

Insights into IFRS 15

Principal versus agent considerations



Revenue recognition is a key principle in financial reporting, underpinning the integrity and comparability of financial statements across industries and global markets. IFRS 15 ‘Revenue from Contracts with Customers’ was jointly developed by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to harmonise revenue reporting under IFRS and US GAAP. Rather than redefining what constitutes revenue, the Standard focuses on establishing a consistent framework for recognising revenue at the correct point in time and at a reliable amount. The Standard provides comprehensive guidance on accounting for revenue recognition – however, the detailed requirements of IFRS 15 can still be challenging for preparers of financial statements to apply.

Our ‘Insights into IFRS 15’ series summarises the key areas of the Standard, highlighting some areas that are challenging to apply in practice, to assist reporting entities in understanding how to apply IFRS 15’s requirements.

In many revenue transactions, more than one party is involved in delivering the goods and services to the customer. In those situations, it is sometimes difficult for an entity to determine whether it is acting as a principal or as an agent, and an entity must often apply significant judgement to reach a conclusion. While the principal-agent guidance in IFRS 15 does not eliminate the need for judgement, it is intended to make the principal versus agent assessment easier.

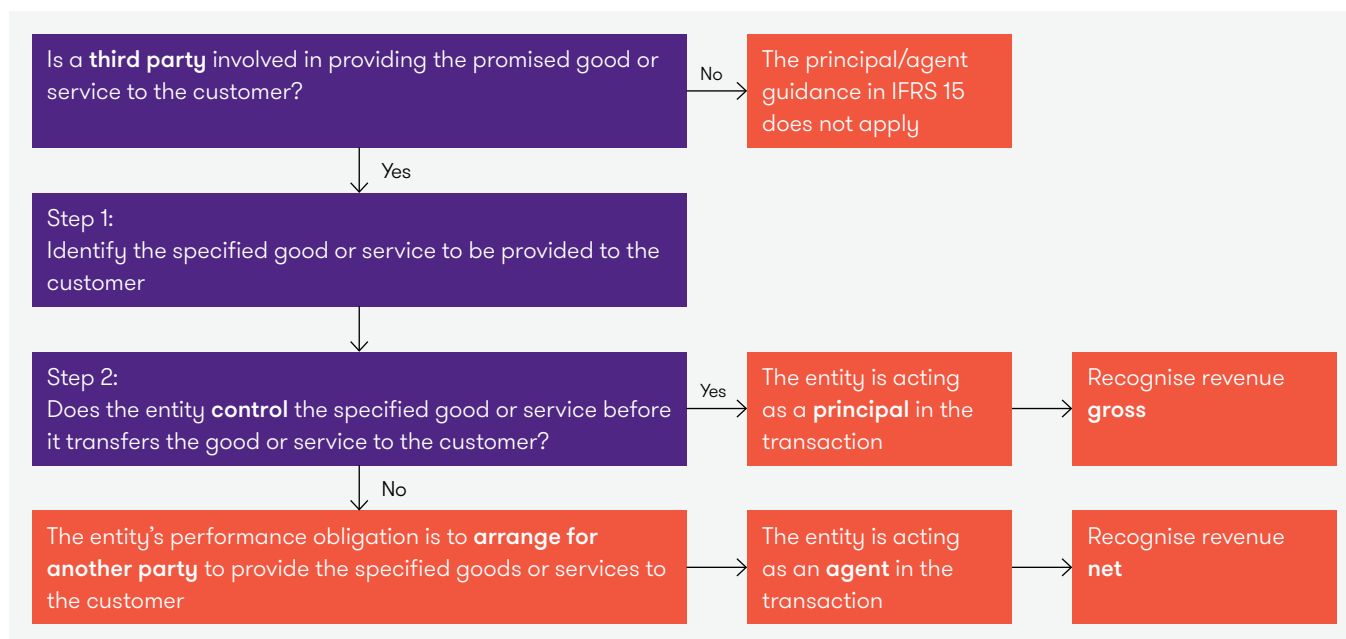
IFRS 15 requires an entity to determine whether the nature of its promise is to provide the specified goods or services to the customer or to arrange for another party to provide the goods or services to the customer. If the nature of the promise is to provide the specified goods or services directly to the customer, the entity is a principal and recognises revenue on a gross basis at the amount of consideration to which it expects to be entitled. In contrast, if the nature of the promise is to arrange for another party to provide the goods or services to the customer, the entity is an agent and recognises revenue in the net amount of the fee or commission it is entitled to for its agency services. In this case, the net amount might be the amount of consideration that the entity retains after paying the other party if the entity is responsible for collecting the full amount of consideration.

