

## Financial Reporting Center – Revenue Recognition

# Working Draft: Broker-Dealer Revenue Recognition Implementation Issue



### Issue #3-3: Principal vs. Agent: Costs Associated with Underwriting

#### Expected Overall Level of Impact to Industry Accounting:

Minimal

#### Wording to be Included in the Revenue Recognition Guide:

1. Members of an underwriting syndicate should evaluate whether they are principal or agent in providing underwriting services to the issuer in accordance with the guidance in FASB ASC 606, Revenue from Contracts with Customers, ASC 606-10-55-36 through ASC 606-10-55-40. The principle governing the analysis is outlined in FASB ASC 606-10-55-36 and 36A. ASC 606-10-55-36 states that “When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods and services to be provided by the other party (that is, the entity is an agent).” ASC 606-10-55-36A states that “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...
  - 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.”

This analysis should be performed by the lead underwriter and the participating underwriters for the services provided to the issuer. Refer to Broker-Dealer Issue # 3-4 “Underwriting and Related Fee Income” for guidance on defining the performance obligation(s).

*Principal versus agent considerations for the lead underwriter with regard to services provided by participating members*

2. FASB ASC 606-10-55-37A indicates that when another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:
  - a. A good or another asset from the other party that it then transfers to the customer
  - b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity’s behalf
  - c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.

3. The lead underwriter organizes the other participating underwriters and the selling group, negotiates the transaction with the issuer of the securities, maintains the subscription records for the underwriting and maintains a record of all of the direct expenses of the underwriting. These activities (i) do not give the lead underwriter control of any good or asset of the participating underwriters, (ii) do not give the lead underwriter any right to the services performed by the participating underwriters and (iii) do not combine the goods or services of the participating underwriters in order to provide services to the issuer; rather, each syndicate member, including the lead underwriter, is responsible to the issuer only for its committed share of the total offering (i.e., underwriting services provided by any individual underwriter do not impact services provided by any of the others.).
4. Additionally, FASB ASC 606-10-55-39 provides the following indicators that an entity controls the specified good or service and is acting as principal. A lead underwriter could evaluate these indicators as follows:
  - a. The entity is primarily responsible for fulfilling the contract – Each syndicate member named in the underwriting agreement is legally responsible to perform services for the issuer in accordance with the terms of the contract. Each syndicate member is severally obligated to perform and, in the event that there is alleged wrongdoing, each underwriter in the group is severally liable under the terms of the contracts. Although the lead underwriter negotiates with the issuer on behalf of the entire syndicate, its role is to arrange for the services of the syndicate. This is an indicator of an agent relationship.
  - b. The entity has inventory risk before or after the goods have been ordered, during shipping, or upon return – The lead underwriter does not have inventory risk because it does not purchase or commit to purchase the services of the participating underwriters at any time. Further, the lead underwriter does not commit to provide services to the issuer (i.e., raise capital, which includes engaging other vendors to provide services necessary to help sell securities) prior to execution of the underwriting agreement (and, at that point, all syndicate members have been identified). This is an indicator of an agent relationship.
  - c. The entity has discretion in establishing the price for the specified good or service – The lead underwriter is ultimately responsible for negotiating the engagement terms, including economics, with both the issuer and with the members of the syndicate. However, the level of discretion the lead underwriter has in such negotiations should be considered in the context of the facts and circumstances of the offering. Since the underwriting spread and the syndicate underwriter compensation arrangements are disclosed in the agreements, there is generally transparency between the parties in the deal, ensuring that compensation to all members of the underwriting syndicate must be competitive among the group. That is, the lead underwriter does not have a greater influence on the ultimate pricing than the other members of the syndicate. In such circumstances this indicator may not be determinative.
5. FinREC believes that generally, the role of the lead underwriter with regard to services provided by the participating underwriters is that of an agent (i.e., arrangement of services) because (i) the underwriter does not obtain control over the services of the other members of the syndicate as discussed in FASB ASC 606-10-55-37A and (ii) based on the weight of the indicators in FASB ASC 606-10-55-39. Consequently, in accordance with FASB ASC 606-10-55-38, the lead underwriter should record underwriting revenues net of revenues allocated to the participating members and expenses incurred net of the expenses that are allocated to the participating members. However, the specific facts of each arrangement should be considered when making this determination.

