#### **EITF ABSTRACTS**

Issue No. 99-19

**Title:** Reporting Revenue Gross as a Principal versus Net as an Agent

**Dates Discussed:** March 16, 2000; May 17–18, 2000; July 19–20, 2000

**References:** FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises

FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities

FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

FASB Statement No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others

FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information

FASB Concepts Statement No. 6, Elements of Financial Statements

AICPA Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts

SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements

SEC Staff Accounting Bulletin No. 101B, Second Amendment: Revenue Recognition in Financial Statements

SEC Regulation S-X, Rule 5-03, Income Statements

## **ISSUE**

1. Diversity exists regarding whether a company should report revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to a customer less the amount paid to a supplier) because it has earned a commission or fee. The issue often arises with companies that sell goods or services over the Internet. Many of those companies do not stock inventory and may arrange for third-party suppliers to drop-ship

merchandise on their behalf. Those companies also may offer services that will be provided by a third-party service provider. However, the issue is not limited to companies that sell products or services over the Internet. For example, the issue may arise in, but is not limited to, transactions related to advertisements, mailing lists, event tickets, travel tickets, auctions (and reverse auctions), magazine subscription brokers, and catalog, consignment, or special-order retail sales.

- 2. How companies report revenue for the goods and services they offer has become an increasingly important issue because some investors may value certain companies on a multiple of revenues rather than a multiple of gross profit or earnings. Net income generally does not differ based on whether a company reports revenue on the gross amount billed to the customer or the net amount retained.
- 3. The issue is whether a company should report revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee. The accounting model in this Issue is consistent with the requirements of SAB 101. Those requirements are included in SAB 101 in the interpretive response to question 10 of Topic 13-A and are as follows:

In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the [SEC] staff considers whether the registrant:

- 1. acts as principal in the transaction,
- 2. takes title to the products,
- 3. has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
- 4. acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.

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 a net basis. [Footnote reference omitted.]

- 4. This Issue excludes from its scope transactions for which guidance is provided under categories (a) and (b) of the GAAP hierarchy, including:
- Sales of financial assets, including debt and equity securities, loans, and receivables
- Lending transactions
- Insurance and reinsurance premiums
- Revenue transactions in specialized industries addressed in AICPA accounting and auditing guides (for example, airlines, casinos, investment companies, not-for-profit organizations, construction contractors, and federal governmental contractors).
- 5. This Issue also excludes from its scope other gross-versus-net income statement display issues such as those associated with (a) shipping and handling revenues and costs, which are addressed in Issue No. 00-10, "Accounting for Shipping and Handling Fees and Costs," and (b) rebates, coupons, incentives, and free products, which are addressed in Issue No. 00-14, "Accounting for Certain Sales Incentives." Also excluded from the scope of this Issue are those display issues that will be addressed in future issues on accounting for vendor promotional activities, multiple-element revenue arrangements, and "point" and other loyalty programs. This Issue does not address *when* revenue should be recorded, including *whether* revenue should be deferred (a liability established) because the earnings process is not complete.

#### EITF DISCUSSION

6. The Task Force reached a consensus that whether a company should recognize revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee is a matter of judgment that depends on the relevant facts and circumstances and that the factors or indicators set forth below should be considered in

that evaluation. The Task Force reached a consensus that none of the indicators should be considered presumptive or determinative; however, the relative strength of each indicator should be considered.

# **Indicators of Gross Revenue Reporting**

- 7. The company is the primary obligor in the arrangement—Whether a supplier or a company is responsible for providing the product or service desired by the customer is a strong indicator of the company's role in the transaction. If a company is responsible for fulfillment, including the acceptability of the product(s) or service(s) ordered or purchased by the customer, that fact is a strong indicator that a company has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer. Representations (written or otherwise) made by a company during marketing and the terms of the sales contract generally will provide evidence as to whether the company or the supplier is responsible for fulfilling the ordered product or service. Responsibility for arranging transportation for the product ordered by a customer is not responsibility for fulfillment.
- 8. The company has general inventory risk (before customer order is placed or upon customer return)—Unmitigated general inventory risk is a strong indicator that a company has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross based on the amount billed to the customer. General inventory risk exists if a company takes title to a product before that product is ordered by a customer (that is, maintains the product in inventory) or will take title to the product if it is returned by the customer (that is, back-end inventory risk) and the customer has a right of return. Evaluation of this indicator should include arrangements between a company and a supplier that reduce or mitigate the company's risk level. For example, a company's risk may be reduced significantly or essentially eliminated if the company has

