

Memo No. **1**

Memo

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Project	Revenue Recognition – Gross Versus Net Revenue Reporting		
Project Stage	Pre-Agenda Research		
Issue(s)	Research Update		

Purpose

1. At the March 18, 2015 Board meeting, the staff plans to give the Board an update on research and outreach on the existing research project about gross versus net revenue reporting. The staff plans to ask the Board for input and direction about the research project. The staff does not plan to ask the Board to make technical decisions about the issues in this paper. Following the Board meeting, the staff plans to perform additional outreach and research.
2. The two principal elements of the research project are:
 - (a) Principal versus agent considerations
 - (b) When and whether an entity that is a principal should estimate the amount of gross revenue when it does not (and will not) know the price paid by its customer to an intermediary for its goods or services.
3. In this memo, the staff provides information to the Board, resulting from the staff's research to date, about the following:
 - (a) Existing practice issues

- (b) Information about whether Topic 606, Revenue from Contracts with Customers (Topic 606 or the new revenue standard) addresses those existing practice issues and what different or additional issues have arisen as entities have begun to consider implementation of Topic 606
 - (c) Areas of potential improvement the staff has developed that have the potential to reduce some of the existing practice issues and specific concerns raised about the recently-issued guidance in Topic 606.
4. This paper is structured as follows:
- (a) Background
 - (b) Questions for the FASB
 - (c) Staff Analysis
 - (i) Whether to Pursue Improvements
 - (ii) Potential Improvements to the Principal versus Agent Guidance
 - (iii) Estimating Gross Revenue as a Principal
 - (d) Appendix A – Principal versus Agent Considerations (Topic 606)

Background

5. This background section of the memo is divided into two sections:
- (a) Application questions about the principal-agent guidance in existing GAAP
 - (b) Implementation questions raised about the principal-agent guidance in Topic 606
6. The staff thinks it is important that the FASB have an understanding of which application issues stem from how existing GAAP is articulated (and carried forward to Topic 606) and which application issues stem from the articulation of the principal-agent guidance in Topic 606.

Application Questions about the Principal-Agent Guidance in Existing GAAP

7. Stakeholders (including practitioners, preparers, and regulators) have communicated that questions about whether an entity is a principal or an agent in accordance with the *existing* revenue guidance in Subtopic 605-45 are presently among the most common consultations between entities and regulators and between entities and the national technical office of their auditors.
8. Therefore, despite the fact that there are *some* specific implementation questions that have arisen directly as a result of how the principal versus agent considerations guidance is articulated in Topic 606 (discussed in the next section), *most* of the questions that exist in the area of principal-agent evaluation were not created by the issuance of Topic 606.
9. Stakeholders have submitted the following as some *key* drivers of the application issues with respect to the existing principal-agent guidance in Subtopic 605-45 (not all-inclusive):
 - (a) *The guidance does not have an explicit underlying principle, which often results in entities basing their determination on how many indicators suggest principal versus how many suggest agent or subjective “weightings” of those indicators.* Over time, since the issuance of the principal-agent guidance in Subtopic 605-45, stakeholders have come to colloquially refer to the guidance as being focused on “risk and rewards.” This is at least partially because some of the indicators and examples make reference to risks and rewards. For example, the second gross indicator states: “Unmitigated general inventory risk is a strong indicator that a company has risks and rewards as a principal in the transaction.” However, some stakeholders assert that this is not a clearly-delineated principle. The lack of a clearly-delineated principle has led to:
 - (i) Entities often basing their determination on subjective weighting and/or “counting” of indicators
 - (ii) Entities taking different positions on what risks or rewards should be considered when trying to apply a risks and rewards notion (for example, economic risks or rewards only versus other broader business risks, such as reputational risks).

- (b) *There are too many indicators in the guidance.* A significant amount of the judgment required to apply the existing guidance is because the guidance includes 11 indicators to consider. For example, despite the fact that Subtopic 605-45 establishes a stronger relative weighting to some of the indicators, there is still a significant amount of judgment as to, for example, *how* much stronger one indicator is than another and how many (or whether) “weaker” indicators can overcome a stronger indicator.
- (c) *There is insufficient guidance about how to make determinations that are key to applying the principal-agent guidance.* Nearly every stakeholder with whom the staff have engaged on this topic has highlighted that a proper principal-agent evaluation must begin with the entity properly identifying the deliverable in the contract *and* the entity’s customer. Appropriately identifying the deliverable includes establishing the proper unit of account, and even more fundamentally, answering questions such as whether the deliverable is an underlying good or service (for example, a flight or a meal) or, instead, a *right* to obtain that good or service (for example, a ticket or a voucher). It often is similarly challenging for an entity in a complex arrangement to determine which other party (or parties) is its customer(s). Stakeholders generally think that the guidance in Subtopic 605-45 is lacking with respect to (i) providing guidance within the Subtopic or (ii) more directly referring to guidance elsewhere in GAAP that would assist entities in making those key determinations.
- (d) *The guidance does not explicitly require consideration of the entity’s position in the contract.* Some stakeholders have asserted that there are arrangements in which the contract *states* the entity is an agent and the contract might provide specific details in support of the entity’s role as an agent (for example, the entity does not have inventory risk). Despite those contractual terms, the entity attempts to assert it is a principal by evaluating the indicators. Stakeholders that have raised this concern have suggested that the guidance could require that persuasive evidence should exist if an entity wants to overcome its expressed position as an agent in the contract.

