STAFF PAPER

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Project	Revenue Recognition		
Paper topic	Collectibility		
CONTACT(S)	Kristin Bauer	kdbauer@fasb.org	+1 203 956 3469
	Glenn Brady	gbrady@ifrs.org	+61 3 9617 7605
	Allison McManus	amcmanus@ifrs.org	+44 20 7246 6462

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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.

Summary of staff recommendations

2. The staff recommend the Boards:
   - (a) Improve the drafting as outlined in paragraph 14 that principally (a) refine paragraph 12 in the draft standard excerpts are included in Appendix A (the "draft standard") (b) reduce the amount of guidance on price concessions and (c) clarify subsequent accounting; and
   - (b) Introduce a collectibility threshold into the revenue model.

Structure of the paper

3. This paper is organized as follows:
   - (a) Background information, including past proposals, current decisions and feedback on decisions reached (paragraphs 4 – 11)
   - (b) The possible paths forward (paragraphs 12 – 40)

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(i) Drafting improvements

(ii) Are the drafting improvements sufficient to address concerns? (Alternative A)

(iii) Analysis of the design and features of a collectibility threshold and implications on the model (Alternative B)

(c) Staff recommendation (paragraphs 41 – 43)

(d) Appendix A – Comparison of drafting improvements

(e) Appendix B – Current guidance

(f) Appendix C – Examples

Background

4. Existing revenue standards include a recognition threshold that acts to preclude the recognition of revenue if the collectibility of that revenue does not pass the threshold specified in the standard (see Appendix B). Those thresholds include:

   (a) ***Reasonably assured*** – used in the majority of U.S. GAAP, including SEC SAB Topic 13, Media & Entertainment (Topic 926, formerly SOP 00-2), and Real Estate (Subtopic 360-20, formerly FAS 66).

   (b) ***Probable*** (as defined in Topic 450, Contingencies, formerly FAS 5) – used in U.S. GAAP software accounting (Subtopic 985-605, formerly SOP 97-2)

   (c) ***Probable***– used in IAS 18 *Revenue* and IAS 11 *Construction Contracts* (although not defined in IAS 18 and IAS 11 it is defined elsewhere in IFRS to mean 'more likely than not').

5. Since the basic building blocks of the revenue model were first proposed in the 2008 Discussion Paper, the revenue model has not included an explicit recognition threshold for collectibility. Paragraph BC170 of the 2011 ED outlined the consequences of having collectibility as a recognition criterion in the revenue model.

6. The revenue model (in paragraph 68 of the 2011 ED) defines the concept of collectibility narrowly, as follows:

> Collectibility refers to a customer's credit risk – that is, the risk that an entity will be unable to collect from the

customer the amount of consideration to which the entity is entitled in accordance with the contract.

7. In contrast, the term 'collectibility', as it is used in existing IFRSs and U.S. GAAP, may apply to a broader range of collectibility concerns other than just customer credit risk. In the revenue model, collectibility can be defined by reference only to customer credit risk because other aspects of the model separately address other types of collectibility uncertainties that are not primarily related to a customer's ability to pay, such as:
   - (a) Uncertainty about the validity of the contract is addressed by the fact that contracts are subject to the revenue model only if, among other factors, the contract has been approved, has commercial substance and the parties are committed to perform their respective obligations (paragraph 12 of the draft standard).
   - (b) 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 draft standard) after having identified the performance obligations (paragraphs 23-30 of the draft standard).
   - (c) Uncertainty about whether the entity will perform in the future and, hence, become entitled to an amount of consideration is addressed in the requirements on variable consideration and the constraint on estimates of variable consideration (paragraphs 53-57 of the draft standard).

Past proposals

8. Instead of a threshold, the Boards have previously proposed to address collectibility concerns arising from customer credit risk in the following ways:

Past proposals	**Summary of feedback**

The 2010 ED proposed to address collectibility concerns in the measurement of the transaction price. This proposal would adjust the transaction price, and hence revenue, to reflect the customer's credit risk. Consequently, the principle was that an entity would recognize revenue at the amount of consideration that the entity expects to receive in exchange for the goods or services transferred.	• Many preferred recognizing revenue at the entitled amount (ie the contract price or invoice amount), especially because most entities do not enter into contracts with customers with significant credit risk • Concern about subsequent assessments (in particular upwards adjustments) not being recognized as revenue. • Users preferred revenue to be measured at the 'entitled' amount so that revenue growth and receivable management (or bad debts) can be analysed separately.[1]
The 2011 ED proposed to address collectibility concerns primarily by requiring impairment losses to be presented adjacent to the revenue line. In particular, the 2011 ED proposed: • Measuring revenue at the entitled amount • Presenting impairment losses for contracts without a significant financing component adjacent to revenue • The existence of significant doubt about the customer's ability to pay could indicate that the customer is not committed to the contract, in which case the revenue model would not	• Almost all agreed with recognizing revenue at the 'entitled' amount. Users supported the proposal because it provides visibility of the entity's performance (ie revenue) and receivable management activities (ie customer credit risk). • While some, including users, supported the adjacent presentation many disagreed. • Additionally, several respondents requested clarification about the Boards' intent in paragraphs 14 and BC34(b), specifically the customer commitment criteria and how an entity should think about significant

[1] Feedback on the 2010 was presented to the Boards in IASB paper 10A / FASB memo 140A in March 2011. Additionally, there was a supplemental handout provided for the March 2011 meeting.

apply to the contract	credit risk in evaluating whether there is a valid contract.[2]

9. Although the Boards have not previously proposed to include an explicit collectibility threshold in the revenue model, the 2010 and 2011 EDs proposed criteria that must be met in order for a contract with a customer to be within the revenue model. Those criteria required that, among other things, the contract has commercial substance and the parties are committed to performing their obligations under the contract. As noted above, the clarification in paragraph BC34(b) of the 2011 ED that the existence of 'significant doubt at contract inception about collectibility' might call into question whether the parties are committed to perform their respective obligations under the contract resulted in some observers regarding the existence of a contract requirements in paragraph 12 of the draft standard as acting as a de facto collectibility threshold.