the right to return unsold products to the supplier or receives inventory price protection from the supplier. A similar and equally strong indictor of gross reporting exists if a customer arrangement involves services and the company is obligated to compensate the individual service provider(s) for work performed regardless of whether the customer accepts that work.

- 9. The company has latitude in establishing price—If a company has reasonable latitude, within economic constraints, to establish the exchange price with a customer for the product or service, that fact may indicate that the company has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer.
- 10. The company changes the product or performs part of the service—If a company physically changes the product (beyond its packaging) or performs part of the service ordered by a customer, that fact may indicate that the company is primarily responsible for fulfillment, including the ultimate acceptability of the product component or portion of the total services furnished by the supplier, and that it should record revenue gross based on the amount billed to the customer. This indicator is evaluated from the perspective of the product or service itself such that the selling price of that product or service is greater as a result of a company's physical change of the product or performance of the service and is not evaluated based on other company attributes such as marketing skills, market coverage, distribution system, or reputation.
- 11. The company has discretion in supplier selection—If a company has multiple suppliers for a product or service ordered by a customer and discretion to select the supplier that will provide the product(s) or service(s) ordered by a customer, that fact may indicate that the company is primarily responsible for fulfillment and that it should record revenue gross based on the amount billed to the customer.

- 12. The company is involved in the determination of product or service specifications—If a company must determine the nature, type, characteristics, or specifications of the product(s) or service(s) ordered by the customer, that fact may indicate that the company is primarily responsible for fulfillment and that it should record revenue gross based on the amount billed to a customer.
- 13. The company has physical loss inventory risk (after customer order or during shipping)—Physical loss inventory risk exists if title to the product is transferred to a company at the shipping point (for example, the supplier's facilities) and is transferred from that company to the customer upon delivery. Physical loss inventory risk also exists if a company takes title to the product after a customer order has been received but before the product has been transferred to a carrier for shipment. This indicator may provide some evidence, albeit less persuasive than general inventory risk, that a company should record revenue gross based on the amount billed to the customer.
- 14. The company has credit risk—If a company assumes credit risk for the amount billed to the customer, that fact may provide weaker evidence that the company has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross for that amount. Credit risk exists if a company is responsible for collecting the sales price from a customer but must pay the amount owed to a supplier after the supplier performs, regardless of whether the sales price is fully collected. A requirement that a company return or refund only the net amount it earned in the transaction if the transaction is cancelled or reversed is not evidence of credit risk for the gross transaction. Credit risk is not present if a company fully collects the sales price prior to the delivery of the product or service to the customer (in other words, before the company incurs an obligation to the supplier). Credit risk is mitigated, for example, if a customer pays by credit card and a company obtains authorization for the charge in advance of product

shipment or service performance. Credit risk that has been substantially mitigated is not an indicator of gross reporting.

# **Indicators of Net Revenue Reporting**

- 15. The supplier (not the company) is the primary obligor in the arrangement—Whether a supplier or a company is responsible for providing the product or service desired by a customer is a strong indicator of the company's role in the transaction. If a supplier (and not the company) is responsible for fulfillment, including the acceptability of the product(s) or service(s) ordered or purchased by a customer, that fact may indicate that the company does not have risks and rewards as principal in the transaction and that it should record revenue net based on the amount retained (that is, the amount billed to the customer less the amount paid to a supplier). Representations (written or otherwise) made by a company during marketing and the terms of the sales contract generally will provide evidence as to a customer's understanding of whether the company or the supplier is responsible for fulfilling the ordered product or service.
- 16. The amount the company earns is fixed—If a company earns a fixed dollar amount per customer transaction regardless of the amount billed to a customer or if it earns a stated percentage of the amount billed to a customer, that fact may indicate that the company is an agent of the supplier and should record revenue net based on the amount retained.
- 17. The supplier (and not the company) has credit risk—If credit risk exists (that is, the sales price has not been fully collected prior to delivering the product or service) but that credit risk is assumed by a supplier, that fact may indicate that the company is an agent of the supplier and, therefore, the company should record revenue net based on the amount retained.