- (e) *The guidance includes a number of examples, but those examples have not been updated in many years and no new examples have been added.* Because the existing guidance requires significant judgment, stakeholders often look to the examples in Subtopic 605-45 in order to apply the guidance. Those examples have not been updated since the guidance was first issued in EITF Issue No. 99-19. Therefore, some stakeholders assert that the usefulness of those examples is becoming more limited as new types of arrangements not covered by any of the examples have emerged and become more prevalent (especially those related to virtual/internet scenarios and new types of service arrangements). Some stakeholders assert that the examples are important because there is no explicit principle to apply for the principal versus agent assessment. Some entities determine their accounting based on which example most closely reflects its facts and circumstances.
10. While specific implementation questions about the Topic 606 principal-agent guidance are discussed in the next section, it is important to this discussion that many stakeholders do not think the principal-agent implementation guidance in Topic 606 substantively “moves the needle” in terms of reducing judgment and complexity in principal versus agent evaluations. Many TRG members offered a similar view at the July 2014 TRG meeting. Most stakeholders have expressed the view that they would expect entities to apply the new principal-agent guidance in a similar manner to the existing principal-agent guidance. Many stakeholders have expressed the view that the new principal-agent guidance does not substantively change or improve the existing principal-agent guidance because it does not resolve the key concerns about the existing guidance outlined above. For example, some stakeholders assert:
- (a) The new principal-agent guidance attempts to establish a principle upon which to base the principal-agent analysis. That principle is whether an entity controls the good or service before its transfer to the customer (paragraph 606-10-55-37), but there are questions about the application of that principle, such as:
- (i) How to apply this principle to virtual/intangible good and service arrangement scenarios (discussed further below) in which it is

difficult to evaluate whether an entity “obtains control” of the good or service before it is transferred to the customer. It is those types of arrangements that are most causing the most application issues under existing GAAP. Prior versions of the Basis for Conclusions to the new revenue standard, all the way up until the final version, acknowledged that it may be difficult to determine whether an entity has obtained control of a good or service before it is transferred to the customer; hence, the standard retains indicators (those in paragraph 606-10-55-39) based on those in existing revenue guidance to assist making the evaluation in those cases.

- (ii) Whether/how the indicators in paragraph 606-10-55-39 relate to *controlling* the good or service. That is, as explained in more detail in the next section, some stakeholders think the guidance is unclear as to how the control principle relates to the indicators. For example, some stakeholders question whether control is evaluated first (before assessing the indicators), or whether control is assessed *by* the indicators.
- (b) The new principal-agent guidance retains many of the indicators included in Subtopic 605-45. Thus, it does not resolve the application issues resulting from those indicators, including issues resulting from relying upon a series of indicators. The staff notes that the number of indicators has been reduced, from 11 to 5, but that is somewhat misleading because Subtopic 605-45 includes, for example, credit risk and primary obligor each as two indicators (one each as an indicator of gross reporting and the converse of each as an indicator of net reporting). In addition, the new principal-agent guidance, unlike existing GAAP, does not provide any guidance as to whether one or more of the indicators should be weighted more heavily in an entity’s principal-agent analysis than one or more of the others, which some stakeholders thinks *adds* judgment to the analysis.
- (c) The new principal-agent guidance does not include additional guidance, either within the principal versus agent consideration implementation guidance or by

reference to other parts of the revenue guidance, to further assist entities in determining their performance obligation or customer in the contract. This does not mean additional guidance around these areas, in particular around identifying performance obligations, does not exist in Topic 606. However, stakeholders have expressed that the new revenue standard could link the principal-agent guidance and those other areas of the guidance to assist entities in their evaluations (for example, as was done in other sections of the implementation guidance such as licensing).

- (d) For those that think an entity should have to overcome an agency position in the contract, they note that, like existing GAAP, the new principal-agent guidance does not include discussion of this notion. The staff thinks that entities should be drawn to do so by the emphasis in the new revenue standard as a whole on the contract with the customer, but this message is not, broadly, coming through.
 - (e) The principal-agent guidance includes some new examples, including a couple that are relevant to practice issues in recent years (for example, Examples 45 and 48); however, the overall number of examples has decreased significantly as compared to the existing guidance. As noted above, entities often apply the existing guidance by analogizing the arrangement in question to one or more of the existing examples.
11. The staff thinks it is important to note that principal-agent guidance concerns were not amongst those most raised during the revenue recognition project that resulted in the issuance of Topic 606, and much of the focus on principal versus agent considerations is relatively recent. Therefore, it was never a key focus or objective of the new revenue standard to substantially revise or improve principal versus agent accounting. The staff notes the principal-agent guidance in Topic 606 was last formally deliberated as part of the revenue project in June 2009, and that discussion was not about making any fundamental change to the principal versus agent framework.
12. The staff also thinks it is important to note that while principal-agent issues are among the top revenue issues in current practice, the population of arrangements that require an entity to make difficult principal versus agent judgments is a minority of the overall arrangements

to which this guidance applies. Some of those transactions are inherently complex in terms of the number of parties involved and the rights and obligations of each of those parties. In some of those transactions, the staff thinks that preparers and auditors find it challenging to identify the contractual rights and obligations of the parties, which only makes the accounting for such arrangements more difficult. The staff does not think the Board will be able to eliminate judgment in this area, even if it is able to reduce judgment and complexity in this area.

Implementation Questions Raised About the Principal-Agent Guidance in Topic 606

13. The staff thinks that implementation questions about the principal-agent guidance in Topic 606 stem primarily from questions stakeholders have about the interaction of the “control principle” in paragraph 606-10-55-37 with the agency indicators in paragraph 606-10-55-39.
14. For some stakeholders, the issue stemming from the interaction of the control principle with the agency indicators appears to be as fundamental as trying to determine whether the Boards *intended* to substantively change the principal versus agent evaluation. On the one hand, the fact that the indicators in paragraph 606-10-55-39 are substantially the same as the indicators in the existing principal-agent guidance has led those stakeholders to think that the Boards did not intend to substantially change the principal-agent evaluation from existing GAAP. On the other hand, those stakeholders note that paragraph 606-10-55-37 (and the Basis for Conclusions) states that there is a new principle (based on control) for making this evaluation that is not present in the existing principal-agent guidance.
15. Other stakeholders express one or more of the following concerns. All three of the following concerns expressed by stakeholders are closely related to each other in that the concerns in (b) and (c) largely *result* from (a).
 - (a) It is unclear how the agency indicators relate to the notion of control used throughout the rest of Topic 606 (that is, how the agency indicators relate to determining whether an entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, a good or service).

