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2015-290
Comment Letter No. 10

Ms. Susan M. Cospers
Technical Director
File Reference No. 2015-290
Financial Accounting Standards Board
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Proposed Accounting Standards Update, *Revenue from Contracts with Customers (Topic 606) – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* (File Reference No. 2015-290)

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Revenue from Contracts with Customers – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* (the Proposed ASU) issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective to provide additional clarifications and examples to reduce diversity in practice when entities adopt the new revenue standard and to reduce the costs and complexity of applying the new guidance. Overall, we believe that the proposed amendments to the principal versus agent guidance would enhance the operability of Accounting Standards Codification (ASC) 606 and result in more consistent application across entities, although significant judgment will still be required.

We commend the decision by the FASB and the International Accounting Standards Board (collectively, the Boards) to propose converged amendments to the principal versus agent application guidance. We believe that having the same language in both standards would promote comparability and improve consistency in the application of judgment across entities and industries. Accordingly, we believe that any decision by the Board to include additional guidance in ASC 606 or use words that are different from those in IFRS 15 should be very carefully considered.

In our view, the proposed amendments do not make it clear when entities would conclude that the specified good or service is the *actual* good or service or the *right* to a good or service in transactions when another party provides some or all of the goods or services to a customer. We recommend that the FASB consider revising the proposed guidance and further clarifying the examples, as discussed in our responses to Questions 1 and 4 in Appendix A.

Our responses to the questions posed in the Proposed ASU are set out in Appendix A. In Appendix B, we recommend an additional clarification.



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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

cc: International Accounting Standards Board

Appendix A – Responses to questions posed in the Proposed ASU, Revenue from Contracts with Customers (Topic 606) – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)

Question 1: The proposed amendments to paragraph 606-10-55-36 clarify the unit of account (the “specified good or service”) at which an entity would determine whether it is a principal or an agent and clarify that an entity can be both a principal and an agent in a single contract. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.

We support clarifying the unit of account (i.e., the specified good or service) at which an entity would determine whether it is a principal or an agent. This is an important step to improve the operability and understandability of the principal versus agent guidance.

We believe clarifying that an entity can be both a principal and an agent in a single contract also would be helpful.

We recommend that the proposed guidance be further clarified to clearly explain when an entity should identify the specified good or service as a *right* to a good or service or the *actual* good or service that will be transferred to the customer. For example, paragraph 606-10-55-324D in Example 46A identifies the office maintenance services as the unit of account but does not explain why the specified good or service is not the right to the maintenance services under paragraph 606-10-55-36A(a). Similarly, the application of paragraph 606-10-55-36A(a) is not explained in Examples 47 and 48, where the units of account are determined to be the right to the service and not the actual service desired by the customer.

In addition, when the specified good or service is determined to be a right to a service under paragraph 606-10-55-36A(a), it is not clear how an entity should apply paragraph 606-10-55-37A to determine whether it is a principal in the arrangement. Our concern is best illustrated by Example 47. The entity determines that the specified good or service is a right to fly on a specified flight, which is in the form of a ticket. The entity appears to have concluded it obtained control of a good or another asset (the ticket) under paragraph 606-10-55-37A(a). However, the entity could inappropriately conclude that it should report revenue on a net basis because it won't have the ability to direct the airline to provide the service to the customer under paragraph 606-10-55-37A(b).

We believe the guidance in the Proposed ASU could be further improved by requiring entities to identify the specified good or service as the actual good or service that will be transferred to the customer, not a right to a good or service that will be provided by another party. Therefore, we suggest amending paragraph 606-10-55-36A of the Proposed ASU as follows (deleted text is struck out):

“To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

- a. Identify the specified goods or services to be provided to the customer ~~(which, for example, could be a right to a good or service to be provided by another party (see paragraph 606-10-25-18))~~.

- b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer."