IFRS 15 establishes a two-step approach to assessing a principal-agent relationship in cases where a third party is involved in providing the goods or services to the customer. The entity first identifies the specified good or service to be provided to the customer. It then assesses whether it has control over the affected goods or services before they are transferred to the customer.

Under IFRS 15, ‘control’ of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (either inflows or savings in outflows) that might be obtained by using the asset to produce goods or provide services, to enhance the value of other assets, or to settle liabilities or reduce expenses:

- by selling or exchanging the asset
- by pledging the asset to secure a loan, or
- by holding the asset.

The following flowchart demonstrates how any entity should consider whether they are acting as a principal or as an agent:



Identifying the specified goods or services promised to the customer

An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. 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. IFRS 15 defines ‘distinct’ goods and services as those that are both capable of being distinct and are separately identifiable from other promises in the contract. If a contract contains more than one specified good or service, an entity should determine if it is principal or agent for each one and may be a principal for some goods or services and an agent for others.

Practical insight – Specified good or service – not performance obligation

The IASB decided to use the term ‘specified good or service’ rather than ‘performance obligation’ to describe the unit of account for purposes of the principal versus agent evaluation because using the term ‘performance obligation’ would have been confusing when the entity is acting as an agent. An agent’s promise [its performance obligation] is to arrange for another party to provide that party’s goods or services to the customer. In that circumstance, the specified good or service itself is not the agent’s performance obligation.

While the identification of the specified good or service may be straightforward in many contracts, it may be more difficult when an entity attempts to determine whether the specified good or service promised to the customer is the underlying good or service itself or whether it is a right to that good or service.

Example 1 – Promise to provide goods or services (entity is a principal)

An entity enters into a contract with a customer to deliver office maintenance services. Both parties agree on the scope of the services and negotiate the pricing. The entity is responsible for ensuring the services are carried out in accordance with the contract terms. It invoices the customer monthly for the agreed amount, with payment due within 10 days of invoicing.

To deliver these services, the entity frequently engages third-party providers. Upon securing a contract with a customer, the entity contracts with a service provider to perform the office maintenance services for the customer. The payment terms with these providers generally align with those in the entity's customer contracts. However, the entity remains liable to pay the service provider even if the customer fails to pay.

Analysis

To assess whether the entity acts as a principal or an agent, it must identify the specific good or service promised to the customer and determine whether it controls that good or service before it is transferred.

In this case, the promised service is office maintenance. Although the entity acquires the right to these services from a third-party provider after entering into the contract with customer, that right is not transferred to the customer. The entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right, ie control over how and where the services are used. For example, it can choose to allocate the service provider to this customer, another customer, or even for its own use. The customer cannot instruct the service provider to perform services beyond what the entity has agreed to deliver.

Therefore, the right to office maintenance services obtained from the service provider is not the specified good or service in the customer contract.

(The analysis of this example continues in the section below on **evaluation of control**).

Example 2 – Identifying the specified good or service when a third party is legally required to provide certain services in the contract

A wellness company provides cancer patients with an overall specified service of a 'cancer treatment and wellness program'. The wellness company developed its proprietary wellness program that caters to all of a cancer patient's needs throughout their cancer treatment and recovery journey. After completing a comprehensive intake form using the entity's proprietary approach, each patient is assigned a 'wellness leader', who customises the program for each patient, including program execution, chemotherapy treatments, physical and mental rehabilitation, and pharmacy needs. The chemotherapy treatments and physical rehabilitation are provided by licensed physicians, and the mental rehabilitation is performed by licensed psychologists, all vetted and engaged separately by the wellness company.