- (b) It is unclear whether an entity *first* assesses control (for example, in accordance with how control is defined and evaluated elsewhere in Topic 606 – such as in Step 5 of the revenue model), and then evaluates the agency indicators *only* if it is unclear whether the entity controls the good or service before it is transferred to the customer, or instead evaluates control *by applying* the indicators (meaning that the indicators effectively govern the principal-agent evaluation because they are *how* you apply the principle in paragraph 606-10-55-37).
 - (c) Topic 606 does not appear to apply the control principle in paragraph 606-10-55-37 in all cases. In particular, some stakeholders assert that at least one of the examples (Example 46) suggests that even if control of the good or service is not obtained before it is transferred, an entity can still be a principal.
16. Many stakeholders do not see the relationship between “control” and the indicators in paragraph 606-10-55-39 because (a) those indicators are substantially the same as in existing GAAP where they were developed for a different evaluation, that of assessing whether an entity has the significant risks and rewards of being a principal, and (b) entirely different indicators are used elsewhere in Topic 606 when evaluating whether a customer has obtained control of a good or service. Despite the fact that the final Basis for Conclusions (BC382) states that these indicators have now, in effect, *become* control indicators, those stakeholders assert that evaluating the risks and rewards of being a principal is a different evaluation from that of evaluating whether an entity controls a good or service before it is transferred to a customer (at least as control is defined elsewhere in Topic 606). For example, those stakeholders assert that exposure to credit risk of the end customer or the structure of the entity’s payment (that is, in the form of a commission or not) would not seem to directly affect whether the entity obtains control of the good or service prior to its transfer to the customer. It is clear that for many of those stakeholders, the history of the indicators matters in terms of how they view them in relation to the control principle.
17. Those stakeholders that think paragraphs 606-10-55-37 and 55-39 are *separate* evaluations have generally expressed that they read the guidance as requiring that an entity should assess control for purposes of the principal-agent evaluation in the same manner as it

would assess control elsewhere in Topic 606. Then, only when control cannot be readily determined (for example, in some contracts for intangible goods or services), does one apply the indicators to complete its evaluation. Those stakeholders further note that the Basis for Conclusions to the 2010 and 2011 Exposure Drafts (BC209 and BC295, respectively) both appeared, in their view, to state this, and note that the implementation guidance (paragraphs 606-10-55-36 through 55-40) did not substantively change between the 2011 ED and the final standard so as to warrant a different explanation thereof in the Basis for Conclusions to the final standard (BC382).

BC295. It may not always be readily apparent whether an entity has obtained control of goods or services before they are transferred to a customer. Similar issues arise in consignment sales. **For that reason, the Boards have included in the proposed implementation guidance some indicators that a performance obligation relates to an agency relationship.** They are based on the indicators specified in the guidance on principal-agent considerations in Subtopic 605-45 and in the illustrative examples that accompany IAS 18. (emphasis added)

BC382. The nature of the entity's promise may not always be readily 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 services before transferring them** and thus whether the entity is a principal or an agent. Those indicators are based on indicators that were included in previous revenue recognition guidance in U.S. GAAP and IFRS. However, as noted in paragraph BC380, the indicators in Topic 606 have a different purpose than previous revenue recognition guidance in that they are based on the concepts of identifying performance obligations and the transfer of control of goods or services. (emphasis added)

18. In questioning whether the guidance always *applies* the control principle, many stakeholders point to Example 46. Even if those stakeholders agree with the conclusion that the entity is the principal in the transaction, they do not think the entity obtains control of the equipment before it is transferred to the customer (based on how control is evaluated

in paragraphs 606-10-25-25 through 25-30). Yet, the example concludes that the entity is a principal because the entity does not meet any of the agency indicators (for example, it is primarily responsible for fulfilling the contract with the customer, it has discretion in setting the selling price, it has the credit risk of the customer, etc.). To those stakeholders that point to this example, it appears the agency indicators continue to answer a different question than whether the entity controls the good or service before it is transferred to the customer. The agency indicators instead continue to evaluate whether the entity, rather than the other party involved in transferring the good or service to the customer, is exposed to the risks and rewards of ownership of the good or service. Thus, some stakeholders point to this example in questioning whether, under the principal-agent guidance in Topic 606, an entity can be a principal even when it does not control the good or service (in accordance with paragraph 606-10-25-25) before it is transferred to the customer.

Estimating Gross Revenue as a Principal

19. 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.
20. Under existing GAAP, the staff is aware that some entities estimate the gross amount of revenue charged to the end customer when they determine they are the principal in the transaction with the end customer, while others, even if they determine they are the

principal, recognize only the net amounts they receive from the intermediary. By way of example, if an entity that is a principal is entitled to \$4 for each unit sold to an end customer by an intermediary, and it does not know what the intermediary charges the end customer (that is, it could be \$5, \$6, \$7, etc.) some entities recognize the \$4 as revenue, while others estimate the \$5, \$6, or \$7 and recognize that amount as revenue (with the difference between that estimate and the \$4 it will receive from the intermediary as a cost), despite the fact that they do not know what the intermediary charged (and will never know that amount).

21. The July 2014 TRG discussion highlighted that entities do not think the new revenue standard resolves the issue as to what is the proper approach for a principal to take when it does not know the price paid by the end customer to the intermediary for its goods or services. Stakeholders suggested a number of possible interpretations of the new revenue recognition standard in this scenario. These are outlined and discussed in the staff analysis section of this memo.

Questions for the FASB

1. Does the FASB want the staff to continue to (a) explore potential improvements to the principal-agent guidance, (b) clarify if/when a principal should estimate gross revenue, or both?
2. Does the FASB want the staff to explore those improvements just for Topic 606 or also for Topic 605?
3. What additional information or outreach would the FASB like before it is asked to vote on potential improvements?
4. Does the FASB think one or more of the potential improvements to the guidance (for either issue) should not be further considered?

Staff Analysis

Whether to Pursue Improvements

Improvements to the Principal versus Agent Guidance

22. The staff thinks there are clarifications that the FASB *could* enact that would improve the principal-agent guidance in Topic 606 for specific concerns raised about that guidance.

For example, the staff could envision improving the principal-agent guidance in Topic 606 by clarifying the interaction between the “control principle” in paragraph 606-10-55-37 and the indicators in paragraph 606-10-55-39. Eliminating the inconsistency that some stakeholders see between the two might be accomplished in a number of ways, which are discussed later in this memo.