- 18. The examples in Exhibit 99-19A are presented to illustrate the application of the consensus.
- 19. The SEC Observer reminded registrants that Regulation S-X, Rule 5-03(b)(1), requires separate presentation in the income statement of revenues from the sale of products and revenues from the provision of services. Because commissions and fees earned from activities reported net are service revenues, this may often have the effect of requiring separate presentation of revenues reported gross and revenues reported net.
- 20. Some Task Force members observed that the voluntary disclosure of gross transaction volume for those revenues reported net may be useful to users of financial statements. Task Force members observed that such disclosure could be made parenthetically in the income statement or in the notes to the financial statements. However, if gross amounts are disclosed on the face of the income statement, they should not be characterized as revenues (a description such as "gross billings" may be appropriate), nor should they be reported in a column that sums to net income or loss.

## **Transition**

21. The Task Force reached a consensus that the consensus guidance in this Issue should be applied by SEC registrants no later than the required implementation date for SAB 101. According to SAB 101B, that implementation date is the fourth quarter of a registrant's fiscal year beginning after December 15, 1999. Accordingly, all registrants, including those that already have adopted SAB 101, are required to apply the consensus guidance in this Issue in their financial statements for the fourth quarter of their fiscal year beginning after December 15, 1999. Nonregistrants should apply the consensus no later than in annual financial statements for the fiscal year beginning after December 15, 1999. Upon application of the consensus, comparative financial statements for prior periods should be reclassified to comply with the classification guidelines of this Issue.

If it is impracticable to reclassify prior-period financial statements, disclosure should be made of both the reasons why reclassification was not made and the effect of the reclassification on the current period.

22. The SEC Observer noted that in Topic No. D-85, "Application of Certain Transition Provisions in SEC Staff Accounting Bulletin No. 101," the SEC staff has indicated that registrants should retroactively apply the guidance in SAB 101 regarding income statement classification to all periods presented in their next financial statements (whether interim or annual) filed with the Commission after January 20, 2000, if that information is available. The SEC Observer indicated that that same guidance applies to any income statement reclassification required by this Issue. The SEC observer also noted that companies registering shares in an initial public offering are expected to comply with SAB 101 at the time they file their initial registration statement with the SEC.

## **STATUS**

23. No further EITF discussion is planned.

# EXAMPLES ILLUSTRATING THE APPLICATION OF THE INDICATORS IN THE EITF CONSENSUS ON ISSUE 99-19

The following examples illustrate the application of the indicators. The application of the indicators for gross and net reporting of revenue depends on the relative facts and circumstances and requires significant judgment. The assessment below reflects those judgments in the given fact pattern based on the assumed facts; however, those judgments will vary in differing fact patterns.

## **Product Sales**

## Example 1

Company A facilitates the sale of home furnishing products. Each product marketed has a unique supplier and that supplier is identified in product catalogs distributed to customers. Company A maintains no inventories of products in advance of customer orders. Company A takes title to the products ordered by customers at the point of shipment from suppliers. Title is passed to the customer upon delivery. The gross amount owed by a customer is charged to the customer's credit card prior to shipment and Company A is the merchant of record. Company A is responsible for collecting the credit card charges and must remit amounts owed to suppliers regardless of whether that collection occurs. Suppliers set product selling prices. Company A retains a fixed percentage of the sales price and remits the balance to the supplier. Written information provided to customers during marketing and included in the terms of sales contracts states:

Company A manages ordering, shipping, and billing processes to help you purchase home furnishing products. Company A does not buy, sell, manufacture, or design the products. When you use Company A, you are purchasing the products from the Suppliers. Company A has no control over the quality or safety of the products listed. Orders will not be binding on Company A or the Suppliers until the applicable Supplier accepts them. Company A will process your requests for order changes, cancellations, returns, and refunds with the applicable Supplier. All order changes, cancellations, returns, or refunds are governed by the Supplier's policies, and you agree to pay additional shipment costs or restocking charges imposed by the Supplier. You agree to deal directly with the Supplier regarding warranty issues. Company A will not be liable for loss, damage, or penalty resulting from delivery delays or delivery failures due to any cause beyond reasonable control.