*Principal versus agent considerations for each member of the syndicate group, including the lead and participating underwriter*

6. FASB ASC 606-10-55-37A indicates that when another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:
  - a. A good or another asset from the other party that it then transfers to the customer
  - b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf
  - c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.
7. The members of the underwriting syndicate incur expenses such as, but not limited to, marketing and advertising, legal fees and other costs (e.g., accounting, travel, printing, and taxes) of setting up the syndicate group. The vendors that the underwriting syndicate contracts

with for these services are not directly responsible for the performance obligation in the underwriting agreement. Rather, they are engaged to perform services for the underwriting syndicate. The underwriters use these services and combine their benefits as part of their efforts to deliver the performance obligation (raise capital) to the issuer as discussed in FASB ASC 606-10-55-37A(c).

8. Additionally, FASB ASC 606-10-55-39 provides the following indicators that an entity controls the specified good or service and is acting as principal. Each member of the underwriting syndicate could evaluate these indicators as follows:
  - a. The entity is primarily responsible for fulfilling the contract – This is the case for each participating underwriter's pro rata obligation to perform. The vendors hired for the services have no obligation to the issuer and the issuer does not have recourse to the vendors; rather, the obligation to the issuer lies with each member of the underwriting syndicate. This is indicative of a principal relationship for the members of the underwriting syndicate for the services they are performing on behalf of the issuer.
  - b. The entity has inventory risk before or after the goods have been ordered, during shipping, or upon return – Each member of the underwriting group is obligated to pay the service providers even if they do not deliver the performance obligation to the issuer. In addition, certain vendor services are often provided prior to the execution of the underwriting agreement. This is indicative of a principal relationship for the members of the underwriting syndicate.
  - c. The entity has discretion in establishing the price for the specified good or service – The prices for the underwriting services are negotiated by the lead underwriter on behalf of the syndicate. It is often the case that the terms of the underwriting contract are subject to highly competitive market conditions that limit the variability in spreads. In addition, for public U.S. underwritings, underwriters' compensation is subject to regulation by FINRA. Therefore, it is often the case that the underwriters also have limited discretion in the pricing of the combined elements of their service. That is, the underwriting syndicate does not charge a direct reimbursement fee for the third party vendor costs (e.g., legal, marketing and advertising) and may not be able to negotiate a higher underwriting fee to cover the increased costs. In such cases this indicator may not be determinative.
9. FinREC believes that generally, the role of the members of the underwriting syndicate, including the lead and participating underwriters, is that of a principal because (i) the underwriter obtains control of these services and combines them with other services as part of delivering on its performance obligation as discussed in FASB ASC 606-10-55-37A(c) and (ii) based on the weight of the indicators in FASB ASC 606-10-55-39. Consequently, in accordance with FASB ASC 606-10-55-37B, each underwriter should reflect their proportionate share of the underwriting costs on a gross basis in the statement of earnings. However, the specific facts of each arrangement should be considered when making this determination.
10. In accordance with FASB ASC 940-340-25-3, underwriting expenses incurred before the actual issuance of the securities shall be deferred.
11. In accordance with FASB ASC 940-340-35-3, underwriting expenses deferred under the guidance in FASB ASC 940-340-25-3 shall be recognized at the time the related revenues are recorded. In the event that the transaction is not completed and it is determined that the securities will not be issued, at that time the entities that have agreed to participate in the costs associated with the underwriting shall write those costs off to expense.

Comments should be received by May 1, 2017, and sent by electronic mail to Ivory Bare at [ivory.bare@aicpa-cima.com](mailto:ivory.bare@aicpa-cima.com), or you can send them by mail to Ivory Bare, Content Development, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.