23. However, as outlined in the background section above, the primary reason that the FASB might want to consider enacting changes is to help provide additional clarity about issues under the *existing* principal-agent guidance. As outlined above, stakeholders are communicating that the new principal-agent guidance will not resolve the practice issues that exist today in this area.
24. Because the staff has heard that this is presently the number one revenue recognition practice issue, and that the new revenue guidance will not resolve the existing practice issues, the staff thinks improvements to the principal-agent guidance would be warranted if substantive improvements can be developed. If substantive improvements can be developed (which the staff would define as improvements that would both (i) reduce, but by no means eliminate, judgment and complexity in the analysis and (ii) enhance consistency in application), the staff thinks that the FASB should consider enacting improvements not only to Topic 606, but also to Subtopic 605-45 *if* the FASB decides to defer the effective date of Topic 606 *and* improvements can be developed that fit within both revenue models. The staff does not think the Board should enact changes that would require entities to transition to revised Subtopic 605-45 guidance only to then transition shortly thereafter to *different* Topic 606 guidance on principal versus agent. The staff thinks any improvements the Board might adopt could be enacted in a reasonable timeframe that will help practice, and those improvements would be useful and could be implemented separately from the full implementation of Topic 606 (that is, an entity could adopt principal-agent improvements that would be substantially the same in Subtopic 605-45 and in Topic 606 earlier than it adopts Topic 606 as a whole). It is too early for the Board to make a decision about this matter because (a) the staff currently is in the process of developing alternatives for improvements to the principal-agent guidance and testing those alternatives with stakeholders, and (b) the Board has not made a decision about whether to delay the effective date of the new revenue standard.

Estimating Revenue as a Principal

25. Stakeholders have communicated that there is diversity in practice for substantially similar arrangements. The staff thinks that this reduces the usefulness of information for financial statement users. The staff is also aware that the absence of clear guidance in these situations under existing GAAP is leading to costs in the form of complex evaluations and consultations.
26. The staff thinks there is a clearer path to resolving this issue than there is to resolving the existing practice issues about evaluating whether an entity is a principal or an agent. The staff thinks that the FASB could resolve this issue and, therefore, resolve a practice issue that is resulting in non-comparable information for users and cost and complexity for preparers, with a relatively minor amendment to both existing GAAP and Topic 606. As a result, the staff might recommend that the FASB address this issue even if the Board concludes that substantial improvements cannot be made to the existing and/or new principal-agent guidance.
27. The staff notes that it would not be required for the FASB to decide to fix both issues or to reach the same conclusion for each issue on whether to amend only Topic 606 or both Topic 605 and 606. However, the staff think that it might not make sense to revise the guidance in Topic 605 solely for the estimating gross revenue because it is quite narrow in scope.

Potential Improvements to the Principal versus Agent Guidance

Clarifying a Single Premise

28. Both existing GAAP and Topic 606 assess whether an entity is providing a good or service (principal) or arranging for someone else to provide a good or service and earning a commission/fee (agent). However, as outlined in the background section, stakeholders have expressed that the existing GAAP principal-agent guidance is lacking a clear premise upon which to base the principal versus agent evaluation (that is, to determine whether the entity is providing or arranging). The background section also highlights that many stakeholders do not think the control guidance in paragraph 606-10-55-37 constitutes a single premise because they think entities will often conclude they are a principal or an

agent *without* directly assessing whether they control the good or service before it is transferred to the customer (that is, because they will conclude they are a principal based on an evaluation of the indicators, which those stakeholders think constitutes a secondary principal-agent evaluation when control cannot be readily determined).

29. In order for control to become a single premise upon which to base the evaluation as to whether an entity's promise is to provide a good or service or to arrange for another party to provide that good or service, it may be necessary to address the concern that the indicators in paragraph 606-10-55-39 do not clearly link to the control principle in paragraph 606-10-55-37 and/or to address the concern that it is often difficult to determine control over some goods and services.
30. To enact a single, unifying premise to the provide versus arrange determination, the staff thinks the FASB could either:
 - (a) Amend the guidance in Topic 606 to clearly assert the control premise in paragraph 606-10-55-37 as *the* single determining factor to the principal-agent evaluation. This would likely include revising paragraph 606-10-55-38 to be the direct converse of 606-10-55-37 such that it is clear that when an entity controls a good or service before it is transferred to the customer it is a principal, and when it does not, it is an agent. More importantly, this approach would also include substantive revisions to the indicators in paragraph 606-10-55-39, such that some indicators may be added, deleted, or modified, or the indicators may be restructured as criteria. The effect of those revisions would be to ensure each indicator (or criterion) clearly links to the notion of control that exists elsewhere in Topic 606.
 - (b) Restructure the implementation guidance around a different premise for when an entity is a principal (that is, other than control of a good or service before it is transferred to the customer). The staff does not think evaluating whether the entity's promise is to provide or to arrange must be linked to "control" because determining the nature of the entity's promise is fundamentally a Step 2 evaluation about identifying the entity's performance obligation, not a Step 5 evaluation about when the entity satisfies that performance obligation. Of course, the staff thinks that once an entity has appropriately determined its performance obligation (that is,

to provide goods or services or to arrange for another party to provide goods or services) the guidance about satisfying performance obligations (which is focused on the notion of control) applies in determining when to recognize revenue, but control does not have to be the focal point of the question about determining the nature of the entity's promise.