**Evaluation:** Certain of the indicators point toward gross reporting, while other indicators point toward net reporting. Company A concludes that revenues should be reported net in this example. Although indicators of gross reporting exist for physical

loss inventory risk (during shipping) and credit risk (for collecting amounts charged to credit cards), those indicators are not sufficient to overcome the stronger indicators that revenues should be reported net, including (a) the supplier, not the company, is the primary obligor and (b) the amount earned by the company is a fixed percentage of the total amount billed to the customer.

# Example 2

Reseller of office furniture receives an order for a large quantity of desks with unique specifications. Reseller and the customer develop the specifications for the desks and negotiate the selling price for the desks. Reseller is responsible for selecting the supplier. Reseller contracts with a supplier to manufacture the desks, communicates the specifications, and arranges to have the supplier deliver the desks directly to the customer. Title to the desks will pass directly from the supplier to the customer upon delivery. (Reseller never holds title to the desks.) Reseller is responsible for collecting the sales price from the customer and is obligated to pay the supplier when the desks are delivered, regardless of whether the sales price has been collected. Reseller extends 30day payment terms to the customer after performing a credit evaluation. Reseller's profit is based on the difference between the sales price negotiated with the customer and the price charged by the selected manufacturer. The order contract between Reseller and the customer requires the customer to seek remedies for defects from the supplier under its warranty. Reseller is responsible for customer claims resulting from errors in specifications.

**Evaluation:** After applying the indicators, Reseller concludes that revenue from the transaction should be reported based on the gross amount billed to the customer. The fact pattern does not clearly point to either the supplier or Reseller as the primary obligor to the customer. Reseller has complete latitude in negotiating the selling price for the desks and selecting a supplier among alternatives, and it earns a variable amount in the transaction equal to the difference between the selling price negotiated with the customer and the amount to be paid to the supplier, pointing to gross reporting. Finally, Reseller has credit risk from financing amounts billed to customers as accounts receivable, which is a weaker indicator that revenue should be reported gross.

#### Example 3

Company G is a large grain merchant that maintains inventory sites throughout the regions where crops are grown. Most of Company G's business involves the purchase of grain from local producers, which is stored and resold to customers such as mills, bakeries, and other users. However, a portion of Company G's business involves merchandising grain between unrelated producers and customers in return for a commission paid by the producer that is a percentage of the selling price (plus reimbursement for shipping costs). Company G negotiates the selling price subject to acceptance by the producer. This grain is handled by Company G in the same manner as grain purchased for the company's own inventory. The grain is picked up by Company G and stored on its premises on a segregated basis until the scheduled shipping date. While in storage, title to the gain resides with the producer; however, Company G is responsible for any physical loss. If the customer order is cancelled while the grain is in storage, the

producer is obligated to pay Company G handling and storage fees until another buyer is located. The producer is responsible for collecting the sales price from the customer and for settling any claims by the customer. Title to the grain never passes to Company G.

Evaluation: After applying the indicators, Company G concludes that it should record revenue from its grain merchandising activities for the net amount earned in those transactions. The only indicator of gross reporting is that Company G has physical loss inventory risk while the grain is on its premises, a less persuasive indicator of gross reporting. Indicators of net reporting are (a) the producer is the primary obligor to the customer as the producer is responsible for fulfillment, including remedies if the customer is dissatisfied, (b) Company G earns a fixed percentage of the selling price to the customer, and (c) the producer, and not Company G, has credit risk for the gross amount billed to the customer.

# Example 4

A major Chain of athletic shoe stores obtains 60 percent of its seasonal shoes from an overseas source. The lead-time for the order is four months and the selling season lasts three months. Chain takes title to the products upon delivery and is obligated to pay the Supplier according to typical industry payment terms. Selling prices for the products are determined exclusively by Chain. As long as Chain devotes at least 20 percent of its advertising budget to the Supplier's brands and prices the shoes within 20 percent of the national average price, Chain may return for full credit any unsold shoes and any customer returns within 60 days of the end of the season. Sales to customers are by cash or credit card.

