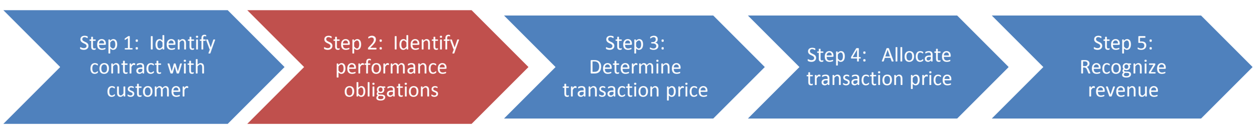
Revenue Accounting Update for Principal Versus Agent Transactions

On March 17, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net).* The ASU doesn't change the core principle of the new revenue standard, but rather is intended as clarification to reduce potential diversity in practice and cost and complexity both at transition and on an ongoing basis. Distinguishing between principal and agency roles requires significant judgment and is a challenge even under current guidance due to growth in the service industry and the rise in "virtual" transactions. This distinction is important because it determines if revenue is recognized on a gross or net basis. The amendments clarify how to identify the unit of account for the principal versus agent evaluation, reframe the indicators to focus on evidence that an entity is acting as a principal rather than an agent and further define "control" for service arrangements and intangible goods. The ASU also adds several illustrative examples to assist financial statement preparers in their decision process.



The second step of the revenue guidance requires an entity to determine whether the nature of its promise is to provide a good or service to the customer, *i.e.*, the entity is a principal and would recognize gross revenue, or to arrange for the good or service to be provided to the customer by the other party, *i.e.*, the entity is an agent and would recognize net revenue. An entity determines the nature of its promise on the basis of whether it controls the good or service before transfer to the customer. The amendments are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations by clarifying the unit of account, control for service arrangements and role of the indicators.

An entity that manufactures a good or performs a service itself is always a principal and would not need to perform the additional assessment noted below. If an entity transfers a good or provides a service to an intermediary that is a principal in providing that good or service to an end customer (whether individually or as part of a distinct bundle of goods or services), the entity's customer is the intermediary.

Unit of Account

The amended guidance first requires an entity to identify the specified good or service provided to the customer, *e.g.*, good, service or a right to a good or service. An entity then determines whether it is a principal or an agent for each promised good or service. If a customer contract includes more than one good or service, an entity could be a principal for some items and an agent for others. A new example was added to the revenue guidance highlighting this fact pattern.

Control in Service Contract

The ASU clarifies how the control principle applies to services performed by another party. A principal can control a service—even when another party actually performs the service—if it can direct that party to perform the service for the customer on its behalf, *e.g.*, an entity that provides office maintenance services, but subcontracts with another party to perform the services instead of using its employees. In contracts where goods or services provided by another party are inputs to a combined item, an entity would be the principal if it controls the combined item before transfer to the customer, *e.g.*, integration services.

Indicators

The ASU clarifies the indicators in the new revenue standard may be more or less relevant or persuasive to the control assessment, depending on the facts and circumstances. This ASU also eliminates the indicators related to credit risk and consideration in the form of commission. The control indicators in the new revenue standard (as originally issued) were drafted from an agent's point of view (when an entity didn't control the goods/services before transfer). This ASU reframes the indicators from the principal's point of view (when an entity controls the goods/services before transfer), which is more intuitive for readers.

Effective Date

This ASU has the same effective dates as the new revenue recognition standard. For public business entities, adoption is required for annual and interim reports beginning after December 15, 2017. All other entities would apply the guidance to annual reporting periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019.

Other Revenue Recognition Updates

FASB issued two other sets of proposed amendments to the revenue recognition guidance; one covered performance obligations and licensing, and a second included several narrow scope improvements for transition, sales tax presentation, collectability and the measurement date for noncash consideration. FASB plans to finalize both proposals in the second quarter of 2016. Also in the second quarter, FASB is expected to issue an exposure draft with technical corrections to the new revenue standard, with a final standard planned by the end of 2016. Notable corrections include:

- Preproduction costs guidance on long-term supply arrangements would be eliminated
- Update to impairment guidance for deferred costs to reflect that contract renewals and extensions should be considered when measuring the expected remaining consideration. Entities would include both the consideration already received but not recognized and the amount the entity still expects to receive in its impairment analysis. The amendments also would clarify the order of impairment testing. The update would clarify that the contract is the lowest level at which onerous contract testing is required, but entities would not be precluded from evaluating such contracts at the performance obligation level.
- Clarify that all contracts (not only insurance contracts) covered by insurance guidance are excluded from the scope of Topic 606
- New scope exception to exclude fixed odds wagering from derivatives guidance
- Clarification on capitalized costs between public and private funds for investment companies

BKD continues to monitor the revenue recognition standard process. Visit our Hot Topics page to learn more.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com