STAFF PAPER

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Project	**Revenue recognition**		
Paper topic	Collectibility		

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Purpose of this paper

1. This paper considers how assessments of a customer's credit risk should be reflected in accounting for contracts with customers without a significant financing component.

Summary of staff recommendations

2. The staff recommend the Board make the following clarifications to the staff draft (see Appendix A for excerpts from the latest staff draft):
   (a) Clarify the objective and application of paragraph 14;
   (b) Eliminate the final sentence in paragraph 50; and
   (c) Eliminate the final sentence in paragraph 53.1(b).
3. To respond to concerns regarding how an entity should distinguish between doubts about customer credit risk that result in variable consideration (ie a price concession) compared with those that result an impairment loss, the staff think that Alternative A (ie retain the approach in the staff draft and include additional guidance) represents a viable approach. However, the staff acknowledge that Alternative B (ie presenting impairment losses adjacent to revenue) would

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alleviate the difficulty in distinguishing between a price concession and an impairment loss by requiring a 'linked' presentation of the revenue and impairment losses from contracts with customers without a significant financing component.

Structure of this paper

4. The remainder of this paper is structured as follows:

   (a) Background (paragraphs 5 – 6)

   (b) Current decisions and draft requirements on collectibility (paragraphs 7 – 15)

   (c) Feedback (paragraph 16)

   (d) Clarifying the apparent overlap between paragraph 14, 50 and 53.1(b) (paragraphs 17 – 22)

   (e) Clarifying the distinction between collectibility as an impairment issue and a price concession (paragraphs 23 – 24)

   (f) Paths forward (paragraphs 25 – 46)

      (i) Alternative A—Retain the approach in the staff draft and add guidance to clarify the distinction between price concessions and impairment losses (paragraphs 26 – 36)

      (ii) Alternative B—Present impairment losses adjacent to revenue, clarify these two amounts would represent 'net revenue' (paragraphs 37 – 45)

      (iii) Alternatives rejected by the staff (paragraph 46)

   (g) Staff recommendation (paragraphs 47 – 50)

   (h) Appendix A: Excerpt from the latest staff draft

   (i) Appendix B: Feedback on the 2011 ED – *excerpt from Agenda Paper 7B/162B September 2012*

Background

5. The core principle of the revenue model is that an entity should recognise revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. A consequence of measuring revenue at the amount of consideration to which the entity is entitled is that the amount recognised as revenue is not adjusted for the risk that the entity will not ultimately collect that amount because the customer does not have the ability to pay. In other words, under the revenue model, customer credit risk does not directly affect the measurement of revenue (see paragraph 52.1, Appendix A). (However, customer credit risk is reflected in the measurement of revenue if a contract with a customer includes a significant financing component. This is because an interest rate that reflects the customer's credit risk is used to discount the promised consideration to the amount that the customer and entity would have agreed if the customer paid cash at the time they received the good or service from the entity. The measurement of revenue arising from contracts with a significant financing component is not discussed further in this paper, but the presentation of impairment losses from those contracts is discussed at paragraph 38 below.)

6. Measuring revenue at the entitled amount was proposed in the 2011 ED *Revenue from Contracts with Customers*. The 2011 ED proposal was a change from the original proposal in the 2010 ED *Revenue from Contracts with Customers*, which was for revenue to be recognised at the amount at which the entity receives, or expects to receive, in exchange for the promised goods or services. In reaching the decision to measure revenue on the basis of entitlement to the consideration rather than on expectations of the amount of consideration that will be collected, the Boards noted that (among other things) users of financial statements prefer revenue to be measured at the 'entitled' amount so that revenue growth and receivables management (or bad debts) can be analysed separately.

Current decisions and draft requirements on collectibility

7. The staff draft (see Appendix A) includes the following requirements on collectibility:
   (a) Measurement of revenue and presentation of impairment losses;
   (b) Identifying a contract with a customer; and
   (c) Measurement of variable consideration.

Measurement of revenue and presentation of impairment losses

8. As part of their redeliberations on the 2011 ED, the Boards considered possible approaches for addressing customer credit risk in accounting for contracts with customers without a significant financing component. In November 2012, the Boards decided:
   (a) to reaffirm their proposal in the 2011 ED that the transaction price, and therefore revenue, should be measured at the amount of consideration to which the entity is entitled (that is, an amount that is not adjusted for customer credit risk and the revenue recognised is not subject to a collectibility threshold); and
   (b) to present any corresponding impairment losses (recognised initially and subsequently in accordance with the respective financial instruments Standards) arising from those contracts with customers prominently as an expense in the statement of comprehensive income.

