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# Revenue Recognition

## Evaluating Whether an Entity Is Acting as a Principal or as an Agent

### Background

The FASB's new revenue standard (the guidance in [ASU 2014-09](#),<sup>1</sup> as amended<sup>2</sup>) provides indicators that are similar to those in legacy U.S. GAAP<sup>3</sup> 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 the new revenue standard because of the standard's shift from a risks-and-rewards model to a control model?

In March 2016, the FASB issued [ASU 2016-08](#),<sup>4</sup> which amended the principal-versus-agent implementation guidance and illustrations in ASU 2014-09 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 judgment, and conclusions reached under legacy U.S. GAAP may not be the same as those reached under the new revenue standard.

<sup>1</sup> FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

<sup>2</sup> For a full list of final ASUs issued by the FASB to amend and clarify the guidance in ASU 2014-09, see [Section 19.2.2](#) of Deloitte's [A Roadmap to Applying the New Revenue Recognition Standard](#). The guidance in ASU 2014-09, as amended, is codified primarily in FASB Accounting Standards Codification (ASC) Topic 606, *Revenue From Contracts With Customers*, and FASB Accounting Standards Codification Subtopic 340-40, *Other Assets and Deferred Costs: Contracts With Customers*.

<sup>3</sup> See FASB Accounting Standards Codification Subtopic 605-45, *Revenue Recognition: Principal Agent Considerations (ASC 605-45)*.

<sup>4</sup> FASB Accounting Standards Update No. 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*. In April 2016, the International Accounting Standards Board (IASB®) issued *Clarifications to IFRS 15*, which contains amendments that are consistent with those in ASU 2016-08.

## Key Principal-Versus-Agent Considerations Under the New Revenue Standard

### 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

The new revenue standard'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 before it is transferred to the customer, the entity is acting as a principal and recognizes revenue on a gross basis. Alternatively, if the entity does not control the specified 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 recognizes revenue on a net basis.

The meaning of "control" under the principal-versus-agent guidance is consistent with its meaning under ASC 606-10-25-25. 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. ASC 606-10-25-25 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 obligated 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 obligated to identify an alternative supplier or service provider if the third party cannot perform?
- Is the entity primarily obligated 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 obligated to accept product returns irrespective of its ability to return products to the supplier?

These questions, though not intended to be determinative, are just 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**

The new revenue standard provides three indicators (codified in ASC 606-10-55-39) to help an entity determine whether it obtains control of a specified good or service and is therefore the principal in the transaction. Unlike the indicators in legacy U.S. GAAP, which an entity would evaluate to *conclude* whether it was the principal or the agent in an arrangement, the indicators in the new revenue standard should be used to *support* an entity's conclusion that the entity does or does not obtain control of the specified good or service before control is transferred to a customer. The conclusion that an entity reaches by analyzing the indicators of control in the new revenue standard should not be different from the conclusion it reaches by evaluating the standard's overall definition of control.

The indicators in ASC 606-10-55-39 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 determining whether a third party’s good or service is acceptable)* — 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 economic risk associated with either (1) holding the inventory before a customer is identified 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 FASB 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, they “do not override the assessment of control, should not be viewed in isolation, do not constitute a separate or additional evaluation, and should not be considered a checklist of criteria to be met in all scenarios.”<sup>5</sup> Further, the new revenue standard 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 judgment to determine which of the indicators are more relevant depending on the facts and circumstances of the specific transaction.

### **Comparison With Legacy U.S. GAAP (ASC 605-45)**

As discussed above, the three indicators of control in the new revenue standard 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, ASC 605-45 contained eight indicators that suggested an entity was a principal and three indicators that suggested an entity was an agent.

<sup>5</sup> Quoted from ASU 2016-08.

Assessment of the first two indicators under the new revenue standard (primary responsibility and inventory risk) might be similar to the assessment of the primary obligor and general inventory risk indicators under legacy U.S. GAAP. However, in some of the more challenging scenarios, it may not be clear whether the entity is primarily obligated to provide the specified goods or services to the customer. Further, unlike legacy U.S. GAAP, which noted that primary obligor and inventory risk were strong indicators of an entity's role as a principal in an arrangement, the new revenue standard notes that these indicators may be more or less relevant in each fact pattern. Consequently, an entity that relied on either being the primary obligor or having general inventory risk to support the presentation conclusions under legacy U.S. GAAP will still need to determine whether it controls the underlying goods or services before they are transferred to the customer by considering how the control indicators should be evaluated under the facts and circumstances of the entity's arrangements.

In addition, whether an entity has discretion in establishing pricing is also an indicator for gross reporting under legacy U.S. GAAP and an indicator of control under the principal-versus-agent guidance in the new revenue standard. However, the new revenue standard also notes that an agent may have discretion to establish pricing in some cases. Latitude in establishing pricing may be more important in situations in which the control framework and the other indicators do not provide persuasive evidence that an entity is acting as either the principal or the agent.

Because of the overall shift from a risks-and-rewards model to a control model, it will be important for entities 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 ASC 606.

## 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 the new revenue standard, see Deloitte's [A Roadmap to Applying the New Revenue Recognition Standard](#). If you have questions about the new revenue standard or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

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