STAFF PAPER

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Project	**Revenue recognition**		
Paper topic	Collectibility		

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#Purpose of this paper

1. This paper considers feedback on the revised Exposure Draft *Revenue from Contracts with Customers* (the '2011 ED') in relation to the accounting for customer credit risk, which is defined in the 2011 ED as, "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" (paragraph 68), in contracts with customers.

2. This paper should be read in conjunction with Agenda paper 7C/162C, which considers whether customer credit risk should affect recognition of revenue for those contracts with customers that include nonrecourse, seller-based financing.

Staff recommendation

3. The staff recommend the Boards maintain the accounting for collectibility as proposed in the 2011 exposure draft and make the following refinements:

   (a) clarify that the impairment loss line item adjacent to the revenue line item is a component of revenue;

   (b) simplify the "adjacent presentation" requirement by providing the option of presenting revenue net on the face of the statement of financial position if an

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entity has an insignificant impairment loss line item. If this optional presentation is elected, then an entity would either be required to disclose the components in the footnotes or identify the amount of customer credit risk in the title of the line item; and

(c) clarify in the standard the accounting for impairment losses pertaining to the financing component of contracts with a significant financing component. In this regard, some of the guidance in paragraphs BC174 and BC175 would be moved into the standard (into paragraphs 68 and 69) along with the example in paragraph BC174 which compares bifurcation of a contract with a customer that has a significant financing component with a loan with the same features.

Structure of the paper

4. This paper is organized as follows:

(a) Current accounting (paragraph 5)

(b) Forms of collectibility uncertainty unrelated to a customer's credit risk (paragraphs 6)

(c) Proposals in the exposure draft (paragraphs 7-13)

(d) Feedback on the exposure draft (paragraphs 14-27)

(e) How should the revenue model address collectibility? (paragraphs 28-50)

(f) If there is no recognition threshold, should the impairment loss line item reflect credit risk impairments for *both* initial and subsequent periods? (paragraphs 51-55)

(g) If there is no recognition threshold, should clarification be provided as to the presentation of revenue and credit loss impairments? (paragraphs 56-64)

(h) Should the presentation of impairments on receivables differ depending on whether a significant financing component exists? (paragraphs 65-70)

(i) Applicability of the collectibility proposals to contract assets (paragraphs 71-72)

(j) Appendix A: Suggested changes

Current accounting

5. Under current accounting standards, concerns about customer credit risk generally affect the timing of revenue recognition (ie, whether an entity recognizes revenue when a good or service is transferred), rather than the amount of revenue that is recognized. Both Section 605-10-S99 (SEC SAB Topic 13, *Revenue Recognition*) and IAS 18 specify a threshold that must be passed in order for revenue to be recognized. That threshold for U.S. GAAP is "reasonably assured" and for IFRSs (specifically IAS 18 *Revenue* and IAS 11 *Construction Contracts*) it is when "it is probable that the economic benefits associated with the transaction will flow to the entity". Additionally, a customer's credit risk may affect the measurement of revenue based on the requirements in IAS 18, which state that the amount of revenue recognized should be measured at the fair value of the consideration received or receivable.

Forms of collectibility uncertainty unrelated to a customer's credit risk

6. Collectibility can pertain to uncertainty unrelated to a customer's credit risk. For example, collectibility uncertainty can relate to the entity's performance under the contract. The 2011 exposure draft addresses the various types of collectibility uncertainty unrelated to a customer's ability to pay as follows:

   (a) uncertainty about the customer's commitment to complete the transaction is addressed by the fact that arrangements are only subject to the revenue recognition model if, amongst other factors, the parties are "committed to perform their respective obligations" (paragraph 14(b));

(b) uncertainty about whether the consideration is due because of uncertainty about whether the entity has performed is addressed by the guidance on the satisfaction of a performance obligation (paragraphs 31-37); and

(c) uncertainty about whether the entity will perform in the future and hence be entitled to collect consideration for a performance obligation already satisfied is addressed in the guidance on variable consideration (paragraphs 53-57).

Proposals in the 2011 ED

7. Collectibility is addressed differently depending upon whether a contract has a significant financing component (as defined in paragraphs 58 and 59 of the 2011 ED).

Contracts without a significant financing component

8. For contracts with customers *without* a significant financing component, the 2011 ED proposes that the consideration promised by the customer should not be adjusted for the customer's credit risk. As such, the entity would determine the transaction price and, ultimately, recognize revenue at the amount of consideration to which the entity is entitled (ie, a gross revenue amount).

9. Concerns about the collectibility of the revenue would be addressed in the recognition and measurement of any impairment of the corresponding unconditional or conditional rights to consideration (that is, for receivables or contract assets, respectively). The recognition and measurement of any impairment on the receivable or contract asset would be determined in accordance with Topic 310 or IFRS 9, *Financial Instruments* / IAS 39. Importantly, the 2011 ED proposes that any impairment loss associated with a contract without a significant financing component should be presented in a separate line item adjacent to revenue. That presentation of the impairment loss line is an essential feature of the Boards' proposal because it provides users with two separate but related pieces of information: the amount of revenue to which the entity is entitled in exchange for transferring promised goods or services to a customer; and the amount of cash the entity expects to receive on its contracts with customers. Recording revenue on a gross basis and presenting the impairment loss line item

adjacent to the revenue line item is a package of proposals that the Boards determined best provides transparency for users into an entity's sales and receivables management activities.

10. Additionally, as explained below, initial measurement differences between the amount of revenue recognized, which is generally the invoiced amount, and the amount recognized as a financial asset, which is fair value according to IAS 39 for example, are recorded in the adjacent impairment loss line item.

