

STAFF PAPER

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Project	Revenue recognition		
Paper topic	Contracts with customers that contain nonrecourse, seller-based financing		
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Purpose of this paper

1. The objective of this paper is to consider respondents' concerns about the recognition of revenue under the 2011 exposure draft *Revenue from Contracts with Customers* ("The 2011 ED") for transactions that contain financing provided by the seller where the only security for the financing is the asset that has been transferred to the customer.
2. In these types of contracts, if a contract is breached (eg, the customer fails to make payments when due), a seller would have the right to repossess the asset but may not have the right to enforce payment. Even if a seller has the right to enforce payment, in many cases the full faith and credit of the buyer would not be sufficient to support the receivable. These types of arrangements are referred to as "nonrecourse, seller-based financing" in this paper.
3. Specifically, this paper considers two questions:
 - (a) whether an explicit collectibility recognition threshold should be included for nonrecourse, seller-based financing arrangements or whether the existing proposals in the 2011 ED are appropriate; and

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(b) if the Boards decide to retain the 2011 ED requirements, whether additional guidance should be provided to help entities determine whether a contract with a customer exists.

4. This paper should be read in conjunction with Agenda paper 7B/162B, which discusses the collectibility proposals more broadly, including possible refinements to the revenue model to help clarify the proposals on the presentation of the impairment loss line item.

Staff recommendation

5. The staff recommend that the Boards:
- (a) maintain the accounting for collectibility as proposed in the 2011 ED; and
 - (b) provide guidance for determining when a customer is committed to perform their obligations, by including indicators to assist in evaluating the attribute of a contract with a customer in paragraph 14(b).

Structure of the paper

6. This paper is organized as follows:
- (a) Feedback on the 2011 exposure draft (paragraphs 7-11)
 - (b) How collectibility affects revenue recognition under existing guidance for sales of real estate (paragraphs 12-19)
 - (c) How collectibility affects revenue recognition under the 2011 ED for sales of real estate (paragraphs 20-24)
 - (d) Why collectibility uncertainty is not a form of variable consideration subject to the constraint (step 5 of the model) (paragraphs 25-27)
 - (e) Staff analysis on whether a collectibility recognition threshold should apply to contracts with customers that contain nonrecourse, seller-based financing (paragraphs 28-33)

- (f) Staff analysis on whether additional guidance should be provided to help entities determine when there is a contract with a customer, if the Boards retain the 2011 ED proposals (paragraphs 29-34)
- (g) Appendix A: Suggested changes

Feedback on the 2011 exposure draft

7. While a question was not asked in the 2011 ED about whether there should be a collectibility recognition threshold¹, feedback on this subject was nonetheless received in a few comment letters and at some staff outreach events.
8. Generally, practitioners and preparers expressed support for the proposals; that is, the revenue standard should not to have a collectibility recognition threshold. Users overall supported excluding customer credit risk from the determination of the transaction price (and hence from revenue), preferring transparency into an entity's revenue growth and receivables management (the 2011 ED proposals). Additionally, most users favored retaining a collectibility recognition threshold, with one user group noting, "Eliminating the revenue recognition threshold may provide companies with an opportunity to overstate revenues by booking revenues (offset by the impairment adjustment) that have a collectibility probability of less than 50%." (CL #28, Investors Technical Advisory Committee).
9. Additionally, a few respondents requested additional guidance on how to determine whether a customer is committed to perform because the collectibility requirements in current U.S. GAAP which are intended to address this concern (as discussed below) would be removed under the proposed model. A representative comment is as follows:
- Paragraph 14(b) also states that the proposal would apply only if the parties to the contract are committed to perform their respective obligations. We recommend the Boards provide additional guidance on how an entity (buyer or seller) can demonstrate a commitment to perform. The need for this additional guidance is particularly important for some transactions (e.g., sales of real

¹ Question 2 of the 2011 exposure draft asked about the presentation proposals for the effects of a customer's credit risk.

estate) because the recognition of revenue (or a gain) when a customer has not made a down payment would represent a significant change in practice from current US GAAP. For example, in an arrangement in which the seller finances the transaction and the customer is not required to provide a down payment or the customer makes a down payment but the financing is nonrecourse, it is unclear how the customer would demonstrate a commitment to perform. (CL #77, Ernst & Young)

10. Of those respondents who disagreed with the proposals, a regulator, a user group and a few preparers expressed concern about what they perceive as an unintended consequence of “inappropriate acceleration” of revenue under the proposed model for U.S. GAAP filers (and IFRS filers who look to U.S. GAAP for some guidance on sales of real estate²) who engage in contracts with customers that contain nonrecourse, seller-based financing. In particular, the user group noted the following:

We continue to be concerned as application of the current ED may allow up front revenue recognition for these risky transactions and requires no special disclosures to alert investors to the risks.