Evaluation: After applying the indicators, Chain concludes that revenue from sales of products from the overseas source should be reported based on the gross amount charged to customers. Indicators of gross reporting are (a) Chain is the primary obligor to the customer, a strong indicator, as Chain is responsible for fulfillment and customer remedies in the event of dissatisfaction, (b) Chain has general inventory risk as a result of taking title and maintaining inventory, although that risk is mitigated through the return provisions with the supplier, (c) Chain has complete latitude to set the prices for the products (even though product pricing may affect Chain's return rights and expose it to greater inventory risk) and the net amount to be earned varies with that selling price, and (d) Chain also has credit risk for credit card transactions (a weaker indicator). No indicators of net reporting are present.

Similar fact patterns: A change in the fact pattern as to product return provisions for unsold products between the Chain and the Supplier would not change the result that Chain should report revenue gross. Those changes would include, for example, a vendor-imposed restocking fee or a limit on the number of items that may be returned. Those types of changes would increase the amount of general inventory risk present and increase the strength of that indicator of gross reporting.

In this example, the conclusion to report revenue gross based on the indicators would not be affected if the products sold by Chain were in Chain's inventory on a consignment basis. While a consignment arrangement would eliminate the general inventory risk indicator of gross reporting, the primary obligor indicator, a strong indicator of gross reporting, and the pricing latitude and credit risk gross indicators continue to point to gross reporting. Further, there continues to be no indicator of net reporting.

#### **Service Transactions**

# Example 5

Servicer provides Internet-based college application services to assist applicants in applying for admission to colleges. Servicer enters into a service contract with a college to place the college's application forms electronically on Servicer's web site. Applicants can either access Servicer's web site directly or click-through from the subscribing college's web site to complete an application. Applicants electronically submit the completed application to Servicer. The applicant also submits credit card information so that Servicer can charge the applicant's credit card for the college's admission fee. Before accepting the application, Servicer verifies the applicant's credit availability and charges the applicant's credit card. The Servicer then promptly forwards the application to the college. Servicer is the merchant of record in the transaction with the applicant and collects the proceeds from the applicant's credit card issuer.

The contract with the college compensates Servicer with either a fixed dollar fee or a fixed percentage of the admission fee, which Servicer withholds from the admission fees collected. The college determines its own admission fee. Servicer and the college negotiate the withholding of Servicer's fee from an applicant's admission fee in advance. On the fifteenth day of each month, Servicer remits to the college all proceeds collected in the prior month, net of the Servicer's fees. If the applicant subsequently denies the credit card charge, Servicer is at full risk of loss for the admission fee and remains obligated to remit the college's share of the admission fee to the college.

**Evaluation:** After applying the indicators, Servicer concludes that revenue should be reported for the net amount earned in the application transactions. Indicators of net reporting are (a) the college, and not the company, is the primary obligor to the applicant, because the college is responsible for reviewing and accepting or denying applications, and (b) the college sets the admission fee and Servicer receives a fixed percentage of that amount. An indicator of gross reporting is present only for credit risk in the form of collecting credit card charges, a weaker indicator. Similar to Example 1, the credit risk indicator for gross reporting is not sufficiently strong to overcome the indicators for net reporting.

# Example 6

Company B provides small, unrelated Internet merchants with credit card processing services. Customers of those merchants visit merchant web sites to select products. When a customer clicks on the button to purchase a product, the customer is redirected to Company B's secure server and the credit card information is processed. Company B utilizes an unrelated major bank to process the credit card transactions and the merchant

is not a party to that service contract. Company B is the merchant of record with that bank.

Company B notifies both the customer and the merchant by e-mail when the credit card charge is approved and, at that time, the merchant is authorized to ship the product by one of several common carriers that provide on-line package tracking so that the customer, Company B, and the merchant are able to monitor the order status. Company B has no responsibility for, or involvement with, the products. Merchants receive from Company B semi-monthly net payments based on the gross sales processed by Company B less a 6 percent processing fee, a 5 percent holdback for potential returns (released after 6 months), and an adjustment for actual returns. Company B is evaluating whether it should report revenues equal to the gross amounts processed for participating merchants (the amount billed to the retail customer) or for the net amount earned (the 6 percent processing fee).

