Project	**Revenue recognition**
Topic	**Collectibility**

Purpose of this paper

1. This paper seeks the Boards' views on how an entity should account for the effects of a customer's credit risk, and changes in that risk, in a contract with a customer.

2. This paper relates to issues that the Boards are discussing in other projects, including how an entity measures financial assets and tests those assets for impairment. Those issues are not addressed directly in this paper. The interaction between the Boards' revenue model and impairment models will be discussed at a future meeting.

Staff recommendations

3. The staff recommends that to account for the effects of a customer's credit risk, an entity should:

    (a) measure the transaction price at the gross amount of customer consideration (i.e. at the stated contract price) so that the entity recognizes that amount as revenue when it satisfies its performance obligations;

    (b) recognize separately an allowance for an expected impairment loss concurrently with that recognition of revenue; and

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(c) present those line items next to each other so that users of the entity's financial statements can simultaneously observe the entity's gross revenue and reduction of revenue from expected credit losses.

4. In addition, the staff recommends that the final revenue standard not specify a recognition threshold for collectibility in addition to the criteria for determining whether a contract exists for purposes of applying the revenue model.

Structure of this paper

5. This paper is organized into the following sections:

   (a) feedback on the exposure draft (paragraphs 6–16),

   (b) main issues to be considered (paragraphs 17–19),

   (c) should the initial measurement of the transaction price reflect credit risk? (paragraphs 20–31),

   (d) should there be a separate recognition threshold for collectibility? (paragraphs 32–34),

   (e) should subsequent changes in credit risk be reported as a change to revenue or as other income or expense? (paragraphs 35–37), and

   (f) private company considerations (paragraphs 38 and 39).

Feedback on the exposure draft

Summary of the proposals

6. As paragraph 43 of the Exposure Draft *Revenue from Contracts with Customers* explained, collectibility refers to the customer's credit risk—the customer's ability to pay the amount of promised consideration. The Boards proposed that an entity should reflect the customer's credit risk in the measurement of the transaction price by taking that risk into account when determining the probability-weighted amount of the consideration that the entity expects to

receive from the customer. After the performance obligation has been satisfied and the entity's right to that consideration has become unconditional, the Boards' proposed that any subsequent changes in the assessment of credit risk should be recognized as income or expense outside of revenue.

7. The Exposure Draft also included implementation guidance to clarify, among other things, that an entity often would account for the effects of customers' credit risk at the level of a portfolio of similar contracts.

Feedback on the proposals

8. Collectibility was one of the topics on which respondents most commented. And feedback on the topic was mixed. Some respondents did agree with the *concept* of the transaction price reflecting the customer's credit risk. But nearly all respondents expressed concerns about applying that concept in practice.

9. Those respondents who supported the proposals made comments that were generally consistent with the following comment:

> Most revenue transactions are an exchange of goods or services for a financial asset (receivable). Given that financial assets are recognised at fair value on initial recognition (which takes credit risk into account), it is appropriate to include the effect of credit risk in the measure of customer consideration (the transaction price). Without qualifying our support, we suggest that information on gross or contractual revenue, and subsequent credit losses, is useful. (CL #207)

10. The respondents who disagreed with the Boards' proposal commented that revenue should be:

    (a) recognized when the likelihood that the entity will receive consideration from the customer passes a predefined threshold (e.g. probable, reasonably assured); and

    (b) measured at the amount of the consideration the seller is *entitled* to receive in accordance with the contract (i.e. the contract price).

11. Feedback from users of financial statements also was mixed. Some users (and securities regulators) would prefer for revenue to be measured at the gross

amount so that revenue growth and receivables management can be analysed separately. For instance, one user group stated:

> We are afraid that the reflection of the customer's credit risk on the transaction price could be misleading and does not provide the investors with better information on revenue and contracts with customers. We believe that revenue should be recognized based upon the transaction price without any adjustment to the credit risk and that the allowance should be recorded separately to reflect such a risk. We think this approach is more informative and useful to users' investment decisions.... It is important for investors to know how much of the credit risk of the customers management expects could be realized over time in terms of the percentage to revenue. This information will be lost if the credit risk is deducted from a transaction price and, hence, revenue. It is easier for investors to obtain it if the allowance and actual credit losses are recognized separately from the contract assets and revenue respectively on the BS and the PL. (CL #965)

