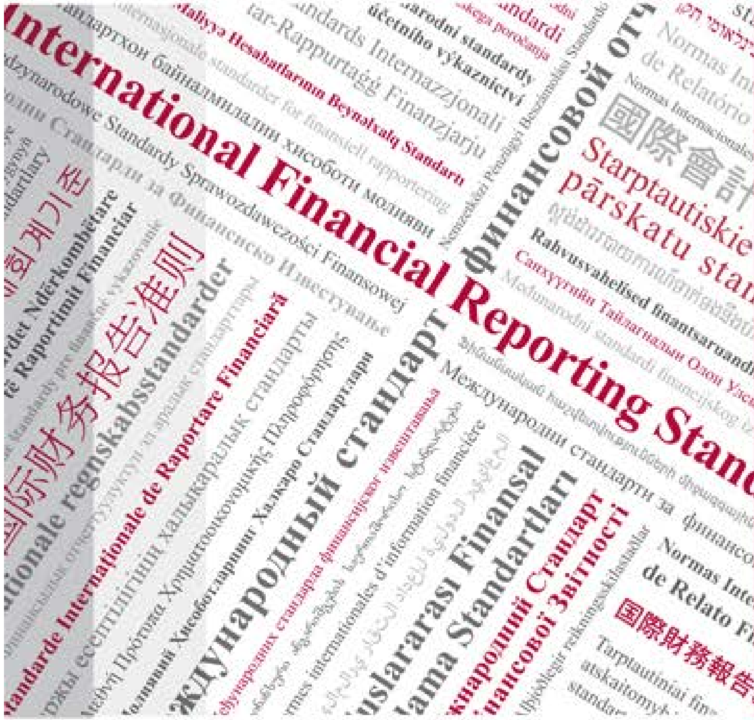
Financial Accounting Standards Board

International Accounting Standards Board



Revenue from Contracts with Customers

Accounting for customer credit risk

CMAC meeting October 2012

IASB staff contacts:
Glenn Brady gbrady@ifrs.org +44 20 7246 6460
Allison McManus amcmanus@ifrs.org +44 20 7246 6462

Purpose of this session

To get CMAC members' views on the following:

A. How should customer credit risk be accounted for?

1. The 2011 ED approach (see slides 3-5)
2. Presenting all customer impairment losses in one location, either (see slides 8-9):
   a) in expenses (with other impairment losses); or
   b) adjacent to the revenue line item
3. Having a revenue recognition threshold for collectibility (see slides 11-13)

B. If the impairment loss line is presented adjacent to the revenue line, should that impairment loss be treated as a component of revenue? (see slide 10)

Summary of the 2011 proposals

Contracts without a significant financing component

Revenue is recognised at the ‘gross’ amount (ie the invoiced amount which is unadjusted for customer credit risk)

Impairment losses are presented adjacent to the revenue line

Contracts with a significant financing component (ie includes a loan receivable)

Revenue is recognised at the ‘gross’ amount discounted at a customer-specific rate

Impairment losses are presented as expenses (with other loan losses)

2011 ED : Example with no financing

On 1 November, an entity sells products to customers for CU1,000 with payment due 3 months later.

At 31 December, the entity estimates that 5% of those sales are uncollectible. Cost of sales are CU400 and other expenses are CU300.

Statement of comprehensive income	CU
Revenue	1000
Customer credit risk	(50)
Cost of sales	(400)
Gross margin	550
Other expenses	(300)
Profit	250

Bad debts were all formerly recorded in Other expenses

Revenue reflects invoice amount

Initial/subsequent impairment (addition or reversal) is reflected in an adjacent line

2011 ED : Example with financing

On 1 January, an entity sells products to customers for CU1,210 with payment due 2 years later. The customer-specific discount rate is 10%.

On 31 December, the entity estimates that 5% of its receivables are uncollectible. Cost of sales are CU400 and other expenses are CU300.

Statement of comprehensive income	CU
Revenue	1000
Interest revenue	100
Cost of sales	(400)
Gross margin	700
Other expenses	(300)
Impairment losses on long-term receivables	(55)
Profit	345

Revenue reflects the gross amount (CU1,210) discounted at the customer specific discount rate of 10%

Interest revenue of CU100 arises from the unwinding of the discount (Note: could be presented net with other finance expenses)

Calculated as 5% loss on year-end receivable balance of CU1,100

Three alternatives for accounting for customer credit risk

In September, the boards asked the staff to analyse alternatives for accounting for customer credit risk:

