

## Heads Up

### In This Issue

- Introduction
- Summary of the ASU's Key Provisions
- Effective Date and Transition
- Appendix — Overview of the ASU's Changes to Examples in the New Revenue Standard

# Gross or Net

## FASB Clarifies the New Revenue Standard's Principal-Versus-Agent Guidance

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### Introduction

On March 17, 2016, the FASB issued [ASU 2016-08](#),<sup>1</sup> which amends the principal-versus-agent implementation guidance and illustrations in the Board's new revenue standard (ASC 606).<sup>2</sup> The FASB issued the ASU in response to concerns identified by stakeholders, including those related to (1) determining the appropriate unit of account under the revenue standard's principal-versus-agent guidance and (2) applying the indicators of whether an entity is a principal or an agent in accordance with the revenue standard's control principle.<sup>3</sup>

### Summary of the ASU's Key Provisions

#### 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 (i.e., the entity is the principal in the transaction) or to arrange for the third party to provide the underlying goods or services (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 to be provided to the customer and then (before transferring it) assess whether it controls each specified good or service.

#### Identifying the Specified Goods or Services

The ASU clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. As defined in the ASU, a specified good or service is "a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer." Therefore, for contracts involving more than one specified good or service, the entity may be the principal for one or more specified goods or services and the agent for others.

<sup>1</sup> FASB Accounting Standards Update No. 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*.

<sup>2</sup> FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers*.

<sup>3</sup> Under step 5 of the new revenue standard, a performance obligation is satisfied when "control" of the underlying goods or services related to the performance obligation is transferred to the customer.

**Editor’s Note:** The FASB decided to use the term “specified good or service” throughout the principal-versus-agent guidance because it believed that the term “performance obligation” (under step 2 of the new revenue standard<sup>4</sup>) would be confusing in connection with an entity that is an agent. The nature of an agent’s promise is to arrange for another party to provide a good or service to a customer; therefore, the agent does not have a performance obligation to supply the underlying good or service to the customer.

Correctly identifying the specified goods or services to be provided to the customer is a crucial step in applying the principal-versus-agent guidance. A specified good or service could be the underlying good or service itself, a bundle of goods or services that are not individually distinct, or a right to goods or services. Once the specified goods or services have been appropriately identified, the control principle is often easier to apply.

**Editor’s Note:** For certain services, it can be difficult to determine whether the specified good or service is the underlying good or service or a right to a good or service. The ASU contains examples of various scenarios. For instance, the ASU’s Example 47 discusses a transaction in which an entity (a ticket broker) provides airline tickets to its customer and concludes that the specified good or service is the right to the service (i.e., the right to fly on the aircraft). In contrast, Example 46A describes a transaction in which an entity contracts with a third party to provide office maintenance services to its customer and concludes that the specified good or service is the underlying office maintenance services (rather than a right to such services). See the [appendix](#) below for an overview of the ASU’s examples.

We believe that there are two main differences between Examples 47 and 46A:

- *Sequence of events* — In Example 47, the entity purchases the airline tickets from a third party before it receives an order from its customer, while in Example 46A, the entity only engages a third party to perform the office maintenance services after it has received an order from its customer. Therefore, in Example 47, the entity first obtains a right to fly (the ticket), which it subsequently transfers to its customer.
- *Type of benefit transferred to the customer* — In Example 47, the ticket broker controls the right to fly (the ticket) and can direct its use to (1) obtain a flight itself, (2) resell the ticket to another party, or (3) allow the ticket to expire unused. The entity then transfers *that right* (i.e., the right to fly) to the customer. In Example 46A, the entity engages a subcontractor to perform office maintenance services on its behalf. However, unlike the ticket broker, the entity in Example 46A does not transfer such right to its customer. That is, the customer cannot direct the services from the subcontractor as it sees fit.

Distinguishing between (1) a good or service and (2) a right to a good or service is important in assessing whether the entity is a principal or an agent. When the specified good or service is a right, the entity is not responsible for providing the underlying good or service itself. Therefore, we believe that an entity will most likely need to place greater weight on the control indicator related to inventory risk (discussed further below) when assessing whether it controls the right before it is transferred to the customer (i.e., whether the entity is the principal in a transaction that includes a right).

<sup>4</sup> Step 2 of the new revenue standard requires an entity to identify the performance obligations in the contract.

## Application of the Control Principle

Paragraph BC11 in the ASU's Basis for Conclusions states that "assessing whether the entity controls the specified good or service before it is transferred to the customer is the basis for determining the nature of the entity's promise." In other words, if the entity controls the specified good or service before it is transferred to the customer, it is the principal. Conversely, if the entity does not control the specified good or service, it is the agent. To help an entity determine whether it controls a specified good or service, the ASU added ASC 606-10-55-37A, which states:

When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- a. A good or another asset from the other party that it then transfers to the customer.
- b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
- c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

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.