9. These decisions are reflected in staff draft of the standard at paragraphs 50 and 52.1 (for determining the transaction price) and paragraphs 106(a) and 108.2 (for the recognition, measurement and presentation of impairment losses from contract with customers).

10. Some respondents to the 2011 ED expressed concerns that measuring revenue at the entitled amount without the transaction initially passing a collectibility threshold would increase the likelihood that amounts of revenue recognised by the entity might not be ultimately collected from the customer and, hence, decrease

the quality of the revenue line in the statement of comprehensive income. However, in making their decision in November 2012, the Boards noted:

(a) The collectibility thresholds in existing IFRSs and US GAAP (such as ‘probable’ or ‘reasonably assured’) apply to a broader range of collectibility concerns other than just customer credit risk, which are separately addressed by the revenue model. Specifically, the revenue model separately addresses collectibility uncertainties unrelated to a customer’s ability to pay as follows:

    (i) uncertainty about the customer’s commitment to the contract is addressed by the fact that contracts are only subject to the revenue model if, among other factors, the parties are ‘committed to perform their respective obligations’ (paragraph 14, Appendix A). This is discussed further in paragraphs 11-12 below.

    (ii) uncertainty about whether the consideration is due because of uncertainty (or disputes) about whether the entity has performed is addressed by the requirements on the satisfaction of performance obligations (paragraphs 31-37 of the 2011 ED).

    (iii) uncertainty about whether the entity will perform in the future and hence entitled to collect the consideration for a performance obligation already satisfied is addressed in the requirements on variable consideration and the constraint on estimates of variable consideration (paragraphs 53-57 of the 2011 ED).

(b) In general, most entities would not sell goods or services on credit if they had significant doubts about the credit risk of a customer.

(c) For contracts in which the entity sells goods or services on credit (including to low credit quality customers), the requirement to separately (and prominently) present any subsequent impairment loss arising from those contracts will provide users with information that can be used to

assess the quality of the entity's customer base and, therefore, the entity's revenue.

Identifying a contract with a customer

11. Paragraph 14 of the staff draft (see Appendix A) specifies criteria that must be met before an entity can account for a contract with a customer in accordance with the revenue model. The criterion in paragraph 14(e) requires that 'the parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights'. Paragraph 14(e) also lists some factors that an entity should consider when assessing whether the parties to the contract are committed to perform their respective obligations and enforce their respective rights under the contract.

12. An assessment of collectibility is implicit in paragraph 14(e) criterion, but the assessment is based only on whether, at the time the paragraph 14 criteria are applied (which usually would be at contract inception), the customer intends to perform by paying for the promised goods or services. Any assessment of a customer's intentions will be inherently subjective. However, if, at contract inception, an entity assesses that there is a significant risk that the customer does not have the ability to pay, that fact should raise doubts about whether the customer entered into the contract with the intention of performing its obligations under the contract. In those cases, if the customer's commitment to the contract is in significant doubt, the entity's contract with that customer cannot be regarded as a bona fide contract.

Measurement of variable consideration

13. As mentioned above, the transaction price is not adjusted for customer credit risk (paragraph 52.1, Appendix A). However, paragraphs 50 and 53.1(b) (see Appendix A) contemplate circumstances in which uncertainties about collectibility are taken into account in the measurement of the transaction price, and hence revenue.

14. The intention of paragraph 50 is to clarify that the stated contract price (or 'list' price) will not necessarily be the enforceable price in a contract if an entity has an established past practice of enforcing a lower amount because the entity routinely offers price concessions (or discounts) to its customers.

15. Paragraph 53.1(b) requires an entity to consider whether the facts and circumstances related to the contract indicate that the entity is expected to offer a discount or price concession on the consideration promised in exchange for the goods or services transferred to the customer. In some cases, the offer of a discount or price concession might be specified in the contract or evident from the entity's customary business practices. However, paragraph 53.1(b) also acknowledges that an entity may be contemplating offering a price concession if the entity enters into a contract with a customer and there is significant doubt about the collectibility of the amount of promised consideration. This acknowledgement was added because Board members commented that, in the absence of a collectibility threshold for revenue recognition, an entity should not presume that it can recognise revenue at the stated contract price if it has entered into a contract with a customer who has significant credit risk. That is because entering into a contract with a customer who has significant credit risk might indicate that the entity is willing to exchange the promised goods or services for an uncertain amount of consideration. Hence, in those circumstances, recognising revenue at the stated contract price would overstate the measurement of the entity's performance.