Current decisions related to collectibility

Measurement of revenue and presentation of impairment losses

10. In November 2012, the Boards tentatively decided that:

    (a) 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). However, consistent with the 2011 ED proposals, customer credit risk will be included in the interest rate used to discount the consideration promised in a contract with a significant financing component.

    (b) Any corresponding impairment losses (recognized initially and subsequently in accordance with the respective financial instruments guidance) arising from those contracts should be presented prominently as an expense in the

[2] Feedback on the 2011 ED was provided to the Boards in September 2012 (IASB paper 7B & 7C / FASB memo 162B & 162C) and November 2012 (IASB paper 7E / FASB memo 164E). Additionally, a supplemental handout to memo 162B/7B was used at the September 2012 meeting.

statement of comprehensive income instead of presenting any losses adjacent to revenue as proposed in the 2011 ED.

11. In the absence of a general collectibility threshold, revenue will be recognized at the entitled amount (eg the invoice amount) for all contracts with customers regardless of whether a customer is a 'normal' credit risk or is a significant credit risk. Consequently, some observers are concerned that the perceived quality of the revenue line could be adversely affected if an entity can recognize revenue (at the entitled amount) from customers who are significant credit risks and therefore may not have the capacity or the intention to pay the promised consideration.

12. In light of those concerns, in July 2013, the Boards decided to clarify the determination of the transaction price by including additional guidance to enable an entity to distinguish between doubts about collectibility arising from customer credit risk that should be accounted for as either (a) variable consideration (ie a price concession or discount) or (b) an impairment loss (that is recognized in accordance with the financial instruments standards). The guidance should state that, in determining whether the promised consideration is variable (and therefore subject to the constraint on estimates of variable consideration), an entity should:

    (a) Assess all relevant facts and circumstances related to the contract and the customer's credit risk that might indicate that the entity would grant a price concession and, therefore, expects to be *entitled to* an amount that is less than the contractually stated price; and

    (b) Consider whether attributes of the contract with a customer might indicate that the promised consideration is variable (because, for example, the incremental cost to the entity to transfer the good or service to the customer is negligible or the good that transfers to the customer is not expected to substantially diminish in value and it therefore serves as adequate collateral).

Commitment to the contract

13. Step 1 of the revenue model (ie paragraph 12 of the draft revenue standard) specifies criteria that must be met in order for an entity to apply the revenue model to a

contract with a customer. In September 2012[3] and July 2013, the Boards considered adding guidance in the standard to determine whether "the parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights". In July 2013, the Boards tentatively decided to clarify that:

(a) An entity should make an overall qualitative assessment of the facts and circumstances of the contract to determine whether the parties are committed to the contract.

(b) The assessment of the commitment and intention of the parties to the contract is to identify whether the contract is a substantive arrangement. A contract can be substantive even if the entity does not intend to enforce all of its rights under the contract.

(c) The assessment about the amount of consideration to which the entity expects to be entitled is considered when determining the transaction price. That assessment does not affect whether a contract meets the criteria in paragraph 12 of the draft revenue standard.

Feedback on decisions reached

14. The Boards' tentative decisions on collectibility have been incorporated into an external review version of the draft revenue standard and a further revised version of the collectibility requirements (see Appendix A prior to marked changes in Alternative A). The revised version was discussed with some external reviewers during targeted outreach activities conducted in August 2013. Feedback on the draft language in Appendix A was as follows:

    (a) Many noted that they broadly understood the concern the Boards were trying to address. However, they thought the drafting created confusion and was unnecessary for typical contracts. Many suggested placing less emphasis on the idea of what is a price concession by removing much of the guidance in paragraphs 50-53.3 and

[3] The Boards also considered this guidance in their tentative decision in January 2013 regarding application of the revenue model to the transfer of nonfinancial assets.

eliminating the references to 'credit risk' in determining the transaction price.

(b) A few suggested other criteria in paragraph 12 (eg 'commercial substance' in paragraph 12(d)) could be used by auditors to ensure that only the substantive terms are accounted for in the revenue standard. In these cases, the contractually stated price may not equal the transaction price (that is, the 'entitled' amount).

(c) A few suggested that challenges with collectibility in specific industries (for example, U.S. healthcare) be addressed in implementation.

(d) Many explained that it would be extremely difficult to estimate (and audit) the transaction price as explained in paragraphs 53.2 and 53.3 of the draft standard for price concessions that the entity may 'intend' to provide because of credit risk. This is because when a contract has significant credit risk, estimates of the amount of consideration to which the entity expects to be entitled are inherently imprecise. Those respondents suggested that the Boards establish a clearer 'gate' in paragraph 12 (that is, a threshold) for contracts where there is significant doubt about collectibility at contract inception. When that threshold is not met, an entity would recognize no revenue until such time the threshold is met. Some also suggested that before that threshold is met an entity could apply another model such as the cost-recovery or installment method used in U.S. GAAP today.[4]

(e) Many expressed difficulty in subsequent accounting for price concessions versus impairment losses.

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[4] The cost-recovery and installment methods are outlined in paragraph 605-10-25-4 (*Revenue Recognition*) "As defined in 360-20-55-7 through 55-9 (*Property, Plant and Equipment – Real Estate Sales*), the installment method apportions collections received between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. Under the cost-recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time." This is illustrated in Appendix C – Example 1.

(f) Some also questioned how an entity would assess whether a contract meets the criteria in paragraph 12, and furthermore how the entity would determine the transaction price when it has a portfolio of contracts with low credit quality customers.

(g) Some raised other drafting suggestions that the staff will take into consideration. One such suggestion was to improve paragraph 12(e) by clarifying the 'commitment' notion and removing the notion of 'intention to enforce' in paragraph 12(e) as that concept was misunderstood.

