Addendum to July 2013 Agenda Paper 7A/173A – Revenue Recognition

Collectibility

Introduction

This addendum outlines another alternative (Alternative C) to address the concerns in paragraphs 23 and 24 of the July 2013 Agenda Paper 7A/173A *Collectibility*. Specifically, how should an entity distinguish between doubts about collectibility arising from customer credit risk that results in variable consideration (ie a price concession) compared with those that result in an impairment loss.

Alternative C

When an entity enters into a contract that has significant credit risk, the entity is deemed to have offered discounts or price concessions to the customer (thus the consideration promised in the contract is variable).

- In contracts with significant credit risk, the transaction price will be lower than the stated contract price.
- The discounts or price concessions in contracts with significant credit risk will correspond to the entity's expectations about the ability of the customer to pay. That is, the amount of consideration to which the entity expects to be entitled from a customer (ie the transaction price) is the amount that the entity expects to collect from the customer.
- Because the promised consideration is variable, an entity should apply the constraint in the same way as for other variable consideration. That is, "an entity shall include the amount of variable consideration in the transaction price only if the entity expects that…a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal" (paragraph 56.1 of the latest staff draft).
- As with all variable consideration, any changes in estimates will affect the measurement of revenue (ie will be recognised in the revenue line). Changes in estimates may result from changes in the amount the entity ultimately collects from the customer.

NOTE: This alternative applies to contracts that have met the criteria in paragraph 14.

Consider the following examples

Case facts:

- Sale of a good (point in time transfer)
- Contractually stated price = 100; payment due in normal trade terms of 90 days (no significant financing component identified)
- **Example 1** – The customer is identified as a 'normal' credit risk customer and the entity initially expects to collect 100. A subsequent event occurs and the entity accepts 50 as full payment for the contract requiring an impairment to be recognised.
- **Example 2** – The entity initially estimates that it will provide a price concession of 40, and subsequently provides a price concession of 50 (that is, an increase of 10) for quality/performance issues. These price concessions will be treated as variable consideration (and subject to the constraint). The customer is also assessed to have 'high' credit risk.
- **Example 3** – The customer has 'high' credit risk and past business practices indicate that the entity customarily accepts as full payment something less than the contractually stated price (for example, healthcare self-pay patients). The entity implicitly provides price concessions that are treated as variable consideration (and subject to the constraint). The entity initially estimates that it will provide a price concession of 40, and subsequently provides a price concession of 50 (that is, an increase of 10) for quality/performance issues.
- **Example 4** – The customer has 'high' credit risk and there is no contractual requirement to provide price concessions. At inception, the entity expects to collect 60; however, the entity ultimately collects 50. Under both Alternative A and B in the agenda paper 7A/173A, an entity determines that the consideration does not include a variable amount and instead assesses that the receivable is impaired. However, in Alternative C due to the 'high' credit risk the consideration is deemed variable (and subject to the constraint).

Note: Alternatives A and B are as described in the July 2013 Agenda Paper 7A/173A.

Alternative C is as outlined above.

Alternative A			Alternative B			Alternative C		
Example 1 - normal credit risk, no price concession								
	Day 1	Subsequent		Day 1	Subsequent			
			Revenue	100	-			
			Impairment	-	(50)			
Revenue	100	-	Revenue	100	(50)			
						Alternative C not applicable.		
Cost of sales	XX	-	Cost of sales	XX	-			
Impairment exp	-	(50)	Impairment exp	-	-			
Example 2 - price concession provided to customer for quality/performance								
	Day 1	Subsequent		Day 1	Subsequent		Day 1	Subsequent
			Revenue	60	(10)			
			Impairment	-	-			
Revenue	60	(10)	Revenue	60	(10)	Revenue	60	(10)
Cost of sales	XX	-	Cost of sales	XX	-	Cost of sales	XX	-
Impairment exp	-	-				Impairment exp	-	-
Example 3 - high credit risk, price concession expected (for performance & credit risk)								
	Day 1	Subsequent		Day 1	Subsequent		Day 1	Subsequent
			Revenue	60	(10)			
			Impairment	-	-			
Revenue	60	(10)	Revenue	60	(10)	Revenue	60	(10)
Cost of sales	XX	-	Cost of sales	XX	-	Cost of sales	XX	-
Impairment exp	-	-				Impairment exp	-	-
Example 4 - high credit risk, impairment (?)/price concession(?) issued for credit risk								
	Day 1	Subsequent		Day 1	Subsequent		Day 1	Subsequent
			Revenue	100	-			
			Impairment	(40)	(10)			
Revenue	100	-	Revenue	60	(10)	Revenue	60	(10)
Cost of sales	XX	-	Cost of sales	XX	-	Cost of sales	XX	-
Impairment exp	(40)	(10)	Impairment exp	-	-	Impairment exp	-	-