Another solution could be for the Board to further explain how to determine when the specified good or service is a right to the good or service and not the actual good or service that the customer wants to obtain. Further clarification to the examples would be important to explain the application of the guidance to those fact patterns. If the Board decides this approach is appropriate, we would recommend acknowledging explicitly in the Basis for Conclusions for ASC 606 that an entity needs to exercise judgment in evaluating whether the specified good or service is the provision of the good or service itself or a right to the good or service.

Question 2: Paragraph 606-10-55-37A clarifies application of the control principle to certain types of arrangements by explaining what a principal controls before the specified good or service is transferred to the customer. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.

We support the proposed amendments to paragraph 606-10-55-37A. We believe that they would help explain the application of the control principle and improve the operability and understandability of the principal versus agent guidance. In particular, we believe adding paragraph 606-10-55-37A(b) would help clarify how the control principle will apply to service contracts.

Question 3: The proposed amendments to paragraph 606-10-55-39 provide indicators of when an entity controls the specified good or service before it is transferred to the customer and, therefore, would be a principal. The amendments also clarify the relationship of each indicator to the control principle in paragraph 606-10-55-37. Paragraph 606-10-55-39A was added to explain that the indicators may be more or less relevant to the principal versus agent assessment depending on the nature of the arrangement and that different indicators may provide more or less persuasive evidence about whether the entity controls the specified good or service before it is transferred to the customer in different contracts. Would the proposed amendments improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.

We believe the proposed amendments would improve the operability and understandability of the principal versus agent guidance. We support reframing the indicators to describe when an entity controls a specified good or service before transfer (and is a principal rather than an agent) and adding explanatory guidance on how each indicator supports the control assessment.

We believe it would be helpful to incorporate aspects of Basis for Conclusions paragraph BC15 from the Proposed ASU into proposed paragraph 606-10-55-39A to clarify that the purpose of the indicators in paragraph 606-10-55-39 is to support or assist in the assessment of control, not override the control assessment. We believe that applying the level of judgment needed to determine whether an entity controls a good or service before it transfers to a customer will be challenging in many cases. Unless the principal versus agent determination is straightforward, we anticipate that companies will need to apply the control indicators to support their conclusions.

In addition, we have several observations on the indicators, as explained below.

Credit risk indicator

We understand credit risk to be the risk that an entity will not collect the amount of the receivable from the customer. However, paragraph 606-10-55-39(e) includes the following statement: "For example, if the entity is required to pay the other party involved in providing the specified good or service regardless of whether it obtains payment from the customer, this may indicate that the entity is directing the other party to provide goods or services on the entity's behalf." We think entities may incorrectly interpret the proposed amendments to mean that the notion of "credit risk" in the Proposed ASU would constitute more than just the risks associated with the amount of a receivable due from a customer. That is, entities may incorrectly believe that the consideration of economic risks, such as an obligation by the entity to pay third parties involved in fulfilling the contract with the customer, is required.

Furthermore, we note that Example 46A acknowledges that there is risk related to both the customer receivable and the requirement to pay another party involved in providing the services. It is not clear how much weight should be given to each of those considerations in the credit risk analysis. We also note that Examples 47 and 48 evaluate credit risk (or the absence thereof) without consideration of any other economic risks.

We believe that it would be helpful to clarify that the credit risk indicator relates only to the customer receivable. Therefore, we suggest the following edits to paragraph 606-10-55-39(e) (proposed text is underlined):

"... the entity is exposed to credit risk for the amount receivable from the customer in exchange for the specified good or service. For example, if the entity is required to pay the other party involved in providing the specified good or service regardless of whether it obtains payment from the customer for the amount of the receivable due to the entity, this may indicate that the entity is directing the other party to provide goods or services on the entity's behalf. Therefore, the entity has exposure to credit risk in respect of the amount due and receivable from the customer. However, in some cases, an agent may choose to accept credit risk as part of its overall service of arranging for the provision of the specified good or service."