The possible paths forward

15. In September 2013, the Boards discussed the feedback and directed the staff to further consider the following alternatives:

    (a) Drafting improvements; and

    (b) Introducing a collectibility threshold, which would preclude revenue recognition until the threshold is met.

16. Based on the feedback above, the staff think that the drafting improvements should be made regardless of whether the Boards decide to introduce a collectibility threshold. Therefore, the remainder of the paper:

    (a) Explains the necessary drafting improvements;

    (b) Considers whether or not those drafting improvement are sufficient to address the concerns raised (Alternative A); and

    (c) Provides an analysis of the design and features of a collectibility threshold, including implications on the revenue model (Alternative B).

Drafting improvements

17. Based on the feedback received on the draft requirements for identifying a contract (paragraphs 12-14 see Appendix A) and determining the transaction price,

particularly in relation to price concessions (paragraphs 50-53.5), the staff think that the following drafting improvements are required:

(a) *Refine the criterion in paragraph 12(e) about the commitment of the parties to the contract.* Refine paragraph 12(e) by removing the notion of 'intending to enforce'.

(b) *Reduce the amount of guidance on price concessions in paragraphs 50-53.3.* Feedback indicated that much of the additional guidance on price concessions, particularly in paragraph 53.3, was too detailed and confusing, such that it might lead to more questions of interpretation being raised instead of resolved.

(c) *Clarify subsequent accounting.* Clarify that when facts and circumstances indicate that the entity intends to issue a price concession at contract inception, subsequent changes in that estimate are likely changes in the transaction price (not impairment losses).

Suggested changes to current drafting	**Reasoning**
12(e). The parties are committed to perform their respective obligations ~~and they intend to enforce their respective contractual rights (see paragraph 14)~~. An indication that a customer may not be committed to the contract is when there is significant doubt at contract inception about the entity collecting the consideration to which the entity expects to be entitled (in accordance with paragraph 50) in exchange for the goods or services promised to the customer. 14. [Paragraph to be deleted]	Several comments indicated there was confusion about the draft requirement for an entity to enforce its contractual rights (as per paragraph 12(e)) and the acknowledgement in paragraph 14 that an entity may choose not to enforce its rights under the contract because they intend to offer a price concession. Based on that feedback, the staff think that the clarification provided by this expanded drafting has been ineffective. Consequently, the staff replaced that clarification with an indication of when the customer may not be committed to the contract. This indication was previously mentioned in paragraph BC34(b) of the 2011 ED.
53.2 The variability relating to the	The additional guidance in paragraph

consideration promised by the customer may be specified in the contract. In addition to the terms and conditions specified in the contract, the promised consideration is variable if either of the following circumstances exist: (a) [no change, see Appendix A] (b) Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer. For example, ~~those facts and circumstances indicate that there is [significant doubt][significant uncertainty] about the ability of the customer to pay all of the promised consideration (that is, the customer is a significant credit risk)~~ an entity may transfer goods or services to the customer even though the entity has [significant] doubts about the customer's ability or intention to pay the promised consideration and the customer has not offered the entity [adequate] collateral in the event that the customer does not pay. 53.3 [Paragraph to be deleted] 53.4 [Paragraph to be deleted]	53.3 was confusing to many reviewers and, hence, has been deleted. Paragraph 53.2 has been retained because it explains how an entity might offer price concessions that are not explicitly stated in the contract. Paragraph 53.2(b) has been revised to provide some guidance on a circumstance in which customer credit risk might indicate that the entity is intending to offer a price concession, even if the entity does not have a past practice of doing so.
53.5. ~~If an assessment of the facts and circumstances in paragraph 53.3 does not indicate that the entity intends to offer a price concession to a customer who is a significant credit risk~~ Once an entity has determined the amount of consideration to which it is entitled (and if that entitled amount is not expected to be subject to a subsequent variation from a further price concession), the ~~an~~ entity shall ~~subsequently~~ consider any subsequent changes in the customer's credit risk when assessing the carrying amount of a	This revised guidance is added to indicate that an entity should consider whether a further price concession is likely to be granted to the customer. In the event that the granting of another price concession is not expected, an entity should account for any subsequent changes in the assessment of a customer's credit risk as a matter for impairment of the receivable (or contract asset) in accordance with the financial instruments standards.

contract asset (or a receivable) for impairment in accordance with Topic 310 on receivables [IFRS 9 *Financial Instruments*].	

Are these drafting improvements sufficient to address collectibility concerns? (Alternative A)

18. The consequence of retaining the Boards' tentative decisions and refining the drafting as above is that for contracts that meet the criteria in paragraph 12 —even when the customer is a significant credit risk or is within a customer class that is more likely to default—an entity would be required to apply judgement to determine whether it intends to offer a price concession (that is, a reduction in the transaction price) or it will recognize an impairment expense. In some cases, this may result in the entity recognizing revenue at the stated contract price and recording an impairment expense (which may be significant).

19. Despite this consequence, there are several reasons for making these drafting improvements without also incorporating a collectibility threshold into the revenue model. Those reasons include the following:

    (a) The risks associated with an entity ultimately being able to collect the consideration promised in a contract are adequately addressed throughout the model (see paragraph 17 above).

    (b) The Boards' respective impairment models appropriately account for losses arising from a customer's credit risk.

    (c) In general, most entities would not sell goods or services on credit if they had significant doubts about the credit risk of a customer. Normal and rational economic behavior should adequately prevent any perceived risks of not explicitly disallowing revenue recognition in the rare cases when an entity enters into a contract with a customer who is a significant credit risk.

    (d) 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.

(e) In rare cases, a collectibility threshold might inappropriately prevent an entity from accounting for a contract with a significant financing component even though the transaction price, and hence revenue, has been adjusted to exclude the effects of the credit risk associated with a low credit quality customer. A related effect of the application of collectibility threshold is that the loan provided by the entity for goods or services transferred would not be depicted in the entity's financial statements.

(f) Any threshold established would be arbitrary and a stark contrast would be drawn between those contracts that pass the threshold from those that do not.