Feedback

16. During the drafting process, the staff received comments related to the accounting for collectibility. Primarily those comments requested greater clarity on:

    (a) the apparent overlap in the application of paragraph 14 (identifying the contract) and the requirements for determining the transaction price (paragraphs 50 and 53.1(b)) that address uncertainties related to the contract; and

(b) determining when to account for customer credit risk as either an impairment expense or as a price concession.

Clarifying the apparent overlap between paragraph 14, 50 and 53.1(b)

17. In the drafting process, many questioned the relevance of paragraphs 50 and 53.1(b) in light of the criteria in paragraph 14 for identifying a contract. In particular, reviewers commented that the staff draft is unclear about:

    (a) Whether (and when) doubts about a customer's ability to pay should either:

        (i) affect the identification of a contract (in accordance with paragraph 14); or

        (ii) indicate that the entity may grant a price concession (in accordance with paragraph 53.1(b)).

    (b) Whether the expectation that either the customer or the entity might only *partially* perform their obligations or enforce their contractual rights (such as by granting a price concession) affects the identification of a contract in accordance with paragraph 14. Some reviewers noted that the confusion partly stemmed from paragraph 14(e) referring to the entity's intent and past practice of enforcing its contractual rights and the acknowledgement in paragraph 50 that an entity may seek to not enforce all of the rights to the promised consideration.

    (c) Whether paragraph 52.1 (which states that the transaction price is not adjusted for the effects of customer credit risk) is contradicted by paragraph 53.1(b) (which notes that the existence of significant doubt about collectibility might indicate that the promised consideration is variable).

18. To address those comments, the staff recommends clarifying the objective and application of paragraph 14 of the staff draft as follows:

    (a) *Clarify the objective* – In applying the paragraph 14(e) criterion, an entity should make an overall qualitative assessment of the facts and

circumstances of the contract with the customer to determine if the parties to the contract are committed to the contract. Uncertainties about whether the customer subsequently may only partially perform their obligations (ie if the customer is expected to have the ability to pay only some, but not all, of the consideration) or the entity subsequently may only partially enforce their contractual rights (ie by granting a price concession that was not specified in the contract) would not prevent the criterion in paragraph 14(e) criteria from being met. Instead, those uncertainties would be addressed by other parts of the revenue model.

(b) *Clarify the application: eliminate the indicators (1-3) in paragraph 14(e)* – Indicators 1-3 in paragraph 14(e) were added as part of the Boards' tentative decisions in September 2012 to provide additional guidance about how to determine whether a contract with a customer exists based on the customer's commitment to perform its obligations under the contract. However, the addition of these indicators has raised questions from reviewers about whether the criterion in 14(e) can be met in many common sales contracts. (For example, in contracts where the entity chooses not to enforce a requirement that the customer make a minimum level of purchases or to enforce a termination penalty.) In addition, the indicators seemed to detract from the overall purpose of paragraph 14, which is to exclude from the revenue model bona fide transactions and other contracts that lack commercial substance or legitimacy.

19. In addition to these clarifications related to paragraph 14 of the staff draft, the staff recommends deleting the following sentence in paragraph 50:

> However, if an entity's customary business practices, published policies, or specific statements create a valid expectation of the customer that the entity will enforce its rights to only a portion of the stated contract price, the amount of consideration to which the entity expects to be

> entitled is equal to the amount of the contract price to which the entity intends to enforce its rights to receive.

20. The staff think that this sentence in paragraph 50 is not necessary because paragraph 53.1(b) provides sufficient guidance to indicate that an entity's intention to only enforce some, but not all, of its right to consideration indicates that the consideration is variable because a price concession is being granted. (Paragraph 53.1(b) explains that 'an assessment of the facts and circumstances related to the contract indicates that the entity might accept a discount or price concession on the consideration promised by the customer in exchange for the promised goods or services'.) The staff note however, the comments on the difficulty in distinguishing between a price concession and an impairment loss (ie a bad debt write off or debt forgiveness), which is discussed in the next section.

21. The staff also think that the Boards should delete the final sentence in paragraph 53.1(b) of the staff draft:

> For example, entering into a contract with a customer when there is significant doubt about the collectibility of the amount of promised consideration indicates that the entity may intend to provide a price concession.