Analysis

The wellness company concludes that the specified good or service in the arrangement is its cancer treatment and wellness program. It determines that it is primarily responsible for providing this service to its customers and therefore is acting as the principal in the arrangement.

When considering the role of the licensed physicians and psychologists, the wellness company observes that it obtains control of the services provided by these doctors through its contractual relationships, and that it then directs the doctors to treat the patients on its behalf. Further, the wellness company notes that it integrates the individual services into a unique and comprehensive proprietary wellness program for each of its customers.

Evaluating control

Once an entity has identified the specified goods or services to be provided to the customer, it must evaluate whether it controls those goods or services before they are transferred to the customer, in which case, it is acting as a principal in the transaction.

An important aspect of the guidance is that a principal either provides the specified good or service to the customer or engages another party to provide some or all of the good or service on its behalf.

Obtaining control as a principal

In a transaction with more than one party providing goods or services to the customer, a principal obtains control of any one of the following prior to its transfer to a customer:

- a good or asset from the other party
- a right to service to be performed by the other party (ie the entity directs the other party on providing the service to the customer on its behalf), or
- a good or service from the other party that it then combines with other goods or services to provide the specified good or service to the customer.

The first instance is generally straightforward to identify. For example, a car dealer purchases 10 vehicles from a used-car auction for resale to third-party customers. The car dealer assumes inventory risk for the 10 vehicles while they are in its possession before the resale to the customers.

The second case may be less straightforward to identify. For example, as discussed in Example 1 above, an entity may engage a third-party service provider to provide office maintenance services to the entity's customers. The entity first obtains a contract with a customer and then enters into another contract with a service provider, directing the service provider to perform office maintenance services for the customer. The specified service is the office maintenance services. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. In other words, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right.

An entity is also a principal when it obtains control of the third-party's good or service before it integrates the good or service with other goods or services that it provides to the customer as part of transferring control of the overall performance obligation. This situation is common in the engineering and construction industry where entities often engage third-party entities to perform pieces of an overall project (for example, to construct a building), but the entity retains overall responsibility for integrating all of the services into the combined output requested by the customer. The entity identifies a single performance obligation because it conducts a significant service by integrating the promises into the overall output for the customer. As a result, the entity would likely conclude that it is acting as principal.

Example 1 – Promise to provide goods or services (entity is a principal)

Analysis (continued)

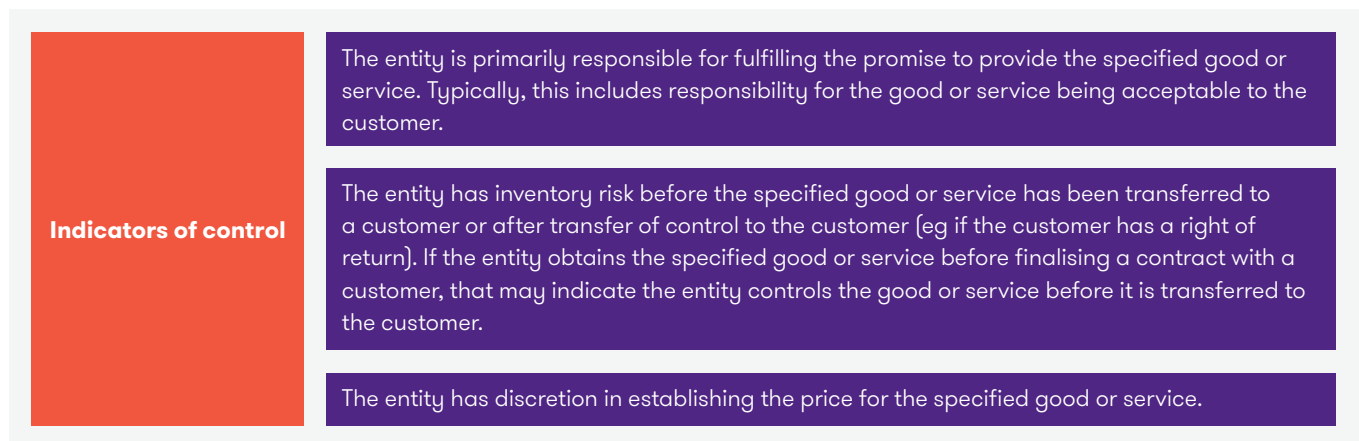
The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of the right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf.