Analysis of the design and features of a collectibility threshold and implications on the model (Alternative B)

20. The staff have identified the following points to consider in deciding whether to incorporate a collectibility threshold into the revenue model:

    (a) How should the threshold apply?

    (b) When should the threshold apply?

    (c) Interaction with significant financing components

    (d) What should the threshold be?

    (e) Interaction with the constraint

    (f) Drafting a collectibility threshold

    (g) Concluding remarks on a collectibility threshold

How should the threshold apply?

21. In the context of the revenue model, the purpose of a collectibility threshold would be to assess a customer's credit risk—and, as a consequence, to preclude the recognition of revenue from a contract with a customer when that contract exposes the entity to a

significant risk that it will not collect the consideration to which it has a contractual right to receive. A collectibility assessment involves assessing:

(a) The ability (that is, the financial capacity) of the customer to pay a specified amount; and

(b) The customer's intention to pay that amount. An assessment of the customer's intention should be made on the assumption that the amount is due (that is, the corresponding performance obligation has been satisfied and the consideration is not subject to further variability which might affect the entity's entitlement to that consideration).

22. Assessing a customer's intention to pay typically would be expected to be an assessment of whether or not the customer intended to honor the contract and to meet its obligations as specified in the contract. Hence, an assessment of a customer's intention is an assessment of whether the customer will pay the amounts specified in the contract as and when they become due. In contrast, an assessment of a customer's ability to pay would focus on the amount of the consideration that the customer is capable to pay. Consequently, a collectibility threshold would need to clarify the amount of consideration that is to be assessed as being collectible from the customer.

23. The staff think that a collectibility threshold should not necessarily require an assessment of the collectibility of all of the consideration promised in the contract. Instead, the assessment of collectibility should consider each of the following factors:

(a) The consideration should be limited to the amounts attributable to the goods or services to be transferred to the customer for the non-cancellable term of the contract. For example, in a two-year service contract in which either party can terminate the contract after one year, an entity should assess the collectibility of the consideration promised in the first year because this is the non-cancellable term of the contract.

(b) The collectibility assessment is based on the amount of consideration that the entity ultimately expects to be entitled in exchange for the promised goods or service transferred to the customer. For example, if an entity's customary practice is to offer a CU30 price concession on a product sold at a

contractually-stated price of CU100, the collectibility assessment should be based on the customer's capacity to pay CU70.[5]

(c) An entity's exposure to collectibility risk in a contract should be made after considering the relative position of the entity's contractual rights to consideration and the entity's performance obligations. For instance, if all of the promised consideration is payable subsequent to the transfer of goods or services to the customer, the collectibility assessment should be based on all of the consideration promised in the contract. However, if the entity has received some or all of the consideration either in advance (eg an upfront payment) or at the time goods or services transfer to the customer, the entity would not be subject to collectibility risk for the consideration already received. Consequently, in those cases, the assessment of the entity's exposure to collectibility risk should consider the following factors:

i. The collectibility of the outstanding consideration (because, by definition, the consideration already received has been collected).

ii. The ability of the entity to stop transferring promised goods or services to the customer if the customer fails to perform as promised, which would reduce the effect of the collectibility risk.

iii. The effect of the contractual payment terms on the customer's ability to pay the consideration when due. For instance, the consideration promised in a contract may include variable amounts (such as sales-based royalties or bonuses) which are intended to align the economic interests of the entity and the customer. For those contracts, a customer may only have an obligation to pay an amount of consideration to the entity after the customer has generated an economic benefit from the goods or service that it received from the entity.

[5] Whether or not the entity can recognize revenue at CU70 when the good or service transfers will also depend on the entity's analysis of the constraint.

24. The following example illustrates how the collectibility threshold could be applied to a contract in which less than 50% of the consideration is collectible.

> An entity enters into a non-cancellable contract with a low credit quality customer for the supply of a good and the provision of a subsequent service for 1 year. The contract price is CU340, payable as follows:
>
> - CU160 on contract inception. The contract specifies that the amount is the sum of CU100 for the good and CU60 for the first 3 months of the services to be provided
> - CU60 payable at end of month 6 (ie payable in arrears for the services provided in months 4-6)
> - CU60 payable at end of month 9 (ie payable in arrears for the services provided in months 7-9)
> - CU60 payable at end of month 12 (ie payable in arrears for the services provided in months 10-12).
>
> The good, as inventory, has a cost of CU95. The incremental cost to the entity of providing the service to the customer is negligible.
>
> The stand-alone selling price of the good is CU100 and the service is CU20 per month. (In this example, the stand-alone selling price of each item is the same as amount the contract specifies that the customer must pay in exchange for each item.)
>
> The entity concludes that it is not confident that it will collect CU180 (or 53% of the promised consideration) in exchange for the services that the entity has promised to provide in months 4-12. The entity does not offer price concessions to encourage non-performing customers to pay because it might change the market's perception of the value of that monthly service. Instead, the entity's policy is to disconnect non-performing customers from its service after a specified period of non-performance.

25. If an entity were to apply the collectibility threshold to the total promised consideration of CU340, the entity would be precluded from recognizing revenue from that contract until such time as the collectibility threshold could be subsequently passed, which might be when the cash is received from the customer. However, such an outcome would not faithfully represent the entity's performance at that time because the entity has already collected the consideration that would be allocated to the satisfied performance obligation. The staff thinks that an entity should instead recognize revenue when the good is transferred to the customer and when, and as, the

first 3 months of services are provided to the customer. This is because the circumstances in that contract indicate that the entity is not subject to collectibility risk for that part of the contract.

26. The staff acknowledges that applying the collectibility threshold in the manner described in the preceding paragraphs may require an entity to apply other aspects of the model (eg identification of performance obligations and allocation of the transaction price) to determine whether the collectibility threshold is met.

When should the threshold apply?