Main implications of Alternative C for the rest of the model

Interaction with financial instruments standard

- Under Alternative C, contracts with a significant credit risk component should be excluded from the scope of the financial instruments standard because any reassessment of customer credit risk would be accounted for as an adjustment to revenue rather than as an impairment loss.

Identification of a contract with a significant credit risk component

- Guidance may need to be developed to assist an entity to assess whether a contract has a significant credit risk component. Some of the factors identified in paragraphs 31-36 of agenda paper 7A/173A may be able to be incorporated into that guidance.

Measurement of variable consideration

- Paragraph 55 of the staff draft states that an entity should estimate variable consideration at its expected value or at the most likely amount, depending on which method better predicts the amount of consideration to which an entity will be entitled.
- The 2010 ED, which included expectations of customer credit risk in the measurement of the transaction price, required an entity to estimate the transaction price at its expected value.
- The staff think that an expected value technique could be the most appropriate technique for estimating variable consideration for contracts that have significant credit risk. This is because an expected value technique would take into account an entity's expectations of the full range of possible cash flow scenarios.
- In some contracts, an expected value technique may yield a lower estimate of variable consideration than a most likely amount. As a result, that lower estimate may more easily pass the constraint.

Application of the constraint

- The constraint would apply similarly to estimates of consideration when the customer that have significant credit risk (ie 'Alternative C') as for other forms of variable consideration.

- In assessing the options explained in the July 2013 Agenda Paper 7C/173C - Constraint – minimums requirements, the Boards will need to consider the effect of Alternative C, if adopted.
    - For example, 'option 1' in Agenda Paper 7C/173C (ie to draw a distinction between point in time and over time performance obligations in the minimums requirements - see paragraphs 17-21 of that paper) may not be appropriate if Alternative C is adopted. This is because the rationale for the minimum requirements in option 1 is to differentiate changes in the estimate of variable consideration that are correlated with the entity's performance. However, in Alternative C changes in the transaction price are related to assessments of customer credit risk that would be present in all transactions and therefore would not be correlated to the entity's performance.
    - In contrast, 'option 2' in Agenda Paper 7C/173C (ie the 2011 ED approach for royalties on licenses – see paragraphs 22-27) would avoid this inconsistency because the minimums requirements would only apply to a subset of contracts that are not correlated to the entity's performance.

Interaction with significant financing component

- The Boards would need to consider how an entity should account for a contract that has both a significant financing component and a significant credit risk component. In particular, should precedence be given to accounting for the significant financing component (as per the requirements in the staff draft) or to accounting for the significant credit component (as per Alternative C)?
    - If an entity gave precedence to the contract's significant financing component, assessments of a customer's credit risk would be reflected in the interest rate that is used to discount the promised consideration. The constraint on revenue recognition is not generally applicable to contracts with a significant financing component because the uncertainty associated with customer credit risk relates to the loan receivable rather than to the revenue recognised. This is because the staff draft accounts for contracts with a significant financing component as the granting of a loan to the customer (measured initially at the discounted amount of promised consideration) and the customer uses the proceeds of the loan to purchase a good or service at its

notional cash selling price. In contrast, under Alternative C, the constraint might apply to preclude revenue recognition for contracts without a significant financing component. Therefore, additional tension would be placed on the assessment of whether a contract has a significant financing component because this could affect whether an entity could recognise revenue at the time a good or service transfers to the customer.

- If an entity gave precedence to the contract's significant credit component, the constraint might apply to preclude the recognition of revenue and the corresponding loan receivable until the uncertainty associated with customer credit risk is resolved. In effect, this could result in an entity recognising revenue on a cash basis. Further analysis would be required to consider how the constraint would apply to the promised consideration when the contract has a significant financing component.