22. This is because the final sentence in paragraph 53.1(b) appears to directly contradict with paragraph 52.1 of the staff draft, which specifies that customer credit risk is not included in the measurement of the transaction price. The staff also think that this sentence will not be necessary if the Boards adopt Alternative A below and provide additional guidance about when paragraph 53.1(b) was intended to apply, which ultimately was the intention of the final sentence of that paragraph in the staff draft. If however, the Boards decide to adopt Alternative B below (ie impairments presented adjacent to revenue), the staff think that the final sentence in paragraph 53.1(b) in the staff draft can be replaced with some of the notions in paragraph 30 below such as:

> Examples of such facts and circumstances include:
>
> (a) the entity does not intend to enforce the stated contract price;

(b) the entity explicitly promises price concessions/discounts; and

(c) the customer has a valid expectation, based on the entity's customary business practices, that the entity will grant the customer a price concession.

Question 1, 2 and 3 for the Boards

Do the Boards agree with the following clarifications?

1. Clarify the objective and application of paragraph 14 of the staff draft as follows:

(a) Clarify the objective: In applying the criteria in paragraph 14(e), an entity should make an overall qualitative assessment of the facts and circumstances of the contract with the customer to determine if the parties to the contract are committed to the contract; and

(b) Clarify the application: eliminate the indicators (1-3) in paragraph 14(e).

2. Eliminate the following sentence in paragraph 50 of the staff draft:

"However, if an entity's customary business practices, published policies, or specific statements create a valid expectation of the customer that the entity will enforce its rights to only a portion of the stated contract price, the amount of consideration to which the entity expects to be entitled is equal to the amount of the contract price to which the entity intends to enforce its rights to receive."

3. Eliminate the following sentence in paragraph 53.1(b) of the staff draft

"For example, entering into a contract with a customer when there is significant doubt about the collectibility of the amount of promised consideration indicates that the entity may intend to provide a price concession."

Clarifying the distinction between collectibility as an impairment issue and a price concession

23. In the drafting process, the staff added paragraph 53.1(b) which states that significant doubt about the collectibility of the amount of promised consideration could indicate that the entity intends to provide a discount or a price concession to the customer. In addition to the concern discussed above related to the interplay between paragraph 53.1(b) and paragraphs 50 and 14, many questioned:

    (a) how an entity should distinguish between doubts about customer credit risk that result in variable consideration (ie a price concession) compared with those that result an impairment loss.

    (b) whether that distinction can be practically applied.

24. Many comments highlighted the importance of this distinction because the accounting for each is different:

    (a) *Variable consideration—explicitly or implicitly promising a discount or price concession*—The consideration promised in the contract is variable, and therefore subject to the constraint, if a discount or price concession is explicitly or implicitly promised. Accordingly, an entity would apply paragraph 55 of the staff draft to estimate the amount of consideration to which it expects to be entitled (using either an expected value method or a most likely amount method). The estimate of the variable consideration can be included in the transaction price, and hence in revenue, only if the entity expects that, based on an assessment of factors in paragraph 56.2 of the staff draft, a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. If the entity cannot meet those factors (which may be common if the entity has to offer concessions of varying amounts to individual customers), the entity would not be able to recognise revenue until the uncertainty is resolved—which might be if and when the customer pays for the good or service transferred. As with

other variable consideration, any changes in estimates will be presented as an adjustment to revenue.

(b) *Impairment loss*—When customer credit risk results in an impairment loss, the transaction price (and hence revenue) would not be adjusted and instead an entity would recognise revenue and a related receivable or contract asset and apply the appropriate impairment model (ie Topic 310 or IFRS 9). Any impairment losses would be presented separately, along with any changes to that loss.

Paths forward

25. To address those concerns, the staff think the Boards should consider the following alternatives:

(a) **Alternative A** – Retain the approach in the staff draft and add guidance to clarify the distinction between price concessions and impairment losses.

(b) **Alternative B** – Present impairment losses adjacent to revenue, clarify that these two amounts would represent 'net revenue' (2011 ED approach – with a clarification). From a practical perspective, this alternative would lessen the tensions associated with distinguishing between price concessions and impairment losses because both would be presented as components of revenue.

Alternative A – Retain the approach in the staff draft and add guidance

26. Alternative A would maintain the approach in the staff draft with clarifications to assist an entity to assess whether it should account for the customer credit risk inherent in a contract as an impairment matter or as variable consideration.

