IASB Meeting Agenda reference **6B**

Staff Paper Date **May, 2009**

Project **Revenue recognition**

Topic **Collectibility**

Purpose of this paper

1. The objective of this paper is for the boards to decide how collectibility of the customer consideration amount affects the carrying amount of an entity's net contract position and, hence, its effect on revenue recognition. Specifically, this paper considers the effects of the customer's credit risk. This is another aspect of the broader topic of considering how the rights in the contract should be measured, which the boards began discussing in March.

2. In addressing this issue, the boards will also be considering the boundary between the revenue recognition model and accounting for receivables. In other words, when does the revenue recognition model hand over the accounting to standards dealing with receivables (eg IAS 39 *Financial Instruments: Recognition and Measurement*). Our thinking about the issues in this paper (and other measurement of rights issues) is in part governed by our desire to avoid creating an awkward jump from the proposed revenue recognition model to those standards.

Summary

3. The staff recommend

   (a) the measurement of an entity's net contract position should reflect the customer's credit risk. Hence, uncertainty of collectibility because of the customer's credit risk would affect the amount of revenue recognised when a performance obligation is satisfied.

   (b) after a performance obligation is satisfied, any change to the amount allocated to that performance obligation relating to customer credit risk should be recognised as income or expense rather than revenue.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

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(c) once the entity has an unconditional right to cash, that right should be accounted for in accordance with existing receivables standards.

Background

4. Collectibility is one of the four revenue recognition criteria in the SEC's SAB 104 *Revenue Recognition*—ie revenue can be recognised only if 'collectibility is reasonably assured'. IAS 18 *Revenue* specifies that revenue 'is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity'.

5. Current standards are not clear what they mean by collectibility. The staff think there are four main reasons why there could be uncertainty about the collectibility of the consideration.

   1 Uncertainty about customer's ability to pay the consideration.

   2 Uncertainty about the customer's commitment to complete the transaction (ie the customer might default on the contract).

   3 Uncertainty about whether the consideration is, in fact, due (and, hence, the customer will pay) because it is uncertain whether the entity has performed in accordance with the contract (ie the entity may not have satisfied the performance obligation).

   4 Uncertainty about whether the entity will perform (ie satisfy a performance obligation) in the future and, hence, be entitled to collect consideration for a performance obligation already satisfied.

6. Hence, collectibility can relate to more than just credit risk and there is interdependence amongst the above reasons. However, this paper focuses on (1) and (2)—ie credit risk. Reason (3) will be dealt with when the boards develop the guidance on when a performance obligation is satisfied, in the light of feedback on the discussion paper. Reason (4) is being considered in the paper on uncertain consideration.

7. There is arguably less pressure on (2) in the boards' proposed model than in some existing standards, because revenue is recognised only when an entity transfers goods and services to the customer, not as the entity undertakes activities towards transferring those goods and services. At that point of transfer there likely would be less uncertainty about the customer's commitment to complete the transaction.

How does collectibility affect the net contract position and revenue recognition?

8. Consider the following simple example.[1]

> On 1 January 20X0, Manufacturer contracts with a customer to provide a machine on 30 June 20X0 for CU10,000. Payment is due on 31 December 20X0. Assume that control of the machine is transferred to the customer on 30 June and that there are no remaining performance obligations on that date.

Does collectibility affect whether revenue is recognised or how much revenue is recognised?

9. In the above example, the question is whether Manufacturer recognises revenue on 30 June (when it satisfies the performance obligation) if there is uncertainty about whether Manufacturer will collect the CU10,000.

10. One approach would be to specify that the likelihood of collecting the consideration has to satisfy a specified probability hurdle before revenue can be recognised. As noted, this is the approach in both IAS 18 and SAB 104—in effect both require collectibility to be 'probable', though they may mean different likelihoods by that term. In the above example, that would mean that although the performance obligation is satisfied at 30 June, no revenue would be recognised until collectibility of the consideration was determined to be, say, probable.

11. In support of that 'recognition' approach it could be argued that:

    (a) In simple contracts, it would be the most straightforward approach.