Examples of risky transactions include, but are not limited to:

- Sales in exchange for the buyer’s non-recourse debt, particular when the sale involves real estate.
- Sales in exchange for the buyer’s debt when the buyer is a special purpose entity that is thinly capitalized.
- Sales to resellers where the seller grants a long return period, price protection, and assistance in finding end-use customers (in substance consignment).
- Cash sales when the seller guarantees or otherwise backstops debt financing the buyer’s purchase.
- Seller financed purchases to entities with unusually weak credit.

² IFRSs do not include revenue recognition guidance specifically for sales of real estate. While IAS 18, *Revenue* would apply if an entity determined that a transaction was the sale of real estate (rather than a construction of real estate on behalf of a customer within the scope of IAS 11 *Construction Contracts*), there is diverse practice in how IFRS filers account for sales of real estate. Some IFRS filers refer to the indicators in U.S. GAAP for determining if revenue can be recognized at the time of sale.

(CL #28, Investors Technical Advisory Committee)

11. However, concerns are most acute for real estate and particularly for entities which transact sales of real estate as part of their ordinary activities. The regulator, user group and preparers believe that the collectibility assurance requirements in existing U.S. GAAP for sales of real estate, including retail land sales³ (eg, initial and continuing investments)⁴ are the best indicators of an entity's commitment to a contract and hence of the appropriateness of revenue recognition for those transactions. Notably, these requirements were established to prevent abuse, to help ensure that profit is only recognized when there is a high likelihood of the customer fulfilling its obligations and not walking away from or otherwise breaching the contract.

How collectibility affects revenue recognition under existing guidance for sales of real estate

U.S. GAAP guidance

12. Subtopic 360-20 specifies that profit is recognized in full when the real estate is sold (which is at the time of closing), if both of the following conditions are met:
- (a) The profit is determinable; that is, collectibility of the sales price is reasonably assured or the uncollectible amount can be estimated, and
 - (b) The earnings process is virtually complete; that is, the seller is not obligated to perform significant activities after the sale to earn profit.

³ According to paragraph 976-605-15-3, "Retail land sales are sales, on a volume basis, of lots that are subdivisions of large tracts of land. They are characterized by down payments so small that local banks and savings and loan institutions would not loan money on the property at market rates or purchase the buyer's note for the remaining purchase price without a substantial discount. The seller is unable to enforce the sales contract or the buyer's note against the buyer's general credit. If the buyer cancels the contract within an established cancellation period, its money is refunded. Defaults by the buyer after the cancellation period result in recovery of the land by the seller and forfeiture of at least some principal payments made by the buyer."

⁴ FASB Codification Subtopics 360-20, *Property, Plant, and Equipment—Real Estate Sales*, and Subtopic 976-605, *Real Estate—Retail Land Revenue Recognition*

13. Recognition of all or part of the profit should be deferred if both conditions are not met.
14. Subtopic 360-20 requires a specified amount of initial and continuing investment from the buyer in order for the seller to conclude that collectibility is reasonably assured.
15. An initial investment must be adequate, as measured by its size and composition. For example, some types of real estate sales must have a minimum 20 percent down payment if all of the profit on the sale is to be recognized when the real estate is sold. Also, the down payment must be cash, buyer's notes supported by irrevocable letters of credit from an independent lending institution, payments to third parties to reduce existing indebtedness of the property, or other amounts paid that are part of the sales value. Other consideration received by the seller should only be included as part of the buyer's initial investment when that consideration is sold or otherwise converted to cash without recourse to the seller.
16. The buyer's continuing investment is acceptable if the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than: (a) twenty years for debt for land, and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate.
17. If collectibility is not reasonably assured, full profit recognition at the time of sale is precluded and the entity might recognize a portion of the total revenue initially and/or over time as the cash is received, depending on other specified criteria.
18. With respect to the second criterion for full profit to be recognized at time of sale (that is, that the earnings process is virtually complete), continuing involvement with the property by the seller must be assessed. If the seller's continuing involvement with the property indicates that the seller has not transferred substantially all of the risks and rewards of ownership, full profit recognition upfront would be prohibited. Profit recognition then would be determined by the nature and extent of the seller's continuing involvement. Some transactions would result in deferral of the profit while others would result in a failed sale. In a failed sale, the seller would have to account