Contracts with a significant financing component

11. For contracts with customers *with* a significant financing component, the 2011 exposure draft proposes that these contracts be bifurcated into a revenue component and a loan component. As explained in paragraph BC174, the revenue component is within the scope of the revenue standard and the loan component is subject to the guidance in the financial instruments standards. Further with respect to the loan component, subsequent impairment losses are to be presented "consistent with the presentation of impairment losses for other types of financial assets within the scope of the financial instruments standards" (paragraph BC175). Recognition and measurement of impairment losses are also determined by reference to the financial instruments standards. The Boards explained that impairment losses would be presented differently for contracts without a significant financing component (as compared to contracts with a significant financing component) as a result of 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. (paragraph BC175)

All contracts with customers

12. Irrespective of whether a contract has a significant financing component, the referenced guidance to Topic 310 and IAS 39/IFRS 9 only addresses subsequent (day two) impairments – because impairment is a measurement issue that arises

after initial recognition of an asset[1]. However, due to IFRS 9 requiring financial assets to be measured at fair value at initial recognition, the Boards explain in paragraph BC171 "that the proposed guidance also should specify the accounting for any difference between the amount of revenue that has been recognized and the corresponding initial measurement of the receivable". As such, any initial impairment of a receivable (or contract asset) arising from a contract with a customer "shall be presented in profit or loss as a separate line item adjacent to the revenue line item". (paragraph 69)

Reasons for moving away from the 2010 proposals on customer credit risk

13. The Boards ultimately arrived at a package proposal for the 2011 exposure draft, which is described above. Specifically, for contracts with customers without a significant financing component, revenue would be presented on a gross basis (ie, collectibility would not be incorporated into the determination of the transaction price) and credit risk uncertainty would be reflected in an impairment loss line item adjacent to the revenue line item. As a result, the transaction price would no longer reflect the amount of consideration that an entity expects to receive (as per the 2010 exposure draft) and would instead reflect the amount of consideration an entity expects to be entitled to in exchange for transferring goods or services to a customer. The Boards believed this was the best way to address the mixed feedback received on the 2010 exposure draft, in which preparers were concerned about significantly changing existing practices that are well established and understood and users did not like the lack of visibility of credit risk with a probability-weighted measurement of revenue. The Boards believed that these proposals provided a more complete and faithful picture of the entity's position under the contract (ie, that a transfer of a good or service has occurred and that the entity has a right to consideration in the arrangement).

Feedback on the exposure draft

[1] This is not expected to apply in practice to contracts with a significant financing component because the discounted promised consideration would generally be equivalent to fair value.

14. Question 2 in the exposure draft requests feedback about the Boards' proposal to present customer credit risk as a separate line item adjacent to revenue in an entity's financial statements.

15. Almost all respondents agreed with the proposal to exclude the effect of customer credit risk from the transaction price. Most users consulted expressed support for the visibility of credit risk apart from revenue, as indicated by the following comment:

> We support the requirement to measure revenue without regard to collectability and present bad debt expense separately. In our view, netting credit risk commingles information on how management addresses credit reserving with revenue recognition. The revised proposal to present uncollectible amounts because of credit risk as a separate line item adjacent to the revenue line item would better allow the separate analysis of revenue growth and credit risk management. (CL #275, Standard & Poor's Ratings Services)

16. Overall, a smaller number of respondents agreed with the proposal to present any corresponding impairment loss (on the receivable or contract asset) adjacent to the revenue line. However, the proposal elicited strong support from users and regulators who indicated that presenting the impairment loss line adjacent to revenue would yield more transparent information with which they can assess the quality of an entity's earnings. One user explained:

> …we strongly support these proposals to disaggregate credit risk from the transaction price, and believe that this is the most significant positive advance in the revised ED. (CL #329, Hermes Equity Ownership Services)

A threshold for collectibility

17. A few respondents (preparers, users and regulators) explained that they support the proposal to present the impairment loss line item adjacent to revenue. However, these respondents further explained that, in their view, it was also necessary to add a collectibility threshold that must be passed before revenue can be recognized. These respondents think that revenue should be recognized only for amounts where there is a reasonably high likelihood of collection.

18. The addition of a collectibility threshold was raised by a user group as an alternative to their suggestion to require an additional assessment of the transfer of risks. They expressed comfort with the absence of a collectibility threshold in the proposed model *provided* revenue could be recognized upon the transference of *both* control over a promised asset *and* the risks related to such asset. Otherwise, in absence of having a control and risks based recognition model, a collectibility threshold would address their concerns related to the amount of revenue that may be recognized for transactions where they believe risks have not adequately transferred to the customer.

19. A few preparers questioned whether it was the Boards' intention (explained in paragraph BC34) to include an implicit collectibility threshold with the requirement in paragraph 14(b) (that is, in order for a contract to exist, the customer must be committed to perform under the contract). However, these respondents commented that such a constraint would not be effective in all situations because the wording is vague and if the attribute of a contract in paragraph 14(b) is intended to be a collectiblity threshold, then it should be made explicit.

Disagreement with proposed presentation

20. Many other respondents disagreed with the proposal to present customer credit risk adjacent to revenue (even though they agreed with the proposal to measure the transaction price and, hence, revenue without any adjustment for customer credit risk). Most often, these respondents disagreed because they believe that the proximity of the effect of customer credit risk to the revenue line item would inappropriately imply that the entirety of the impairment expense relates to revenue recognized in the current period. In fact, at least a portion of each year's impairment expense most likely would relate to revenue that was recognized in prior period(s).

> …we do not agree with presenting any impairment of receivables arising from contracts with customers in profit or loss as a separate line item adjacent to the revenue line item. Such a treatment implies a nexus between current period revenue and impairment losses when this may not be the case (i.e. impairment

> losses recognised in the current period may relate to revenue recognised in previous periods). We believe that it would be more appropriate to present impairment losses on receivables arising from contracts with customers in the same line item as all other financial asset impairment losses.
>
> To the extent that information on the impairment of receivables arising from contracts with customers (on initial recognition and subsequently) is considered necessary, we suggest that this information would be better disclosed in a note to the financial statements. (CL #302, BHP Billiton)

21. These respondents generally proposed that expenses associated with customer credit risk be presented as administrative expenses, and that any supplemental information be reported in the notes to the financial statements. Another respondent suggested that entities be permitted to present revenue net of credit risk in the statement of comprehensive income, with a breakdown of the gross revenue and expense related to customer credit risk in the notes to the financial statements.

