IFRS | FASB

| IASB Agenda ref | 7E |
|---|---|
| FASB Agenda ref | 164E |

**Week of 19 November**

FASB Education Session 14 November 2012

# STAFF PAPER

FASB | IASB Meeting

| **Project** | **Revenue recognition** | | |
|---|---|---|---|
| Paper topic | Collectibility | | |



| CONTACT(S) | Heather L. Harris | hlharris@fasb.org | +1 203 956-3455 |
|---|---|---|---|
| | Glenn Brady | gbrady@ifrs.org | +44 (0) 20 7246 6460 |



This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

## Purpose of this paper

1. This paper considers whether the revenue standard should:

   (a) retain (subject to some refinements) the collectibility requirements that were proposed in the 2011 Exposure Draft *Revenue from Contracts with Customers* ('2011 ED');

   (b) revise the 2011 ED collectibility proposals by modifying the proposed presentation of the impairment loss line, either for contracts with customers without a significant financing component or for all contracts with customers; or

   (c) introduce a different approach to addressing collectibility concerns, including the introduction of a revenue recognition threshold for collectibility.

2. This paper includes feedback received from respondents and from the Boards at the September 2012 joint Board meeting.

3. In this paper and in the 2011 ED, collectibility refers to customer credit risk – that is, the risk that an entity will be unable to collect from the customer the

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

amount of consideration to which the entity is entitled to in accordance with the contract.

## Staff recommendation

4. The staff recommend the Boards:

    (a) retain the 2011 ED proposals for accounting for customer credit risk (which is described in this paper as Approach 1);

    (b) refine those proposals to clarify that the impairment loss line item adjacent to the revenue line item is a component of revenue; and

    (c) require impairment losses to be presented in the entity's primary financial statement (eg statement of comprehensive income) (unless immaterial).

## Structure of the paper

5. This paper is organized as follows:

    (a) September 2012 joint Board meeting (paragraphs 6 - 9)

    (b) Outreach performed subsequent to September 2012 (paragraph 10)

    (c) Setting the context for thinking about collectibility (paragraph 11)

    (d) Background on the 2011 ED approach for collectibility (paragraphs 12 - 13)

    (e) Developing a collectibility model (paragraphs 14 - 15)

    (f) A targeted approach for dealing with collectibility (paragraphs 16 - 20)

    (g) Alternative approaches to collectibility (paragraph 21)

    (h) Presentation alternatives (Approaches 1 – 3) (paragraph 22)

        (i) Approach 1 – Presentation – 2011 ED proposals (paragraphs 23 - 31)

        (ii) Approach 2 – Presentation – prominent expense (paragraphs 32 - 36)

(iii) Approach 3 – Presentation – all contracts with customers treated similarly (paragraphs 37 - 42)

(i) Threshold alternative (paragraphs 43 - 44)

(i) Approach 4 – Collectibility threshold (paragraphs 45 - 54)

(j) Does adjacent to revenue mean a component of revenue? (paragraph 55)

(k) Can an entity disclose rather than present the impairment loss line item if the balance is material? (paragraphs 56 - 58)

(l) Appendix A: Examples

(m) Appendix B: Implications of Approach 4 on the model

(n) Appendix C: Suggested changes

## September 2012 joint Board meeting

6. At the September 2012 meeting (Agenda papers 7B/162B and 7C/162C), the Boards discussed feedback on, and suggested clarifications to, the proposals for collectibility. In particular, that discussion focused on considering the requirements that should be included in the revenue standard for addressing collectibility concerns for contracts with customers generally or specifically for contracts that include nonrecourse, seller-based financing.

7. In that discussion, the Boards considered whether to:

   (a) affirm their proposed requirement in the 2011 ED that if a contract with a customer does not include a significant financing component, the consideration promised by the customer should not be adjusted for the customer's credit risk and that any impairment loss (either initial or subsequent) arising from that contract should be presented as a separate line item adjacent to the revenue line item; or

   (b) consider other approaches for accounting for a customer's credit risk, including:

(i) modify the 2011 ED proposals to require that all impairment losses arising from contracts with customers (regardless of whether the contract has a significant financing component) be presented adjacent to the revenue line item; or

(ii) introduce a revenue recognition threshold for collectibility.

8. The Boards did not reach a tentative decision on how collectibility should be addressed in the revenue standard. Instead, they requested the staff to perform further analysis on these approaches.

9. However, the Boards tentatively decided to:

   (a) provide additional guidance in the standard on determining whether a contract with a customer exists based on the customer's commitment to perform its obligations under the contract (paragraph 14 of the 2011 ED), to help alleviate concerns about the absence of a collectibility threshold in the model; and

   (b) present any impairments recognized in the current period or in a subsequent period in a consistent manner.

## Outreach performed subsequent to September 2012

10. The staff performed targeted outreach subsequent to the September 2012 meeting, including discussing potential alternatives presented in the supplement the staff had prepared to help the Boards evaluate collectibility alternatives (ie Approaches 1, 3, and 4 addressed in this paper). The feedback received from that outreach is presented in relevant parts of the paper.