Indicators of control

As set out in IFRS 15, the main criterion for assessing whether an entity is acting as principal or agent is the **existence or non-existence of control of the transferred goods or services by the reporting entity prior to the customer transaction**. To support the assessment of whether the entity obtains control of a good or service in situations where the assessment might be difficult, IFRS 15 includes three indicators that generally indicate a principal position in a customer transaction.

These indicators can have different weight depending on the type of goods or services involved and are also not to be understood as an exhaustive list. All relevant facts and circumstances are to be included in the assessment of control.

The below chart sets out these three indicators that an entity is principal:



Primary responsibility for fulfilling the promise to provide the specified good or service typically includes responsibility for the acceptability of the good or service. The assessment should also include whether the entity is directly responsible for delivering goods or services to the customer and who the customer considers to be primarily responsible for providing the service.

Inventory risk within the context of IFRS 15 can be presumed for the reporting entity if it is responsible for the proper condition of the goods at the time of their transfer to the customer, has committed to a specified minimum purchase quantity from its suppliers before the goods are purchased by the customer, and does not have a right of return to the supplier for goods not transferred to the customer.

Pricing discretion may be less relevant to the assessment of control if, for example, the market for the product means that the entity, in effect, has limited flexibility in setting prices.

The IASB included these indicators to support an entity's assessment of whether it controls the specified good or service before it is transferred or provided to the customer. It is important to emphasise that the indicators

- do not override the assessment of control
- should not be viewed in isolation
- do not constitute a separate or additional evaluation, and
- are not a checklist of criteria to be met in all situations or factors to be considered, in all scenarios.

Considering one or more of the indicators will often be helpful and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control.

Practical insight – Indicators of control

The nature of the entity's promise may not always be readily apparent. For that reason, the IASB included indicators in IFRS 15 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 requirements. However, the indicators in IFRS 15 have a different purpose than previous revenue recognition requirements in that they are based on the concepts of identifying performance obligations and the transfer of control of goods or services.

Practical insight – Indicators are not weighted

When an entity has an arrangement to provide goods and services to a customer that includes more than one party, it needs to perform an analysis under IFRS 15 to determine whether it is acting as a principal or an agent. IFRS 15 focuses on the transfer of control to determine how and when an entity is acting as a principal or an agent. In other words, does the entity control the specified good or service before that good or service is transferred to a customer?

IFRS 15 provides three indicators to inform the entity about its control assessment if that assessment is not determinative in itself. These three indicators are not weighted, and no single indicator alone is determinative of whether an entity is acting as a principal or agent. Instead, the Standard says that the indicators may be more or less relevant to the assessment of control, depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

Examples of the principal versus agent assessments

The following comprehensive example goes through a scenario where an entity concludes that it is acting as an agent. In its assessment, the entity identifies the specified good or service and then determines whether it controls the specified good or service before it is transferred to the customer. The entity considers the indicators to support the control assessment.

Example 3 – Arranging for the provision of goods or services (entity is an agent)

Entity A operates a website that connects customers to suppliers who sell and deliver goods directly to the customers. Entity A has contracts in place with the suppliers that entitle Entity A to a commission of 15% of the sales price when a good is purchased via the website. The suppliers set the prices and Entity A's website facilitates the customers' payments to the suppliers. Entity A requires payment upfront before orders are processed and does not allow for refunds. After arranging the transaction between the suppliers and customers and processing payments, Entity A has no further obligations.

