Amendment to Gross Versus Net Revenue Recognition

Curriculum: Accounting and Auditing

Level: Basic

Designed For: CPAs in public practice and CPAs in public or private companies

Objectives: To clarify the amendment to Topic 606 (revenue recognition) in gross versus net revenue recognition

Key Topics: Principal, agent and gross versus net revenue recognition

Prerequisites: None

Advanced Preparation: None

By Josef Rashty

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). In June 2014, FASB and the International Accounting Standards Board (IASB) announced the formation of Transition Resource Group (TRG) for revenue recognition. TRG does not issue any authoritative guidance, but makes recommendations about potential implementation issues on the new revenue recognition standards to both boards. In May 2016, FASB issued ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net) under Topic 606 based on TRG recommendation.

In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with corresponding offset to cost of sales. Thus, FASB provides for an alternative method of revenue recognition on a net basis (i.e., recognizing as revenues only the fee or commission that an entity receives as a reward for its participation in the transaction process). For example, in case of a travel agency that sells airline tickets to customers on behalf of an airline company for a commission, the travel agency recognizes its net amount of revenue (i.e., its commission).

Nevertheless, regardless of the method of accounting (i.e., gross versus net), the amount of net income remains the same under either of the two acceptable accounting methods.

However, in certain circumstances, the stock market and investors may judge the performance of a company based on its top line (i.e., gross revenues) instead of net income and as a result, reporting revenues on gross versus net methods becomes important.

This article will discuss the new revenue guidance and its amendment for recognition of revenues for principals (on a gross basis) versus agents (on a net basis) and compares the new revenue guidance (ASC 606 as modified by ASU 2016-08) with the existing revenue standard (ASC 605).

Existing Guidance (ASC 605)

ASC 605-45-45-10 states that it is a matter of judgment whether the entity should recognize revenues as the gross amount billed to a customer or the net amount retained (the amount billed to the customer less the amount paid to a supplier).

ASC 605 has the following indicators for gross revenue reporting:

- The entity is the primary obligor in the arrangement (ASC 605-45-45-4).
- The entity has general inventory risk (ASC 605-45-45-5).
- The entity has the latitude to establish the price of transaction (ASC 605-45-45-8).
- The entity is primary responsible for fulfillment and can change the product or perform part of services (ASC 605-45-45-9).
- The entity has discretion to select the supplier for fulfillment of customer order (ASC 605-45-45-10).
- The entity is primary responsible or involved in the determination of specifications for a customer order (ASC 605-45-45-11).
- The entity has the risk for the physical loss of inventory after customer order or during shipping (ASC 605-45-45-12).
- The entity carries transaction's credit risk (ASC 605-45-45-13).

Additionally, ASC 605 has the following three indicators for net revenue reporting:

- Suppliers, rather than the entity, have the primary obligation to fulfill the contract (ASC 605-45-45-16).
- The amount that the entity earns is fixed (ASC 605-45-45-17).
- The suppliers, rather than the entity, have the credit risk (ASC 605-45-45-18).

Topic 605 did not specifically address the principle underlying these indicators. However, since Topic 605 is a risk and reward model, we can fairly assume that these indicators use the same framework.

The boards brought forward these indicators more or less unchanged to ASC 606, but the new guidance is based on control rather than risk and reward, and that contributed to confusion on gross versus net revenue reporting under Topic 606. TRG made recommendations for clarification of the standard and FASB issued ASU 2016-08 based on those recommendations.

Effective Date of Amendment

The effective date for ASU 2016-08 is the same as the effective date for ASC 606; that is, ASU 2016-08 is effective for public business entities (PBEs) for annual reporting periods after Dec. 15, 2017 (i.e., 2018 for calendar year PBEs and interim periods therein).

Non-PBEs will be required to adopt the standard for annual reporting periods beginning Dec. 15, 2018, and interim periods within annual reporting periods beginning after Dec. 15, 2019.

All entities are permitted to adopt the standard as of the original PBEs' effective date (i.e., annual periods beginning after Dec. 15, 2016 and interim periods therein). Earlier adoption prior to that date is not permitted.

New Guidance (ASC 606)

The revenue recognition model has changed from a risks and rewards model to a model based on control (ASC 606-10-55-37). ASC 606-10-55-39 identifies the following indicators that enable the company to exercise control over the specified goods or services before they are transferred to customers:

- **Fulfillment responsibility** – The entity is primary responsible for fulfilling the promise to provide the specified goods or services to customers.
- **Inventory risk** – The entity has inventory risk before the specified goods and services are transferred to customers.
- **Price determination** – The entity has discretion in establishing prices for specified goods and services.

ASU 2016-08 Specific Clarifications

ASU 2016-08 amended ASC 606 and clarified the following, regarding principal versus agent classification:

Unit of Accounting – ASU 2016-08 has clarified how an entity should identify the unit of accounting for the principal versus agent evaluation. The unit of accounting refers to "specified goods or services" as distinct goods and services (or distinct bundle of goods and services) to be transferred to customers. Thus, for contracts involving more than one specified good or service, an entity could possibly be designated as a principal for certain goods and services and as an agent for others.