## Setting the context for thinking about collectibility

11. Revenue is often regarded as being 'special' because revenue is typically a leading indicator of an entity's operating performance. Hence, the amount of revenue recognized by an entity in a reporting period can affect an entity's share price and possibly the management's remuneration. For this reason, many capital

market participants (including users, auditors, and regulators) place a lot of attention on assessing the quality of the revenue recognized. One aspect of this assessment of the quality of revenue relates to the estimate of any promised variable consideration and the risk of significant revenue reversals. This is addressed in the revenue model through the application of the constraint on revenue recognition (refer to Agenda paper 7B/164B). Another aspect of the assessment of the quality of revenue relates to the ultimate collectibility of the promised consideration in exchange for the goods or services that have transferred to the customer. The staff note that the degree of concern about the quality of revenue recognized and the collectibility of that revenue will differ between industries and between jurisdictions. However, because the Boards are developing a single revenue recognition standard to apply to all industries and in all jurisdictions that use IFRS or US GAAP, a universally applicable collectibility proposal must be decided upon.

### Background on the 2011 ED approach for collectibility

12. The core principle of the 2011 ED is that an entity should recognize revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The principle of recognizing revenue at the ‘entitled’ amount was a change from the 2010 ED, which had proposed that revenue be recognized at the amount that the entity expects to receive (ie adjusted for customer credit risk). That change to the principle was not strongly supported by most constituents, including many users. Paragraph BC167 of the 2011 ED explained that those users commented that they would prefer that revenue be measured at the ‘entitled’ amount so that revenue growth and receivables management (or bad debts) can be analyzed separately.

13. The staff understand that recognizing revenue at the entitled amount would often not adversely affect assessments of the quality of revenue. That is because, generally speaking, most entities would not sell goods or services on credit if they

have doubts about a customer's credit risk. However, there will be some contracts with customers in which the collectibility risk is greater and therefore the proposal in the 2011 ED to recognize revenue at the entitled amount (eg the contract price) may appear to be too lax and could adversely affect assessments of the quality of revenue. In accounting for those contracts, the following table identifies several other aspects of the 2011 ED that might apply in addition to the collectibility requirements.

| 2011 ED proposals | Remarks |
|---|---|
| ***Existence of a contract*** A contract must be enforceable and must meet the criteria proposed in paragraph 14 of the 2011 ED. Those criteria require, among other things, that the contract have commercial substance and that the customer be committed to perform its obligations in the contract. Paragraph BC34(b) clarified that if there is significant doubt at contract inception about the collectibility of consideration from the customer, that doubt may indicate that the parties are not committed to perform their obligations under the contract. In September 2012, the Boards decided that additional guidance should be included in the standard to assist with this assessment. | An entity would not recognize revenue if the entity does not have an enforceable right to consideration from the customer (consistent with the guidance in paragraph 13 of the 2011 ED). A contract that fails any of the criteria in paragraph 14 of the 2011 ED could be a sham transaction and therefore revenue would not be recognized. |
| ***Control*** Revenue is recognized when (or as) the customer obtains control of a promised good or service. | An entity would not recognize any revenue if the entity has not satisfied its performance obligation because the customer has not obtained control of the promised good or service. The staff note that, in practice, some collectibility concerns are actually disputes about whether the entity has satisfied their performance obligation rather than concerns about customer credit risk. |
| ***Determining the transaction price and*** | An entity would not necessarily recognize revenue at the contract price |

| | |
|---|---|
| ***discounts***<br>An entity should consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price would be reduced by any discounts promised to the customer. | if the entity offers discounts to customers or routinely waives its rights to some or all of the promised consideration. |
| ***Determining the transaction price and time value of money***<br>The promised amount of consideration must be adjusted to reflect the time value of money if a contract with a customer has a significant financing component. | The objective of the time value of money proposals is for an entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash at the point that promised goods or services are transferred to the customer. Effectively, this is the amount to which the entity is entitled. In paragraph BC151, the Boards explain that the discount rate would reflect the characteristics of the party receiving financing as well as the customer's creditworthiness. |
| ***Constraint on revenue recognized***<br>The amount of cumulative revenue recognized may be limited if the entity is entitled to variable consideration. The limitation on recognition relates to the degree of uncertainty in the *amount* of consideration to which the entity is entitled to (ie not to *whether* the entity is entitled to the amount). | An entity would not recognize revenue to the extent the entity does not have experience with (or other evidence of) similar types of performance obligations and that experience (or other evidence) is not predictive of the amount of consideration to which the entity will be entitled. (As proposed in the 2011 ED; see also Agenda paper 7B/164B.)<br>The staff note that, in practice, some collectibility concerns are actually disputes about whether the entity *will* perform (ie satisfy a performance obligation) in the future in order to be entitled to collect consideration for the good or service that has already transferred to the customer. |

## Developing a collectibility model

14. Nevertheless, there will be a subset of contracts with customers that contain a significant credit risk in which those aspects of the revenue model (which are highlighted in the table above) would not preclude revenue recognition. As such, the staff evaluated whether a viable approach to collectibility would be to (a) identify those contracts of concern (ie contracts with a significant credit risk), and (b) develop a treatment targeted to apply only to those contracts.

