

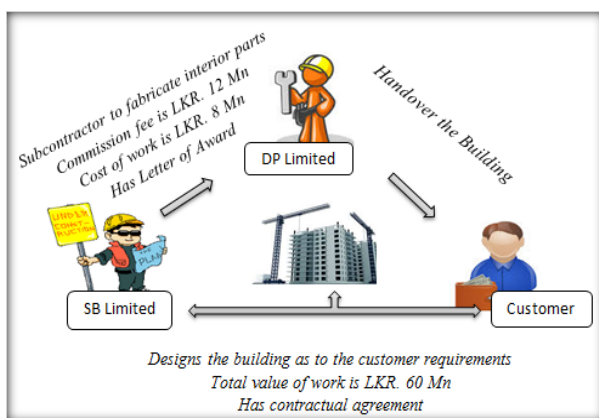
Measuring the Revenue in an Agency Relationship

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Introduction

Today, the corporate sector is well established in producing and delivering different types of products and services in each industry. Nowadays, entities highly engage into agency transactions related to revenue. Realistically, it is very challenging concept to determine when and whether to recognize the revenue in the financial statements or not.

SB Limited is a prominent building construction company in Sri Lanka. It is engaged with contractual agreements with customers as well as with subcontractors. As to the customers' requirements, SB Limited designs the building and the interior settings. During the process of construction, SB Limited hires DP Limited to fabricate the interior settings for the designed building by engaging into the legal contract called as "Letter of Award" which demonstrates that "DP Limited satisfies the finishing performance obligation of the project on behalf of SB Limited by receiving a fixed rate of commission on the total contract value."



After the completion of the work, DP limited handovers the building, with the certification of letter of award to end customer. Once SB Limited obtains the acknowledgement from the customer, commission is paid to DP Limited and subsequently, total contract value is paid by the customer.

Discussion of the Issue

SB Limited has the primary responsibility of title of consideration and it recognizes the revenue based on the stage of completion of the work at the end of the reporting period according to the LKAS – 11 Construction contracts. Paragraph 8 of IAS 18 Revenue states that, "In an agency relationship, the amount collected on behalf of principal, is not revenue. Instead, revenue is the amount of commission."

So that DP Limited recognizes the commission as revenue (LKR.12 Mn) and also cost incurred to the work (LKR. 8Mn) as cost of sales. Hence they are reflected on gross basis in the financial statements.

But EITF – Emerging Issues Task Force, Issue No 99-19 says that “If the company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, sales should be reported on net basis.” Further the paragraph B35 of IFRS -15 “Revenue from contracts with customers” directs, when an entity is a principal and satisfies a performance obligation, it recognizes revenue in the gross amount of consideration whereas when an entity is an agent and satisfies a performance obligation, it recognizes revenue in the amount of any fee or commission which may be the net amount of consideration. Such business practices raise attention about whether the construction contract is acting, in substance, as agency relationship. If it is so, there will be a question, “**How to report Revenue in Agency Relationship**” as well as whether the presentation of revenues must be reported on Gross as a Principal or Net as an Agent.

Furthermore, DP Limited acts as agent for SB Limited. However, on the other hand, it acts as principal in its ordinary course of business by obtaining contracts directly from the customers. Therefore, it further makes the agency transactions more complex when revenue is reported in the statement of comprehensive income by puzzling the gross and net revenue reporting.

Implication of the Issue

Underlying the issue, it is mandatory to identify both principal and agent concerning the nature, timing and scope of the business since stakeholders of the financial statements will fail to make corrective decisions on their specific purposes. In addition, the picture of the financial statements draws the fault presentation of revenue which is very much significant caption.

Conclusion and Recommendation

The EITF resolved in Issue No. 99-19 that decisions about whether to record revenue, gross or net. After applying indicators of EITF Issue No. 99-19, it is crystal clear that SB Limited (Principal) is the primary obligor to the customer and has full credit risk under its credit policies with customers whereas DP Limited (Agent) has no latitude or control over the prices charged to customers and earns fixed amount to the subcontract.

Hence, according to the paragraph B34 to B38 of IFRS – 15 “Revenue from contracts with customers”, it is necessary to apply the principal versus agent considerations. As per that, SB Limited is primarily responsible for fulfilling the contract as well as it gasps the general inventory risks and title of the product whereas DP Limited is receiving a fixed rate of commission of total contract value and does not expose to credit risk for the amount receivable from the customer.

Therefore EITF - Issue No. 99-19 and IFRS – 15 “Revenue from contracts with customers” clearly conclude that SB Limited acts as principal whereas DP Limited acts as agent (sub-contractor) and revenue obtained from SB Limited in the form of commission should be recognized as net basis (LKR. 4Mn). Therefore, SB Limited recognizes the revenue upon the gross basis whereas DP limited cannot recognize the revenue on gross basis, in substance, as agency relationship in the above construction contracts.

For instance, Statement of Comprehensive Income of both companies will be as follows:

SB Limited		DP Limited	
Statement of Comprehensive Income		Statement of Comprehensive Income	
For the year ended 31st March 2015		For the year ended 31st March 2015	
	LKR (Mn)		LKR (Mn)
Revenue	60	Net revenue	4
Less: Cost of construction	<u>(40)</u>		
Gross Profit	20		

With reference to the noted argument on DP Limited, accounting standards are quiet about the agency transaction when DP Limited acts as an Agent and Principal together for their ordinary course of business. Since DP Limited is able to separate the revenue from all principal transactions and all agent transactions, it is recommended that all transactions in which the company acts as a principal, should be recognized on the gross basis and all transactions in which the company acts as an agent should be recognized on the net basis as referring EITF - Issue No. 99-19 and IFRS – 15 “Revenue from contracts with customers” paragraph B34 to B38.

For instance, Statement of Comprehensive Income of DP Limited will be as follows:

DP Limited		DP Limited	
Statement of Comprehensive Income		Notes to the Financial Statements	
For the year ended 31st March 2015		For the year ended 31st March 2015	
	LKR (Mn)		LKR (Mn)
Revenue	104	Revenue from Principal Business	100
Less: Cost of Construction	<u>(35)</u>	Revenue from Agency Business	<u>4</u>
Gross Profit	69	Total Revenue	104