12. Other users thought that collectibility should affect how much revenue an entity recognizes, but only if the entity also provides additional disclosures about expected credit losses (and changes in those expectations). For instance, another user group stated the following:

> We agree with the expected value approach that factors the uncertainty associated with collectability of consideration in the estimated transaction price estimate. We propose that the assessment of collectability should be made at contract inception rather than as the performance obligation is satisfied. It is critical that collectability be evaluated at inception otherwise revenue would be recognized without adequate information regarding collectability. However, we propose that the credit impairment should be presented separately and that subsequent measurement should also be adjusted through revenue rather than separately through income or expense. It is useful for investors to have information on the initial expectation of credit losses associated with customers as well as the change in expectations. Accordingly, separate disclosures of initial expectations of credit losses plus changes in expectations are necessary for users to have transparency into total credit losses as a percentage of revenue. As noted previously, a rollforward of credit losses would also be helpful. (CL #967)

13. Preparers of financial statements generally are concerned that the proposals would:

    (a) significantly change existing practices that are well established and understood; and

(b) be costly to implement because many entities have separate accounting and billings systems. For example, one preparer commented that:

> the incorporation of credit risk into the measurement or revenue and the related accounts receivable would increase the operational complexity for financial statement preparers due to the significant efforts that would be required to estimate credit risk on a customer-by-customer basis and to reconcile between (a) the accounts receivable subsidiary ledger, comprising amounts actually received to customers, and (b) the amount of accounts receivable presented in the financial statements, which consists of invoiced amounts adjusted for credit risk and the time value of money. (CL #514)

14. Respondents also expressed the following concerns with the proposals:

(a) Adjusting the transaction price for credit risk is unlikely to faithfully represent an entity's contracts with its customers because entities typically do not include explicit credit risk premiums in contract prices. Instead, entities typically use other strategies to protect themselves against credit risk (such as requiring the customer to pay in advance or to provide collateral).

(b) Many respondents remarked that the risk of a credit loss does not imply a failed sale—accordingly, a customer's credit risk should not affect revenue so long as the entity has fulfilled its performance obligations under the contract.

(c) Some respondents were concerned that the proposal could lead to management manipulation of the measurement of revenue. In addition, respondents also mentioned that the credit risk adjustment would be difficult to audit because of the lack of objective evidence.

(d) Most respondents commented that the customer's credit risk should affect the measurement of the entity's unconditional right to consideration (a financial asset that is within the scope of ASC Topic 310 Receivables and IFRS 9 *Financial Instruments*). In that context, some of those respondents questioned the link between the exposure drafts on revenue and on financial instruments. For example:

> We believe that credit risk should be presented consistently across different standards. Therefore, we do not find arguments for a different treatment of credit risk in the revenue recognition standard compelling. Particularly this is because the IASB proposes in the Exposure Draft Financial Instruments: Amortised Cost and Impairment that credit risk be presented separately from interest income. (CL #394)

Subsequent changes in credit risk

15. There was very limited support for the Boards' proposal that changes in the assessment of credit risk that occur after the entity has an unconditional right to the customer consideration (i.e. a receivable) should be recognized as other income or expense. Almost all respondents who commented on this proposal said that if the Boards decided to reaffirm their decision to include credit risk in the determination of transaction price, any subsequent reassessments of credit risk should also affect revenue line. Those respondents were concerned that if the customer ultimately pays in full, an entity could 'lose' revenue because the amount that had been expected to be uncollectible could be recognized only as other income.

16. Paragraph BC101 of the Exposure Draft explained that recognizing the change in the assessment of credit risk in other income or expense would be similar to the Boards' proposals for the accounting for non-cash consideration received in exchange for a good or service. However, some respondents commented that a stronger analogy could be found in accounting for subsequent changes to variable consideration, which would be recognized as revenue (e.g. CL #408).

Main issues to be considered

17. Based on that feedback, the staff thinks that the Boards should re-consider their proposals for accounting for a customer's credit risk.

18. The main issues identified by respondents with respect to the accounting for credit risk can be summarised as follows:

(a) Should the initial measurement of the transaction price—and therefore revenue—reflect the customer's credit risk?

(b) Should the revenue standard specify a separate recognition threshold for collectibility?

(c) Should the effects of subsequent changes in the assessment of credit risk be reported as a change to revenue rather than as other income or expense?