27. In the revenue model, a collectibility threshold could be regarded as an extension to the requirements in paragraph 12 of the draft standard on identifying the contract. In essence, those requirements are assessing whether the contract is valid and represents a genuine transaction because paragraph 12 specifies that, among other things, the contract must be approved by the parties to the contract, the contract must have commercial substance and the parties must be committed to perform their respective obligations. A collectibility threshold could be regarded as also being related to assessments of whether a transaction is genuine and provides economic benefits to the entity because most entities would not enter into contracts with low credit quality customers where the entity exposes itself to a significant credit risk.

28. In many cases, subsequent assessments of changes in—and, in particular, deterioration of—expectations in the collectibility of consideration from a customer should be assessed in accordance with the impairment requirements in the financial instruments standards. However, the staff think that, subsequent to contract inception an entity typically should not reassess unless there is a significant change in facts or circumstances. This is because the staff think that an entity should be precluded from recognizing revenue if the entity continues to transfer goods or services to the customer after determining a significant change in circumstances in the likelihood of collecting consideration from the customer for those goods or service. In those rare circumstances, the staff thinks that recognizing revenue (and possibly a full contemporaneous impairment loss) would not provide a faithful depiction of the entity's performance. This is because the staff thinks that such a transfer of goods or

services in exchange for a right to consideration that may be worthless would fail a commercial substance test as there is no economic benefit recognized when revenue is recognized with a corresponding full impairment loss. Therefore, the staff recommend clarifying this point in paragraph 15.2 of the draft standard to indicate that an entity generally makes the assessment of paragraph 12 of the draft standard at contract inception and does not reassess unless there is an indication of a significant change in circumstances.

Interaction with significant financing components

29. One of the issues identified in prior deliberations on the possible introduction of a collectibility threshold relates to whether a collectibility threshold should be applied to a contract with a significant financing component. This is because, in a contract with a significant financing component, a customer's credit risk will be reflected in the interest rate that is used to discount the promised consideration to a present value amount, which becomes both the initial measurement of a loan receivable and the measurement of revenue for the goods or services that have transferred to the customer. Hence, the amount of revenue recognized by the entity has been adjusted to exclude the credit risk component from the promised consideration. In principle, excluding the credit risk component from the measurement of revenue (especially when the credit risk is properly priced) would provide a better depiction of an entity's financial performance and position than a collectibility threshold, which acts as a 'blunt instrument' to either permit or preclude revenue recognition and recognition of the corresponding receivable. The application of a collectibility threshold in conjunction with the significant financing component requirements could result in an accounting outcome that is arguably over-conservative.

30. The main reasons for applying a collectibility threshold to contracts with a significant financing component are as follows:

    (a) It is a consistent approach because the threshold would apply equally to those contracts without a significant financing component and to those contracts with a significant financing component and therefore reduces complexity;

(b) Contracts with extended payment terms intuitively pose greater collection risks compared to contracts with shorter payment terms, and so it might seem counterintuitive to preclude revenue recognition from short-term contracts with significant credit risk and yet permit revenue recognition for long-term contracts with a significant credit risk (albeit at a risk adjusted amount).

31. For these reasons, the staff recommends that if the boards decide to introduce a collectibility threshold into the revenue model, the threshold should apply equally to contracts with or without a significant financing component.

What should the threshold be?

32. The collectibility thresholds in current guidance (see paragraph XX above) use two terms 'reasonably assured' and 'probable'. However, the staff note the term 'probable' presently has two meanings:

(a) ***U.S. GAAP Probable*** (from Topic 450, Contingencies, formerly FAS 5)

(b) ***IFRS Probable*** (meaning more likely than not)

33. The staff also understand that when considering the collectibility threshold in current practice in U.S. GAAP the term 'probable' in Subtopic 985-605 (Software) is used in a consistent manner as the term 'reasonably assured' in SEC SAB Topic 13. However, except when used to make assessment about collectibility the staff understand that the term 'reasonably assured' is generally understood to be a higher threshold than 'probable.' For example, the assessment of lease term in Topic 840 for bargain renewal options uses the term 'reasonably assured' and such term in that context has a meaning much closer to 'virtually certain' than 'probable'. In addition, the term 'reasonably assured' is closely linked to 'reasonable assurance' in auditing literature.

34. The staff acknowledge the baggage of the terms 'probable' and 'reasonably assured' and therefore the Boards could choose a new term and establish its meaning as they intend in this circumstance. For example, the term *highly confident* could be established to set the threshold. However, while the baggage of an old term presents challenges it does offer some advantages, specifically familiarity and a decreased

chance of unintended consequences. Additionally, the use of familiar terms also provides the Boards with the opportunity to establish the threshold in a similar manner to current guidance.

35. Therefore, the threshold could be set at the same level of confidence as currently used in existing revenue guidance in IFRS and U.S. GAAP as follows:
    (a) IFRS – probable (meaning 'more likely than not')
    (b) U.S. GAAP – probable (meaning "the future event or events are likely to occur" as used in Topic 450)
36. Although the interpretation underpinning both collectibility thresholds will not be identical under IFRSs and U.S. GAAP, the staff note that the use of these terms will not change current practice which the staff think is the Boards intent. Therefore any difference in the level of confidence assigned to the collectibility threshold is unlikely to have a significant practical effect that leads to differences in the timing of revenue recognition between entities applying IFRSs and U.S. GAAP as most contracts pass the threshold today and that result would likely continue if the Boards include a collectibility threshold.
37. The staff also highlight the potential alignment of terms with the constraint evaluation considered in paper 175A/7A where the staff is recommending to use the term probable in U.S. GAAP and highly probable in IFRS. The Boards could choose to use the same term as decided for the constraint; however, for IFRS preparers this could be a more significant change as the current threshold of 'probable' would likely be lower than a 'highly probable' threshold.

Interaction with the constraint

38. 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.
39. The uncertainties that make consideration variable are reflected (either explicitly or implicitly) in the negotiated and agreed terms and conditions of the contract (eg

volume discounts, 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 generally provided to maintain a relationship with a customer.