15. The alternative would be to develop a single approach that would apply equally to all contracts with customers, regardless of whether doubt exists about the customer's credit risk.

## A targeted approach for dealing with collectibility

16. Assuming rational economic behavior, an entity would presumably enter into contracts where there is a high risk of non-collection only if the contracts are:

    (a) contracts in which the entity purposely sells to low credit quality customers and specifically adjusts the pricing to compensate for accepting that credit risk; or

    (b) contracts for the sale of goods or services in which the entity is generally not going to be worse off if the customer fails to pay. Consider, for example:

        (i) Timeshares—With timeshares, the entity grants access to the customer to use a property. If the customer does not pay, the entity suffers no economic loss because the entity can deny the customer access to the property and the property is available for other customers.

        (ii) Software—The incremental cost of providing software to a customer is nil or negligible if the costs to develop and commercialize the software have already been incurred. If the customer does not pay, the entity would suffer only an

immaterial economic loss and the opportunity cost of being unlikely to sell that software to that customer (because they now already have the software).

(iii) Real estate and some other tangible assets—The cost of the real estate may be significant but the day-to-day volatility of the value of real estate is generally low and real estate often holds or increases in value over time rather than depreciates. Consequently, if the customer does not pay and the entity expects to be able to repossess the asset in substantially the same condition, the entity would be unlikely to suffer a significant economic loss. As the risk of an economic loss becomes greater, the more likely it is that the entity will adjust the price to compensate for the customer credit risk.

17. Identifying whether a contract with a customer is subject to a significant credit risk would require judgement based on the facts and circumstances relevant to that transaction. Accordingly, instead of developing criteria to assess whether a contract is subject to significant credit risk, the revenue standard could list a series of facts and circumstances that might be present if an entity offers to sell goods or services on credit terms to customers with poor credit quality.

18. However, identifying those facts and circumstances proved to be difficult. Some facts and circumstances contemplated included the following:

(a) the amount of promised consideration differs substantially from the cash selling price of the promised good or service;

(b) the entity controls the customer's access to the good or service (eg timeshares);

(c) the incremental cost to the entity to transfer the good or service to the customer is negligible; and

(d) the good that transfers to the customer is not expected to substantially depreciate (or diminish in value) before the entity obtains control of the good from the customer.

19. Ultimately, the staff determined that identifying universally applicable attributes of the contracts of concern would be challenging to clearly define. Additionally, the staff note that pursing this path of identifying contracts with significant credit risk would place significant pressure on identifying whether a contract is subject to significant credit risk.

20. Therefore, the staff do not recommend pursing this method. Instead, the staff recommend pursuing a methodology that would apply to all contracts. The alternatives for collectibility, then, are consistent with those presented in September 2012 and fall into two categories, presentation alternatives or the introduction of a collectibility threshold alternative, which is generally consistent with current GAAP. These alternatives are discussed in the sections below.

## Alternative approaches to collectibility

21. Instead of pursuing a targeted approach to addressing collectibility concerns, as discussed above, the following four alternatives are presented for the Boards' consideration:

| Approach | Description | Threshold included? (YES/NO) | Contracts with customers WITHOUT a significant financing component | Contracts with customers WITH a significant financing component | Loans * | Presentation |
| --- | --- | --- | --- | --- | --- | --- |
| **1** | Presentation - 2011 ED proposals (modified by staff) | NO | Adjacent to revenue (component of) | Expense | Expense | Presented |
| **2** | Presentation - prominent expense | NO | **Expense** | Expense | Expense | Presented |
| **3** | Presentation - treat all contracts with customers the same | NO | Adjacent to revenue (component of) | **Adjacent to revenue (component of)** | Expense | Presented |
| **4** | Collectibility threshold | **YES** | **Expense** | Expense | Expense | Presented or Disclosed |

* Not within the scope of the revenue project, but provided here for comparison purposes only.

Note: The shaded cells highlight areas of difference with Approach 1.

### Presentation alternatives (Approaches 1 – 3)

22. Approaches 1-3 treat revenue recognition consistently (ie at the entitled amount) but they each address presentation of any corresponding impairment loss differently. Because these three approaches share some common advantages and disadvantages, the following analysis initially outlines the advantages and disadvantages of Approach 1 and then the analysis of Approaches 2 and 3 builds on the previous approaches and only offers incremental or differential advantages/disadvantages.

### *Approach 1 – Presentation – 2011 ED proposals*

23. Approach 1 represents the collectibility proposals in the 2011 ED. The 2011 ED proposals differentiate between contracts with customers without a significant

financing component and contracts with customers with a significant financing component.

*Contracts with customers without a significant financing component*

24. The collectibility proposals in the 2011 ED for contracts that do not have a significant financing component were envisaged as a 'package deal', whereby:

    (a) the transaction price should be measured, and therefore revenue should be recognized, at the amount to which the entity is entitled (ie the gross transaction price or invoice amount); and

    (b) any initial and subsequent credit risk impairment (which would be recognized and measured in accordance with the financial instruments guidance) should be presented in a line item adjacent to the revenue line item.