19. Rather than identifying and analysing possible alternative credit risk accounting models, this paper analyses each issue separately. The Boards' preferred model for accounting for a customer's credit risk should become apparent after compiling the Boards' decisions on each of those issues.

Should the initial measurement of the transaction price reflect credit risk?

20. The first issue for the Boards to consider is whether an entity should initially measure the transaction price—and therefore revenue—at a:

(a) net amount—the amount of consideration promised by the customer, reduced to reflect the customer's credit risk (i.e. the expected amount); or a

(b) gross amount—the amount of consideration promised by the customer (i.e. the invoiced amount).

Approach A—a net amount

21. Measuring the transaction price at the net amount described in paragraph 20(a) is consistent with the Boards' proposals in the Exposure Draft. Under that approach, the credit risk adjustment would be included by measuring the transaction price either at the amount of customer consideration that the entity is more likely than not to receive from the customer or at the expected value of that promised consideration (as per the staff recommendation in IASB agenda paper 10D / FASB memo 140D).

22. The main advantage of Approach A is that it would be consistent with the core principle of the revenue standard, which paragraph 2 of the Exposure Draft describes as being that an entity should "recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for those goods or services". For the same reason, measuring the transaction price net of credit risk would be consistent with the measurement of a different type of uncertainty—the measurement of variable consideration that has been promised by the customer.

23. One of the main disadvantages of Approach A is that offsetting the revenue and the related credit risk could diminish the visibility of an entity's performance in satisfying performance obligations and the entity's expectations and ability in collecting the promised consideration from the customer. Users commented that this visibility is important and therefore requested that separate presentation or disclosure should be provided to enable them to evaluate credit losses relative to revenue.

24. The other disadvantages of Approach A are summarized in paragraph 14 above.

Approach B—a gross amount

25. Measuring revenue at the gross amount would bring the accounting for credit risk closer to existing practices. That approach is supported by most respondents. In addition, for many contracts, measuring revenue at the gross amount of consideration promised by the customer might not result in a different outcome to that *intended* by the Boards when they developed the Exposure Draft. Paragraph BC100 explained that:

> … For many contracts, an entity would expect to collect the full amount of promised consideration because the effect of the customer's credit risk would be immaterial. For those contracts, recognising the full amount as revenue would be consistent with IAS 39 *Financial Instruments: Recognition and Measurement*, which acknowledges that short-term receivables with no stated interest rate may be measured at the invoiced amount if the effect of discounting is immaterial.

26. The main advantage of Approach B is that, by largely replicating existing practices, many of the practical concerns relating to preparation costs and systems changes raised in the comment letters would not eventuate. Consequently, the staff thinks that adopting Approach B could mitigate many respondents' concerns regarding the relative costs and benefits of applying the revenue standard.

27. The main disadvantage of Approach B is that an entity may recognize revenue at an amount that is in excess of the amount that the entity receives or expects to receive. Consequently, revenue would be overstated relative to the measurement of revenue under Approach A, whereby the revenue would be measured either at expected value or the amount that is more likely than not to be received.

Exception: a contract with a significant financing component

28. In IASB agenda paper 10B / FASB memo 140B, the staff is recommending that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component. An entity would discount the promised consideration using the rate that would be used in a separate financing transaction between the entity and its customer. That discount rate would reflect the credit characteristics of the parties to the contract, and consequently could result in the measurement of transaction price being reduced to reflect the customer's credit risk. The staff thinks that when a contract has a significant financing component, credit risk plays an integral part in determining the contract terms and therefore it should be reflected in the measurement of the transaction price.

Approach C—having cake and eating it too?

29. Approaches A and B both have their merits and shortcomings. However, the staff thinks that there might be another approach that could be consistent with the core principle of the revenue model while still responding to many of the

concerns raised by users and preparers. That approach (i.e. Approach C) would involve:

(a) measuring the transaction price at the gross amount of customer consideration (i.e. at the stated contract amount) so that the entity recognizes that amount as revenue when it satisfies its performance obligations;

(b) recognizing separately an allowance for an expected impairment loss concurrently with that recognition of revenue; and

(c) presenting those line items next to each other so that users of the entity's financial statements can simultaneously observe the entity's gross revenue and reduction of revenue from expected credit losses.