Evaluation: Company B processes credit card transactions as the merchant of record, but is not directly involved in the sales transactions between merchants and customers. Company B concludes that it should report revenue net for the fee earned in the transaction (that is, the 6 percent fee) because of the near absence of gross reporting indicators and the presence of persuasive net reporting indicators. The merchant, and not Company B, is the primary obligor to the retail customer, a strong indicator that revenue should be reported net. Company B has no fulfillment or customer service role with respect to the delivery of the products ordered or their acceptability. Company B has no latitude or control over the prices charged to customers and earns a fixed amount (6 percent) from each transaction. The only indicator of gross reporting is that Company B assumes credit risk for the amounts billed on customer credit cards and that risk is mitigated by controls in place that allow the merchant to ship the product only after approval of the credit card charge, delayed remittance of sale proceeds to the merchant, and the 5 percent hold-back.

#### Example 7

Company C sells access to industrial application software that assists customers in managing their energy usage levels. Billings are on standard 30-day terms. Company C's software is resident on Company C's hardware and is accessed through the Internet. Company C's software incorporates software from another vendor. In its marketing literature and sales contracts, Company C clearly states that its software includes the other vendor's software (by name) and that the customer has the right to use that software as a component of Company C's software. (The other software vendor is not party to the sales contract between Company C and the customer.) Company C sells access to its software for \$50,000 per year and pays the other vendor a fixed fee of \$15,000 per year for each annual access right sold. Currently, Company C has complete discretion in determining the selling price.

**Evaluation:** Company C concludes that it should report its revenue from software access gross at an annual total of \$50,000 per copy. [Note that the timing of recognition of that revenue is not within the scope of this Issue.] Company C is primarily responsible

to the customer for providing access to the "total solution" software, a strong indicator of gross reporting. Company C has complete control over the sales price and has developed or physically changed its software (irrespective of the use of components from others), both indicators of gross reporting. Company C has discretion to incorporate any other vendor software into its software, irrespective of the fact that changing to another vendor for a component would be difficult or expensive or that Company C's agreement with its current supplier makes that supplier the exclusive supplier of the component for a stated period of time. Company C determines software specifications, an indicator of gross reporting. Company C has full credit risk under its credit policies with customers, a weaker indicator of gross reporting. No indicators of net reporting are present.

## Example 8

Bank D is a large bank that provides a wide range of services to customers. One popular offering is payroll processing with direct deposit. Bank D provides the interface with its customers but has a contract with a major payroll processing service to handle all aspects of the payroll processing. When a Bank D customer needs assistance with payroll processing, the customer service department of the processor answers the telephone announcing "Bank D Payroll Processing Service." The customer also may directly contact Bank D and the customer's account manager will coordinate with the processor. The customer is aware that Bank D outsources the payroll processing service; however, the contract for the processing establishes Bank D as the obligated party for all aspects of the processing. The processor is not a party to that contract. Bank D has complete discretion in determining the fees to be charged for the payroll processing service.

**Evaluation:** Bank D concludes that it should report the fees from payroll processing gross. Bank D is primarily responsible to the customer for providing the service, a strong indicator of gross reporting, even though Bank D outsources certain processes to an unrelated party. Bank D has complete control over the fees charged to customers and discretion at any time to engage any of a number of payroll processors to perform the service, both indicators of gross revenue reporting. Bank D has credit risk; however, fees for payroll services are debited to a customer's account at the time payroll is distributed, providing weak, if any, support for gross reporting. No indicators of net reporting are present.