27. To address the concerns raised by reviewers, the staff think that the staff draft could be improved by:

(a) clarifying the distinction between customer credit risk and variable consideration;

(b) requiring an entity to assess all relevant facts and circumstances related to the contract in determining whether the promised consideration might be variable (and therefore subject to the constraint);

(c) identifying attributes of contracts with customers in which price concessions are more likely to be granted; and

(d) requiring an assessment of other evidence about whether the entity's actions indicate that that it might grant price concessions in a contract.

The distinction between customer credit risk and variable consideration

28. In concept, there is a distinction between customer credit risk and variable consideration. They are similar in the sense that the entity's future cash flows from a contract are uncertain based on a future action or event. However, the key difference is how the uncertainty arises.

29. The uncertainties that make consideration variable are reflected (either explicitly or implicitly) in the negotiated and agreed terms and conditions of the contract (eg indexation or bonuses) or offered unilaterally by the entity to the benefit of the customer (eg price concessions). One reason for granting a concession might be to enable the entity's customer to move old inventory so that the entity's customer can purchase additional inventory from the entity. Other reasons for granting a concession might be because the entity had difficulty in establishing the price of a new product or because the quality of the product sold did not meet agreed specifications. In any of those cases, concessions are likely to be granted to encourage future sales from the same customer. In other words, concessions are provided to maintain a relationship with a customer.

30. In contrast, the uncertainties about the customer not meeting their obligations under the contract to pay the promised consideration (that is, customer credit risk) arise irrespective of the negotiated terms and conditions of the contract. Although it may require action of the entity to accept a partial payment as full settlement of

a debt, it is not a unilateral decision of the entity because it initially requires default by the customer. A genuine decision to settle a debt at a lower amount based on a customer's inability to pay the full amount typically would occur after initial attempts to enforce full payment have been unsuccessful. Subsequent actions may involve some level of negotiation or discussion to determine the amount that the customer could pay and that the entity would be willing to accept as payment in full.

Assessment of facts and circumstances

31. The revenue Standard should clarify that variability can arise for many reasons and, consequently, an entity should consider all relevant facts and circumstances which may indicate that the entity expects to be entitled to an amount that is less than the stated contract price. Examples of such facts and circumstances include:
    (a) the entity does not intend to enforce the stated contract price;
    (b) the entity explicitly promises price concessions/discounts; and
    (c) the customer has a valid expectation, based on the entity's customary business practices, that the entity will grant the customer a price concession.
32. In any of the above cases, the staff think that typically the entity and the customer are aware at the time of entering into the contract as to whether a price concession/discount will be granted (or expected). In addition, the staff think the guidance could explain that if an entity is aware of significant credit risk of the customer upon inception of the contract, the entity must also consider what is the amount to which the entity is entitled. This is because by knowingly entering into a contract with a customer with significant credit risk, the entity may effectively be demonstrating that it is willing to accept a lower price in exchange for the promised goods or services.

Identifying attributes of contracts with customers

33. Consistent with the purpose of paragraph 53.1(b) of the staff draft (as explained earlier in paragraph 15 of the paper), the staff think that the revenue Standard

should acknowledge that most contracts would not be affected by paragraph 53.1(b) even if the entity ultimately does enforce (or accept) a lower amount of consideration from the customer. This is because, as noted in paragraph 10(b) above, most entities would not sell goods or services on credit if they had doubts about the credit risk of a customer.

34. The staff also think that further guidance could be added—possibly in application guidance—to highlight that some transactions may be more likely to result in an entity determining that the consideration is variable and the transaction price is less than the stated contract price. This may occur when:

    (a) the entity controls the customer's access to the good or service

    (b) the incremental cost to the entity to transfer the good or service to the customer is negligible

    (c) the good that transfers to the customer is not expected to substantially depreciate (or diminish in value) and it therefore serves as adequate collateral (eg tangible assets in which the asset is unlikely to substantially depreciate).

35. This is because in those transactions, the entity is generally not going to be worse off if the customer fails to pay and therefore is likely willing to accept a lower price for the promised goods or services. (This assessment of being 'worse off' is intended to refer to a real economic cost rather than only an opportunity cost.)