40. 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.

41. For this reason, while acknowledging the interconnection, the staff continue to think that an assessment of customer credit risk (that is, the ability and intention of the customer to pay) should be apart from the constraint assessment. However, the staff acknowledge that when an entity plans or expects at contract inception to accept a lower amount of consideration as full settlement of the contract price (even if due solely to customer credit risk), it is a strong indication that the entity is considered to have offered a price concession, which would make the promised consideration variable and subject to the constraint.

Drafting a collectibility threshold

42. If a collectibility threshold is included in the revenue model, the staff recommend adding the collectibility threshold to paragraph 12(f) of the draft standard. Paragraph

12(e) of the draft standard currently specifies that the parties must be committed to the contract. However, if the revenue model includes a collectibility threshold, the staff thinks generally the assessment of the commitment of the parties to the contract is included within the threshold because (as described above) an assessment of collectibility would consider both the customer's commitment and intention to perform as promised and the customer's ability to perform. It is hard to think of a scenario in which the customer (or the entity for that matter) is not committed to the contract but collectibility of the consideration is probable. However, the staff think the linkage to paragraph 50 and in particular paragraph 53.2(b) of the draft standard is important so we recommend retaining the concept in paragraph 12(e) in a consistent manner as noted above or by incorporating it into the threshold. The drafting the threshold in paragraph 12(f) could be the following:

> It is probable that the entity will collect the consideration to which it will be ultimately entitled in exchange for the goods or service that will be transferred to the customer. In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider both the customer's ability to pay and intention to pay the amount of consideration when due.

Concluding remarks on a collectibility threshold

43. Reasons for including a collectibility threshold in the revenue model include the following:

    (a) The threshold provides greater clarity and therefore is more operable to clearly exclude the problematic contracts in a consistent manner rather than relying on identification of a price concession or challenging the commercial substance of a contract.

    (b) When customer credit risk was addressed (i) in the 2010 ED through measurement and (ii) in the 2011 ED with adjacent presentation, the collectibility threshold was unnecessary. However, the tentative decisions to date have changed such that the linkage between revenue and collection (or

impairment) is not as clear (especially when there is no significant financing component identified).

(c) Some users of financial statements might confuse the quality of an entity's revenue if the revenue recognized at the 'entitled' amount without a collectibility threshold. Furthermore, there is a concern that, in the absence of a collectibility threshold, an entity may recognize revenue with a corresponding impairment loss (which could be significant) and the timing (that is, the potential lag) of the recognition of loss.

(d) While there are not many transactions in practice today that 'fail' the threshold, this risk could increase based on the current Board decisions (specifically, revenue at the 'entitled' amount). That is, the current collectibility threshold presently prevents such transactions from occurring and should be retained.

(e) While the core principle of the model is to depict performance, in some instances that performance may not provide future economic benefit due to the significant credit risk. In such cases, recognition of revenue should not be depicted so as not to dilute the quality of revenue.

(f) The concerns previously identified by the Boards regarding a threshold have been mitigated, specifically (i) the threshold could be defined as probable (ii) the assessment can be performed, consistent with practice today, for a contract even when portfolios are identified and (iii) the interaction with the impairment project can be aligned.

(g) Some think that a collectiblity threshold is generally consistent with past board decisions, albeit implicit rather than explicit decisions, regarding Step 1 of the model. Therefore, to adequately address the feedback about confusion over "commitment to the contract" those decisions need to be made explicit.

Staff recommendation

44. First, as noted above, the staff recommend the drafting changes and improvements noted in paragraphs 17 of this paper. Those improvements include:

(a) *Refining paragraph 12* – removing the notion of 'intending to enforce' from paragraph 12(e) and moving the content of paragraph 14 (the linkage to determining the transaction price (paragraph 50)) into paragraph 12(e).

(b) Reduce the amount of guidance on price concessions – Refinements made to paragraphs 50 and 53.2 and deletion of 53.3.

(c) *Clarify subsequent accounting of a contract which includes an implicit price concession*

45. The staff also recommend including a collectibility threshold in the model. While the drafting improvements are necessary to address the feedback, they alone will not resolve the inherent risk that a contract may pass into the revenue model despite doubts about the commercial substance of the contract and the commitment of the parties to the contract. Therefore, for the avoidance of doubt and more as a prevention tool (admittedly only to address a significant minority of contracts), the staff think the simplest and most effective way to address the concerns raised is to incorporate a threshold into the revenue model.

46. The staff acknowledge the potential risk of a change to the model at this late stage of the project. The staff note that while it may be perceived as a significant change to the model, the inclusion of a collectibility threshold has been previously discussed by the Boards in their redeliberations and it has been inherent in the Boards' decisions regarding Step 1 of the model as noted in the following:

    (a) *March 2011 (IASB paper 10A, FASB memo 140A)* refer paragraphs 32 – 34, "… an entity's assessment of the criteria for the existence of a contract is similar, in effect, to the assessment in current practice to determine whether collectibility is reasonably assured."

    (b) *2011 ED basis for conclusions, paragraph BC34(c)* – "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.

(c) *September 2012 (IASB paper 7C, FASB memo 162C) and January 2013 (IASB paper 7D, FASB memo 166D)* – In September 2012, the Boards tentatively decided to provide additional guidance in the standard on determining whether a contract with a customer exists based on the customer's commitment to perform its obligations under the contract (Step 1 – paragraph 14(b) of the 2011 ED). In January 2013, the Boards reviewed drafting of the September 2012 tentative decision in light of their decision on the sale or transfer of nonfinancial assets.

Questions for the Boards
1. Do the Boards agree with the drafting with improvements suggested herein (paragraph 17)? 2. Do the Boards agree with the staff recommendation to also include a collectibility threshold (in addition to the drafting improvements) in the final revenue standard (Alternative B)?