25. This 'package deal' approach acknowledges that a user's assessment of an entity's financial performance and quality of revenue is predicated on assessing the entity's sales performance (ie transferring goods or services to customers), the entity's performance in managing its trade receivables and, thus, the quality of the customers in which the entity is willing to provide goods or services on credit. In developing the 2011 ED, the Boards decided that this transparency should be provided by requiring any impairment losses to be presented adjacent to the revenue line item.

*Contracts with customers with a significant financing component*

26. For contracts with a significant financing component, the 2011 ED proposed that:

    (a) the transaction price should be measured and, therefore, revenue should be recognized, at the amount of promised consideration adjusted at a customer specific discount rate;

    (b) initial credit risk impairment should be reflected in the rate used to discount the promised amount of consideration; and

(c) subsequent credit risk impairment should be presented together with impairment on all other financial instruments (in expense).

27. The rationale for this proposal was outlined in paragraph BC175 of the 2011 ED, which states:

> A contract that has a financing component that is significant to the contract includes, in concept, two transactions—one for the sale and another for the financing. The presentation of any impairment losses from long-term trade receivables (ie receivables arising from the financing components of contracts with customers) would be consistent with the presentation of impairment losses for other types of financial assets within the scope of the financial instruments standards. Although this means that impairment losses would be presented differently for long-term trade receivables than for short-term trade receivables (ie receivables arising from contracts with customers that do not have separately identified financing components), that outcome follows naturally from the boards' decision to propose that an entity account for the effects of the time value of money if the financing component is significant to the contract.

*Advantages and disadvantages of Approach 1*

28. In addition to the rationale outlined above for the collectibility proposals in the 2011 ED, Approach 1 has the advantage of being consistent with the core principle. That is because revenue is recognized when goods or services transfer to the customer. At that point in time, the parties to the contract have exchanged economic resources—for example, the entity may have exchanged an item of inventory for a right to consideration. Determining whether the entity expects to collect the promised consideration is a separate assessment. Additionally, Approach 1 could address feedback received about what is revenue, if the Boards agree with the staff recommendation in Question 2 below. As noted below, the

staff recommend that Approach 1 also clarify that adjacent to revenue means a component of revenue (see discussion below).

29. The following concerns were identified with recognizing revenue at the entitled amount instead of either applying a collectibility recognition threshold or adjusting the transaction price for the initial assessment of customer credit risk:

    (a) the approach potentially allows greater revenue and impairment losses to be recognized earlier than under today's GAAP because of the absence of a recognition threshold; and

    (b) the approach does not addresses the concern expressed by a few respondents of, in their words, "inappropriate acceleration" of revenue (ie there is potential to recognize revenue on contracts that have a high risk of non-collection).

30. The staff acknowledge that these concerns were not generally held by all respondents. However, these concerns were raised by some users, including the FASB's Investors Technical Advisory Committee (CL#28), and regulators. Many other respondents and some other users were supportive of the recognition of revenue not being subject to a collectibility threshold. Recent outreach with the IASB's Capital Markets Advisory Committee and with national standard setters also supported the recognition of revenue not being subject to a collectibility threshold.

31. The following concerns were identified with the proposal to present the impairment loss line item adjacent to the revenue line item:

    (a) if the impairment loss line item is classified as either adjacent to or a component of revenue, it would be included in gross margin calculations, which would be a change from current practice;

    (b) the adjacent presentation of the impairment loss line item implies a correlation that does not necessarily exist between the recognition of current period revenue and any impairment losses recognized in that period. That is because those impairment losses might relate to amounts of uncollectible consideration that was recognized as revenue in previous

reporting periods. However, paragraph BC172 of the 2011 ED explained that the adjacent presentation should be useful because "Although there is not necessarily a connection between the revenue recognized in a particular reporting period and the impairment losses recognized in that period, presenting the impairment loss adjacent to revenue facilitates users' understanding of the amounts that an entity ultimately expects to receive from the customer". Additionally, the staff note that other changes and adjustments to revenue estimates (for example, contingent consideration or product returns) may impact a period subsequent to initial recognition;

(c) some respondents, in particular many standard setters, were concerned that the presentation proposal was too prescriptive for a line item that would often be immaterial and also because it commingles revenue and expense items; and

(d) the 2011 ED proposals may provide structuring opportunities to arbitrage between contracts with or without a significant financing component and the resulting differences in presentation of impairments under this approach. However, the staff note that if a transaction is deemed to have a significant financing component, then there are other differences, namely balance sheet classification other than a trade receivable and interest expense recognized.

### *Approach 2 – Presentation – prominent expense*

32. Approach 2 is consistent with Approach 1, except that impairment losses on contracts with customers that do not contain a significant financing component would be presented <u>prominently</u> as a separate line item in expenses in the statement of comprehensive income (as opposed to in a line item adjacent to (or as a component of) the revenue line item). Approach 2 would not change the presentation of impairment losses on contracts with customers that *do* contain a significant financing component—those impairments would also be presented in

expenses in the statement of comprehensive income consistent with current practice.

33. Like Approach 1 (ie the 2011 ED proposal), Approach 2 would enable users to separately assess an entity's sales performance and credit management activities for contracts without a significant financing component. However, Approach 2 addresses the concerns about the presentation of the impairment loss line item that were identified in paragraph 31 above.