Assessment of other evidence

36. An entity's actions in dealing with a customer (or other customers within a similar class) may provide evidence of whether the entity intends to enforce its full rights to consideration or whether it might consider offering a price concession. Accordingly, the revenue Standard could specify that an entity should consider the following factors, which might indicate that the entity intends to enforce the debt even if it ultimately collects less than the full amount of consideration:

    (a) When debts are overdue and there would be a genuine attempt by the entity to enforce payment—A genuine attempt to enforce payment does

not necessarily require initiating or completing court proceedings to enforce payment from a customer, especially when that would be uneconomic to do so. Other evidence could indicate the entity intends to enforce the debt, such as (for example) an invoice from Berchowitz's Bruisers debt collection agency. But a sternly-worded standard-form letter from the accounts receivable clerk is unlikely to be sufficient. The approach to enforcement should be proportionate to the amounts owed, so intent to enforce a CU10 million debt might be best demonstrated by pursuing legal action.

(b) The entity has not previously agreed to a partial payment from the same customer as full settlement—Past actions to settle for less than the full amount from the same customer should taint the entity's assertion that it intended to enforce full payment from the customer. If the customer has previously been unable to pay its debts and the entity knowingly sells goods on credit to the customer again, the staff thinks that provides a strong indication that the entity will offer a concession to maintain the customer relationship.

Alternative B – Present impairment losses adjacent to revenue (based on 2011 ED)

37. Alternative B requires the presentation of impairment losses (ie any losses arising from initial and subsequent credit risk impairment—which would be recognised and measured in accordance with the financial instruments guidance) in a line item adjacent to the revenue line item (as proposed in the 2011 ED).

38. Consistent with the 2011 ED proposals, the requirement to present impairment losses adjacent to revenue would apply only to contracts with customers without a significant financing component. This is because customer credit risk is already included in the measurement of the transaction price for contracts with a significant financing component and any impairment losses related to the financing component (ie the loan) would be presented together with other financial instruments as an expense.

Why is the 2011 ED approach being re-considered?

39. The determination of the transaction price, including variable consideration will be the same in Alternatives A and B. However, the main difference between those Alternatives is the location of the presentation of impairment losses. In Alternative B, these losses would be presented adjacent to revenue, whereas in Alternative A, they are presently prominently as an expense.

40. The main benefit of presenting the losses adjacent to revenue (and the rationale for including this alternative for the Boards) is that it responds to concerns raised by reviewers by alleviating the tension in determining whether significant doubt about collection has resulted in an impairment expense or as a reduction of revenue (ie because the entity has granted an implicit price concession).

41. In light of the feedback received on the 2011 ED (see Appendix B for a full summary) in which many respondents requested more guidance as to how revenue should be presented, the staff think that a decision to incorporate Alternative B into the revenue standard would require the Boards to clarify what is 'revenue'.

What is 'revenue'?

42. In September and November 2012, the staff recommended that the Boards specify that the impairment losses on contracts with customer represent a component of revenue. The staff continue to think that specifying that impairment losses as a component of revenue is appropriate. This is because the impairment loss will affect the amount of consideration which the entity will ultimately receive and transparency over this amount is useful to users. The staff think that the result of this clarification means that the 'net' amount (ie revenue from contracts with customers less impairment losses from contracts with customers) would represent 'revenue'.

43. The staff note that when the impairment losses are material, an entity should present the amount, along with the line item 'revenue from contracts with customers' on the face of the statement of comprehensive income. However, when the amount of impairment is immaterial, an entity would present only the 'net' amount.

Other considerations

44. The 2011 ED proposal to present impairment losses elicited support from some 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. However a significant number of other respondents disagreed with the approach. 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 recognised in the current period. (the impairment expense would include both initial and subsequent impairment losses, some of which may relate to revenue recognised in a prior period.) A full summary of the feedback on the approach in the 2011 ED was presented to the Boards in September 2012 and is included in Appendix B for ease of reference.

45. The staff observe that an adjacent presentation of impairment losses is also consistent with :

    (a) 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).

    (b) the industry specific guidance in US GAAP in Topic 978, Real Estate – Time Sharing Activities that requires (in paragraph 978-310-30-2) "An estimate of uncollectibility that … is expected to occur shall be recorded as a reduction of sales revenue at the time that profit is recognised on a time-sharing sale recorded under the full accrual or percentage-of-completion method."