1. The 2011 ED approach (see slides 3-5)
2. Presenting <u>all</u> impairment losses arising from contracts with customers together in one location, either (see slides 8-9):
   a) in expenses (with other impairment losses); or
   b) adjacent to the revenue line item
3. Having a revenue recognition threshold for collectibility (see slides 11-13)

1) The 2011 ED approach (slides 3-5)

Rationale

- For contracts without significant financing components, users could separately assess an entity's:
  - **sales performance** - because revenue is recognised at the invoice amount; and
  - **credit management activities** - because the impairment losses associated with those sales are presented adjacent to the revenue
- Contracts with significant financing components would be accounted consistently with other similar instruments–that is, loans

Implications

- Need to clarify whether impairment losses should be a component of revenue (see slide 10)
- May encourage some entities to structure their contracts to have a significant financing component so that any subsequent impairment loss is not shown adjacent to revenue

2) Presenting <u>all</u> impairment losses together

- Revenue would be recognised at the gross amount (as per the 2011 ED proposals)
- Impairment losses arising from <u>all</u> contracts with customers (including contracts with and without a significant financing component) would be presented together in one of the following locations:
  a) In expenses (with other impairment losses); or
  b) Adjacent to the revenue line item

Rationale

– All impairment losses related to contracts with customers would be presented uniformly

Implications

a) With other impairment losses	b) Adjacent to revenue
- Lack of prominence of the impairment losses from contracts with customers - No connection of impairment losses to revenue	- Prominence of impairment losses from contracts with customers and close connection to revenue - Disconnect between impairment losses on contracts with customers with a financing component and impairment losses on other loan receivables

2) Presenting Losses Together: Example 1

- Use case facts from slide 4 and 5; that is, entity has **two** contracts with customers, one with no financing, one with financing
- Impairment losses arising from all contracts with customers (including contracts with and without a significant financing component) would be presented together….

b) Adjacent to the revenue line item

Statement of comprehensive income	**CU**
Revenue	2000
Customer credit risk *(includes impairment losses on long-term receivables arising from contracts with customers)*	(105)
Interest revenue	100
Cost of sales	(800)
Gross margin	**1195**
Other expenses	(600)
Impairment losses on long-term receivables *(not arising from contracts with customers)*	???
Profit	**595**

Customer credit risk **CU50** (slide 4) + *Impairment losses long-term receivables* **CU55** (slide 5)

Could be presented net with other finance expenses

Impairment losses from other loans

Impairment as a component of revenue

Statement of comprehensive income	CU
Revenue	2000
Customer credit risk *(includes impairment losses on long-term receivables arising from contracts with customers)*	(105)
Subtotal	**1895**

Should this subtotal be revenue?

Implications:

The amount that would be disclosed (ie in press releases) as revenue

3) Recognition threshold for collectibility

- Revenue would not be recognised until collectibility threshold is passed (like current guidance)
- Boards have not discussed what that threshold would be: collectibility threshold in current guidance is as follows:
  - US GAAP: collectibility must be “reasonably assured”
  - IFRS: must be “probable that the economic benefits associated with the transaction will flow to the entity”

Rationale

- Limits the amount of revenue that can be recognised when there is significant uncertainty about the customer’s ability to pay

Implications

- Less transparency over an entity’s sales performance because revenue would be recognised when collectibility is assured and not when performance occurs
- Likely that impairment losses would not be presented adjacent to revenue

3) Recognition threshold: Example

An entity sells products to sub-prime customers on 90 day credit terms. The entity expects to make sales to 10 customers and expects that only 4 customers will pay in full (the other 6 customers are not expected to pay anything). The entity sets the price of the products at CU275 each. Each product has a cost of CU100.

Sale activity

- The entity sells 10 products in period 1. At the end of period 1, there are no changes to the assessment of collectibility arising from those credit sales.
- Cash is collected from the 4 customers in period 2 (which is 90 days after sale). No sales are made in period 2

See results on the next slide

3) Recognition threshold: Example

WITH a recognition threshold

Statement of comprehensive income	Period 1 (CU)	Period 2 (CU)
Revenue	0	1,100
Cost of sales	(1,000)	0
Impairment loss expense	0	0
Profit	**(1,000)**	**1,100**

WITHOUT a recognition threshold (applying the 2011 ED)

Statement of comprehensive income	Period 1 (CU)	Period 2 (CU)
Revenue	2,750	0
Impairment loss	(1,650)	0
Cost of sales	(1,000)	
		0
Profit	**100**	**0**

Thank you


individual comments
questions
expressions of
individual views
comments
feedback
questions
feedback
questions or comments
expressions of individual views
comments
expressions of individual views
dividual comments
questions or
expressions
feedback
expressions of individual views