for the transaction as a financing, leasing or profit sharing arrangement. For example, a transaction in which the buyer has the right to force the seller to repurchase the property is not a sale for accounting purposes. Such a transaction is a financing or leasing transaction depending on whether the repurchase price is above or below the initial sale price. Additionally, a sale of real estate to a limited partnership (which may be a special purpose vehicle) in which the seller is a general partner (ie, the partner that controls the special purpose vehicle) may be viewed as a profit sharing arrangement.

19. Retail land sales also have requirements for collectibility and continuing involvement in order for profit to be recognized in full at the time of sale, but are addressed separately in Section 976-605. In order for revenue to be recognized in full at time of sale for retail land sales, the receivables from the seller must be collectible (Section 976-605-25). For receivables to be collectible, the entity must have collection experience for the project in which the sale is made or for the seller's prior projects that indicates that at least ninety percent of the contracts in the project in which the sale is made that are in force six months after certain other criteria have been met⁵ will be collected in full.

How collectibility affects revenue recognition under the 2011 ED for sales of real estate

Existence of a contract (step 1 of the model)

20. In order to recognize revenue under the proposed model, an arrangement must meet the definition of contract as defined in paragraphs 13 and 14 of the ED. One of the attributes that a contract must possess is a commitment by the parties to perform their respective obligations (paragraph 14(b)). As discussed in paragraph BC34(b), this attribute must be evaluated based on all relevant facts and circumstances. One factor that may be considered in this respect is collectibility, which paragraph 68 of the ED defines as being “the risk that an entity will be unable to collect from the customer the

⁵ The criteria in paragraph 976-605-25-8.

amount of consideration to which the entity is entitled in accordance with the contract”. However, paragraph BC34(b) proceeds to caution the following:

The Boards also clarified that this attribute [of a contract] is not intended to represent a threshold for recognizing revenue if there are concerns about a customer’s ability and willingness to pay the promised consideration. The Boards decided that those concerns typically relate to the collectibility of the receivable, which a measurement issue...However, 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.

Control (step 5 of the model)

21. Unlike under today’s accounting, collectibility does not affect when revenue is recognized. Instead, revenue is recognized when an entity transfers a promised good or service (an asset) to a customer. The transfer of a promised asset occurs when (or as) the customer obtains control of that asset. Paragraph 32 of the ED states that control refers to “the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.” The ability of the customer to pay the contracted amount for the good or service is not factored into the notion of control.

Customer credit risk impairment loss (paragraphs 68 and 69)

22. The model changes the location in the income statement of the line item for impairment losses arising from contracts with customers without a significant financing component. The model also requires contracts with customers with a significant financing component (as defined in paragraphs 58 and 59) to be bifurcated into sale and loan components, with the financing component reflecting the time value of money and hence reflecting customer credit risk (in the discount rate). However, the model does not change the recognition and measurement guidance for impairment losses of financial assets, such as trade receivables. As discussed in paragraph BC171, “Instead, an entity would recognize and measure the impairment

loss in accordance with Topic 310 or IAS 39.” For further discussion on the 2011 ED’s collectibility requirements, see Agenda memo 7B/162B.

Why collectibility uncertainty is not a form of variable consideration subject to the constraint (step 5 of the model)

23. Variable consideration is explained in the 2011 ED as the amount of promised consideration that varies due to discounts, rebates, refunds, credits, incentives, performance bonuses, price concessions or other similar items. Variable consideration is included in the determination of the transaction price based on either the expected value method or the most likely amount, depending on which method better predicts the amount of consideration to which the entity will be entitled (paragraph 55). However, collectibility uncertainty does not pertain to the amount to which an entity is *entitled*. Instead, collectibility uncertainty reflects how much the entity will ultimately *receive* (which could be less than what the entity is entitled to, whether fixed or variable).
24. The Boards decided against including collectibility in the determination of the transaction price based on feedback received on the 2010 ED. The 2010 ED had proposed reflecting the customer’s credit risk in the transaction price but nearly all respondents (including preparers, users, and securities regulators) expressed concerns about applying that concept in practice, as explained in paragraph BC165. In the 2011 ED, the Boards decided that revenue should be measured at the amount to which the entity expects to be entitled, therefore excluding any adjustments that the entity may not be able to collect from the customer. As explained in paragraph BC167, the Boards were persuaded by users who expressed a preference for visibility into the sales and receivables management functions of entities – which would not be available if revenues were to be reflected on a net basis (ie, sales and collectibility reflected together in the revenue line).

