How to tell if my company is agent and not principal (1) (3/32/20)

Revenue recognition is one of the trickiest challenges, especially in a transaction involving two or more parties. When it comes to recognising revenue in such transactions, companies often have questions. Is the full invoice amount my revenue? Am I an agent? This article explores what legal provisions should be applied in order to answer these questions.

The legal framework

The relevant Latvian legislation – the Rules for Applying the Company and Consolidated Accounts Act – offers a brief interpretation: "Any amounts a company collects for a third party are excluded from the company's revenue. If the company is an agent, its revenue is only the agency fee payable by the third party."

Accordingly, if the company is an agent, its revenue is its commission. This interpretation helps me answer the question of whether the full invoice amount is my revenue, yet the question of whether I am an agent remains open.

This question is best answered by International Financial Reporting Standard 15, *Revenue from Contracts with Customers* ("IFRS 15"). Like the Latvian rules, IFRS 15 also explains that a company supplying goods or services should assess whether it is the seller (principal) or merely acts as agent. According to IFRS 15, an agent should recognise as revenue its commission only, not the full invoice amount.

Using the IFRS 15 terminology, the "principal" is an entity that controls goods or services before they are sold, whereas an "agent" is an entity that undertakes to arrange a deal without controlling the goods or services before they are sold.

The following signs, which indicate that the company is an agent, are recommended criteria that can help the company make its professional judgement:

- Another company is responsible for manufacturing the goods or supplying the services. We need to evaluate which company is responsible to the customer for performing the transaction, and which company offers support to the customer, handles customer complaints and takes responsibility for the quality of the goods or services supplied;
- The company has no inventory risk. The company does not take risks associated with inventory obsolescence, wastage or damage before the goods/services are supplied or if the product is returned. Inventory risk is substantially reduced by the right to return the product to its supplier at any time, yet guarantees and other agreements can mitigate this risk only partially. Inventory risk may exist also in the case of services where the company has to pay the end service provider regardless of how many customers are won;
- The company is not authorised to set the price of goods or services supplied by another party, and the company's profit from the transaction is limited and specified in the contract with the manufacturer or service provider;
- The company receives consideration in the form of commission;
- The company has no credit risk. If the end customer fails to pay the amount due, the company is not

liable to pay for the customer and afterwards collect the unpaid amount from the customer. The company does not pay its supplier until it receives payment from the customer.

Let us look at two practical examples to better understand how these signs should be used in practice, keeping in mind that using them involves making judgements and evaluating all known facts.

Example 1. Online sales of goods

Furniture Ltd maintains a website for selling furniture. Furniture Ltd has a contract with furniture manufacturer Table Ltd to sell its tables through the website, which ensures payments. Payments are made only by payment cards or bank transfers and only by prepayment. For each table sold, Furniture Ltd receives 5% of the table price, which is set by Table Ltd. Table Ltd delivers the table to the customer. If the customer is not happy with the quality of the table, they may return the table to the warehouse of Furniture Ltd, yet Furniture Ltd is authorised to return it to Table Ltd, receiving full payment for the compensation paid to the customer.

Is Furniture Ltd the principal or agent?

The answer: Furniture Ltd is an agent. The revenue of Furniture Ltd is the 5% commission it receives for selling tables. Furniture Ltd should recognise revenue from promotion when the customer buys the table.

The reasoning: Furniture Ltd does not control the tables before selling them and is not required to deliver the goods to the customer or set their price. Although the customer may return the table, Furniture Ltd may also return it to Table Ltd, without suffering any loss (no inventory risk). Since all sales are prepaid, Furniture Ltd takes no credit risk.

Example 2. Sales of flight tickets

Flight Ltd collaborates with all major airlines and has discounted tickets available. Flight Ltd sells those tickets to customers on its website. Flight Ltd has entered into contracts with the airlines for buying a stated number of tickets at agreed prices. Flight Ltd is required to buy the tickets even if the company is unable to find a customer for them. When buying tickets on the website, customers choose a ticket they like from those bought from the airlines. Flight Ltd is free to set a price at which the ticket is offered to the end customer.

Flight Ltd is responsible for delivering tickets to the customer and undertakes to help the customer in handling any disputes with the airline. The airline is responsible for performing flights and for preventing causes for customer complaints.

Is Flight Ltd the principal or agent?

The answer: Flight Ltd is the principal and should recognise revenue from the gross amounts charged to the customers for the tickets.

The reasoning: Flight Ltd sells a ticket that allows the customer to take the flight. Flight Ltd controls the tickets before they are delivered to customers because Flight Ltd may determine how the tickets will be used – they may be sold on, or they can be used otherwise. Also, Flight Ltd takes inventory risk, the probability that the tickets will not sell. And Flight Ltd is free to set the price of a ticket.

(to be completed)