31. Retaining the control premise in paragraph 606-10-55-37 for determining the nature of the entity's promise in the principal-agent evaluation might represent a smaller "change" to Topic 606 (in terms of a conceptual shift), but also may not (in terms of volume of changes to the issued guidance) if it takes substantial revisions to the indicators and the examples to more closely align them with the control premise. From a conceptual standpoint, the staff thinks, to some extent, it is difficult to argue with the viewpoint that, in order for an entity to *provide* a good or service, it *must* first control that good or service (that is, an entity must first have something to then provide it to a customer as a principal). Conversely, as outlined above, many stakeholders do not think the issued guidance in Topic 606 presently leads an entity to conclude it is a principal *only* if it controls a good or service before its transfer to a customer. The staff thinks that clarifications of the nature described in (a) above may result in changes for some entities because (a) would focus on control; whereas, current GAAP (and some would argue Topic 606 as issued) is about indicators linked to risks and rewards. The staff further notes that this avenue of clarification may be more difficult to make in existing GAAP if the Board wanted to make a single, directional change to existing GAAP and Topic 606. Because the concept of control to which the new principal-agent guidance refers is new to Topic 606, enacting similar revisions to Subtopic 605-45 may not be possible in a short amount of time. The staff would not want to require entities to change to a revised Subtopic 605-45, only to be required to change again to the Topic 606 guidance. A double switch to an entity's principal versus agent analysis could be costly and complex for both users and preparers.
32. However, if the Board were to decide that the "provide versus arrange" question does not *have* to hinge on a control premise, the staff thinks there *are* possible alternative premises to the "control" notion. One such premise would be that, when another party is involved in providing goods or services, an entity should conclude that the nature of its promise is to provide the specified goods or services *when it is the party most significantly exposed to*

profits or losses from fulfilling the promise to the customer. This premise acknowledges that agents may also have some exposure to variability of profits or losses from fulfillment of the promise to the customer, but it is premised on the view that an agent’s exposure is generally limited by the nature of the agency relationship such that its profit or loss in the transaction is fixed, is subject to only narrow variability, or, in any event, its exposure to variability is less significant than the other party involved in that fulfillment. Importantly, the focus on “profits or losses” would attempt to clarify the scope of the analysis to economic gains or losses in the contract, rather than to a broad “risks and rewards” notion that the staff understands is sometimes applied in practice currently (for example, some preparers include general business risks or reputational risks in their evaluation of whether they are exposed to significant risks and rewards).

33. The staff thinks the indicators in paragraph 606-10-55-39 are already more closely aligned to this notion, rather than a control notion. In addition, the staff thinks that this proposed premise (in the paragraph above) *could* both encompass the notion underlying those indicators as well as accommodate (or at least would not be inconsistent with) the control notion presently included in paragraph 606-10-55-37. This is because the staff thinks that when an entity has obtained control of a good (or firmly committed to obtain a good or service), and agreed the price it will pay for that good, prior to obtaining a contract with a customer to sell that good, it is significantly exposed to variability in profit or loss from its ability, or inability, to obtain a customer and negotiate a favorable price to transfer control that good or service.
34. The staff thinks the exposure to profits or losses premise could be reconciled with the principal-agent indicators in both Subtopic 605-45 and Topic 606 and, therefore, could be enacted within both constructs. However, as discussed in the next sub-section, the staff does not think it would be *necessary* for the FASB to retain a series of indicators such as in Subtopic 605-45 or the new principal-agent guidance in Topic 606 to enact this premise. This is, in no small part, because practice has evolved since the issuance of the guidance in Subtopic 605-45 such that the focus of the principal-agent evaluation is on a subset of those indicators in most cases. Significantly reducing the number of indicators, to those that typically most significantly affect the conclusion, has the potential to eliminate one of the key drivers of existing practice issues.

Changes to the Principal versus Agent Indicators

35. The background section of this memo highlights that the number of indicators in existing principal-agent guidance is something that many stakeholders cite as significantly contributing to existing practice issues. The background section also highlights that, because the new principal-agent guidance in Topic 606 retains many of the Subtopic 605-45 indicators, it is unlikely to alleviate existing practice issues that result from those indicators. In fact, some stakeholders have suggested that it may be *more* judgmental to apply the Topic 606 indicators because, unlike Subtopic 605-45, Topic 606 does not give weighting to any of the indicators and also does not provide additional explanatory language as to how the indicators support or detract from the view of the entity as a principal or an agent.
36. As outlined in the previous sub-section, the staff thinks that there are potential avenues to improving how the underlying premise to the principal-agent guidance is applied. With respect to control, revised indicators or criteria would generally have to link to answering whether an entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, a good or service (that is, the definition of control in paragraph 606-10-25-25). For example, an entity may control a good when it obtains control of a good from a third party prior to obtaining a contract with a customer involving the transfer of that good based on an evaluation of the indicators in paragraph 606-10-25-30 (the point in time transfer of control indicators). An entity may conclude it controls a good or a service when it controls an asset in the form of an intangible right to obtain a good or service when it firmly commits to obtain a good or service from a third party, and that third party firmly commits to provide that good or service, for a fixed amount of consideration. For example, assume an entity has obtained control over a right to a designated portion of the supplier's service capacity. The entity might reasonably conclude that it has the ability to direct the use of its right to that capacity (that is, the entity can consume the service for its own needs or transfer its right to a third party), as well as the ability to obtain substantially all the remaining benefits from that right either by consuming those benefits or obtaining the cash flows from transferring that right to a third party.

37. If, instead of a control premise, the premise of the principal-agent evaluation is that a principal is the party most significantly exposed to profits or losses from fulfilling the promise to the customer, the staff thinks the following might be the key factors (or potentially criteria) to assess in making the principal versus agent determination:
- (a) *The entity has obtained control of a good, or has committed to obtain a good or service, and agreed the price it will pay for that good or service, prior to obtaining a contract with a customer involving the transfer of control of that good or provision of that service.* When an entity has obtained control (as defined by paragraph 606-10-25-25) of a good, or firmly committed to obtain a good or service, and agreed a price that it will pay for that good or service, prior to obtaining a contract with a customer involving the transfer of that good or provision of that service, it is exposed to variability in profit or loss from its ability, or inability, to obtain a customer and negotiate a favorable price to transfer that good or service.
 - (b) *The entity must obtain a supplier of a good or service in order to satisfy a performance obligation from an existing contract with a customer (that is, a contract to which it is already committed).* If an entity is contractually committed to provide a good or service prior to obtaining a supplier for that good or service, the entity is exposed to variability in profit or loss from the effects of market prices for the good or service, supplier availability and selection, and efficiencies or cost overruns in fulfillment.
 - (c) *The entity is primarily responsible to the customer for the acceptability of fulfillment.* If an entity is the party primarily at risk of incurring costs to perform rework or to grant incentives or refunds to the customer for defects in a good or deficiencies in a service provided to the customer, that risk exposes the entity to variability in profit or loss in fulfilling the promise to the customer.
38. If an entity meets none of those factors/criteria, the staff thinks that would generally suggest the entity is not significantly exposed to profits or losses from fulfilling the promise to the customer. The staff could envision structuring the principal-agent guidance

so as to presume an entity is a principal where it meets (a) and/or (b) *and* (c). If an entity meets none of those, then it would be presumed the entity is an agent.

