



A Closer Look

Revenue recognition—evaluating whether an entity is acting as a principal or as an agent

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Background

The IASB's new revenue Standard, IFRS 15 *Revenue from Contracts with Customers*, provides indicators that are similar to those in IAS 18 *Revenue* to help an entity determine whether it is a principal or an agent in a transaction. But did you know that there is a difference in the principal-versus-agent indicators under IFRS 15 because of the Standard's shift from a risks-and-rewards model to a control model?

In April 2016, the IASB issued *Clarifications to IFRS 15* which amended the principal-versus-agent implementation guidance and illustrations in IFRS 15 to clarify how the principal-versus-agent indicators should be evaluated to support an entity's conclusion that it controls a specified good or service before it is transferred to a customer. However, given the complexities of some arrangements, including those involving three or more parties, the evaluation of whether an entity is acting as a principal or as an agent continues to require significant judgement, and conclusions reached under IAS 18 may not be the same as those reached under IFRS 15.

Key principal-versus-agent considerations under IFRS 15



Assessing the nature of the entity's promise to the customer

When a revenue transaction involves a third party in providing goods or services to a customer, the entity must determine whether the nature of its promise to the customer is to provide the underlying goods or services itself (i.e. the entity is the principal in the transaction) or to arrange for the third party to provide the underlying goods or services directly to the customer (i.e., the entity is the agent in the transaction). To determine the nature of its promise to the customer, the entity must first identify each specified good or service that is distinct (or a bundle of goods or services that is distinct) to be provided to the customer and then assess whether the entity obtains control of each specified good or service (or a right to a good or service) before it is transferred to the customer. In arrangements involving more than one distinct good or service, an entity could be a principal for certain aspects of a contract with a customer and an agent for others.



Application of the control principle

IFRS 15's core principle results in the recognition of revenue when or as control of the specified goods or services is transferred to a customer. When an entity controls the specified good or service (or a right to receive a good or service) before it is transferred to the customer, the entity is acting as a principal and recognises revenue on a gross basis. Alternatively, if the entity does not control the specified good or service (or a right to receive a good or service) before it is transferred to the customer, the nature of the entity's promise is to arrange for another party to provide the specified good or service to the customer. That is, the entity is acting as an agent and recognises revenue on a net basis.

The meaning of "control" under the principal-versus-agent guidance is consistent with its meaning under IFRS 15:33. Therefore, an entity controls a specified good or service if it has the ability to direct (or prevent another party from directing) the use of, and obtain substantially all of the remaining benefits from, the specified good or service. IFRS 15:33 notes that there are many ways in which an entity can directly or indirectly obtain benefits (i.e. potential cash inflows or savings in cash outflows) from an asset (i.e. a good or service), including the following:

- Using the asset to produce goods or provide services (including public services)
- Using the asset to enhance the value of other assets
- Using the asset to settle liabilities or reduce expenses
- Selling or exchanging the asset
- Pledging the asset to secure a loan
- Holding the asset

Often, it will be clear that an entity controls a good or service before it is transferred to a customer because the entity acquired the good (i.e. obtained control) from a third party before transfer of the good to the customer, or is providing a service itself by using its own resources. However, other scenarios may not be as clear, including, but not limited to, the following:

- An entity arranges to have a product shipped directly from the manufacturer to the customer
- An entity obtains physical possession of a product but does not take legal title to it (or takes legal title to it only momentarily when it is sold to the customer)
- An entity has some, but limited, discretion in determining (1) the party from whom it can purchase the product (i.e. the vendor), (2) the party to whom it can sell the product (i.e. the customer) or (3) both
- An entity distributes intellectual property to its customers (e.g. software, software as a service, digital media) but does not own the underlying intellectual property
- An entity uses a third party to provide some or all of a service to the customer
- The customer is unaware of a third party's involvement in providing the good or service
- Situations in which more than three parties are involved and there are different relationships among the parties

In these scenarios, it is particularly important to evaluate whether the entity is obliged to provide the specified good or service to the customer itself (i.e. the entity's performance obligation is to provide the specified good or service to the customer) or is arranging for the specified good or service to be provided by a third party. An entity may find the following questions helpful in making this assessment when a third party is involved in providing the goods or services to the customer:

- Is the entity limited in whom it can purchase the goods from (i.e. the vendor)? Similarly, is the entity limited in whom it can sell the goods or services to (i.e. the customer)?
- Which party (i.e. the entity or third party) does the customer believe it is purchasing the good or service from?