34. Feedback received recently from outreach with users on the IASB's Capital Markets Advisory Committee indicated a general preference for this approach. Their view was that revenue should be recognized at the entitled amount and that any associated credit risk should be presented prominently, but preferably not adjacent to revenue because of the implications for gross margin. National standard setters consulted recently were also supportive of this approach.

35. Advantages of Approach 2 include the following:

    (a) unlike Approach 1, there would be no uncertainty about what is revenue or the determination of gross margin because the impairment loss line item would be presented as an expense;

    (b) unlike Approach 1, there would not be any implication of a correlation between the recognition of current period revenue and the recognition of any related subsequent impairment loss; and

    (c) there would be less incentive for entities to structure transactions around the twelve-month time value of money practical expedient because all impairment losses arising from contracts with customers would be presented below the line.

36. The main disadvantage of Approach 2 is that it would reduce the connection of impairment losses to revenue. While impairment losses on contracts with customers may be prominently presented in their own line item under this approach, that line item would not be adjacent to the revenue line item. This treatment is counter to the 'package-deal' of proposals in the 2011 ED.

### *Approach 3 – Presentation – all contracts with customers treated similarly*

37. Approach 3 is consistent with Approach 1, except that impairment losses arising from <u>all</u> contracts with customers (ie contracts *with* or *without* a significant financing component) would be presented adjacent to the revenue line item. Similar with Approach 1, the staff recommend below in Question 2 that the Boards clarify that adjacent to revenue means a component of revenue (see discussion below).

38. The rationale underpinning Approach 3 is to address the concern raised with respect to Approach 1 that an entity might extend the payment terms for some contracts so that they would be deemed to have a significant financing component and any impairment loss would no longer be presented adjacent to the revenue recognized (which would be recognized at the amount of promised consideration discounted at the customer-specific discount rate). Requiring impairment losses from all contracts with customers to be presented adjacent to revenue would resolve this concern.

39. One of the disadvantages with Approach 3 is that this approach fails to present financing contracts (loans and contracts with customers that contain a significant financing component) consistently.

40. Other disadvantages with Approach 3 were identified in the targeted outreach conducted after the September 2012 joint Board meeting.

41. The staff consulted four preparers which have a captive finance subsidiary or typically engage in financing activities. Two of those entities primarily, or only, provide financing for their own customers (and even then only rarely) and the other two entities provide financing for customers to purchase their goods or services and others' customers. The former two companies preferred having a collectibility threshold to the 2011 ED proposals because of either (a) the potential under the 2011 ED proposals for a mismatch in presentation of subsequent impairments with current period revenue, or (b) the inability to differentiate

presentation based on who is being financed (a customer or a non-customer, or a customer that has been extended financing or one that has not).

42. The preparer with a greater mix of businesses (ie manufacturing and financing) suggested that the 2011 ED proposals may be preferable for their finance businesses as it would be difficult to differentiate between financings of customers and non-customers. This preparer would not prefer an approach like Approach 3 whereby financing transactions that differ only by form of contract (ie loans and customer receivables) would be treated differently when those are internally managed similarly. Additionally, this preparer expected that users would prefer all financing transactions reported consistently. This preparer acknowledged the merits of Approach 3 when considering only its manufacturing businesses (ie with no financing operations), however noted current systems limitations. On balance, they supported the 2011 ED proposals.

## Threshold alternative

43. As an alternative to addressing customer credit risk primarily through the presentation of any corresponding impairment loss, the Boards could decide that customer credit risk should affect:

    (a) whether revenue is recognized—by introducing a revenue recognition threshold for collectibility; or

    (b) the measurement of revenue—by incorporating credit risk into the measurement of revenue.

44. This paper only considers whether the Boards should introduce a revenue recognition threshold for collectibility. That is because the 2010 ED proposed incorporating credit risk into the measurement of revenue but the Boards rejected that approach in developing the 2011 ED because most respondents disagreed with that particular proposal.

### *Approach 4 – Collectibility threshold*

45. Approach 4 would introduce a collectibility recognition threshold into the revenue standard. The collectibility threshold would preclude an entity from recognizing

revenue until it can demonstrate that the likelihood of collectibility from the customer meets a specified confidence level (eg reasonably assured or probable). Determining when that threshold has been met is a matter of judgment. Once that threshold has been met and revenue is recognized, any subsequent impairment of the trade receivable would be recognized in expense (irrespective of whether the contract contains a significant financing component).

46. Proponents of Approach 4 state that a collectibility threshold:

    (a) appropriately precludes revenue from being recognized when there is significant uncertainty about the customer's ability to pay and, therefore, avoids 'grossing up' the statement of comprehensive income for the revenue recognized and the corresponding impairment loss (which might be recognized at or near the same time as when the revenue would be recognized); and

    (b) is understood by entities (and users and regulators) and can be applied in practice without changing systems or processes.