30. Approach C is directionally consistent with the tentative views of FASB Emerging Issues Task Force (EITF) in Proposed Accounting Standards Update *Health Care Entities (Topic 954)—Presentation and Disclosure of Net Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts*. The Proposed Update proposes that, as an interim step until the revenue standard is completed, "a health care entity shall present revenue (net of contractual allowances and discounts), the provision for bad debts, and the resulting net revenue less the provision for bad debts as separate line items on the face of the statement of operations". The comment deadline for the Proposed Update was 15 February 2011. The EITF has not yet considered the comments received. Appendix A provides further background on this issue.

31. The main disadvantages of Approach C are as follows:

(a) A linked presentation may not resolve some of the preparation and commercial concerns that respondents raised with the proposal in the Exposure Draft. A FASB constituent expressed the following concern with the EITF's proposal:

> …the decision to require a health care entity to present the provision for bad debts as a component of net revenues may require recasting of budgets and forecasts, making information technology system changes, revising revenue guidance to analysts/investors, reviewing

compensation metrics and debt covenants, revising pro forma financial statements related to mergers and acquisitions, and determining the effect to state income tax allocation formulas.[1]

(b) A linked presentation for revenue from contracts with customers would be inconsistent with the Boards' proposals on accounting for interest income and the impairment of loan contracts.

(c) In some jurisdictions, the linking of the presentation of gross revenue and the impairment allowance could conflict with local laws or regulations that may prescribe the location of the impairment allowance on the face of the income statement. For instance, in the US, the SEC's Article 5 of Regulation S-X requires entities to include on the face of the income statement separate line items for 'net sales and gross revenues' and for 'provision for doubtful accounts and notes'. The staff thinks the existence of regulations such as Regulation S-X should not prevent the Boards from requiring a linked presentation of revenue and the impairment allowance if the Boards agree that this presentation would best meet users' needs. However, some jurisdictions may need to consequentially amend their laws or regulations to ensure consistency with the requirements of the revenue standard.

Staff recommendation and question for the Boards

Question 1
The staff recommends Approach C. Accordingly, to account for the effects of a customer's credit risk an entity should: (a) measure the transaction price at the gross amount of customer consideration (i.e. at the stated contract price) so that the entity recognizes that amount as revenue when it satisfies its performance obligations;

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[1] See paragraph BC11a of the Proposed ASU *Health Care Entities (Topic 954)—Presentation and Disclosure of Net Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts*.

(b) recognize separately an allowance for an expected impairment loss concurrently with that recognition of revenue; and

(c) present those line items next to each other so that users of the entity's financial statements can simultaneously observe the entity's gross revenue and reduction of revenue from expected credit losses.

Do the Boards agree?

Should there be a separate recognition threshold for collectibility?

32. The second issue for the Boards to consider is whether to include collectibility of revenue as a recognition criterion in the revenue standard. Conceivably, the recognition threshold could be applied in conjunction with measuring revenue either net of credit risk or gross. However, a recognition threshold for collectibility would seem to be more relevant if revenue was measured gross (i.e. as per Approach B or Approach C).

33. Unlike current IFRSs and most U.S. GAAP, the Exposure Draft did not include the collectibility of revenue as a specific recognition criterion. Instead, the Exposure Draft addressed collectibility in:

    (a) the existence of a contract—by specifying that a contract only exists if, among other things, the contract has commercial substance and the parties to the contract have approved the contract and are committed to satisfying their respective obligations;[2] and

    (b) the measurement of the transaction price—by specifying that the measurement of the probability-weighted amount of consideration that the entity expects to receive would incorporate credit risk.

34. The proposed criteria for existence of a contract effectively create a collectibility threshold. In February 2011, the Boards affirmed the proposals in the Exposure Draft that addressed those criteria for the existence of a contract. The Boards

[2] See paragraphs 10(a) and (b) of the exposure draft

agreed to clarify that for a contract to exist, both parties to the contract must have the intention and the ability to fulfil their respective obligations. That criterion would apply generally (i.e. not just to collectibility) but it would require an entity to assess whether the customer has the intention and ability to pay the promised amount of consideration. The staff thinks that an entity's assessment of the criteria for the existence of a contract is similar, in effect, to the assessment in current practice to determine whether collectibility is reasonably assured. Hence, the staff does not think a separate recognition threshold is necessary.