    (b) It reduces the risk of having to recognise in subsequent periods a debit in the income statement that (i) in effect reverses the revenue previously recognised and (ii) introduces additional 'noise' into the financial statements.

    (c) It is prudent.

12. The other approach would be to reflect the uncertainty of collectibility in the measurement of the net contract position—and, hence, in the amount of revenue

[1] The staff acknowledges the simplicity of the example. In practice, entities would often not deliver under the contract if there was significant risk of default by the customer.

recognised—rather than in determining whether revenue should be recognised. In the above example, after the machine has been transferred to the customer on 30 June, Manufacturer's net contract position is a financial asset that otherwise would be accounted for in accordance with IAS 39. In other words, without revenue recognition guidance Manufacturer would simply have a financial asset to account for. It would recognise that financial asset, and uncertainty of collectibility would be reflected in its measurement.

13. In support of that 'measurement' approach it could be argued that:

    (a) It is consistent with the fundamental premise of the boards' proposed model, namely that revenue recognition should reflect an entity's performance of transferring goods and services to its customer in a contract.

    (b) It avoids arbitrary thresholds. A probability hurdle results in no revenue being recognised if the hurdle is not satisfied, but (potentially) all of the revenue being recognised if the hurdle is satisfied.

    (c) It is consistent with the accounting for a receivable outside the revenue recognition model.

    (d) It is consistent with the boards' decision about non-cash consideration. In the above example, on 30 June, Manufacturer can be regarded as having exchanged the machine for non-cash consideration: a promise of payment. With other forms of non-cash consideration, the boards decided that revenue should be recognised, when the performance obligation is satisfied, in the amount of the fair value of the asset received.

    (e) It would reflect events and circumstances as they occur. If some revenue is recognised but subsequently the consideration becomes uncollectible, that subsequent event is reported in the period in which it occurs.

Recommendation and question

For the reasons summarised in paragraph 13, the staff recommend that the measurement of an entity's net contract position should reflect the customer's credit risk. Hence, uncertainty of collectibility because of the customer's credit risk would affect the amount of revenue recognised when a performance obligation is satisfied. Do you agree?

How does collectibility affect how much revenue is recognised?

14. In the above example, if Manufacturer recognises revenue on 30 June when it satisfies the performance obligation, the question is how much revenue should be recognised.

15. The boards have already decided that the net contract position should reflect the effects of the time value of money (when material). They also specified that the discount rate should be the rate at which the entity and its customer would have entered into a financing transaction that did not involve the provision of other goods and services. The staff notes that these principles could also apply to a transaction in which the effects of customer credit risk are material. In other words, in the above example, the transaction price of CU10,000 could be discounted at the rate at which manufacturer would have provided financing to its customer, which would reflect the customer's credit standing. Suppose this rate is 30%. The discounted amount of the transaction price would therefore be CU8,780 and this would be the amount allocated to the performance obligation. Hence, the revenue recognised at 30 June is CU8,780.

16. Alternatively, the same effect could be achieved by determining the expected (probability-weighted) consideration amount, adjusting that amount for risk and then discounting at the risk-free rate. Suppose in the above example there is a 10 per cent chance that the customer will not be able to pay. The expected consideration amount is CU9,000 (ie 90% x CU10,000 + 10% x CU0). If the risk free rate is 5 per cent, the amount allocated to the performance obligation would be CU8,780.[2]

[2] For simplicity, this calculation has ignored any adjustment for a premium for the uncertainty in the expected cash flows.

17. Note that the CU8,780 carrying amount of the net contract position (a receivable) at 30 June would approximate the fair value of the receivable at that date. In other words, the accounting is similar to how it might otherwise be accounted for as a financial asset in accordance with IAS 39.

18. At this point, some board members may be worried about the complexity for such a simple transaction. However, in the majority of transactions the entity would simply record the revenue at the transaction price, because the effects of credit would be immaterial. This is not unlike IAS 39 which acknowledges that short term receivables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

Recommendation and question
The staff recommend that, if material, the effect of credit risk should be reflected in the carrying amount of the net contract position. An entity can do that by allocating to performance obligations the credit-adjusted expected consideration amount (as illustrated in paragraphs 15 and 16). Do you agree?