Analysis

Entity A considers the following when assessing whether they are the principal or agent in sales transactions that take place on the platform:

Identification of the specified good or services to be provided to the customer:

- Entity A's website is a marketplace where suppliers offer their goods and customers purchase the goods offered by the suppliers
- The specified goods are the goods available for sale on the website

Control assessment:

- Entity A cannot direct the use of the goods at any point (eg Entity A is not able to direct the goods to another party)
- Entity A does not control the suppliers' inventory of goods used to fulfil the orders placed by customers

Entity A also considered the indicators of control laid out in IFRS 15:

- The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. Entity A is not required to fulfil the sale if the supplier fails to do so and is not responsible for customer satisfaction
- Entity A does not have inventory risk. It does not commit to obtain the goods from the supplier before the customer makes the purchase, and does not take responsibility for goods that are damaged or returned
- Entity A does not have the ability to set prices. Sales prices are set by the suppliers

Entity A therefore concludes that it does not control the specified goods before they are transferred to customers.

Based on these considerations Entity A concludes that it is an agent and its performance obligation is to arrange for the provision of goods by the supplier. When the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognises revenue in the amount of the commission to which it is entitled.

As noted above, if a contract contains more than one specified good or service, an entity may be a principal for some goods or services and an agent for others. The following example illustrates where the entity concludes that it is acting as a principal and an agent in the same contract. In the assessment, the entity identifies the specified goods or services and then determines if it controls each specified good or service before they are transferred to the customer. The entity considers the indicators to support the control assessment.

Example 4 – Entity is a principal and an agent in the same contract

Entity B sells flights and hotel accommodation to its customers. Entity B books the flights directly with the respective airlines according to the customer's preferences. In return, Entity B receives a discount compared to the retail price at which the customers could book a flight directly with the airline. However, Entity B does not commit to purchase tickets from the airline before the customer books the holiday, and the airline sets the price that is charged to the end customer. The airline is responsible for fulfilling obligations to provide the flight and is responsible for resolving customer complaints.

In addition, Entity B has purchased room bookings at certain hotels, which it sells on to customers. These room bookings mean that the hotel cannot sell the specified rooms to other parties, and if Entity B is unable to sell the room booking to a customer the room cannot be returned to the hotel.

Analysis

Entity B sells flights and overnight hotel stays separately, ie the customer is free to choose the airline and combine it with a hotel of their choice from Entity B's inventory, or can book just a flight, or just a hotel.

In contracts where a customer purchases a flight and hotel booking, Entity B concludes that there are two specified goods in the contract – the flights and the hotel accommodation.

In this case, Entity B concludes that it acts as an agent with regard to the flights, as it does not have the power of control prior to the booking by the customer. Entity B is neither primarily responsible for providing the flight nor does it bear inventory risk, as a booking with the airline is only triggered by the customer's request. Although Entity B receives a reduced price for the booked flights, it has no pricing authority regarding the final price to the customer. Therefore, the price reduction has the character of a sales commission, and only this amount is shown as revenue.

Regarding the hotel overnight stays, on the other hand, Entity B controls the hotel accommodation prior to providing it to the customer, as they have previously purchased the room bookings from the hotels. Entity B bears inventory risk, as rooms not sold to customers can no longer be returned to the hotels. In return, Entity B has pricing power as it is free to set the resale price to its customers. In relation to the hotel service, Entity B therefore acts as a principal and recognises the room rate as revenue.

Example 5 – Identifying the customer in a distributor relationship

Supplier A manufactures and sells equipment. Supplier A sells directly to end customers and also sells through a distributor.

In transactions with distributors, the distributor identifies the end customer, agrees to a price with the end customer for the equipment, sends notification of the agreed upon sales price back to the supplier, and the supplier has three days to accept or reject the price offered. If the supplier agrees to the end customer pricing, the supplier drop-ships the equipment to the end customer. When the equipment is drop-shipped, the distributor never takes control of the equipment (ie the distributor does not have legal title, physical possession or risks and rewards of ownership related to the equipment). Inventory returns by the end customer are made to Supplier A.

The invoice to the end customer is on Supplier A letterhead, but Supplier A is paid by the distributor upon shipment to the end customer and there is no further credit risk to Supplier A. The distributor takes on credit extension including, in some situations, working with the end customer to set up an instalment sale. Supplier A does not participate in any credit extension as it is paid by the distributor at shipment. The payment received by Supplier A from the distributor at the time of shipment is ‘net’ of distributor commissions (eg if the invoice to the customer is for CU10,000 and the distributor commission is 5%, upon shipment, the distributor remits CU9,500 (CU10,000 - CU10,000 × 5%) to Supplier A).