Alternatives rejected by the staff

46. The staff considered, but ultimately rejected, other alternatives previously considered by the Boards. Some of the reasons for rejecting these alternatives

included the significance of the change to the revenue model that these alternatives would require. These alternatives are summarised as follows:

(a) *Including customer credit risk in the measurement of the transaction price* – The 2010 ED proposed to include estimates of customer credit risk in the measurement of the transaction price. This proposal was almost universally disliked by both users and preparers because they thought that recognising revenue at an invoice (or 'entitled') amount provided more useful information. This is because users wanted transparency over the uncertainty related to receivables management separate from the amount of revenue recognised.

(b) *Introducing a collectibility threshold* – A collectibility threshold (also discussed above in paragraph 10 would restrict revenue recognition when there is uncertainty about collectibility until that threshold is met. The Boards have previously rejected including a collectibility threshold because revenue would not necessarily reflect an entity's performance. Furthermore, a collectibility threshold would provide little transparency over an entity's sales and receivables management, which many users requested. In addition, the Boards observed that it would require them to define a common threshold.

(c) *A targeted approach to customer credit risk* – A targeted approach would employ a two-step approach whereby an entity first would identify contracts in which there may be a high-risk of a customer's credit risk and then as a second step, require specific accounting for the credit risk in those contracts. The specific accounting for those contracts could be either to reflect initial estimates of customer credit risk in the measurement of the transaction price (ie similar to the 2010 ED approach) or the 2011 ED presentation approach, whereby impairment losses would be presented adjacent to revenue and 'revenue' would be defined as the net amount. The staff ultimately rejected this approach because it may be difficult to define the sub-set

of contracts that would be identified as 'high-risk' and furthermore it may be practically difficult to apply.

Staff recommendation

47. Throughout the course of the revenue recognition project, the Boards have discussed several different approaches to address collectibility. There is no perfect solution, as each alternative comes with advantages and disadvantages. However, the staff think that Alternative A (ie retain the approach in the staff draft and include additional guidance) represents a viable approach. This is because the clarifications proposed in paragraphs 28-36 above will likely address much of the concern raised on the staff draft—that is that the revenue Standard should provide guidance on how to distinguish between when facts and circumstances result in the entity effectively providing a price concession (adjustment to revenue) and when they result in an impairment loss (expense).

48. The staff acknowledge that Alternative A would be preferred by those who disagreed with the 2011 ED proposal to present impairment losses adjacent to revenue (ie Alternative B) because it comingled impairment adjustments with that of revenue. The staff also acknowledge that those who opposed the 2011 ED proposal and agreed with the Boards tentative decision in November 2012 may see Alternative B as a late and unexpected change to the final revenue model.

49. However, the staff observe that, even with the clarifications suggested as part of Alternative A, it may be difficult to clearly and consistently make the distinction between a price concession and impairment expense in practice. Consequently, this could lead to greater diversity in the reporting of financial performance by entities if the distinction is not made consistently between entities. If the Boards are concerned about this potential diversity, the staff think that the only other viable approach is Alternative B (presenting impairment losses adjacent to revenue). Alternative B would alleviate the risk of this diversity by requiring a 'linked' presentation of the revenue and impairment losses from contracts with customers without a significant financing component. This is because price concessions would be reflected in the measurement of 'top line' revenue and any

impairment losses would be presented adjacent to the revenue line, but as a component of revenue.

50. Those who support Alternative B acknowledge the improvements to differentiate price concessions from impairment but think the linked presentation provides an additional 'safe-guard' that is necessary because of the significance of the revenue number.

Question 4 for the Boards

Do the Boards prefer:

(a) Alternative A —to retain the approach in the staff draft and include additional guidance as proposed in paragraphs 28-36 of this paper; or

(b) Alternative B— presenting impairment losses adjacent to the revenue line item, as a component of revenue (ie the 2011 ED approach with a clarification)?

Appendix A – Excerpt from latest staff draft

Identifying the contract

14. An entity shall apply this guidance to a contract with a customer (or to a modification of the contract) only when all of the following criteria are met:
    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).
    b. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices).
    c. The entity can identify each party's rights regarding the goods or services to be transferred.
    d. The entity can identify the payment terms for the goods or services to be transferred.
    e. The parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights. To assess this criterion, an entity shall consider all relevant facts and circumstances including, but not limited to, the following:
        1. Whether the contractual terms and conditions (for example, payment terms that have the effect of providing financing to the customer and/or any collateral offered) are commensurate with the uncertainty, if any, about the customer performing in accordance with the contract.
        2. Whether there is experience about the customer (or class of customer) not fulfilling its obligations in similar contracts under similar circumstances.
        3. Whether the entity has previously chosen not to enforce its contractual rights in similar contracts with the customer (or class of customer) under similar circumstances.