Appendix A

Comparing drafting improvements and the introduction of a collectibility threshold (contains excerpts of the draft standard)

Alternative A – No threshold	Alternative B – Include a threshold
12. An entity shall apply the guidance in this Topic to a contract with a customer only when all of the following criteria are met: **a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices), which creates enforceable rights and obligations.** **b. The entity can identify each party's rights regarding the goods or services to be transferred.** **c. The entity can identify the payment terms for the goods or services to be transferred.** **d. 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).**	Same as Alternative A (ie no substantive changes expected)
e. The parties are committed to perform their respective obligations~~ and they intend to enforce their respective contractual rights (see paragraph 14)~~. An indication that a customer may not be committed to the contract is when there is significant doubt at contract inception about the entity collecting the consideration to which the entity expects to be entitled (in accordance with paragraph 50) in exchange for the goods or services promised to the customer.	Same as Alternative A (that is, the change would also be made for the collectibility threshold alternative).
f. [not used]	**f. It is probable that the entity will collect the consideration to which it will be ultimately entitled in exchange for the goods or service that will be transferred to the customer. In evaluating whether**

	collectibility of an amount of consideration is probable, an entity shall consider both the customer's ability to pay and intention to pay the amount of consideration when due.
13. An entity shall consider all relevant facts and circumstances when assessing whether a contract between an entity and a customer meets all of the criteria in paragraph 12. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. Additionally, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining when an agreement with a customer creates enforceable rights and obligations.	Same as Alternative A (ie no substantive changes expected)
~~14. A contract may meet the criteria in paragraph 12 if facts and circumstances indicate that the entity and the customer are committed to the contract (see paragraph 12(e)) even though there are doubts about the customer's capacity to pay all of the promised consideration or doubts about the entity's intention to enforce all of the rights under the contract. However, the existence of those doubts could affect the determination of the amount of consideration to which the entity expects to be entitled under the contract (see paragraph 50).~~	Same as Alternative A (ie paragraph 14 to be deleted for reasons identified in paragraph 177 of the paper)
15. For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties). A contract is wholly unperformed if both of the following criteria are met: a. The entity has not yet transferred any promised goods or services to the customer.	Same as Alternative A (ie no substantive changes expected)

b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.	
15.1. Some contracts with customers may have no fixed term and can be terminated or modified by either party at any time. Other contracts may have terms that automatically renew on a periodic basis. An entity shall apply the guidance in this Topic to the term of the contract in which the parties to the contract have present enforceable rights and obligations.	Same as Alternative A (ie no substantive changes expected)
15.2. If a contract with a customer does not meet the criteria in paragraph 12, an entity shall reassess the contract at each reporting date to determine whether the criteria in paragraph 12 are subsequently met.	15.2. If a contract with a customer does not meet the criteria in paragraph 12, an entity shall reassess the contract at each reporting date to determine whether the criteria in paragraph 12 are subsequently met. <u>An entity assesses the criteria in paragraph 12 at contract inception and does not reassess after meeting the criteria unless there is an indication of a significant change in facts and circumstances.</u>
15.3. When a contract with a customer does not meet the criteria in paragraph 12 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when one of the following events has occurred: a. The contract with the customer indicates that the entity has no remaining obligations to transfer goods or services to the customer and all of the consideration promised by the customer has been received by the entity and is nonrefundable. b. The contract has been terminated and the consideration received from the customer is nonrefundable.	Same as Alternative A (ie no substantive changes expected)
15.4 If none of the events in the preceding paragraph [15.3] have occurred, an entity shall recognize the consideration received from a customer as a liability. For example, depending on the facts and circumstances relating to the agreement, an entity might recognize a liability for the entity's obligation to either transfer goods or services in the future or refund the	Same as Alternative A (ie no substantive changes expected)

consideration received. The liability shall be measured at the amount of consideration received from the customer.	
* * * * *	
49. When (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price (which may be constrained in accordance with paragraphs 56.1–56.4) that is allocated to that performance obligation.	Same as Alternative A (ie no substantive changes expected)
~~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). The consideration promised in a contract with a customer may include fixed amounts or variable amounts, or both. ~~The transaction price is not adjusted for the effects of the customer's credit risk, except as follows:~~ ~~a. when facts and circumstances indicate that the entity's intention is to offer a price concession (see paragraph 53.2 and 53.3), for example when entering into a contract with a customer that is a significant credit risk.~~ **b.** ~~the contract has a significant financing component (in accordance with paragraphs 58-62) and thus the transaction price is determined by adjusting the promised consideration using a rate that reflects the customer's credit risk.~~	Same as Alternative A (ie same refinements to be made)
* * * * *	
53. If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the	Same as Alternative A (ie no substantive changes expected)

promised goods or services to a customer.	
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 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 right of return.	Same as Alternative A (ie no substantive changes expected)
53.2. The variability relating to the consideration promised by the customer may be specified in the contract. In addition to the terms and conditions specified in the contract, the promised consideration is variable if either of the following circumstances exist: **a.** The customer has a valid expectation arising from the entity's customary business practices, published policies or specific statements that the entity will accept a lower amount of consideration than the stated contractual price in exchange for the promised goods or services. That is, the entity will offer a price concession and depending on jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit. **b.** Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer. For example, ~~those facts and circumstances indicate that there is [significant doubt] [significant uncertainty] about the ability of the customer to pay all of the promised consideration (that is, the customer is a significant credit risk)~~ an entity may transfer goods or services to the customer even though the entity has [significant] doubts about the customer's ability or intention to pay the promised consideration and the customer has not offered the entity [adequate] collateral in	Same as Alternative A (ie paragraph 53.2(b) to be revised for reasons identified in paragraph 17 of the paper)

