susceptible to factors outside the entity's influence (in this case, the intermediary's control over the pricing of the entity's good or service).

(ii) The uncertainty about the amount of consideration to which the entity will be entitled is not expected to be resolved for a long period of time (in this case, the uncertainty is often *never* resolved).

(iii) The contract has a large number and broad range of possible consideration amounts (the intermediary in these scenarios often offers a wide range of prices for the entity's good or service during the reporting period).

Reassessment of variable consideration at each reporting period is required by paragraph 606-10-32-14 (IFRS 15, paragraph 59). Those that think the constraint should apply acknowledge that it is unclear how and when the amounts that are constrained would be reassessed or resolved in these scenarios.

(d) *View D - Fixed consideration (no variable component):* Others think the entity might conclude that it is providing a good or service to the end customer (not the intermediary), but conclude that the fixed amount the entity is entitled to from the intermediary (and the only transaction price it knows) would be the transaction price. Some assert that the estimated amount that the end customer pays the intermediary above the fixed amount the entity receives does not meet the definition of variable consideration for the entity. This is because those stakeholders think that the notion of variable consideration carries an implied *requirement* that, at some point, the uncertainty associated with that consideration will be resolved, and if that will not occur, the fixed consideration to which the

entity is entitled is the transaction price. Additionally, any variability in the pricing in this scenario is controlled by, and for the benefit of, the intermediary. Therefore, some of those stakeholders argue that this further illustrates that the entity should record the fixed amount of consideration.

Issue 3: How should the transaction price allocation guidance be applied to a transaction in which the entity is a principal for some of the deliverables and an agent for others?

31. To illustrate this potential issue, consider the second example in the background section of this paper (paragraph 2b). In this example, the third-party service provider is delivering a bundle of services to the end customer for a combined fee. A portion of that fee is designated for the originator's service based on the originator's price list. The originator grants access to the data directly to the end customer. The third-party service provider (the intermediary with respect to the data access services) may determine it is an agent for the data access services, while being the principal for all of the other elements in the transaction (that is, the other services provided to the end customer).

32. The staff is aware of the following two views about the interaction of the transaction price allocation guidance with the principal versus agent guidance in determining how the intermediary in the above example should allocate any overall discount in its contract with the end customer:

    (a) *View A* - Any discount in the overall arrangement is allocated to each element, regardless of whether the element is a "gross" or a "net" element (unless the entity meets the criteria to allocate the discount entirely to one or more, but not all performance obligations in the contract).

    (b) *View B* - The entity should recognize its fee (or commission) for any net elements and any discount should be allocated only to the "gross" elements.

33. The appropriate interpretation may not be directly related to application of the allocation guidance. If an entity (for instance the service provider in the example above) determines that it is the principal to some of those promised goods or

services and an agent to the others, then it should question whether it has one customer (that is, the end customer receiving all of the goods or services) or multiple customers (that is, the end customer for those elements for which the entity is the principal and the originator for those elements for which it is an agent).

34. If the entity has a single customer, some think that View A would appear to be consistent with the allocation guidance. However, if the entity has more than one customer, the contract combination guidance does not allow for combining arrangements with two or more unrelated third parties. The contract combination guidance addresses combining contracts with the same customer (or related parties of the customer). Therefore, allocating a bundled discount across these contracts may not be appropriate if the entity has two customers in the arrangement.

35. It may further be appropriate for the entity to consider whether it is principal to only some of the promised goods or services in the contract if those goods or services are not separable from each other (for example, where the goods or services are each inputs to a combined item for which the customer contracted).

Questions for the TRG Members
1. What are your views about the three potential implementation issues included in this paper? 2. Are you aware of other interpretations for any of the three issues that are not included in this paper? 3. Are there any related potential interpretation issues not included in this paper?