The unit of accounting for principal basically identifies the performance obligation in the contract. Significant amount of judgment is required to determine whether the specified goods or services are the underlying goods or services or rights

continued on next page

to obtain such goods or services. Once the unit of accounting is identified, it is easier to determine the party that exercises control over the contract.

Control Principle – ASU 2016-08 has clarified how the control principle applies to transactions. The objective is to determine the party that controls the specified goods and services before being transferred to customers.

ASC 606-10-55-37A clarifies that an entity is considered a principal if it controls any of the following:

- A good or another asset from a third party that gets transferred to customers.
- A right to a service performed by a third party for customers.
- A good or service from a third party that is embedded with entity's own goods and services provided to customers.

The meaning of control under the principal versus agent guidance is consistent with its meaning under ASC 606-10-25-25, which states that control of an asset refers to the ability to direct the use of an asset and obtain substantially all of the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of asset and obtaining any benefits from it.

ASC 606-10-55-37B states that an entity is principal and recognizes revenue in the gross amount of consideration if it satisfies performance obligation, and on the other hand ASC 606-10-55-38 states that an entity is an agent and recognizes revenue in the net amount if the entity's performance obligation is to arrange for another entity to render goods and services.

Indicators – ASU 2016-08 revised the indicators such that focus would be on identification of principal:

- Reframed the indicators to reflect that the principal controls specified goods and services before transfer.
- Added guidance to explain how each indicator supports the assessment of control (ASC 606-10-55-39 discussed earlier).
- Removed the indicator related to the form of consideration.
- Removed the indicator related to credit risk exposure.
- Clarified that these indicators are not an exhaustive list.

FASB did not intend to establish bright lines for identification of principal versus agent. Management exercises significant judgment in each instance to identify the principal in each transaction.

Examples

FASB added a few examples and illustrations to clarify the concept of principal versus agent.

Example 45 – In this example, FASB clarifies that simply arranging to provide goods and services is not enough to make an entity principal. FASB describes an entity that operates a website for commission based on sales price. This website enables customers to purchase goods from a number of suppliers. The suppliers control the price of goods and services that they provide.

FASB concludes that the entity is an agent in this scenario since suppliers have the fulfillment responsibility and inventory risk, and also determine the price, thus having control over the specified goods and services. The website operator in this example is an agent.

> **"IN CERTAIN REVENUE ARRANGEMENTS, AN ENTITY MAY NOT NECESSARILY PERFORM ALL THE REVENUE-RELATED TASKS TO BE ABLE TO RECOGNIZE THE WHOLE SALES PRICE AS REVENUES ON A GROSS BASIS WITH CORRESPONDING OFFSET TO COST OF SALES."**

Example 46 – An entity enters into a contract with a customer for certain custom designed equipment. The customer and entity together design the equipment and agree on the price of equipment. The entity communicates the specifications to suppliers to manufacture and deliver the equipment directly to customers.

FASB concludes that the entity controls the specialized equipment before the equipment gets transferred to customers and is the principal. Although the entity has subcontracted the manufacturing of the equipment to suppliers, it remains responsible for the overall management and performance of the contract. Thus, it has the ultimate fulfillment responsibility and control over the price of goods and services. It may have limited inventory risk but nevertheless that by itself is not a strong enough indicator to exclude it as principal in this example.

Example 46A – An entity enters into a contract with a customer to provide office maintenance services. The entity usually outsources the maintenance services for this and other similar contracts to sub-contractors. Nevertheless, the entity remains responsible for the fulfillment of the contract and determines the price with customers and remains responsible for the payment settlement with the third party subcontractors regardless if it gets paid by its customers.

FASB concludes that the entity is the principal since it has the fulfillment responsibility, and has control over the price of goods and services even though it has limited inventory risk.

Example 47 – In this example, FASB distinguishes between having responsibility for fulfillment and control over specified goods and services versus having rights on specified goods and services. An entity negotiates with major airlines to purchase tickets at reduced rates to sell them to the public.

FASB concludes that the entity is principal because it is obligated to pay for the tickets whether it can sell them to the public or not (inventory risk); it determines the price of the tickets sold to the public (price determination); it obtains control of a right to fly (it can transfer it to a customer) once it obtains the ticket from the airlines (fulfillment responsibility).

However, if the entity was simply facilitating the sale of airline tickets to the public for a percentage of selling prices as commission, it had the rights to sell the tickets, but did not necessarily control the specified goods and services. FASB concludes that the airline company has the performance obligation and as a result, the entity is an agent and must record the revenue transaction in the net amount (i.e., its commission).

Example 48 – An entity sells vouchers to customers that entitle them to receive significant discounts for future meals at specified restaurants. The entity does not purchase or make commitments for the purchase of vouchers. The entity and restaurants together determine the price of vouchers and the entity receives a commission for the sale of vouchers.

FASB concludes that the entity is an agent in this scenario since it does not have any fulfillment responsibility or inventory risk. It controls the price partially, but that is not enough to be designated as principal.