22. Several respondents disagreed with the presentation of impairment in a line adjacent to the revenue line because impairments typically arise after contract inception. They argue that changes in a customer's credit risk "should not affect the presentation of items relating to [current] revenue recognition". (CL #157, Australian Accounting Standards Board) Accordingly, these respondents argue for a distinction between initial and subsequent impairments, with the latter reflected as an operating expense.

23. Other respondents disagreed with the proposals because they thought the requirement to present customer credit risk 'adjacent to revenue' was too vague. Those respondents requested more guidance on the presentation of these amounts, specifically:

    (a) what terminology should be used in identifying these line items (ie, revenue before credit risk);

    (b) whether it is appropriate to refer to 'revenue' as the amount before the adjustment for credit risk;

(c) whether the presentation should include a 'net revenue' amount that is revenue less customer credit risk; and

(d) how the impairment loss line item was intended to relate to the presentation of gross margin (included or excluded).

24. A few respondents also requested the Boards clarify how an entity should present 'other revenues' (ie, revenues that do not arise from contracts with customers) in relation to the line items of 'revenue from contracts with customers' and customer credit risk.

25. Several respondents disagreed with the Boards' reasoning at paragraph BC175 that the effect of credit risk on trade receivables that have a significant financing component should be presented separately from that relating to other trade receivables. They believe that the presentation of credit losses should not differ if contracts are similar other than with respect to whether a significant financing component exists.

Applicability of the proposals to contract assets

26. A couple of respondents questioned the meaning and intent behind the last sentence in paragraph 68, which calls for the effects of credit risk related to a contract asset to be accounted for the same as those related to a receivable. The respondents were unclear as to whether or when the guidance on financial instruments is to be applied.

Other concerns

27. Many respondents also highlighted some other concerns related to the proposals on the presentation of customer credit risk as follows:

(a) the proposed guidance appears to be overly prescriptive and therefore directly conflicts with the principles-based nature of IAS 1 *Presentation of Financial Statements*;

(b) meaningful feedback cannot be provided on the proposal to present customer credit risk until the impairment phase of the financial instruments project is completed; and

(c) several requested clarification about the link between credit risk and financing. These respondents noted specific instances in which credit risk gets mingled with the time value of money and other factors and either: (i) credit risk would not get reflected in the impairment line adjacent to the revenue line for contracts with a significant financing component or (ii) non-credit risk factors would be reflected in the impairment line adjacent to the revenue line if there are differences in amounts initially recorded for revenue and the related receivable or contract asset.

How should the revenue model address collectibility?

28. A revenue model could address customer credit risk with a recognition threshold (current GAAP), measurement of the transaction price (as proposed in the 2010 exposure draft), or separately through presentation of the impairment loss and other areas of the model (as proposed in the 2011 ED). Despite the Discussion Paper, the 2010 ED and the 2011 ED proposing the removal of a revenue recognition threshold, feedback received on the 2011 ED suggests that some respondents (including a user group) support the retention of a collectibility recognition threshold in the revenue standard. Consequently, this section of the paper considers whether the retention of a recognition threshold is preferable to the 2011 ED's proposals for accounting for customer credit risk.

Alternative 1 – Reintroducing a revenue recognition threshold

29. Under this alternative, collectibility certainty must meet or exceed a specified confidence threshold (see discussion below), in order for revenue to be recognized (in addition to the satisfaction of the performance obligations). Subsequent impairment of the customer's credit would be presented in Other expense or Other income separate from revenue.

30. In the feedback received on the 2011 exposure draft, a few preparers, a user group, a regulator, and a state CPA society expressed support for a collectibility recognition threshold, as currently exists in GAAP today. They reasoned that a

collectibility recognition threshold has worked well in practice under both U.S. GAAP and IFRS and that without a collectibility threshold, there would be an opportunity for entities to gross-up revenues and to potentially recognize revenue earlier than under current accounting rules. As relayed in CL #343, Confederation of British Industry:

> We do not see the value in changing current practice in respect of the collectability of promised consideration. Currently, practice would regard such impairments as bad or doubtful debts included as a cost rather than a reduction in revenue. This current approach also responds to the practical difficulties of distinguishing between, say, customers' credit risk and more general disagreements on consideration entitlement.

31. Proponents of Alternative 1 argue that a collectibility threshold is not only consistent with current GAAP and practices, but is more conservative and, therefore, may be perceived to be more prudent. Due to the importance of the revenue balance, proponents believe that ensuring future cash flows reflect the recognized amount is essential. Additionally, Alternative 1 proponents argue that a recognition threshold is generally understood by users, regulators, and preparers today. Also, they view a recognition threshold as minimizing or even preventing in some cases subsequent reversals of revenue. Reducing fluctuations in reported revenue is seen as favorable because of the message it sends to users of business stability.

32. Opponents of Alternative 1 argue that with a recognition threshold:

    (a) the importance of the transfer of control is deemphasized. As proposed, revenue recognition is triggered upon the satisfaction of a performance obligation. However, a recognition threshold would establish a second recognition criterion unrelated to the entity's performance under a contract (ie, entirely outside of the influence of the entity);

    (b) the intent of the 2011 ED's collectibility proposals would be contradicted. The intended benefit and purpose of presenting revenue on a gross basis with an adjacent impairment loss line item is to increase transparency of an entity's sales and collection activities. A collectibility recognition threshold would

deny users that benefit other than with respect to an impairment or reversal related to customer credit risk occurring subsequent to the recognition threshold being reached; and

(c) there would not be much, if any, visibility into subsequent (post-revenue recognition) impairments. This is because credit risk impairment losses would either not be reflected at all (because credit risk would instead *prevent* revenue from being recognized in the first place when collectibility is not "reasonably assured" or "probable") or would be reflected in other expenses subsequent to revenue being recognized.