**Editor's Note:** Criterion (c) in ASC 606-10-55-37A notes that if the specified good or service consists of a bundle of goods or services that are not distinct, an entity controls the specified good or service if it performs a significant service of integration. That is, criterion (c) is determinative of whether an entity controls a specified good or service and is therefore the principal.

The ASU clarifies that an entity's assessment of whether it provides a significant service of integration should be consistent with its identification of performance obligations under step 2 of the new revenue standard. However, we believe that an entity will need to apply considerable judgment when evaluating this criterion and that current practice issues (particularly regarding "virtual" goods or services) may persist.

## Indicators of Control

The ASU removes from the new revenue standard two of the five indicators used in the evaluation of control (i.e., exposure to credit risk and whether consideration is in the form of a commission). In addition, the ASU reframes the remaining three indicators to help an entity determine when it is acting as a principal rather than as an agent. Further, the ASU adds language to the indicators explaining how they are related to the control principle under the new revenue guidance. Thus, the ASU provides the following indicators of when an entity controls specified goods or services (and therefore is acting as a principal):

- *"The entity is primarily responsible for fulfilling the promise to provide the specified good or service" to the customer (including responsibility for determining whether the other party's good or service is acceptable)* — The ASU notes that such responsibilities on the part of the entity may demonstrate that the other party to the contract is acting on the entity's behalf.

- *“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)”* — The ASU further notes, for example, that obtaining (or committing to obtain) the specified good or service before the entity obtains a contract with the customer “may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.”
- *“The entity has discretion in establishing the price for the specified good or service,” which may indicate that it had “the ability to direct the use of that good or service and obtain substantially all of the remaining benefits”* — However, the ASU notes 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.” Therefore, in a manner consistent with the new revenue standard, the ASU 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.

**Editor’s Note:** The ASU notes that because no weight is assigned to the indicators, their relevance in the principal-versus-agent assessment may vary depending on the nature of the arrangement.

As discussed above, if the specified good or service is a right, we believe that more emphasis should be placed on whether the entity has inventory risk (before it is transferred to the customer). Conversely, if the specified good or service is the underlying good or service, we believe that greater emphasis should be placed on whether the entity is primarily responsible for providing that good or service. While neither indicator would be individually determinative, we believe that each provides strong evidence of control of the specified good or service.

## Effective Date and Transition

The ASU has the same effective date as the new revenue standard (as amended by the one-year deferral and early adoption provisions in ASU 2015-14<sup>5</sup>). In addition, entities are required to adopt the ASU by using the same transition method they used to adopt the new revenue standard.

<sup>5</sup> FASB Accounting Standards Update No. 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*.

## Appendix — Overview of the ASU’s Changes to Examples in the New Revenue Standard

The table below summarizes the ASU’s amendments to examples in the new revenue standard as well as new examples that clarify how an entity would assess whether it is the principal or the agent in a revenue transaction.

Example	Description
Example 45 — Arranging for the Provision of Goods or Services (Entity Is an Agent)	Amended. Illustrates how an entity would identify the specified goods or services and perform the related control assessment. Also clarifies that an entity’s consideration of the control indicators is complementary to (rather than different or separate from) its assessment of whether it controls the goods or services before they are transferred to the customer.
Example 46 — Promise to Provide Goods or Services (Entity Is a Principal)	Amended. Illustrates how an entity would identify the specified goods or services and perform the related control assessment. Also clarifies that an entity may not need to consider the control indicators when its evaluation is conclusive regarding whether it controls the good or service.
Example 46A — Promise to Provide Goods or Services (Entity Is a Principal)	New. Illustrates an entity’s principal-versus-agent considerations in a transaction involving services.
Example 47 — Promise to Provide Goods or Services (Entity Is a Principal)	Amended. Clarifies that the nature of the specified good or service to be provided to the customer is a right that the entity controls. Also illustrates how the entity should assess whether it controls the specified good or service and demonstrates that some, but not all, of the indicators of control may be relevant in an entity’s assessment of whether it controls a right.
Example 48 — Arranging for the Provision of Goods or Services (Entity Is an Agent)	Amended. Illustrates an entity’s principal-versus-agent considerations when the specified good or service is a right and an entity acts as an agent because it does not control the right before transfer to the customer.
Example 48A — Entity Is a Principal and an Agent in the Same Contract	New. Illustrates that there may be more than one specified good or service in a contract and that an entity must assess each one separately to determine whether it controls it before transferring it to the customer. The entity in the example concludes that it is a principal with respect to one of the specified goods or services in the contract and an agent with respect to the other specified good or service.

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