47. The disadvantages of introducing a collectibility threshold include the following:

    (a) it would reduce transparency for users into an entity's sales and receivables management activities, and it would remove alignment of revenue recognition with an entity's performance;

    (b) it would not re-establish the stringent, rules-based collectibility requirements in some of today's GAAP (ie Section 360-20-40, Property, Plant, and Equipment - Real Estate Sales – Derecognition) and, as such, it may not address or alleviate all of the concerns raised by those respondents who were concerned about 'inappropriate acceleration' of revenue if the revenue standard does not include a collectibility threshold; and

    (c) it would require the Boards to define a common threshold and clearly articulate their intent in light of different revenue recognition thresholds in existing IFRSs and US GAAP.

*Implications on the model*

48. Introducing a collectibility threshold would be a change in direction from the proposals in the Discussion Paper, the 2010 ED, and the 2011 ED—all of which received general support for the removal of a collectibility threshold for revenue recognition. Furthermore, the 2011 ED proposal to recognize revenue at the amount to which the entity is entitled (ie unadjusted for customer credit risk) has received general support.

49. Introducing a collectibility threshold would also mean that, for some transactions, revenue would become a lagging indicator and revenue would only be recognized when (or as) cash is received. This creates a disconnect between an entity's performance and revenue because the revenue recognized would commingle performance in transferring goods or services and performance in collecting receivables. The staff note that revenue would also be a lagging indicator of an entity's performance if the cumulative amount of revenue recognized is constrained because the entity does not have predictive experience to support its estimate of variable consideration. However, the staff think that there are different measurement objectives associated with uncertainties about an entity's entitlement to an amount of variable consideration and uncertainties about the collectibility of an unconditional right to consideration. The core principle of the revenue model indicates that the measurement of the revenue should be based on entitlement and the constraint applies if there is too much uncertainty about the amount of consideration to which the entity is entitled. In contrast, receivables are typically measured at fair value or at an incurred loss amount, which in either case is a measurement that is intended to approximate the realization amount for those assets.

50. Introducing a collectibility threshold would affect a number of areas of the model and would accordingly require a re-evaluation of the objective and steps of the Boards' proposals. To begin, introducing a collectibility threshold represents a significant change to the core principle of the model, which is that revenue is recognized when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. This principle essentially

revolves around the transfer of control of a promised asset and does not align recognition directly with an assessment of collectibility. A collectibility threshold changes this core principle because two criteria instead of one would need to be met for revenue to be recognized (and, furthermore, the constraint might also apply). Entities would need to satisfy a separate performance obligation by (a) transferring goods or services to the customer (as per the 2011 ED), *and* (b) determining that the entity is reasonably confident of collecting the transaction price allocated to that satisfied performance obligation. In this manner, instead of recognition revolving around the *entity's actions*, recognition would also pertain to a *customer's ability to pay*. As a result, the timing of revenue recognition may be delayed and not correspond with the entity's performance. Furthermore, the true extent of an entity's revenue and the impairment losses associated with its trade receivables could be understated if the threshold applies and the entity effectively recognizes revenue from those transactions only as and when cash is received from the customer.

51. The staff note that some incremental interim and annual disclosures for contracts with customers might be required because the threshold obscures visibility about (a) when revenue recognition has been deferred due to the threshold but which pertains to a performance obligation met in the current period, (b) when subsequent impairments have been incurred, and (c) when out of period revenue has been recognized in the current period. The staff plan to address any incremental disclosures in a future meeting when the broader topic of disclosure is discussed.

52. Other implications of the introduction of a collectibility threshold on the design of the model are summarized in **Appendix B**.

### Staff recommendation

53. The staff think that the ideal approach to accounting for customer credit risk for contracts with customers without a significant financing component would be for:

    (a) revenue to be recognized at the entitled amount (ie the invoiced amount);

(b) any initial impairment loss to be presented adjacent to the revenue line item; and

(c) all subsequent impairment losses on these contracts to be presented in other expenses.

54. However, preparers have explained that this treatment would not be operational. Accordingly, the staff think that the next best alternative is Approach 1. The staff think that this approach best reflects the core principle of the model, provides the most information to users on a timely basis (ie when (or as) the entity satisfies performance obligations), and best accounts for a contract based on its substance (ie as (a) a sale or (b) as a sale and a loan). The *entity's* activities are most accurately portrayed under this approach. However, the staff acknowledge that there is no perfect approach to collectibility.

| **Question 1 for the Boards** |
| --- |
| The staff recommend that the Boards retain the 2011 ED proposals for customer credit risk (Approach 1), do the Boards agree?<br><br>If not, what Approach do the Boards prefer? |

## Does adjacent to revenue mean a component of revenue?

55. If the Boards select Approach 1 or Approach 3 in Question 1, the staff recommend the Boards clarify the intent behind 'adjacent to revenue'. As discussed in the September 2012 Agenda paper 7B/162B, respondents disagreed with the 2011 ED proposals because they thought the requirement to present customer credit risk 'adjacent to revenue' was too vague (refer to paragraphs 23 – 24 and 56 – 58 of that paper). The staff recommended in that Agenda paper that the Boards clarify the classification of the impairment loss line item as a component of revenue (as opposed to expense). The staff continue to think that this classification is appropriate because impairment loss affects the amount of consideration which the entity will ultimately receive and, thus, more clearly confirms that collectibility affects the measurement of revenue. However, the

staff note that some constituents, including national standard setters, disagree with that view (in addition to disagreeing about the presentation proposals).