39. When an entity meets only a subset of the above, an entity would have to apply judgment to determine whether it is the party most significantly exposed to profits or losses from fulfilling the promise to the customer. An entity would consider, based on the nature of the goods or services and the terms of the arrangement, which exposure carries the greater potential for variability in profits or losses. For example, if an entity is subject to substantial pricing risk because of competition in the marketplace for a good or a right it controls, and there is minimal risk involved in fulfillment (to which the other party involved in providing the good or the right is exposed), the entity would likely conclude that it is the party most significantly exposed to profits or losses in the transaction and is, therefore, a principal. While this approach would require judgment, it might require less judgment than Subtopic 605-45 or Topic 606 because the entity would have a cohesive principal-agent principle to apply and the analysis would involve less factors or indicators. The staff does not think it is feasible to eliminate all judgment in the principal versus agent analysis.
40. The staff thinks those factors/criteria are what effectively define whether an entity's promise is to provide goods or services itself or to arrange for another party to do so, and are also those the staff thinks stakeholders are the most focused on when evaluating principal versus agent in existing GAAP. By substantially changing, or eliminating, the "indicator approach" to the principal-agent evaluation (that is, substantially reducing the number of "weaker" indicators that are part of the analysis), it should both streamline the analysis and eliminate the practice issues that result from widely-disparate, and often subjective, methods of evaluating and weighting the indicators. The staff thinks that, potentially, a single core premise and a streamlined set of criteria or factors to assist in evaluating that core premise has the potential to reduce judgment and non-comparability of outcomes in the principal-agent analysis (especially if combined with the other potential improvements outlined below).

The Legal Contract

41. The staff does not think an entity's stated role in a contract should dictate the principal versus agent evaluation any more than the stated price of a promised good or service should dictate the standalone selling price for that obligation. However, as outlined in the background section, some stakeholders have asserted that an objective reading of the terms of some contracts (particularly those in which an entity's role as an agent of another party involved in the transaction is explicit in the contract) might provide additional, objective evidence as to whether the entity's role in the transaction is solely to earn a fee or commission from arranging the sale of the good or service. Those stakeholders suggest that the principal-agent guidance should require that an entity present persuasive evidence to overcome *substantive* provisions of the contract (for example, an entity should have to present substantive evidence that it is the party most significantly exposed to profits or losses from fulfilling the promise to the customer in order to overcome a contract that designates its role as that of an agent of another party).
42. The staff thinks that a presumption linked to the legal contract might help to reduce judgment in application and might also increase objectivity in an analysis that is often influenced by more subjective factors such as an entity's perception of its role in an arrangement or of its business (or business model). However, the staff would intend to carefully evaluate whether any such revision would introduce structuring opportunities. The staff would hope to be able to craft something that would focus on when such indications in the contract are substantive or, at the very least, remind entities to consider contractual agency provisions when applying the premise and the criteria/factors.

Unit of Account/Identifying the Good or Service

43. As described in the background section of this memo, stakeholders have frequently communicated to the staff that one of the primary reasons that entities struggle with their principal-agent evaluation under existing GAAP is that they do not properly identify the deliverable to the customer. This difficulty exists in two respects:
 - (a) First, goods and services are often sold together in a single contract. It is often unclear at what level the principal versus agent evaluation should occur (for example, should each promised good or service be evaluated or should the

evaluation occur only for each separate performance obligation/separate deliverable).

- (b) Second, entities often struggle to identify the promise to the customer. Examples 47 and 48 in Topic 606 highlight scenarios where it is complex to determine whether the promise is to deliver an underlying good or service or, instead, to transfer the entity's *right* to obtain that good or service.
44. With respect to (a), the staff note that a promise to a customer may be a single performance obligation that includes multiple goods or services that are not distinct. A potential improvement to the principal-agent guidance in Topic 606 would be to specify that an entity should determine whether it is a principal or an agent with respect to each performance obligation, rather than with respect to each component good or service that comprises each performance obligation. The staff would also want to specify in the guidance that if a contract with a customer includes multiple performance obligations, an entity may be a principal for some performance obligations and an agent for others. The staff note that this situation is becoming more common and is an issue often discussed in principal-agent consultations with the national technical offices of accounting firms. The staff thinks that specifying the performance obligation as the unit of account under Topic 606 for the principal-agent evaluation might help to result in more consistent outcomes and improve stakeholders' understanding of Example 46 in the implementation guidance (that is, it helps to explain the determination of the entity as the principal in the contract with the customer to transfer specialized equipment). The staff proposed this clarification in outreach performed with some stakeholders regularly making principal-agent determinations and this clarification was received favorably. The staff thinks the identifying performance obligations guidance provides an appropriate framework for determining at what level to evaluate an entity's role as a principal or an agent. The staff thinks that the identifying performance obligations guidance should lead entities to an appropriate determination as to whether the promise to the customer is to deliver, for example, a good *and* a service, or a combined offering that includes the good and the service (which the staff understands is a common source of the judgment and complexity in applying the existing principal-agent guidance). If the former, the entity may be principal for one and an agent for the other; while if the latter, the entity should evaluate

whether it is the principal or the agent for the single unit of account. If the entity is the principal, the other party involved in fulfilling that single performance obligation would be a supplier to the entity in fulfilling its performance obligation.