Example 48A – An entity provides recruiting services to customers. Customers as part of the contract with the entity obtain a license to access a third party's database for recruiting information. The entity invoices the customer for both recruiting services and database license.

FASB concludes that the entity is a principal regarding the recruiting services since it has the fulfillment responsibility and determines the price. However, it is an agent in relation to services related to database since the entity does not have any control over the database, does have any fulfillment responsibility and does not determine the price.

Illustration

An entity acquires an airline ticket from an airline company for $1,000 and sells it to a customer for $1,100. The airline company's cost of sales for the ticket is $700.

The following illustration is based on Example 47 where the entity is principal:

Entity's Books (Principal)

Cash	$1,100	
Revenues		$1,100
Cost of sales	$1,000	
Cash		$1,000

Airline's Books (Agent)

Cash	$1,000	
Revenues		$1,000
Cost of sales	$700	
Cash		$700

An entity sells an airline ticket for an airline company for $1,000 and receives $100 commission. The airline company's cost of sales for the ticket is $700.

The following illustration is based on Example 47 where the entity is agent:

Entity's Books (Agent)

Cash	$100	
Revenues (Commission)		$100

Airline's Books (Principal)

Cash	$1,100	
Revenues		$1,100
Cost of sales (Commission)	$100	
Cash		$100
Cost of sales	$700	
Cash		$700

In both of these scenarios, the net income of the entity remains at $100 and the net income of the airline company remains at $300.

Final Remarks

FASB's guidance on gross versus net revenue recognition has changed since the new revenue recognition model is no longer a rule-based risk and reward model, but instead is a principle-based control model. ASC 606, as modified by ASU 2016-08, provides certain indicators to distinguish principals from agents; however, these indicators should not be viewed as bright lines and an exhaustive list. Management exercises significant judgment on each transaction to determine if the revenue transaction should be recorded at gross versus net. ■

Josef Rashty, CPA is a member of the Texas Society of CPAs. He has held managerial positions with several publicly held technology companies in the Silicon Valley region of the Bay Area in California. He can be reached at j_rashty@yahoo.com.

CPE QUIZ

By Josef Rashty

Amendment to Gross Versus Net Revenue Recognition

1 The article argues that under either gross or net revenue recognition:
- **A.** Revenue remains the same
- **B.** Cost of goods sold remains the same.
- **C.** Gross margin remains the same.
- **D.** Net income remains the same.

2 The article claims that ASC 606 (the new revenue recognition guidance) is based on a:
- **A.** Risk and reward model.
- **B.** Control model.
- **C.** Both (a) and (b).
- **D.** Neither (a) nor (b).

3 For calendar year PBEs, the new revenue recognition guidance is effective in:
- **A.** 2018
- **B.** 2017
- **C.** 2019
- **D.** None of the above.

4 ASC 606 identifies the following indicators for exercise of control over the specified goods or services before they are transferred to customers:
- **A.** Fulfillment responsibility.
- **B.** Inventory risk.
- **C.** Price determination.
- **D.** All of the above.

5 The article claims that for contracts involving more than one specified good or service, an entity can be designated as a principal:
- **A.** For all the goods or services.
- **B.** For none of the goods or services.
- **C.** Possibly for some of the goods or services.
- **D.** None of the above.

6 The new guidance has revised the indicators such that the focus would be on identification of:
- **A.** Principal.
- **B.** Agent.
- **C.** Both (a) and (b).
- **D.** Neither (a) nor (b).

7 The article claims that FASB did not intend to establish bright lines for identification of principal versus agent.
- **A.** True.
- **B.** False.

8 The article claims that management exercises _______ judgment in each instance to identify the principal in each transaction.
- **A.** Little.
- **B.** No.
- **C.** Some.
- **D.** Significant.

9 FASB added a few examples and illustrations to clarify the concept of principal versus agent.
- **A.** True.
- **B.** False.

10 FASB's new guidance on gross versus net revenue recognition in ASC 606 has _______ as existing ASC 605 guidance.
- **A.** Remained exactly the same.
- **B.** Remained more or less the same.
- **C.** Has not remained the same.
- **D.** None of the above.

Today's CPA offers the self-study exam above for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article.

Mail the completed test by **Feb. 28, 2017** to TSCPA for grading.

If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TSCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade. The answers for this exam will be posted in the next issue of *Today's CPA*.

To receive your CPE certificate by email, please provide a valid email address for processing.

Name ______________________________

Company/Firm ______________________________

Address *(Where certificate should be mailed)* ______________________________

City/State/ZIP ______________________________

Email Address ______________________________

Please make checks payable to The Texas Society of CPAs.

__ $15 (TSCPA Member) __ $20 (Non-Member)

Signature ______________________________

TSCPA Membership No. ______________________________

After completing the exam, please mail this page (photocopies accepted along with your check to: Today's CPA; Self-Study Exam: TSCPA CPE Foundation Inc.; 14651 Dallas Parkway, Suite 700; Dallas, Texas 75254-7408. TSBPA Registered Sponsor #260.

Answers to last issue's self-study exam: **1. A 2. C 3. D 4. B 5. B 6. C 7. D 8. A 9. A 10. A**