| Question 2 for the Boards |
| --- |
| If the Boards tentatively decide on either Approach 1 or 3 in Question 1, the staff recommend clarifying that 'adjacent to revenue' means a component of revenue, do the Boards agree?<br><br>If not, what do the Boards prefer? |

### Can an entity disclose rather than present the impairment loss line item if the balance is material?

**56.** In performing outreach, several respondents questioned whether the impairment loss line item under Approaches 1 and 3 would be required to be presented on the face of the financial statements. Some users indicated that presentation of the impairment loss line item would not be necessary as long as the information is disclosed. Their main concern is access to the information.

57. Proponents of providing optional disclosure for the adjacent impairment loss line item if it is material argue that this alternative allows entities to reduce clutter on the face of their financial statements while still relaying necessary information to users. Opponents argue that that disclosure reduces the prominence of the connection between collectibility and revenue, thereby contradicting the intent underpinning the 2011 ED proposals on collectibility.

58. The staff recommend that, when material, impairment losses be presented in the entity's primary financial statement (eg statement of comprehensive income) as this prominent display is a critical element of the staff's recommendation for Approach 1 in Question 1.

| Question 3 for the Boards |
| --- |
| The staff recommend that, when material, impairment losses be presented in the entity's primary financial statement (eg statement of comprehensive income), do the Boards agree?<br><br>If not, do the Boards agree that impairment losses may be presented or disclosed in the footnotes to the financial statements? |

## Appendix A: Examples

***Assumptions (based on the example in paragraph BC174 of the 2011 ED)***

a) Each company has a calendar year-end.

b) On November 1, each company sells two machines with delivery the same day (total of 1,502):
   a. To Customer A with a transaction price of 751 on normal trade terms of 120 days.
   b. To Customer B with a transaction price of 1,000 due in three years.

c) The present value of Customer B's future payment is 751 using a discount rate of 10%.

d) Collection is reasonably assured (US GAAP) / probable (IFRS) for both customers as of the date of sale.

e) The cost of each machine is 400 (total of 800).

f) During the quarter, each company determines that the receivable from Customer A is impaired by 500 and the receivable from Customer B is impaired by 200.

g) Interest income of 13 is recognized for the quarter based on annual interest of 75 x 2/12 of the year.

h) Tax rate is 33%.

For illustration purposes only, the adjacent impairment loss line item in Approaches 1 and 3 is classified as a component of revenue. However, this classification is subject to decision by the Boards.

## Hybrid Company
## (manufacturer with captive finance)

*Quarter ended December 31*

| | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| | 2011 ED / Staff recommendation (Paper B) | Prominent presentation of impairment losses | All impairment losses adjacent to revenue | Current GAAP[1, 2] (all impairment losses recognized as expense) |
| **Revenues** | | | | |
| Contracts with customers: | | | | |
| Sales of products | 1,502 | 1,502 | 1,502 | 1,502 |
| Sales of services | | | | |
| Less: Customer credit risk | (500) | | (700) | |
| Revenue from contracts with customers | 1,002 | | 802 | |
| Revenues from finance operations | 13 | 13 | 13 | 13 |
| ***Total revenues*** | **1,015** | **1,515** | **815** | **1,515** |
| **Costs and expenses** | | | | |
| Cost of products | 800 | 800 | 800 | 800 |
| Cost of services | | | | |
| Selling, general and administrative | | | | |
| Interest expense from finance operations | | | | |
| Provision for losses on contracts with customers | | 700 | | 500 |
| Provision for losses on financing receivables | 200 | | | 200 |
| Other costs and expenses | | | | |
| ***Total costs and expenses*** | **1,000** | **1,500** | **800** | **1,500** |
| **Earnings from operations** | **15** | **15** | **15** | **15** |
| Other and non-operating income | | | | |
| **Earnings before income taxes** | **15** | **15** | **15** | **15** |
| Income tax expense (benefit) | 5 | 5 | 5 | 5 |
| **Net earnings** | **10** | **10** | **10** | **10** |

## Manufacturer

*Quarter ended December 31*

| | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| | 2011 ED / Staff recommendation (Paper B) | Prominent presentation of impairment losses | All impairment losses adjacent to revenue | Current GAAP[1] (all impairment losses recognized as expense) |
| Contracts with customers: | | | | |
| Net sales | 1,502 | 1,502 | 1,502 | 1,502 |
| Less: Customer credit risk | (500) | | (700) | |
| Net revenue from contracts with customers | 1,002 | | 802 | |
| Cost of sales | 800 | 800 | 800 | 800 |
| ***Gross margin*** | ***202*** | ***702*** | ***2*** | ***702*** |
| Operating expenses: | | | | |
| Research and development | | | | |
| Selling, general and administrative | 200 | | | 200 |
| Provision for losses on contracts with customers | | 700 | | 500 |
| ***Total operating expenses*** | 200 | 700 | - | 700 |
| **Operating income** | **2** | **2** | **2** | **2** |
| Interest income, net | 13 | 13 | 13 | 13 |
| Other income and expense | | | | |
| **Income before income taxes** | **15** | **15** | **15** | **15** |
| Income tax expense (benefit) | 5 | 5 | 5 | 5 |
| **Net income** | **10** | **10** | **10** | **10** |

1 = This view is consistent with Current GAAP if either (a) there were no recognition threshold or (b) the recognition threshold is assumed met as of date of sale.
2 = If the impairment loss on contracts with constumers that do not contain a significant financing component are immaterial, then they may be presented in Selling, general and administrative.