Analysis

Supplier A considers whether the distributor or the end customer is its customer and determines that the end customer, not the distributor, is its customer because it is primarily responsible for fulfilling the equipment ordered by the end customer. Supplier A also considers whether it is acting as a principal and therefore would record revenue of CU10,000, or if it is acting as an agent, in which case it would record revenue of CU9,500.

Supplier A determines that it controls the equipment and therefore is acting as a principal for the following reasons:

- Supplier A has the ability to reject the transaction if it does not accept the price negotiated by the distributor
- The end customer knows it is purchasing the equipment from Supplier A
- Supplier A has primary responsibility for fulfilling the contract and Supplier A accepts returns from the end customer, and
- The distributor never takes control of the equipment. Further, the distributor does not purchase the equipment until it has identified the end customer and, as a result, it has no inventory risk.

Supplier A records revenue at the gross amount of CU10,000. The fees retained by the distributor are akin to a finder’s fee or commission, and therefore the supplier should also consider whether the fees to the distributor are an incremental cost of obtaining the contract and whether the fee should be recorded as a deferred commission asset. In this particular example, because the contract is completed at the time the equipment is shipped, the commission is expensed.



Reimbursement of out-of-pocket expenses

Another area where it is important to make an appropriate distinction between the role of the entity as a principal or agent is the reimbursement by a customer of out-of-pocket expenses incurred by an entity in connection with its performance under a contract with a customer. The entity will need to determine whether it is acting as a principal or an agent with respect to the related specified goods or services. In this determination, the entity should first identify the specified goods or services to be provided to the customer and then assess whether it controls the specified goods or services before they are transferred to the customer.

Example 6 – Reimbursable costs

Entity C is a law firm and is reimbursed by its client for out-of-pocket expenses including meals, transportation, and lodging incurred by the engagement team for travel required in the execution of the client's legal services engagement.

Entity C identifies the specified goods and services as the meals, airfare, and lodging consumed by its staff in the performance of the legal services and concludes that it controls the specified goods or services as it is the entity that is primarily involved in selecting the nature of the specified goods and services and directly consumes the benefits from the meals, airfare, and lodging. The benefits of the specified services are not transferred to the customer; rather, Entity C controls the benefit of the meals, airfare, and lodging services, which it integrates into its performance of the legal services for which the client has contracted.

Analysis

Because Entity C concludes that it controls the specified goods or services, the customer's reimbursement of these items is included in the contract price.

IFRIC agenda decision on principal versus agent considerations

The IFRS Interpretations Committee (IFRIC) received an inquiry as to whether a reseller of software licences is a principal or an agent when applying IFRS 15. The inquiry related to very specific fact pattern with a particular contractual constellation between the software manufacturer, the end customer and the software reseller.

The IFRIC rejected the request in an agenda decision in May 2022, pointing to sufficient guidance in the IFRS 15 Application Guidance in IFRS 15. At the same time, however, the IFRIC took the opportunity to once again explain the two-step assessment process set out in IFRS 15 by identifying the specified goods or services to be provided to the customer and assessing whether it controls each specified good or service before that good or service is transferred to the customer.

In its agenda decision, the IFRIC made a detailed evaluation of the facts and circumstances in the specific case of the inquiry in order to show, by way of example, how an appropriate assessment can be made. Nevertheless, the IFRIC did not make a final judgement as to whether the entity in the fact pattern of the request should be classified as principal or agent. Instead, it pointed out that such a conclusive assessment could only be made by using management judgement considering all relevant facts and circumstances in the individual case.

Practical insight – Individual assessment

The agenda decisions of the IFRIC always refer to the specific facts and circumstances of the requested item only. However, the agenda decision on the principal versus agent assessment at a software reseller clearly shows that such an assessment necessarily involves considerable management judgement. In each individual case, the reporting entity must carefully and comprehensibly weigh the arguments for and against a principal position against the background of all relevant facts and circumstances. The application guidance in IFRS 15 provides the appropriate criteria for such an assessment.

How we can help

If you would like to discuss any of the points raised, please contact:

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