Accounting Standards Board

Newsletter October 2020 Edition

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Are all transactions with more than two parties a principal-agent arrangement?

We have recently observed that entities – mistakenly – apply GRAP 109 on *Accounting by Principals and Agents* to any transaction with more than two parties. Most entities focus on assessing whether they are a principal or an agent in an arrangement instead of assessing whether they are party to a principal-agent arrangement at all.

The discussion that follows outlines the process that entities should follow to decide if GRAP 109 should be applied.

Step 1 - Does a principal-agent arrangement exist?

What are the requirements of GRAP 109?

To determine if GRAP 109 should be applied, an entity needs to determine if the arrangement is a "principal-agent arrangement". A "principal-agent arrangement" is defined as follows in GRAP 109.05:

> *"A principal-agent arrangement results from a binding arrangement in which one entity (an agent), undertakes transactions with third parties on behalf of, and for the benefit of, another entity (principal)*".

There are two aspects to consider in assessing whether a principal-agent arrangement exists:

(a) The existence of a binding arrangement between the principal and the agent.

(b) The arrangement is such that one entity (the agent) represents the interests of another party (the principal), in dealing with identified third parties.

The definition refers to undertaking transactions with third parties "on behalf of, and for the benefit of, another entity (principal)". The entity on whose behalf the activities are being undertaken and who ultimately benefits (or bears losses), is the principal in the arrangement. The assessment of whether an entity is a principal or an agent in an arrangement is not undertaken as part of the initial assessment of whether a principal-agent arrangement exists. This is only assessed in step 2 if a principal-agent arrangement exists.

Is there a binding arrangement?

A binding arrangement (for purposes of GRAP 109) is any arrangement that confers enforceable rights and obligations on parties to the arrangement. These rights and obligations could arise from:

- contracts;
- legislation or similar means; and/or
- common law.

Some arrangements may be governed by both legislation (which sets the overarching framework within which certain transactions occur) and contracts (which set out the specific details of an arrangement between the parties, e.g. the activities to be undertaken, re-imbursement of costs, fees, service standards etc.). Both should be considered in deciding the nature of the arrangement and what rights and obligations exist for either parties.

Who are the parties to the arrangement?

As noted, a common misconception is that any transaction with more than two parties is a principal-agent arrangement. This is not the case. A principal-agent arrangement is where one entity (the agent) represents the interests of another entity (the principal) when that entity (the principal) transacts with third parties.

Representing the interests of another entity could include undertaking specific transactions, or it could include having interactions with third parties on an entity's behalf, e.g. negotiating a contract. Where there are specific transactions that are undertaken between the principal and the third parties, the agent would be involved in facilitating or executing the transaction but would not be responsible for fulfilling the rights and obligations in the transaction. A key characteristic of these transactions is often that the principal and the third parties are the counterparties to the transaction rather than the agent and the third parties (although there are exceptions).

In analysing who the parties are to the arrangement, it is also important to note that there may be more than one principal-agent relationship in a single binding arrangement. This is particularly the case when there is a beneficiary in the relationship, as well as service providers that are used to provide goods and services to the beneficiaries in the relationship.

In assessing whether a principal-agent arrangement exists, an entity applies the principle of substance over form. Arrangements might stipulate that "this arrangement is (or is not) a principal-agent arrangement", or "entity X is (or is not) the agent and entity Y is (or is not) the principal", or that an entity "acts on behalf of XXX" or is the "implementing agent". An entity needs to assess if the definition of a principal-agent arrangement in GRAP 109 is met when accounting for the arrangement, irrespective of the terminology used in the binding arrangement.

In summary, to meet the requirements to apply GRAP 109, entities should:

(a) Identify how the arrangement arose, i.e. contract, legislation or otherwise.

(b) Identify how the definition of a principal-agent arrangement is met, i.e. which are the three parties in the arrangement.

(c) Analyse whether there is more than one principal-agent relationship in a single arrangement.

(d) Analyse the rights and obligations outlined in the binding arrangements. Attention is often given to administrative actions such as the review, approval and making of payments, how technical or other support is provided, or how service providers are appointed, rather than understanding what the contractual (or other) rights and obligations are of the various parties and their role in fulfilling these rights and obligations.

(e) Apply substance over form. Reference to an entity being the "implementing agent" or similar terminology is insufficient to conclude that a principal-agent arrangement exists for accounting purposes.

Step 2 - Is an entity a principal or an agent in the arrangement?