33. Opponents also raise the following consequences of having collectibility as a recognition criterion, as noted by the Boards (paragraph BC170):

(a) the Boards would need to specify a probability threshold (for example, reasonably assured or probable) that must be passed before revenue would be recognized;

(b) a threshold would be inconsistent with the accounting for a receivable, which incorporates assessments of collectibility in the measurement of that financial asset; and

(c) in many cases, collectibility is assessed at a portfolio level because an entity typically does not know which customers will default. Consequently, a revenue recognition hurdle may be difficult to apply to individual contracts.

34. Additionally, opponents of Alternative 1 argue that with a collectibility threshold, revenue (1) may not ultimately reflect the amount to which the entity is entitled under the contract because of credit risk and non-payment (the threshold may never be reached, and hence revenue may never be recognized, even if the entity has satisfied its obligations under the contract), and (2) may not represent the amount that an entity ultimately collects because even once the threshold is met and revenue is recorded, a customer's credit risk may subsequently decline, a reserve for bad debts may be recorded and cash may not be collected.

35. Opponents also note that a threshold would create an all-or-nothing recognition situation. No revenue would be recognized if the threshold is not passed, but

potentially all of the revenue being recognized if it is passed. Opponents also argue that setting a collectibility recognition threshold would not be consistent with the control principle of the model (revenue recognition is triggered upon the transference of control over a promised asset), or with the definition of transaction price, which concerns the amount of consideration to which an entity expects to be *entitled* in exchange for transferring promised goods or services to a customer.

36. The reasons behind the Boards rejecting a collectibility recognition threshold in prior deliberations are also raised as a reminder by opponents of Alternative 1. The Boards decided against a collectibility recognition threshold when discussing the 2010 exposure draft[2] in May 2009 for several reasons, including: (a) avoidance of an arbitrary threshold with questionable consistency in practice; (b) consistency with the measurement of receivables under IAS 39 or IFRS 9, which are required to be measured at fair value[3] and therefore incorporate the effects of collectibility; and (c) ability to better recognize revenue when (or as) events and circumstances occur (eg, upon the satisfaction of a performance obligation as opposed to potentially at a later date, once a collectibility threshold has been reached).

37. During redeliberation of the 2010 exposure draft in March 2011, the Boards discussed again whether there should be a collectibility recognition threshold – either explicit in the definition of a contract or applicable once the transaction price has been determined – in light of a possible revision to the 2010 collectibility proposals. The 2010 ED proposals had not been received favorably by either preparers or users, and potential revisions would provide for the recording of revenue on a gross basis (exclusive of collectibility assessment) and the presentation of the impairment loss line item *apart* from revenue. A collectibility threshold was debated because the aforementioned recognition and

[2] For the 2010 exposure draft, the Boards decided to incorporate collectibility directly in the measurement of the transaction price (and hence of revenue).

[3] According to IAS 39 paragraph AG64, "The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received…".According to IFRS 9, financial instruments, such as trade receivables, are normally initially measured at fair value which is the transaction price (ie, the fair value of consideration given or received). Section 5.1 of IFRS 9 (December 2010), paragraph B51.1.

presentation proposals would make it difficult for users of the financial statements to discern the expected amount of cash expected to be collected.

38. In re-examining a collectibility threshold, the Boards discussed arguments *for* a threshold, including: (a) the desire to only recognize revenue when there is reasonable expectation of collecting the amount the entity is entitled to; and (b) the concern about recognizing revenue for customers that may be committed to pay but not able to pay (eg, grossing up top line revenue and immediately writing it off). The Boards decided again against a collectibility recognition threshold. With respect to a collectibility threshold that would constrain the recognition of the amount of allocated transaction price, the Boards decided that the arguments against a threshold were compelling, including:

   (a) collectiblity, when significant, is priced into contracts in most industries;

   (b) it would introduce a second criterion for revenue recognition; and

   (c) collectibility is more of a portfolio notion and as such there should not be a hurdle at the individual contract level.

39. To help highlight the difference between Alternative 1 and Alternative 2, Example 1 below shows the application of Alternative 1. Comparatively, Example 2 below illustrates the outcome under the 2011 ED proposals using the same fact pattern but applying Alternative 2.

Example 1

An entity sells products to two customers on 90 day credit terms. The entity sells the products for CU1,000 and the cost of the products is CU700.

Sale activity

- At the time of sale, one customer is expected to pay in full, however it is determined that it is not reasonably assured (U.S. GAAP) / probable (IFRS) that the second customer will pay anything. There are no changes to the assessment of collectibility at the end of the period.

- In year 2, the first customer does not pay in full, but rather only CU600 is collected on the amount due. The second customer who was not expected to pay anything, pays CU500 on the amount due.

Statement of Comprehensive Income	**Year 1**	**Year 2**
Revenue	1,000	500
Cost of Sales	(1,400)	0
Impairment Loss Expense	0	(400)
Profit	**(400)**	**100**

40. If the Boards reach a tentative conclusion on Alternative 1, the following two questions in this memo related to presentation do not apply. This is because conclusions on the presentation of the impairment loss line item are effectively incorporated into the decision to have a recognition threshold. That is, since revenue would not be recognized until a specified level of collection certainty is reached, only *subsequent* impairments are recorded. Also, Alternative 1 would require subsequent impairments to be presented in Other expense or Other income separate from revenue. Hence, Alternative 1 is a self-contained package of proposals.

41. Additionally, if the Boards reach a tentative conclusion on Alternative 1, the staff intend to evaluate the proposal for a threshold together with any proposed revision to the constraint guidance. The staff think that for ease of implementation and to reduce any unintended consequences, the conditions for recognition should coincide with the conditions for constraining recognition, if feasible. After all, both matters (a collectibility threshold and constraint) affect *the timing of* revenue recognition. As a result, if the Boards were to pursue a confidence threshold for the constraint and wish to incorporate collectibility, then the staff would utilize similar drafting to incorporate collectibility into the constraint requirements. For example:

> For revenue to be recognized, an entity must possess a certain level of confidence, of collecting the amount to which it is entitled to in exchange for having satisfied all or a portion of a performance obligation. The specified level of confidence would correspond with the Boards' decision on constraint, if the

Boards decide on a quantitative threshold for the constraint on revenue (ie, reasonably or highly confident).