# Example 9

Bank E is a large bank providing a wide range of services to customers. One popular offering is payroll processing with direct deposit. Bank E and Payroll Processor F have announced a "partnering" agreement that is used in marketing packaged banking and payroll services. Customers arrange for the service through Bank E and the service contract involves three parties: Bank E, Payroll Processor F, and the customer. Customers pay for the service based on a single fee schedule and are unaware of how much of the fee is earned by Bank E for its banking services and how much is earned by Payroll Processor F for its payroll processing services. All customer billing matters are handled by Bank E and any credit losses are shared by Bank E and Payroll Processor F based on their agreement. Bank E and Payroll Processor F have an agreement that

specifies (a) how customer fees are to be allocated and (b) that Bank E and Payroll Processor F individually bear the credit risk for the fees allocated to them.

**Evaluation:** Bank E concludes that it should report revenue for the fees billed for payroll processing net of the amount remitted to Payroll Processor F. The customer views Payroll Processor F as primarily responsible for its segment of the overall services and views Bank E as an agent for Payroll Processor F responsible for billing, an indicator of net reporting. Bank E has no pricing discretion for the fees charged for Payroll Processor F's services, pointing to net reporting by Bank E of its portion of the revenue. Bank E and Payroll Processor F bear their separate credit risk, an indicator of net reporting. No indicators of gross reporting are present.

# Example 10

Company H provides Internet-based advertising services to companies that want targeted "web surfers" to see their banner ads. Company H and the advertiser (in this example, a golf equipment manufacturer) agree on the goals of the ads and the demographics of the targeted individuals (that is, golfers). Company H utilizes data gathered about web surfers through the means of a software "cookie" placed on the computers of over 2 million people. Those cookies analyze surfing habits and forward that information to Company H. As part of this sophisticated overall service provided to advertisers, Company H purchases advertisement "impressions" or space on various web sites in which the advertiser's message can appear. When a surfer meeting the demographic profile desired by the advertiser visits a site regarding golf, and if Company H has arranged for impressions with that host site, then the surfer will see an ad for the advertiser's newest equipment styles. Company H purchases those impressions for \$1 per 1,000 impressions and maintains an inventory of those impressions on certain major host sites that may be of interest to a number of advertisers. Company H prices the advertising services that include the impressions and the system that targets users at \$3 per 1,000 impressions. Company H views those impressions as minor components of the service product offered. Company H has traditional trade accounts receivable terms for its customers.

Evaluation: Company H concludes that the revenue from its advertising services should be recorded gross. Company H performs much more service than simply finding ad space for advertisers that (by contract) view Company H as the primary obligor, a strong indicator of gross reporting. Company H has general inventory risk related to those web site impressions that are purchased in advance, an indicator of gross reporting. Company H has latitude in establishing the price charged, an indicator of gross reporting. Company H's comprehensive and complex demographic targeting and accurate pinpointing of those persons who should see an advertiser's message represent a significant portion of the service provided and, therefore, is an indicator of gross reporting. Company H has discretion as to those host sites whose banner ad space will be purchased (even though an advertiser may request certain sites) and is highly involved in the determination of service specifications (that is, the nature, type, characteristics, and specifications of the ad services), indicating gross reporting. Company H has credit risk, a weaker indicator of gross reporting. No indicators of net reporting are present.

# Example 11

"Matchmaker" provides the service of matching companies needing advertising space for their advertisements with companies that have advertising space to sell. Matchmaker arranges for space and marks up the price by its fee (while that fee often is equal to 15 percent of the amount charged by the supplier of advertising space, the actual fee is a result of negotiations between Matchmaker and its customers). "Advertiser" needs to purchase advertising space. "Newspaper" is a major newspaper with advertising space to sell.

Advertiser and Matchmaker enter into a service agreement for Matchmaker to find appropriate advertising space. The agreement requires Advertiser to accept advertising space located by Matchmaker if certain criteria are met. Matchmaker reserves appropriate space for Advertiser at Newspaper. Matchmaker is obligated to purchase the space even if Advertiser cancels the advertisement; however, since Advertiser has engaged Matchmaker to find the advertising space, cancellation is unlikely. Advertiser pays Matchmaker 115 percent of Newspaper's rate and Matchmaker pays Newspaper the net amount. Matchmaker provides Advertiser's advertising copy to Newspaper to print and issue. The contract between Matchmaker and Advertiser requires Advertiser to seek remedies from Newspaper for defects in advertisements (for example, improper placement or poor quality print).