- Is the entity obliged to identify an alternative supplier or service provider if the third party cannot perform?
- Is the entity primarily obliged to rectify warranty or service issues associated with the good or service sold to the customer?
- Does the entity have the resources to rectify warranty or service issues, or is it reliant on the third party to rectify them?
- Is the entity required to maintain an inventory of goods on hand, or does the entity purchase goods only once it receives a purchase order from the customer?
- Is the entity obliged to accept product returns irrespective of its ability to return products to the supplier?

These questions, though not intended to be determinative, are some of the considerations that may be relevant in the assessment of the nature of the entity's promise to a customer.



Indicators of control

IFRS 15:B37 provides three indicators to help an entity determine whether it obtains control of a specified good or service and is therefore the principal in the transaction. The indicators in IFRS 15:B37 are as follows:

- *The entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer (including responsibility for the acceptability of the good or service)*—The entity that has primary responsibility for fulfilling the obligation to the customer is often the entity that is most visible to the customer and the entity from which the customer believes it is acquiring goods or services. Often, the entity that has primary responsibility for fulfilling the promise to transfer goods or services to the customer will assume fulfillment risk (i.e. risk that the performance obligation will not be satisfied) and risks related to the acceptability of specified goods or services. That is, such an entity will typically address customer complaints, rectify service issues, and accept product returns or be primarily responsible for exchanges or refunds.
- *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return)*—When an entity has inventory risk, it is exposed to the economic risk associated with (1) holding the inventory before a customer is identified and/or (2) accepting product returns and being required to mitigate any resulting losses by reselling the product or negotiating returns with the vendor. While holding the inventory, the entity bears the risk of loss as a result of obsolescence or destruction of inventory. This risk is generally referred to as front-end inventory risk. In the case of a service, the entity may commit to pay for a service before it identifies a customer for the service, which is also a form of inventory risk. Another type of inventory risk is back-end inventory risk, which is economic risk assumed upon product return (when there is a general right of return). If an entity is willing to assume economic risk upon product return (and there is a general right of return), it is assuming some risk that is typically borne by a principal in a transaction.
- *The entity has discretion in establishing the price for the specified good or service, which may indicate that it has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits*—When an entity has control over the establishment of pricing, it generally assumes substantial risks and rewards related to the demand of the specified product or service, especially when the price it is required to pay a third party for the specified good or service is fixed. While this indicator is helpful, the IASB cautioned that an agent may also have discretion in setting prices (e.g. “to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers”).

While the indicators are intended to help an entity determine whether it is acting as a principal or as an agent, as indicated in the Basis for Conclusions accompanying IFRS 15, they (a) do not override the assessment of control; (b) should not be viewed in isolation; (c) do not constitute a separate or additional evaluation; and (d) should not be considered a checklist of criteria to be met, or factors to be considered, in all scenarios. Further, IFRS 15 does not assign weight to any individual indicator, and no indicator is considered to be individually determinative of whether an entity controls a specified good or service before it is transferred to a customer. An entity should apply judgement to determine which of the indicators are more relevant depending on the facts and circumstances of its specific transactions.



Transition from IAS 18 to IFRS 15

As discussed above, the three indicators of control in IFRS 15 are intended to support an entity's conclusion regarding whether it controls a specified good or service before it is transferred to the customer. By contrast, under IAS 18 the analysis was focused on the exposure to the significant risks and rewards associated with the sale of goods or the rendering of services and the Standard contained four indicators that suggested an entity was a principal and one indicator that suggested an entity was an agent. Although the three indicators that support the conclusion of control were carried forward from IAS 18, the Board acknowledged in the Basis for Conclusions to IFRS 15 that those indicators have a different purpose in IFRS 15. In IFRS 15, the indicators support the concepts of identifying performance obligations and the transfer of control of goods or services. Accordingly, the boards had expected that the conclusions about principal versus agent under IFRS 15 could be different in some scenarios from those reached under the previous revenue recognition Standards.

In addition, IAS 18 allowed considerable room for judgement, which led to diversity in application in practice. IFRS 15 on the other hand, contains more prescriptive guidance and examples on how to determine the nature of the entity's promise and how to assess control of a specified good or service in various circumstances.

Because of the overall shift from a risks-and-rewards model to a control model, it is important for entities not to underestimate the scale of the potential impact on transition and to support their conclusions regarding their role (i.e. as principal or agent) in arrangements involving three or more parties. The assessment should be based on the nature of the entity's promise to the customer and careful evaluation of the control principle and indicators in IFRS 15.

Where to find additional information

For more in-depth discussion and analysis of the principal-versus-agent guidance, as well as discussions of other topics related to IFRS 15, see Deloitte's iGAAP Chapter *A14 Revenue from contracts with customers*. If you have questions about IFRS 15 or need assistance with interpreting its requirements, please contact any of the Deloitte professionals indicated in this publication.

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