Alternative 2 – Retain the 2011 ED's collectibility proposals

42. Advantages of the 2011 ED proposals are:

    (a) showing credit losses separately from revenue is relevant (because it provides users with visibility into the sales and receivables management functions of the entity) and more understandable to users of financial statements; and

    (b) transparency to all users of financial statements that a portion of the entity's gross revenue is expected to be uncollectible.

43. Proponents of Alternative 2 also argue that recognizing revenue without assessment of a recognition threshold better aligns with the recognition event – the satisfaction of a performance obligation. Revenue would be recognized when (or as) the entity satisfies a performance obligation. Proponents also highlight that an adjacent presentation is consistent with the presentation requirements of Accounting Standards Update No. 2011-07, Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force).

44. The proposals also allow for a distinction to be made between short and long-term trade receivables; that is, between contracts with customers without a significant financing component and those with a significant financing component, respectively. As such, proponents of Alternative 2 argue that the substance of the underlying transactions is better relayed to users (ie, whether there is only a sale or a sale and a loan occurring). Users would understand that the impairment loss line item adjacent to the revenue line item relates only to sales while any impairment losses related to a financing component could be assessed together with impairment losses of all other financial assets.

45. While respondents to the 2011 exposure draft generally supported excluding the effects of the customer's credit risk from the transaction price (and hence from

revenue), the proposed presentation of the impairment line item adjacent to the revenue line item was not well received. The main arguments raised against the proposed presentation were: (a) the lack of connection between subsequent uncollectible amounts and current period revenue; (b) the belief that credit risk is a cost of doing business and related to the entity's credit management function (that is, not sales-related); and (c) the concern that for most companies impairments would not be significant enough to warrant such a prominent presentation (particularly for entities not in the financial services industry). However, proponents of Alternative 2 argue that adjacent presentation allows users to assess the amount of cash an entity will ultimately collect, which would not otherwise be clear if the effects of customer credit risk were presented in Other expenses, for example.

46. The main argument opponents raise against Alternative 2 is that, as noted in the 2010 redeliberations, an entity may recognize revenue at an amount that is in excess of the amount that the entity receives or expects to receive. However, notably, this can happen under Alternative 1 as well.

47. Application of Alternative 2 can be demonstrated with the following example:

Example 2

The same fact pattern applies as under Example 1 except that the transactions are accounted for under Alternative 2. Under Alternative 2, the results would be as follows:

Statement of Comprehensive Income	Year 1	Year 2
Revenue	2,000	0
Impairment Loss Expense	(1,000)	100
Cost of Sales	(1,400)	0
Profit	**(400)**	**100**

Staff recommendation

48. The staff recommend that collectibility be accounted for in the manner proposed by the 2011 ED. Accordingly, uncertainty about collectibility would be reflected

in a line item adjacent to the revenue line item for contracts without a significant financing component and in the discount rate for contracts with a significant financing components (pursuant to the time value of money proposals). The staff think that there should be no collectibility threshold for recognition because the 2011 ED already requires an arrangement to be legitimate and to be enforceable in order for revenue to be recognized. Specifically, a contract must have commercial substance and the parties must be committed to perform their respective obligations. Refer to Agenda memo 7C/162C for further discussion about the applicability of a collectibility recognition threshold for a subset of contracts that contain nonrecourse, seller-based financing and possible additional guidance to help entities determine whether a contract with a customer exists.

49. The staff think that the adjacent presentation approach provides for the following financial reporting benefits:

- Users get transparency of an entity's activities (that is, of an entity's satisfaction of contracted performance obligations) as well as of success or failure of the entity's credit risk management activities. As the Boards mentioned in paragraph BC167 of the 2011 exposure draft, they "were persuaded [to propose a linked presentation] by users of financial statements who commented that they would prefer that revenue be measured at that "gross" amount so that revenue growth and receivables management (or bad debts) can be analyzed separately.
- No reporting lag. An entity's activity is recognized when or as the entity performs and is not tied to when (or if) cash is collected.
- An entity does not fail to reflect revenue when it has satisfied a performance obligation. Performance gets reflected in the financial statements when (or as) goods or delivered or services are performed. Because recognition of revenue is not tied to cash collection, revenue better depicts the entity's performance in transferring goods or services to its customers, and an entity gets credit for goods and services transferred when (or as) it transfers them to the customer, irrespective of whether cash

is ultimately received. However, likewise, there is disclosure of non-payment such that users can make their own judgment as to the health of the entity's revenue generating activities.

50. Importantly, the staff highlight that even without a recognition threshold, revenue may still not be recognized or the amount recognized could be restricted, as explained below:

(a) revenue may not be recognized due to the proposed model's definition of a contract. Specifically, one condition for a contract with a customer to exist is that parties to the contract must be committed to perform their respective obligations (paragraph 14(b) of the 2011 exposure draft). The Boards clarified this criterion in paragraph BC34 by saying 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 respective obligations under the contract and thus the criterion in paragraph 14(b) may not be met." While "not intended to represent a threshold for recognizing revenue" (paragraph BC34), there is at least some assessment of collectibility when determining whether a contract is subject to the revenue model;

(b) revenue would not be recognized if the entity has not satisfied its performance obligations. The indicators in paragraph 37 highlight a number of areas that, while subject to judgment, could indicate that control has not transferred and, hence, revenue cannot yet be recognized. For example, an entity may need to assess whether significant risks and rewards have transferred to the customer or whether there has been customer acceptance. As such, the revenue model reminds an entity of various indicators to confirm that control has indeed transferred to the customer when (or as) an entity believes it has satisfied its performance obligations; and

(c) the amount of revenue recognized may be limited if subject to the constraint, as discussed in Agenda paper 7A/162A.

Question 1
The staff think that Alternative 2, the 2011 ED's collectibility proposals, is appropriate. Do the Boards agree?

If there is no recognition threshold, should the impairment loss line item reflect credit risk impairments for *both* initial and subsequent periods?