Determining the transaction price

50. An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes). However, if an entity's customary business practices, published policies, or specific statements create a valid expectation of the customer that the entity will enforce its rights to only a portion of the stated contract price, the amount of consideration to which the entity expects to be entitled is equal to the amount of the contract price to which the entity intends to enforce its rights to receive.

….

52.1 The transaction price is not adjusted for the effects of the 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. However, if the contract has a significant financing component in accordance with paragraphs 58–62, the transaction price is determined by adjusting the promised consideration using a rate that reflects the customer's credit risk.

….

53.1. The amount of consideration to which an entity will be entitled can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if:

a. The entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, the amount of consideration promised in a fixed-price contract would be variable if the contract included a return right.

b. An assessment of the facts and circumstances related to the contract indicates that the entity might accept a discount or price concession on the consideration promised by the customer in exchange for the promised goods or services. For example, entering into a contract with a customer when there is significant doubt about the collectibility of the amount of promised consideration indicates that the entity may intend to provide a price concession.

Presentation

….

106. If an entity performs by transferring goods or services to a customer before the customer pays consideration, the entity shall present the contract as either a contract asset or as a receivable depending on the nature of the entity's right to consideration for its performance.

a. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer, when that right is conditioned on something other than the passage of time (for example, the entity's future performance). After initial recognition, an entity shall assess the carrying amount of the contract asset for impairment in accordance with Topic 310 on receivables [IFRS 9 Financial Instruments]. An impairment of the carrying amount of the contract asset shall be measured, presented, and disclosed in accordance with that Topic [IFRS] (see also paragraph 108.2).

b. A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if nothing other than the passage of time is required before payment of that consideration is due. An entity shall account for a receivable in accordance with Topic 310. [IFRS 9].

….

108.2. Similarly, [in accordance with paragraph 86) separately from the requirements of IAS 1,] an entity shall present or disclose the entity's impairment losses from contracts with customers (determined in accordance with Topic 310 [IFRS 9]) separately from other contracts. Upon initial recognition of a receivable from a contract assets or contract liabilities with a customer, any difference between the measurement of the receivable in accordance with Topic 310 [IFRS 9] and the corresponding amount of revenue recognised shall be presented as an impairment loss.

Excerpt from illustrative examples

Example 15—Implicit price concessions

An entity sells a prescription drug for $1 million payable in 90 days to a customer in a region of the world that is experiencing economic difficulty. At the time of entering into the contract, the entity assesses that there is a significant risk that the customer will not have the capacity to pay the contract price. The entity estimates that the customer will be able to pay $400,000. The entity entered into the contract because the estimated amount the customer will be able to pay covers its cost of sales ($100,000) and the entity is willing to accept a lower amount than the contractual amount because the entity wants to enter the market and develop a relationship with the customer.

The entity determines that the revenue model would apply to this contract because the criteria in paragraph 14 have been met. That is, the contract has commercial substance because the entity's future cash flows are expected to change, and the parties are committed because the entity has transferred the goods and expects that the customer has the intent and capacity to pay a portion of the contract price that is acceptable to the entity. The entity intends to enforce its right to consideration for the amount that it determines to be acceptable.

The entity applies paragraphs 50-67 to determine the transaction price. The entity determines that, because of significant credit risk at contract inception, it is likely to provide a price concession and accept an amount less than $1 million in exchange for the prescription drug. Consequently, the promised consideration is variable. The entity applies paragraph 55 and estimates the variable consideration to be $400,000 using the expected value method.

Variable consideration must pass the constraint before it can be included in the transaction price and, therefore, the entity considers paragraphs 56.1–56.4.

Appendix B: Feedback on the 2011 ED – *excerpt from Agenda Paper 7B/162B September 2012*

B1. 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.

B2. 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)

B3. 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

B4. 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 recognised. These respondents think that revenue should be recognised only for amounts where there is a reasonably high likelihood of collection.

B5. 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 recognised 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 recognised for transactions where they believe risks have not adequately transferred to the customer.

B6. 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

B7. 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 recognised in the current period. In fact, at least a portion of each year's impairment expense most likely would relate to revenue that was recognised 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)

B8. 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.

B9. 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.

B10. 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).

B11. 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.

B12. 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.

…

Other concerns

B13. 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.