45. If the FASB ultimately decides to make changes to both Subtopic 605-45 and Topic 606, this guidance would need to be explained differently in each location since Topic 606 establishes a different separation model from Topic 605. However, in concept, the staff thinks that evaluating principal versus agent at the separate deliverable (or element) unit of account also makes sense and would represent a clarification as compared to existing principal-agent guidance. The staff would not recommend trying to incorporate some alternate separation model (such as that in Topic 606) into any revisions of the existing principal-agent guidance. The staff note, however, that an entity might conclude something is a separate deliverable (or element) that would not be a separate performance obligation, or vice versa. This might result in some entities changing their principal versus agent conclusion for some contracts upon adopting Topic 606.
46. With respect to (b), identifying the promised goods or services in the contract, the staff does not think it would be possible to address all such scenarios where complexity exists in this regard. However, the staff think that, in particular, Examples 47 and 48 could be enhanced as to the facts and analysis to more clearly explain what the entity's promise to the customer is and why that conclusion is reached to help stakeholders understand, for example, when the promised good or service is the underlying and when it is a *right to the underlying*. Some additional discussion in the Basis for Conclusions to any ASU might also allow the Board to help stakeholders through this sometimes complex line of thinking.

Determining the Customer for a Principal

47. The staff thinks that stakeholders sometimes lose sight of the fact that an entity *is* a principal when it provides goods that it already controls or performs services itself (for example, its employees provide a specified service). In that case, the entity's key determination is to whom it provides those goods or services (that is, which party is the entity's customer in the transaction). An entity's customer may not be the party that ultimately will obtain control of those goods or services (for example, an intermediary may resell a good or combine a service with other inputs to produce a combined output). When

another party is involved in providing the entity's goods or services to a customer, the entity's customer may be that other party or *another* party further down the distribution chain that obtains control of the good or right to a service from the entity. When an entity is an agent, its customer will often be the principal in the transaction (that is, in substance, the principal pays the entity a fee for arranging the contract between itself and another party).

48. The staff thinks guidance could be added (whether to Subtopic 605-45 or to Topic 606) to that effect. This additional guidance would not eliminate judgment in this respect. However, the staff thinks that providing a clear statement that an entity *must* be a principal to someone if it *is* actually providing a good or service, and helping entities in that situation to determine its customer (that is, by suggesting that an entity's customer will typically be the party to whom it transfers control of a good or to the party that is responsible for combining the entity's services with its own goods and services to satisfy the promise to the customer), would help to provide structure to an entity's consideration of the principal-agent guidance.

Clarifying when "Multiple Parties" are Involved in Providing Goods/Services

49. In outreach conducted by the staff during 2014, the staff proposed including guidance that if an entity (for example, one that is not the original manufacturer or supplier of a good or service) obtains control of a good or the right to a service (as defined in paragraph 606-10-25-25), *more than momentarily*, at a point in time before it is transferred to a customer, there are not multiple parties involved in fulfilling the promise to the customer. In that case, the good or the right to a service is the entity's asset and its provision of that asset to its customer does not involve another party (for example, the manufacturer or supplier that previously transferred the good or service to the entity). For example, a retailer that obtains control of goods from a manufacturer before stocking those goods in its store and soliciting consumers to purchase those goods would not have to consider the principal-agent guidance. This is because there are not "multiple parties" involved in the transaction to sell those goods to consumers that come into the retailer's store. One party (the retailer) is selling *its* asset (that is, the good it controls) to a customer.

50. The intent of this proposed addition would be to help clarify when the principal-agent guidance applies. Based on feedback received, the staff continues to think this clarification might be useful in applying the guidance such that it might allow some entities to avoid undertaking a principal versus agent evaluation.

Estimating Revenue as a Principal

51. Earlier in this memo, the staff noted that the Board may wish to consider this issue in the scope of any project to revise the principal-agent guidance in Subtopic 605-45 and/or Topic 606.
52. The background section of this memo outlines the issue that stakeholders have outlined.

Considerations for Topic 606

53. Stakeholders have reported four interpretations about the transaction price in arrangements for which the entity has determined it is a principal in a transaction with an end customer, but does not know the price paid (or that will be paid) by the end customer to an intermediary for its products or services and will not know that amount (for example, because the intermediary never reports the price it charges the customer to the entity). A brief summation and analysis of the four interpretations/options follows:
- (a) *View A - The entity's performance obligation is to transfer the good or service to the intermediary, not the end customer.* 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 consideration to which it is entitled from the intermediary (that is, the entity would not include in revenue any estimated

amount of mark-up charged by the intermediary to the end customer). A potential drawback of this approach might be that some intermediaries that presently consider themselves to be agents might be construed as principals based on the view that *someone* must be a principal to the end customer.

- (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. In this case, the amount to which the entity is entitled is the amount paid by the end customer to the intermediary, which may be considered to be variable where the price the intermediary charges the end customer for the same good or service fluctuates. Supporters of View B think the constraint on variable consideration does not apply in these scenarios 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. Therefore, the entity would estimate the transaction price paid by the end customer to the intermediary (recognizing that amount as revenue), and would recognize the amount of the difference between what it is entitled from the intermediary and the estimated transaction price as a cost. This is effectively, what some entities do under existing GAAP.
- (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 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. 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 (for example, if the entity learns of the price charged to the end customer years later, should the transition price be adjusted and would the adjustment provide useful information to investors).

- (d) *View D - Fixed consideration (no variable component)*. Other stakeholders 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 to which the entity is entitled from the intermediary (and the only transaction price it knows) is 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 recognize the fixed amount of consideration. This approach would result in revenue recognition outcomes consistent with those entities under that do not estimate the price paid by customers to an intermediary for its products or services under existing GAAP.