Staff recommendation and question for the Boards

Question 2
The staff thinks that it is not necessary for the final revenue standard to specify a recognition threshold for collectibility in addition to the criteria for determining whether a contract exists for purposes of applying the revenue model. Do the Boards agree?

Should subsequent changes in credit risk be reported as a change to revenue or as other income or expense?

35. The third issue is whether the effects of subsequent changes in the assessment of credit risk should be reported as a change to revenue rather than as other income or expense. This section of the paper is relevant only if the Boards decide to require Approach A for the measurement of transaction price. If they make that decision, the Boards need to consider whether the accounting for subsequent changes in the estimate of credit risk should result in an adjustment to:

    (a) other income or expense (as per the proposals in the Exposure Draft); or

    (b) revenue.

36. Many respondents commented that revenue should equal the amount that ultimately is collected from the customer. Furthermore, several respondents explained that it is important for the accounting for the effects of credit risk, both at contract inception and subsequently, to be consistent. Otherwise, the model would be impracticable. For instance, one respondent commented:

> …we have concerns that it often will not be easy to distinguish between customer credit risk that existed at the time of the entity's performance under the contract and customer credit risk that arose subsequent to performance. However, since this distinction results in two distinctly different accounting treatments under the proposed model, it is very significant. The difficulty in making this distinction is also present for entities that currently make credit risk assumptions for a pool of customers. In such situations, it is unclear how the model should be applied, for example, as write-offs occur. Should the entity assume all non-collections are included in the original pooled estimate until the pooled amount is depleted? (CL #419)

37. The issue is not directly relevant if the Boards decided to require Approach B. In that case, revenue would be recognized gross and the impairment allowance (and any changes to the impairment allowance) would be recognized in other income or expense, consistently with the requirements in the financial instruments standards.

Staff recommendation and question for the Boards

Question 3
If the Boards decide to carry forward the Exposure Draft's proposed requirements on collectibility (i.e. Approach A as described in this paper), the staff recommends that an entity should recognize subsequent changes in credit risk as revenue. Do the Boards agree?

Private company considerations

38. The concerns raised by respondents from public companies on accounting for the credit risk were also shared by respondents from private companies. For instance, one private company respondents commented that:

> Requiring the entity to reduce the amount of promised consideration to reflect a customer's credit risk could be costly and unnecessarily complex for private companies and provide little benefit to their financial statement users. Currently, accounts receivable agings are reviewed periodically and an allowance is provided for doubtful accounts. The change in the allowance is recorded as a bad debt expense. (We) believe that showing the amount of bad debt expense provides better information about how a company manages its credit policies than reducing revenue by the probability-weighted amount of consideration the entity expects to receive. In effect, this results in netting some bad debt expense against revenue. Such a presentation could actually impair a financial statement user's ability to assess credit risk at a company. In addition, the proposed requirements would prove very costly to many private companies because they would need to employ the services of outside businesses to help calculate the probabilities of default. (CL 931)

39. The staff thinks that the staff recommendations in this paper will equally address the concerns that respondents from private and public companies had with the collectibility proposals in the Exposure Draft.

Appendix A Background on the EITF's Proposed Accounting Standards Update for Health Care Entities

A1. The EITF have a project on the recognition of revenue for health care entities because some constituents have raised concerns about the revenue recognition practices used by those entities. Currently, health care entities do not have to consider collectibility when recognizing revenue and constituents are concerned that such practices result in amounts being recognized as revenue that are not expected ultimately to be collected.

A2. The FASB published a proposed Update for public comment on this issue in December 2010. The comment deadline closed recently on 15 February 2011. The objective of that proposed Update is to provide greater transparency about a health care entity's net revenue and allowance for doubtful accounts. The proposed Update would require a health care entity to change the presentation of its statement of operations by reclassifying the provision for bad debts from an operating expense to a reduction from revenue. The proposed Update also would require enhanced disclosures regarding revenue, collectibility, and a reconciliation of the activity in the allowance for doubtful accounts.

A3. The proposed Update would improve current U.S. GAAP because the net revenue amount would be closer to the amount the health care entity expects to collect. The provision for bad debts would still be presented as a separate line item so users would not lose that valuable information. Finally, by reading the new disclosures, financial statement users would better understand how an entity considers collectibility in applying its revenue recognition policies.