51. Several respondents to the 2011 ED favored differentiating the presentation of initial and subsequent period credit risk impairments. They commented that:

    (a) users of financial statements may find the distinction beneficial for their analysis;

    (b) once the revenue recognition criteria have been satisfied (namely, that performance obligations have been satisfied because the promised goods or services have been transferred to the customer), subsequent impairments seem more appropriately classified as operating expenses as opposed to as a component of revenue;

    (c) there is no connection between subsequent credit risk deterioration (or improvement) and current period revenue;

    (d) the generation of revenue is a separate activity from collections, which is a subsequent, day-two activity, and this difference should be reflected in the presentation of initial and subsequent impairments, respectively. Impairments (and reversals) of credit risk impairment loss relate to the success or failure of an entity's cash management activities. Since cash management activities represent a cost of doing business, impairments and reversals should be classified as an operating expense as well;

    (e) a customer's credit risk relates to the subsequent measurement of accounts receivable and as such subsequent impairment should be recorded as an operating expense. Comparatively, initial impairment has a direct relationship with current period revenue; and

(f) recording subsequent impairments as a component of revenue could skew an entity's gross margin in a given period.

52. Opponents to differentiating presentation of impairments by period of applicability argue that there is often a relatively short time between the satisfaction of a performance obligation and collection of amount owed. As such, initial estimates of credit risk ought to contemplate most economic uncertainties. Opponents also argue that distinguishing between initial and subsequent impairments is not considered operational by many preparers. This is because, in practice, contracts are assessed on a portfolio basis for impairment loss. Hence, when contracts in a portfolio are not entered into at the same time, identifying what portion of an estimated impairment loss represents initial impairment becomes impractical. Additionally, as credit loss impairment assessment is often conducted at the end of a reporting period, the line between initial impairment (ie, impairment that exists as of contract inception) and subsequent impairment is not always clear. Further in this respect one respondent noted:

> We further support the Board's view that any loss arising on initial recognition should be presented under the same line item as (future) impairment losses. In our opinion, in many mass-market business operations such distinction would be somewhat clouded anyway. For example, on initial recognition of a large portfolio of customer receivables historical data often suggest that a certain default rate is inherent even if there is not yet any indication of an individual customer receivable being impaired. While it could be argued that a resulting impairment loss on a portfolio basis is still considered a subsequent measurement following immediately after initial recognition, users of financial statements will probably rather view this as a technicality which does not justify a different income statement presentation compared to initial losses. (CL #215, Deutsche Telecom AG)

53. Ultimately, if a material distinction arises between initial and subsequent impairment loss, entities would disclose relevant information. That said, the Boards acknowledged, in paragraph BC171, that they would not expect an entity to typically record an initial impairment loss:

> The Boards expect that an entity typically would not recognize a loss on initial recognition because the receivable normally would initially be measured at the

original invoice amount if the contract with a customer does not include a financing component that is significant.

54. Finally, opponents argue that this topic had been discussed during redeliberation of the 2010 exposure draft at which time the Boards decided against splitting the impairment loss amount, though mixed views were expressed. Some Board members preferred that only initial impairments be reflected in the line item adjacent to the revenue line item, with subsequent impairments reflected in operating expense. However, the staff had raised the operational concern indicated above, which is one that had been raised by respondents. That is, operationally, respondents generally believed that it would likely not be feasible to differentiate between initial and subsequent adjustments given how they typically assess bad debt (ie, assessments are typically conducted at the end of the reporting period, and hence reflect more than just initial customer credit risk).

Staff recommendation

55. The staff recommend that a distinction not be made between initial and subsequent impairments because: (a) credit risk impairments are typically expected to occur subsequent to contract inception; (b) the credit assessment process undertaken by many entities, as indicated above, does not distinguish between initial and subsequent impairments; and (c) determining when initial impairments become subsequent impairment is open to interpretation (eg, do initial impairments only pertain to potential losses identified the day of recognition? in the quarterly period of recognition? in the annual period of recognition?). If a significant difference were to arise between initial and subsequent impairments, the staff would expect disclose of that information.

Question 2
The staff recommend that no distinction should be made between initial and subsequent period impairments. Do the Boards agree?

If there is no recognition threshold, should clarification be provided as to the intended presentation of revenue and credit loss impairments?

What is revenue?

56. Several respondents commented that the guidance for the presentation of the effects of credit risk "adjacent to" revenue is not clear. A couple of respondents asked for an example to illustrate the Boards' intent, while others requested clarification of intent be included in the standard. Respondents requested clarification primarily with respect to the following presentation-related areas:

    (a) subtotals and possible descriptions;

    (b) how amounts should be disclosed in the footnotes; and

    (c) whether the credit risk impairment line item:

        i. is an expense or contra-revenue line item; and

        ii. would be a deduction to arrive at net revenue or gross profit.

Staff recommendation

57. The staff think that the Boards could improve the presentation proposals on collectibility and address many of the concerns raised by respondents by clarifying the classification of the impairment loss line item as a component of revenue (as opposed to an expense). The staff think that this classification is appropriate because impairment loss affects the amount of consideration which the entity will ultimately receive.

58. This classification is a clearer way of confirming that collectibility affects the measurement of revenue. Additionally, this classification allows for the net revenue amount to reflect the anticipated amount of cash to be collected while at the same time providing for the benefits of adjacent presentation (ie, greater transparency of an entity's activities). In this regard, paragraph 1 of the U.S. exposure draft states, in part, that "revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations", and the IFRS exposure draft states in part that revenues are "increases in economic benefits

during the accounting period in the form of inflows or enhancements of assets". A net revenue balance (made possible by the classification of the impairment loss line item as a component of revenue), could arguably better coincide with these description of revenues as "inflows or other enhancements of assets of an entity" and as "increases in economic benefits". Classification of the impairment loss line item as a component of revenue essentially provides for a closer tie with the ultimate amount of cash that will be received.

Can an entity disclose rather than present an insignificant impairment loss line item on the face of the financial statements?