## Appendix B: Implications of Approach 4 on the model

B1. Implications on the design of the revenue model include the following:

| Topic<br>(paragraph in 2011 ED) | Implication |
|---|---|
| ***Core principle (par. 3)*** | Discussed in paragraph 50. |
| ***Portfolio techniques (par. 6)*** | The ability for entities to apply the revenue model on a portfolio basis (if contracts or performance obligations have similar characteristics) as a practical expedient would need to be re-considered for when the collectibility threshold is *not* met for an individual contract. |
| ***Definition of a contract with a customer (par. 14)*** | The criteria for the existence of a contract may not be necessary because the requirements for a contract to have commercial substance (par. 14(a)) and for the parties to have approved the contract and be committed to perform their respective obligations (par. 14(b)) would be addressed by the more encompassing requirement that the collectibility threshold be met. |
| ***Contract modifications (par. 19)*** | The guidance on unpriced change orders may not be necessary for the same reason mentioned above for paragraph 14 of the 2011 ED. |
| ***Contract modifications (par. 22(a))*** | An amendment would need to be made similar to that discussed in the September 2012 Board papers for revenue that was previously constrained. |
| ***Satisfaction of performance obligations (par. 31)*** | This guidance would need to change similar to the aforementioned change in core principle. |
| ***Performance obligations satisfied over time (par. 37(a))*** | This indicator might be redundant if that right to payment is effectively overridden because the collectibility threshold has not been met. |
| ***Measurement of revenue (par. 49-57)*** | Clarification would need to be provided in this section in terms of how revenue is measured. For example, if there is a 75% chance of collecting an invoiced amount of CU100 for services performed – would the entity recognize and measure revenue at CU100 or CU75? |
| ***Collectibility (par. 68-69)*** | To be revised to reflect the re-establishment of a collectibility threshold. |
| ***Constraining the cumulative amount of revenue recognized (par. 81-84)*** | May need to be revised based on the assumption that there would be a single constraint/threshold to deal with uncertainty of entitlement and |

| | |
|---|---|
| | uncertainty of collection. |
| ***Presentation (par. 106)*** | To revise the definition of *contract assets* to also refer to the likelihood of collection. |
| ***Disclosures*** | To consider specific quantitative or qualitative disclosures about (a) revenue that has not been recognized because of the threshold, or (b) revenue that has been recognized based on prior period performance. Disclosure of the latter revenue type could be incorporated into the reconciliation disclosure discussed in par. 117(a)(ii) of the 2011 ED. However, differentiation may need to be made between (a) changes from previously constrained revenue or changes in transaction price and (b) revenue recognized that was previously deemed to fail the recognition threshold. |
| ***Consequential amendments: Financial instruments guidance*** | To determine the impact, if any, on financial instrument guidance if revenue is not recognized as a result of the collectibility threshold not being met. Specifically, to determine whether an entity should also *not* recognize the corresponding financial asset. |
| ***Consequential amendments: Inventory*** | To determine the impact, if any, on guidance for transfers of inventory if revenue is not recognized as a result of the collectibility threshold not being met. Specifically, to determine whether an entity also should *not* de-recognize the related inventory. |

## Appendix C: Suggested changes

C1. The following table lists the proposed requirements from the exposure draft that relate to the guidance on collectibility and identifies which of those proposals might change as a result of the staff recommendations in this paper.

| Proposals from 2011 Exposure Draft | Suggested changes |
|---|---|
| 68. Collectibility refers to a customer's credit risk – that is, the risk that an entity will be unable to collect from the customer the amount of consideration to which the entity is entitled in accordance with the contract. For an unconditional right to consideration (that is, a receivable), an entity shall account for the receivable in accordance with Topic 310 except as specified in paragraph 69. An entity similarly shall account for the effects of a customer's credit risk on a contract asset (see paragraph 106). | • The staff recommend a change in paragraph 55 of this paper. Specifically, the staff recommend clarifying that the classification of the impairment loss line is a component of revenue. |
| 69. Upon initial recognition of the receivable, any difference between the measurement of the receivable in accordance with Topic 310 and the corresponding amount of revenue recognized shall be presented in profit or loss as a separate line item adjacent to the revenue line item. If the contract does not have a significant financing component in accordance with paragraph 58, an entity shall present any impairment of the receivable (or change in the measurement of an impairment) in profit or loss as a separate line item adjacent to the revenue line item. | • The staff recommend that the guidance in paragraphs BC174 and BC175 be brought forward into the standard to clarify the presentation of credit risk in a contract with a significant financing component. |