54. This is a relatively narrow-scope issue. The staff thinks this issue does not, and should not, relate to transactions in which the entity is a principal and does not know the ultimate price that the customer will pay an intermediary for its good or service, but will have such amounts reported to it periodically by the intermediary. In those cases, if the entity is a principal to the transaction with the end customer, recognizing the amount charged to the customer as revenue (with a cost for the amount paid to the intermediary) seems reasonable. The variable consideration guidance addresses what the entity should do if the amount the customer will pay is uncertain.
55. However, in those cases where the entity will not know the price the customer pays the intermediary for its products or services (that is, any “uncertainty” will not be resolved), the staff thinks View D may result in the outcome the staff thinks is most appropriate and would carry the least potential for unintended consequences. The staff acknowledges that any resolution to this issue will mean a change for some entities because some presently estimate revenues in these transactions and others do not.
56. The staff thinks View A arrives at the same answer as View D, but thinks there may be unintended consequences to establishing, in this one narrow population of transactions, an additional consideration to the principal-agent evaluation. The staff thinks it might be preferable to address this issue through an amendment to the variable consideration guidance (that is, explaining that this would not be “variable consideration” in section 606-10-32 of the Codification) rather than through the principal-agent guidance.
57. The staff do not think View B is an appropriate way to consider the applicability of the constraint on variable consideration (that is, the staff does not agree that the constraint does not apply solely because there will be no formal reporting, or “settling,” of the gross amount paid by the customer to the intermediary).

58. View C has some potential complicating factors (as outlined above – reassessment considerations in particular) that the staff does not think are offset by any additional benefits as compared to View D.

Resolution for Existing GAAP

59. The staff thinks View D for Topic 606 has a parallel potential solution that could be enacted in existing GAAP. The staff further thinks if the FASB wants to make a change for this issue to both existing GAAP and Topic 606, the FASB should enact what would, in effect, be the same solution for both Topic 606 and Topic 605 so as to minimize disruption and transition costs.
60. Paragraph 605-10-25-1(a) states:

25-1 The recognition of revenue and gains of an entity during a period involves consideration of the following two factors, with sometimes one and sometimes the other being the more important consideration:

- a) Being realized or realizable. **Revenue and gains generally are not recognized until realized or realizable.** Paragraph 83(a) of FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that revenue and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. That paragraph states that **revenue and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash.** (emphasis added)

61. SEC SAB Topic 13 further requires that, in order to recognize revenue, the seller's price to the buyer must be fixed or determinable. Footnote 5 to SAB Topic 13 also references paragraph 83(a) of CON5, and further states (in part):

SOP 97-2 defines a "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment." (emphasis added)

62. In the staff's view, the FASB could provide clarification to existing GAAP within the Codification by stipulating that an amount that is *unknown*, and will never be known (leveraging off of the guidance in paragraph 605-10-25-1), such as the scenario described above, is not "realized or realizable". Therefore, it should not be accounted for as revenue. Doing so would effectively align existing GAAP and Topic 606 with regard to determining the transaction price to be recognized as revenue for these arrangements (if the FASB were to adopt View D for Topic 606).

Appendix A – Principal versus Agent Considerations (Topic 606)

> > Principal versus Agent Considerations

606-10-55-36 When another party is involved in providing goods or services to a customer, the 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).

606-10-55-37 An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer. An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. 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.

606-10-55-38 An entity is an agent if the entity's 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.

606-10-55-39 Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

- 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.

606-10-55-40 If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the

performance obligation to transfer the promised good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).

Principal versus Agent Considerations (Paragraphs 606-10-55-36 through 55-40)

BC379. Previous revenue guidance required an entity to assess whether it was acting as a principal or an agent when goods or services were transferred to a customer. That assessment was necessary to determine whether an entity should recognize revenue for the gross amount of customer consideration (if the entity was determined to be a principal) or for a net amount after the supplier was compensated for its goods or services (if the entity was determined to be an agent).

BC380. Topic 606 also requires an entity to determine whether it is a principal or an agent. This is because the performance obligations of principals and agents are different. A principal controls the goods or services before they are transferred to a customer. Consequently, the principal's performance obligation is to transfer those goods or services to the customer. Therefore, recognizing revenue at the gross amount of the customer consideration faithfully depicts the consideration to which the entity is entitled for the transfer of the goods and services. In contrast, an agent does not control the goods or services before they are transferred to a customer. The agent merely facilitates the sale of goods or services between a principal and the customer. Consequently, an agent's performance obligation is to arrange for another party to provide the goods or services to the customer. Therefore, the transaction price attributable to an agent's performance obligation is the fee or commission that the agent receives for providing those services.

BC381. The Boards observed that identifying an entity's promise (that is, the performance obligation) in a contract is fundamental to the determination of whether the entity is acting as a principal or an agent. This is because identifying the nature of the entity's performance obligation is necessary for the entity to determine whether it controls the goods or services that have been promised before they are transferred to a customer. For example, a travel agent could be the principal in some contracts with customers if the travel agent determines that its promise is to provide a right to a flight (that is, a ticket) instead of a promise to provide the flight. However, to conclude whether they are a principal or an agent, the travel agent also would need to consider whether it controlled that right before transferring it to the customer, which may occur when the travel agent purchases the tickets in advance for sales to future customers.

BC382. The nature of the entity's promise may not always be readily 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 services before transferring them and thus whether the entity is a principal or an agent. Those indicators are based on indicators that were included in previous revenue recognition guidance in U.S. GAAP and IFRS. However, as noted in paragraph BC380, the indicators in Topic 606 have a different purpose than previous revenue recognition guidance in

that they are based on the concepts of identifying performance obligations and the transfer of control of goods or services.

BC383. After an entity identifies its promise and determines whether it is the principal or the agent, the entity would recognize revenue when it satisfies its performance obligation. This would occur when control of the promised goods or services transfers to the customer. The Boards observed that in some contracts in which the entity is the agent, control of the goods or services promised by the agent might transfer before the customer receives the goods or services from the principal. For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- a. The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- b. The points entitle the customers to future discounted purchases with another party (that is, the points represent a material right to a future discount).
- c. The entity determines that it is an agent (that is, its promise is to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer.

BC384. In contrast, the Boards observed that, if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services and thus the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

BC385. In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. The Boards observed that in those cases, to determine when the performance obligation is satisfied, the entity would need to consider the nature of its performance obligation. This is because until the customer has chosen the goods or services to be provided (and thus whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Thus, the entity may not satisfy its performance obligation until such time as it either delivers the goods or services or is no longer obliged to stand ready. The Boards also observed that if the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent and thus should recognize revenue for only a fee or commission that the entity received from providing the services to the customer and the third party. The Boards noted that this is consistent with previous revenue recognition guidance in IFRS for customer loyalty programs.