59. Respondents also questioned the necessity of presenting a credit risk impairment line on the face of the financial statements if the amount of impairment is relatively insignificant. Instead, they argue that entities should be provided the option to disclose the impairment in the footnotes. One respondent noted the following concerning the required presentation of an impairment line item:

> We do not believe it would be commonplace for the significance of the uncollectible amounts to warrant presentation as a separate line item on the statement of income. We believe this requirement will result in unnecessary additional subtotals on the statement of income (i.e., "net revenue"), without providing useful information to users of the financial statements. (CL #338, FEI Canada/CCR)

Staff recommendation

60. If the impairment loss line item is classified as a component of revenue (as per the above staff recommendation) and an entity concludes that the balance is insignificant relative to its overall financial statements, the staff think that a presentation simplification alternative could be provided to preparers. In this instance, entities could be given the option of presenting revenue on a net basis on the face of the financial statements. If this option is elected, the entity would be required to either: (a) provide a breakout of the components of net revenue in the footnotes; or (b) indicate the amount of the impairment loss in the title of the net revenue line item. The staff think that this is an explicit way of incorporating the Boards' intent with respect to materiality as noted in paragraph BC 171: "The

Boards propose that an entity should present any impairment losses from contracts with customers adjacent to the revenue line in profit or loss (subject to the usual materiality considerations for line-item disclosure)". However, again, this option would not be possible without the classification of the impairment loss line item as a component of revenue.

61. To illustrate the proposed presentation option, assume that an entity enters into contracts for a given period, totalling CU100 in sales. Of this amount, the entity estimates 2% to be uncollectible. Cost of sales is assumed to be CU40. Other expenses is estimated to be CU30 and includes such costs as R&D, restructuring, SG&A, sales and marketing, and amortization. In this situation, assuming the CU2 impairment loss is deemed to be insignificant by the entity in relation to its financial statements, the entity would have the option of presenting revenue and related impairment loss in one of two ways:

Alternative presentation 1*

Statement of Comprehensive Income	**CU**
Net revenue	98
Cost of sales	(40)
Gross margin	58
Other expenses	(30)
Profit	**(28)**

*Breakout of the components (gross revenue of 100 and credit impairment of 2) would be provided in the footnotes. The extent of detail would not be prescribed. However, the staff do not intend for entities to distinguish between initial and subsequent period impairments.

Alternative presentation 2

Statement of Comprehensive Income	**CU**
Revenue, net of allowance for customer credit risk (CU2)	98
Cost of sales	(40)
Gross margin	58
Other expenses	(30)
Profit	**(28)**

How should impairment losses relating to contracts with customers be presented when the loss line item includes losses from other sources of revenue?

62. Another commonly asked presentation question concerned how revenue from contracts with customers and the related credit risk impairment line item should be presented when the entity generates revenue from other sources (eg, leases, insurance, financial instruments). For example, should there be a single aggregated line for impairment related to all revenue sources (with a breakout provided in the footnotes), or should disaggregated impairment charges be shown on the face of the financial statements? Further, should there be subtotals presented, and, if so, which ones?

Staff recommendation

63. The staff recommend that the net presentation option described above apply irrespective of whether an entity generates revenue only from contracts with customers or from multiple sources of revenue (eg, contracts with customers, insurance products or services, financial instruments, leasing transactions). Additionally, if an entity elected to present a disaggregation of revenue from contracts with customers in the statement of comprehensive income (eg, from sales of products and sales of services), the staff recommend against requiring that the impairment loss line item be broken out by each source of revenue. The staff believe that such a determination should be made on an entity by entity basis depending on an entity's ability and deemed usefulness to their users. However, the staff think that potential disclosure implications on the disaggregation of revenue can be considered when redeliberating disclosures.

64. To further clarify the adjacent presentation requirement of the impairment loss line item, the staff recommend that the Basis for Conclusions highlight that the treatment (presentation or otherwise) of credit risk impairment losses pertaining to revenue from sources *other* than contracts with customers are not addressed by the revenue model. This intent could be made explicit in paragraph BC171, which currently states that "The Boards noted that their decision on presentation typically only changes the location of the line item for impairment losses arising from contracts with customers".

Question 3

The staff recommend that:

- the impairment loss line item be clarified as being a component of revenue;
- the standard should clarify the Boards' intent with respect to the presentation of collectibility by providing the option of presenting revenue net of insignificant impairment losses (related to contracts with customers) as long as a breakout of the components is provided in the footnotes or the amount of impairment loss is indicated in the title of the net revenue line item;
- there be no requirement to breakdown the impairment loss by type of contracts with customers (for entities that provide such a breakout of contract with customer revenue); and
- the Basis for Conclusions clarify that the presentation of impairment loss related to revenue generated from sources other than contracts with customers is not addressed by the revenue model.

Do the Boards agree?

Should the presentation of impairments on receivables differ depending on whether a significant financing component exists?

65. Several respondents disagreed with the proposed differences in presentation of credit risk loss impairments based on whether a contract contains a significant financing component. Many of those who disagreed did so because they questioned the usefulness of the distinction to users and the preference for all trade receivables to be accounted for similarly (concern for lack of comparability for otherwise similar contracts). An illustrative response is the following:

> We agree on the basic premise, that normal credit risk should neither affect the timing nor the amount of revenue recognition. However, we believe that all credit losses should be presented on the same line in the statement of profit and loss. To present credit losses on two different lines is potentially misleading. You would expect that the longer the duration of the contract, the higher the risk of a credit loss, possibly making the amount significant. Having credit losses on contracts deemed to have a separate finance component accounted for separately could make it more difficult for a user to get a comprehensive view of revenue and credit losses. (CL #309, The Swedish Financial Reporting Board)

66. Proponents of having different presentation requirements for credit losses based on whether a contract has a significant financing component think that this reflects how most people see transactions. For example, the sale of a piece of furniture with 90 days trade credit would typically be viewed as just a sale. The fact that the buyer could pay in 90 days is seen as a convenience, a good business practice for

these types of sales. The trade credit is not viewed as a necessary and integral part of the transaction. Alternatively, a contract for the sale of household furniture on two year deferred payment terms has two components: the sale of a good and the provision of loan finance by the seller.