Staff analysis

Should a collectibility recognition threshold apply to contracts with customers that contain nonrecourse, seller-based financing?

25. This section considers whether the 2011 ED should be amended to include a recognition threshold for collectibility for contracts with customers that contain nonrecourse, seller-based financing (assuming that the Boards decide against a collectibility recognition threshold for all contracts as discussed in Agenda memo 7B/162B). 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, see the example language in Agenda memo 7B/162B.
26. The main reasons for including a specific recognition threshold for seller-based financing transactions are as follows:
- (a) is currently operational, as it precludes revenue from being recognized when there are reasons to doubt that a customer will fulfill all of their obligations under the contract, and is well understood by regulators, users and preparers;
 - (b) minimizes subsequent reversals of revenue; and
 - (c) provides for uniformity in accounting for similar transactions. No revenue is recognized unless the threshold is met, for all contracts to which the recognition threshold would apply.
27. Alternatively, the main reasons why a collectibility recognition threshold is not needed are as follows:
- (a) *The 2011 ED already requires an arrangement to be legitimate and enforceable in order for revenue to be recognized:* Specifically, the 2011 ED requires an arrangement to have, among other attributes, ‘commercial substance’ and for the parties to an arrangement to be ‘committed to their respective obligations’. To have commercial substance, “the risk, timing or amount of the entity’s future cash flows is expected to change as a result of the contract” (paragraph 14(a)). As such, any down payment and continuing investment would presumably still need to be reviewed for sufficiency, along with prior experience with the customer, the reason for the parties to enter into the transaction, and/or other relevant facts and circumstances. As discussed in paragraph BC34(a), the Boards decided that this attribute is important to help prevent financial reporting abuse.

The “commitment” attribute reflects the reason behind having collectibility requirements in today’s U.S. GAAP, according to the AICPA’s 1973 Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate (AICPA Guide). That is, to ensure that a customer is “committed” to their contractual obligations. The objective of “customer commitment” is retained in principle in the proposed model without establishing bright lines (eg, initial and continuing involvement), such that all relevant facts and circumstances concerning whether the parties intend to be bound by the terms and conditions of the contract can be evaluated as appropriate. The AICPA Guide explains the importance of ensuring a customer’s commitment in sales of real estate as follows:

A real estate sale differs from most business transactions because a significant portion of the consideration is often a note or other receivable collectible over a relatively long period, and the receivable is normally not supported by the full faith and credit of the buyer. Thus, often the only recourse of the seller on default by the buyer is to recover the property sold. For legal and business reasons, sellers usually limit themselves to foreclosure to remedy defaults, even if the terms of the agreements provide for full recourse against the buyers.

- (b) *If the contract includes a significant financing component, customer credit risk will be reflected in the measurement of the revenue and the corresponding financial asset.*
- (c) *Transparency:* If the contract does not include a significant financing component, the amount of revenue recognized will not be adjusted for customer credit risk. However, the 2011 ED proposes that the revenue amount (which would reflect the amount to which the entity is entitled) and the impairment loss line (for any impairments of the corresponding financial asset) should be shown on separate, but adjacent, line items of the statement of comprehensive income. Consequently the user of the financial statements will be provided with visibility into the amount of revenue that the entity is entitled to and the amount of that revenue that the entity does not expect to collect. This information enables the user to assess the quality of the entity’s revenue.

- (d) *Better reflection of an entity's performance*: The revenue recognized would provide a better depiction of the entity's performance in its contracts with customers because revenue would be recognized when the entity has transferred the promised good or service (eg, real estate) to the customer. Consequently, the staff thinks that the absence of a recognition threshold from the 2011 ED proposals cannot be regarded as causing an "inappropriate acceleration" of revenue recognition. Instead, the recognition of revenue under the proposed model better reflects the timing of when a promised asset is transferred to a customer.