How should subsequent changes in credit risk be reflected?

19. Suppose that Manufacturer recognises revenue on June 30 but after that date it becomes evident that the customer will not be able to pay the consideration. Clearly, the net contract position (a receivable) is impaired. Therefore, the expected consideration amount would need to be updated and the net contract position adjusted downwards. How should the corresponding debit be presented in the income statement?

20. The staff thinks there are two ways of looking at this. The first is to view the subsequent credit deterioration as an impairment of the asset (promise of payment) that was received in exchange for providing the machine. In other words, Manufacturer received an asset but subsequently that asset lost value. Hence, the subsequent adjustment to the net contract position would be presented as an expense, rather than revenue. That treatment would be similar to an entity that had received another form of non-cash consideration at 30 June—say, an equity stake in another company—and that asset subsequently became worthless. The revenue recognised at 30 June would reflect the value of the

equity stake at 30 June—ie the value of the asset the entity received in exchange for providing goods and services—and any subsequent change in value would not be considered to have anything to do with the revenue transaction.

21. The second approach views revenue as being an increase in assets from the entire process of producing goods and services, selling those goods and services and collecting the sales price. That approach suggests that if the cash is never collected, the entity never 'realised' the revenues—in other words, ultimately there never was any increase in assets. That reasoning might suggest that the reduction in the net contract position should be presented in revenue (ie a contra revenue).

22. Existing standards and practices are inconsistent. If revenue is not recognised until cash is collected, then implicitly the second approach is followed (because if the cash is not collected, no revenue is ever recognised). On the other hand, existing standards largely follow the first approach by reporting adjustments to revenue already recognised as expenses rather than as adjustments to revenue.[3]

23. Conceptually, some staff prefer the second approach. Nonetheless, the first approach seems most consistent with the boards' proposed model which is focused on the exchange between the entity and its customer. It also has the advantage of practicality: once the entity has a receivable, that receivable can be accounted for outside of the revenue recognition model.

Recommendation and question

The staff recommend that after a performance obligation is satisfied, any change to the amount allocated to that performance obligation relating to customer credit risk should be recognised as income or expense rather than revenue. Do you agree?

[3] eg paragraph 18 of IAS 18 states that 'when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised'.

Multiple element contract

24. The above example was deliberately simple. However, the principles discussed above could be applied to a more complex contract, in which goods and services are transferred to the customer at different times but the whole consideration amount is due from the customer only after all the goods and services are transferred to the customer. In that case, the entity's net contract position would not be a receivable after satisfying the first performance obligation, because it would still contain the remaining performance obligations. Nonetheless, the amount of revenue recognised on satisfying the first performance obligation could be the proportion of the total transaction price attributable to that performance obligation adjusted for credit risk if material.

25. Subsequently, any changes in the collectibility of the consideration (because of the customer's credit risk) that was allocated to that performance obligation would be recognised as income or expense. The staff acknowledges that when the total amount of consideration is uncertain for various reasons, it may be difficult to distinguish a change that is attributable to the customer's credit risk from other changes (eg contingent consideration). As noted above, there could be interdependency between the entity's future performance and the customer's willingness to pay. Nonetheless, the staff thinks that the boards need only to specify the principle rather than provide detailed guidance on this point.

Boundary between the proposed model and existing receivables standards

26. The staff's recommendations suggest that once the entity's net contract position has become a receivable (because there are no remaining performance obligations), that receivable could be accounted for in accordance with existing receivables standards (eg IAS 39). In some cases, even though there are some remaining performance obligations the entity's net contract position might include a right to payment that is not conditional on the entity's past or future performance (ie only the passage of time is required for payment to become due). In those cases, the unconditional rights could also be accounted for in accordance with existing receivables standards. The staff think that their

recommendations on accounting for contractual rights should facilitate a smooth transition from the proposed model to receivables accounting.

Recommendation and question
The staff recommend that once an entity has an unconditional right to cash, that right should be accounted for in accordance with existing receivables standards. Do you agree?