67. Proponents also point to the Boards' decision on the time value of money. As explained in paragraph BC174, the proposals on time value of money by their nature have implications on the presentation of trade receivables because they require bifurcation of long-term receivables into a sale component and a loan component. The financing component is intended to be accounted for "comparable to the accounting for a loan with the same features" (paragraph BC174), which means that the presentation of any impairment losses related to the loan component "would be consistent with the presentation of impairment losses for other types of financial assets within the scope of the financial instruments standards" (paragraph BC175). In practice, presentation of impairment losses for financial assets is often within Other expenses or Other income. Different presentation is intended to reflect the substance of contracts with customers (ie, whether only a sale is occurring or if a loan is also being provided).

68. Additionally, the sentence quoted above from paragraph BC174 also means that the recognition and measurement guidance for impairment loss in Topic 310 or IFRS 9/IAS 39 would be applied to the loan component. As acknowledged in paragraph BC171, "The proposed guidance does not include any changes to the recognition and measurement of impairment losses of financial assets, such as trade receivables. Instead, an entity would recognize and measure the impairment loss in accordance with Topic 310 or IAS 39, *Financial Instruments: Recognition and Measurement* (or IFRS 9, *Financial Instruments,* if the entity has adopted IFRS 9)."

Staff recommendation

69. The staff recommend retaining the proposed presentation requirements for impairments. The time value of money proposals are intended to identify the *substance* of a contract with a customer; that is, whether a contract includes a loan

as well as a sale. Accordingly, if a contract is deemed to include a loan, then the staff think that the financial instrument component becomes subject to existing financial instrument guidance (which addresses presentation of impairment losses among other matters).

70. However, to help clarify the presentation and impairment guidance for contracts with a significant financing component, the staff recommend that the main concepts in paragraphs BC174 and BC175 be brought forward into the standard and that an example be provided in implementation guidance.

Question 4

The staff recommend that the presentation of impairment losses for trade receivables should follow the substance of the arrangement (that is, based on whether a contract has a significant financing component) and that no adjustment be made to the presentation requirements for impairment losses. However, the staff think that to help clarify the treatment of contracts with a significant financing component, some of the concepts in paragraphs BC174 and BC175 should be incorporated into the standard and that an example of the bifurcation of a long-term receivable into a revenue component and a financing component be provided in implementation guidance

Do the Boards agree?

Application of the collectibility proposals to contract assets

71. A couple of respondents requested further guidance as to how the collectibility requirements apply to contract assets. They expressed concern over the lack of specificity for contract assets in paragraph 68, which states, “An entity similarly shall account for the effects of a customer’s credit risk on a **contract asset** (see paragraph 106)”. Their request for additional guidance is summarized as follows by one of the respondents:

> . . . we encourage the boards to provide further guidance on how these proposals [the collectibility proposals] should be applied when an entity is recognising a contract asset rather than a receivable within the scope of IFRS 9 (or IAS 39) or ASC Topic 310. In our view, the final sentence of paragraph 68, which states only that an entity “shall similarly account for the effects of a customer’s credit risk on a contract asset” is not sufficiently specific, particularly when dealing with issues

such as variable consideration (which may or may not be reasonably assured). (CL #75, Deloitte)

Staff recommendation

72. The staff think that the proposals in the revenue model and the guidance in financial instruments standards both apply to contract asset but at different stages. The staff think that the following tables provide a roadmap of applicable guidance for a contract asset (from initial recognition to re-categorization as a receivable once the conditional event has been resolved) and intend to develop an example for the standard to demonstrate application.

<u>Contract asset (before the uncertainty is resolved)</u>

Accounting area	Guidance to follow
Initial recognition (timing)	Revenue recognition model – • *Satisfaction of performance obligations (par. 31 – 37)*
Initial measurement	• Revenue recognition model – *Determining the transaction price (par. 50-67);* • *Allocating the transaction price to separate performance obligations (par. 70-76)*
Subsequent measurement	Revenue recognition model – • *Determining the transaction price: Variable consideration (par. 53-57);* • *Allocating the transaction price to separate performance obligations: changes in the transaction price (par. 77-80)*
Presentation of credit risk impairment loss	Revenue recognition model – • *Collectibility → for contracts with customers that do not have a significant financing component (par. 69)*
Disclosure	Revenue recognition model – • *Disclosure (par. 109-130)*

<u>Trade receivable (upon and subsequent to the resolution of the contingency)</u>

Accounting area	Guidance to follow
Measurement upon the resolution of the contingency	Financial instruments guidance - • *Topic 310 or IAS 39/IFRS 9*
Recognition of any initial impairment	Revenue recognition model – • *Collectibility → for contracts with customers that do not have a significant financing*

	component (par. 69)
Subsequent measurement	Financial instruments guidance - • *Topic 310 or IAS 39/IFRS 9*
Presentation of credit risk impairment loss	Revenue recognition model – • *Collectibility → for contracts with customers that do not have a significant financing component (par. 69)*
Disclosure	Financial instruments guidance - • *Topic 310 or IFRS 7*

Appendix A: Suggested changes

A1. 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
Location of the Collectibility proposals with the section entitled *Determining the transaction price*	• The staff recommend that the guidance on collectibility be moved to the *Presentation* section of the codified version of the final standard, if the Boards reaffirm the linked presentation.
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 60 of this paper. Specifically, the staff recommend clarifying that the classification of the impairment loss line is a component of revenue. • The staff also recommend a change in paragraph 72 of this paper. Specifically, the staff recommend and intend to develop an example for the standard to demonstrate application of the revenue model proposals to a contract asset.
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	• The staff recommend a change in paragraph 63 of this paper. Specifically, the staff recommend that entities be given the option to present revenue net of the impairment loss line item on the face of the financial statements and provide a breakout of the components in the footnotes or indicate the amount of customer credit risk in the title of the line item when the impairment loss line item is insignificant • The staff also recommend a

item.	change in paragraph 70 of this paper. Specifically, 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.