Question 1

The staff recommend that a collectibility recognition threshold not be established for contracts with customers that contain nonrecourse, seller-based financing (View B).

Do the Boards agree?

If the Boards retain the 2011 ED proposals, should additional guidance be provided to help entities determine when there is a contract with a customer?

28. The staff think that there are two views with respect to this question:
- (a) View A: the 2011 ED should be amended to include additional guidance on when an entity has a contract with a customer. Such additional guidance would consist of indicators, not all inclusive, of when the parties to an arrangement may be committed to their respective obligations.
 - (b) View B: the 2011 ED should not be amended to include additional guidance on when an entity has a contract with a customer.
29. Proponents of View A argue that:
- (a) amended guidance would provide more consistency in the analysis of whether the customer is committed to the contract, as currently the 2011 ED leaves the concept open to interpretation; and
 - (b) additional guidance could mitigate potential abuse in applying the model to nonrecourse, seller-based financing transactions.

30. Proponents of View B argue that:

- (a) additional guidance is unnecessary as indicators that parties to the contract have the intent and the commitment to fulfill their respective obligations are based on facts and circumstances, some of which may be implied by customary business practices, as described in paragraph BC34; and
- (b) entities (or auditors or regulators) may view a list of indicators as a checklist, thus enacting a high hurdle for revenue to be recognized under the model.

31. To help clarify the importance of the attributes of a contract in paragraphs 14(a) (commercial substance) and 14(b) (commitment to perform obligations), and the Boards' intent, the staff recommend including indicators of 'commitment to perform their respective obligations' in implementation guidance. Some indicators that the staff is assessing that may be relevant include, but are not limited to, the following:

- payment terms that reflect uncertainty about the customer's interest and intent on following through with its obligations. Such terms may include (i) a small down payment relative to the overall contracted price, (ii) nonrecourse, seller financing, (iii) collateral or guarantees that is (are) not highly liquid, (iv) continuing payments that extend over a relatively long period of time, and/or (v) guarantees which are provided by non-highly rated companies.
- the reason for the parties entering into the transaction, in light of the parties' business models, raises a question as to the customer's intent on following through with its obligations. For example, if a customer is entering into a transaction for speculative purposes, which is not part of their ordinary business activity, the customer may not be committed to fulfill its obligations.
- experience that the entity has with the customer for the same or similar transactions (experience may be that of the entity or another entity). For example, if the entity has limited experience with the customer, and does not have access to the experience that others have had with the customer, then the entity may not have a solid basis on which to conclude that the customer will fulfill its obligations.

32. None of the indicators provided should be viewed in isolation; instead, they should be viewed collectively and weighted based on all relevant facts and circumstances. No single indicator should be considered determinative as to whether the customer is committed.
33. The staff highlight that the provision of indicators of “commitment” (ie, of the attribute in paragraph 14(b)) coincides with the recommendation made by the participants in a FASB-hosted real estate workshop, whose participants included owners/managers of real estate, a real estate investment trust (REIT) and an industry group representing REITs. Those participants expressed that it is difficult to determine whether a buyer of real estate is committed to perform their obligation if they have little or no equity investment in the purchase.

Question 2

The staff recommend that if the Boards decide against re-establishing a collectibility recognition threshold, that indicators of the parties' commitment to perform their respective obligations (paragraph 14(b)) be provided in implementation guidance.

Do the Boards agree?

Appendix A: Suggested changes

A1. The following table lists the proposed requirements from the exposure draft that relate to the guidance on the definition of a contract with a customer and identifies what might change as a result of the staff recommendations in this paper.

Proposals from 2011 Exposure Draft	Suggested changes
<p>14. An entity shall apply the proposed revenue guidance to a contract with a customer only if all of the following criteria are met:</p> <p>(a) The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).</p> <p>(b) The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.</p> <p>(c) The entity can identify each party's rights regarding the goods or services to be transferred.</p> <p>(d) The entity can identify the payment terms for the goods or services to be transferred.</p>	<ul style="list-style-type: none"> The staff recommend a change in paragraph 31 of this paper. Specifically, the staff recommend that implementation guidance be provided that describes indicators of when the parties may or may not be committed to perform their respective obligations (ie, related to the criterion in paragraph 14(b)).