**Evaluation:** Certain of the indicators point to gross reporting, while others point to net reporting. Matchmaker concludes that revenues should be reported net based on the net indicator that Newspaper is the *primary obligor*. Two indicators of gross reporting were identified; however, Matchmaker did not consider them sufficiently strong to overcome the net indicators. Those gross indicators are (a) Matchmaker has a low-level general inventory risk because Matchmaker is obligated to pay Newspaper for the advertising space even if Advertiser cancels the advertisement (however, this risk is mitigated because Advertiser specifically engaged Matchmaker to obtain the advertising space) and (b) Matchmaker has credit risk for collecting the amount billed to Advertiser.

# Example 12

Consolidator negotiates with major airlines to obtain access to airline tickets at reduced rates compared with the cost of tickets sold directly by the airlines to the public. Consolidator determines the prices at which the airline tickets will be sold to its customers and markets the tickets through advertisements in newspapers and magazines as well as the Internet. The reduced rate paid to an airline by Consolidator for each ticket sale is negotiated and agreed to in advance. Consolidator agrees to buy a specific number of tickets, and must pay for those tickets regardless of whether it is able to resell them. Customers pay for airline tickets using credit cards, and Consolidator is the merchant of record. Although credit card charges are pre-authorized, Consolidator incurs occasional losses as a result of disputed charges. Consolidator is responsible for the delivery of an airline ticket to the customer and bears the risk of physical loss of that ticket while in transit (although the airline has procedures for refunding lost tickets). Consolidator also facilitates resolutions of complaints by its customers regarding service provided by

airlines; however, once a customer receives a ticket, the airline is responsible for fulfilling all obligations associated with the ticket.

Evaluation: After applying the indicators, Consolidator concludes, based on the qualitative weight of the gross and net indicators, that revenue from the sale of tickets should be reported for the gross amount billed to customers. General inventory risk exists for the tickets purchased by Consolidator, a strong indicator of gross reporting. Ticket pricing also points to gross reporting as Consolidator has complete latitude to set sales prices for tickets and, as a result, the amount Consolidator earns will vary. Weaker indicators of gross reporting are also present for physical loss inventory risk (loss of tickets during delivery) and credit risk for collecting customer credit card charges. The fact pattern seems to indicate that the airlines are the primary obligors, as only the airlines can fulfill the air travel transportation of a customer, an indicator of net reporting. However, Consolidator assists customers in resolving service complaints, a function associated with the primary obligor role.

# Example 13

Travel Discounter negotiates with major airlines to obtain access to airline tickets at reduced rates compared with the cost of tickets sold directly by the airline to the public. Travel Discounter determines the prices at which the airline tickets will be sold to its customers and markets the tickets through advertisements in newspapers and magazines as well as the Internet. When marketing and selling tickets to customers, the carrier for a trip is identified. The reduced rate paid to an airline by Travel Discounter for each ticket sale is negotiated and agreed to in advance. Travel Discounter pays airlines only for tickets it actually sells to customers. Customers pay for airline tickets using credit cards, and Travel Discounter is the merchant of record. Although credit card charges are preauthorized, Travel Discounter incurs occasional losses as a result of disputed charges. Travel Discounter is responsible for the delivery of an airline ticket to the customer and bears the risk of physical loss of that ticket while in transit (although the airline has procedures for refunding lost tickets). Travel Discounter also assists the customer in resolving complaints with the service provided by the airlines. However, once a customer receives a ticket, the airline is responsible for fulfilling all obligations associated with the ticket, including remedies to a customer for service dissatisfaction.

**Evaluation:** Travel Discounter concludes that revenues should be reported net. The strongest indicator that is also the sole indicator of net reporting is that the airline is the *primary obligor* from the perspective of the customer. Three weaker indicators of gross reporting were identified, including (a) pricing latitude, (b) physical loss of the ticket during shipping, and (c) credit risk (for collecting amounts charged to credit cards). Travel Discounter considered whether it has discretion in selecting the airline and concluded that it does not because Travel Discounter may only suggest a named airline to a customer and the customer has the discretion to accept or reject that suggestion prior to ticket purchase. The strong indicator of gross reporting, general inventory risk, is not present.