Inventory risk indicator

Existing US GAAP (ASC 605-45-45-6) includes the following language: "Evaluation of this indicator shall include arrangements between an entity and a supplier that reduce or mitigate the entity's risk level. For example, an entity's risk may be reduced significantly or essentially eliminated if the entity has the right to return unsold products to the supplier or receives inventory price protection from the supplier." We believe the FASB should consider including similar language in paragraph 606-10-55-39(b) of the Proposed ASU to help entities better understand how to evaluate this indicator.

Fulfillment indicator

Paragraph 606-10-55-39(a) of the Proposed ASU includes the following statements: "The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service." Examples 46, 47 and 48 illustrate the evaluation of who is responsible for the remediation of any customer dissatisfaction after transfer of the good or service.

We suggest elaborating on the concept of acceptability in the fulfillment indicator as follows (proposed text is underlined): "This typically includes responsibility for the acceptability of the specified good or service (e.g., remediation of customer dissatisfaction)." We believe this would be a helpful addition since the concept of "acceptability" is not discussed elsewhere in the standard and may not be well understood.

Other comments

Paragraphs 606-10-55-39(c) and 39(e) regarding the pricing latitude and credit risk indicators include contrasting examples of when an agent may exhibit some form of these indicators but still be considered an agent. The fulfillment and inventory risk indicators do not include contrasting examples.

Current US GAAP (ASC 605-45-45) includes the concept of stronger indicators (i.e., the primary obligor and inventory risk indicators) and weaker indicators (i.e., the credit risk indicator). We understand it was not the intent of the Boards to maintain this concept, as noted in paragraph 606-10-55-39A and paragraph BC15 of the Basis for Conclusions of the Proposed ASU.

We observe that including contrasting examples in only two of the indicators (i.e., pricing latitude and credit risk) could lead preparers to infer that these indicators are "weaker" than the fulfillment and inventory risk indicators. In this regard, we observe that evaluating whether an entity has fulfillment risk is not always a binary assessment, and an entity may conclude that it is an agent in a transaction even if it has some level of fulfillment risk. As such, we suggest adding contrasting examples to all the indicators so no inference could be drawn from the presence of contrasting examples in only two of the indicators.

Question 4: Would the revisions to the principal versus agent illustrative examples (Examples 45 through 48) and the added illustrative examples (Examples 46A and 48A) improve the operability and understandability of the principal versus agent guidance in Topic 606? If not, please explain why and suggest alternatives.

We believe the proposed revisions to and additions of examples would improve the operability and understandability of the principal versus agent guidance. However, as noted above in response to Question 1, we suggest revising the examples to explain why the specified good or service is the right to a good or service instead of the actual good or service.

In addition, we believe that transactions in which a retailer obtains "flash title" (i.e., only momentarily obtains title) of a manufacturer's products at the point of sale are common. We anticipate diversity in practice will emerge unless the standard addresses how the control principle should be assessed for

such transactions. Therefore, we recommend adding an example to illustrate how the principal versus agent application guidance should be applied for flash title transactions. We note that the staff paper from the 22 June 2015 joint Board meeting on principal versus agent considerations included an example of a retailer that had only momentarily obtained title of a manufacturer's products at the point of sale. This example was helpful in highlighting that obtaining title is not determinative and that other factors need to be considered when determining whether an entity obtains control of a good or service prior to transferring it to the customer.

Appendix B – Additional clarification recommended for the Proposed ASU, *Revenue from Contracts with Customers (Topic 606) – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*

In paragraph BC33 of the Basis for Conclusions, an example of a transaction is provided that is not within the scope of the “estimating gross revenue as a principal” discussion. In this example, “... the entity receives a fixed percentage (for example, 65 percent) of a contractually agreed ‘list price’ from the intermediary, regardless of whether the intermediary increases or discounts that list price to the end customer.” BC33 further states, “In those cases, the transaction price for the entity’s good or services is known”

We suggest that the Board make clear what the transaction price would be in this example. That is, would the transaction price be the contractually agreed list price or 65% of the list price, which is the amount the entity expects to receive from the intermediary after the intermediary retains a commission?