What are the requirements in GRAP 109?

If an entity concludes that an arrangement is a principal-agent arrangement, the criteria in GRAP 109.25 are applied to assess if an entity is a principal or an agent:

> An entity is an agent when, in relation to transactions with third parties, all three of the following criteria are present, except as outlined in paragraph .26:
>
> (a) It does not have the power to determine the significant terms and conditions of the transaction.
>
> (b) It does not have the ability to use all, or substantially all, of the resources that result from the transaction for its own benefit.

(c) It is not exposed to variability in the results of the transaction.

GRAP 109 provides detailed guidance on the application of each of these criteria.

In analysing these requirements, entities should clearly indicate how each of the criteria are met or not. The analysis should focus on the substantive rights and obligations in contracts, legislation and/or other arrangements. The monitoring and oversight responsibilities of entities should be distinguished from substantive rights and obligations to fulfil the terms and conditions of the arrangement.

Frequently Asked Question

Access the ASB's FAQ 3.12 here.

South African appointed as new Deputy Chair of the IPSASB

The IPSASB announced last month that Ms Lindy Bodewig has been appointed as the Deputy Chair of the IPSASB from 1 January 2021.

Lindy is currently the Chief Director of the Technical Support Services Unit at the Office of the Accountant-General. She has also served as a Board member of the ASB for a number of years.

Her experience both as an implementer of accrual accounting in the public sector as well as a national standard-setter will ensure that she brings a wealth of experience to the IPSASB.

We wish her well in her new role.

Read the full press release here.

Participate in discussions on the changes to GRAP 25 on Employee Benefits

We will be hosting a roundtable discussion on the proposed changes to GRAP 25.

The proposed changes can be accessed by following this link. If you are interested in attending this session, please email elizna@asb.co.za.

Date	Event	Stakeholder group
2 November	Roundtable discussion	Auditors, firms, technical specialists, professional bodies, and academics

New Exposure Drafts issued by the IPSASB

At its September meeting, the IPSASB approved two Exposure Drafts for comment.

- Proposed IPSAS on *Non-Current Assets Held for Sale and Discontinued Operations.*
- Proposed amendments to IPSAS 5 on *Borrowing Costs*.

Non-Current Assets Held for Sale and Discontinued Operations

The IPSASB decided that guidance is needed on how to measure assets that are held for sale, as well as provide information in the financial statements on discontinued operations. As a result, the IPSASB has issued a proposed equivalent of IFRS 5 on Non-current Assets held for Sale and Discontinued Operations.

As the transactions supporting the sale of assets in the public and private sectors are the same, the IPSASB decided that this should be a convergence project. This means that limited changes have been made to the concepts in IFRS 5 in developing the proposed IPSAS. The IPSASB agreed that additional information should be disclosed in the notes to the financial statements when the fair value less costs to sell of an asset is materially higher than the carrying amount recognised in the financial statements. The IPSASB agreed that the disclosure of the fair value less costs to sell in these circumstances would provide useful information to users of the financial statements.

The ASB revised GRAP 5 on Non-current Assets Held for Sale and Discontinued Operations in 2013 by deleting the requirements for assets held for sale. Stakeholders locally expressed concerns about applying the requirements for assets to be held for sale, particularly the requirement that the sale should be executed within one year from the reporting date. Given the regulatory environment within which entities operate, it is difficult for entities to demonstrate that they meet this requirement.

When the Exposure Draft is discussed locally, this issue – among others – will need to be revisited to assess whether they are appropriate for the environment in South Africa.

Proposed amendments to IPSAS 5 on *Borrowing Costs*

As part of the IPSASB's Consultation Paper on Measurement, it requested respondents' views on whether borrowing costs should only be expensed, i.e. eliminate the allowed alternative accounting treatment which permits the capitalisation of borrowing costs. Respondents' views varied, with support expressed by some, and disagreement expressed by others.

The IPSASB agreed to retain both options, which means there are no changes proposed to the authoritative material in IPSAS 5. The basis for conclusions has been updated to reflect the IPSASB's deliberations on the expensing or capitalisation of borrowing costs. Respondents raised a number of application issues with IPSAS 5 in their responses. The IPSASB has developed non-authoritative implementation guidance and illustrative examples to address these issues.

How to access the Exposure Drafts

The Exposure Drafts – once published - can be accessed on the IPSASB's website by following this link.

Locally, the Secretariat will arrange roundtable discussions to discuss the proposals in the IPSASB's Exposure Drafts.

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