the event that the customer does not pay.	
~~53.3. Factors that indicate that, at the time of entering into a contract, an entity intends to offer a price concession to a customer who is a significant credit risk include, but are not limited to, the following:~~ ~~**a.** The goods or services promised to the customer are not expected to expose the entity to a significant economic loss if the customer does not pay the promised consideration. For example, an entity would not be expected to incur a significant economic loss in any of the following circumstances:~~ ~~(i) The incremental costs that an entity incurs to produce the good or service or transfer it to the customer would be negligible.~~ ~~(ii) The entity can deny the customer further access to the promised good or service if the customer fails to meet its obligations under the contract.~~ ~~(iii) The good that transfers to the customer is not expected to depreciate substantially (or diminish in value) and, therefore, the good provides the entity with sufficient collateral in the event of the customer failing to meet its obligations under the contract. For example, the good is a tangible asset that is not expected to have depreciated substantially if and when the entity obtains control of the good from the customer.~~ ~~**b.** The entity has previously chosen not to enforce its rights to the promised consideration in similar contracts with the customer (or class of customer) under similar circumstances.~~ ~~**c.** The entity has experience (or other evidence) about the customer not fulfilling its obligations to pay the~~	Same as Alternative A (ie paragraph 53.3 to be deleted for reasons identified in paragraph 17 of the paper)

~~promised consideration in other contracts.~~ **d.** ~~The entity has experience (or other evidence) about the class of customer to which the customer belongs not fulfilling their obligations to pay the promised consideration in similar contracts under similar circumstances.~~	
~~53.4 If it is determined that an entity would accept a lower amount of consideration than the stated contractual price in exchange for the promised goods or services from a customer who is a significant credit risk, an entity shall apply paragraph 55 to estimate the amount of consideration to which the entity expects to be entitled in exchange the promised goods or services.~~	Same as Alternative A (ie paragraph 53.4 to be deleted for reasons identified in paragraph 17 of the paper)
53.5. ~~If an assessment of the facts and circumstances in paragraph 53.3 does not indicate that the entity intends to offer a price concession to a customer who is a significant credit risk,~~ Once an entity has determined the amount of consideration to which it is entitled (and if that entitled amount is not expected to be subject to a subsequent variation from a further price concession), the ~~an~~ entity shall ~~subsequently~~ consider any subsequent changes in the customer's credit risk when assessing the carrying amount of a contract asset (or a receivable) for impairment in accordance with Topic 310 on receivables [IFRS 9 *Financial Instruments*].	Same as Alternative A (ie paragraph 53.5 modified to clarify subsequent accounting as identified in paragraph 17 of the paper)

Appendix B: Current guidance, collectibility guidance highlighted yellow

U.S. GAAP	IFRSs
SAB Topic 13 indicates that revenue should not be recognized until it is earned and realized, or realizable. Revenue is generally earned and realized, or realizable, when all of the following conditions have been satisfied: 1. There is persuasive evidence of an arrangement. 2. Delivery has occurred (eg, an exchange has taken place). 3. The sales price is fixed or determinable. 4. Collectibility is reasonably assured.[6]	Paragraph 14 of IAS 18 states, "Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied: (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods; (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; (c) the amount of revenue can be measured reliably; (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably."

Subtopic 985-605 – Software – Revenue Recognition

25-3 If the arrangement does not require significant production, modification, or customization of software, revenue shall be recognized when all of the following criteria are met:

a. Persuasive evidence of an arrangement exists (see paragraphs 985-605-25-15 through 25-17).
b. Delivery has occurred (see paragraphs 985-605-25-18 through 25-29).
c. The vendor's fee is fixed or determinable (see paragraphs 985-605-25-30 through 25-40).
d. Collectibility is probable (see paragraphs 985-605-25-13 through 25-14 and 985-605-25-30 through 25-40).

25-4 The term *probable* is used in this Subtopic with the same definition as used in Topic 450 [Contingencies].

SOP97-2 – Basis for conclusions, paragraph 115:

[6] Footnote 6 to SAB Topic 13states, "FASB ASC paragraph 605-10-25-3 through 25-5. See also Concepts statement 5, paragraph 84(g) and FASB ASC paragraph 985-605-25-3.

In paragraph .08 of this SOP, AcSEC concluded that collectibility must be probable before revenue may be recognized. This conclusion is based on paragraph 84(g) of FASB Concepts Statement 5, which reads:

- If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

Additionally, paragraphs 985-605-25-33 to 25-35 provide guidance on extended payments terms. Specifically, paragraph 25-34 states "… any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable."

Subtopic 360-20 – Property, plant & equipment – Real Estate Sales

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.

Recognition of all or part of the profit should be deferred if both conditions are not met. 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. 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.

Subtopic 926-605 Entertainment – Films - Revenue Recognition

25-1 An entity may enter into a sale agreement or licensing arrangement for a film. A sale occurs when the entity transfers control of the master copy of a film and all the associated rights that go along with it (that is, an entity sells and gives up all rights to a film). An entity shall recognize revenue from a sale or licensing arrangement of a film when all of the following conditions are met:

a. Persuasive evidence of a sale or licensing arrangement with a customer exists.
b. The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery.
c. The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
d. The arrangement fee is fixed or determinable.
e. Collection of the arrangement fee is reasonably assured.

If an entity does not meet any one of the preceding conditions, the entity shall defer recognizing revenue until all of the conditions are met.

Appendix C - Reference Examples

Example 1—Illustrative example of paragraphs 15.3 & 15.4 of the draft standard (consistent with the deposit method)

- Sale of a good on Day 1 (Month 0) and cost of good is 500.
- Collectibility is not probable/reasonably assured.
- There is no significant financing component identified.
- Consideration is deposit of 250 and 10 monthly payments of 100 (total = 1,250)
- Expected profit on the transaction is 750 (1,250 less 500)

Month	0	1	2	3	4	5	6	7	8	9	10	Total
Payments	250	100	100	100	100	100	100	100	100	100	100	1,250
Requirement of paragraph 15.3 & 15.4 (consistent with the deposit method)												
Revenue	-	-	-	-	-	-	-	-	-	-	1,250	*
Expense	-	-	-	-	-	-	-	-	-	-	500	*
Profit	-	-	-	-	-	-	-	-	-	-	750	*

* In accordance with paragraphs 15.3 & 15.4 , no revenue or expense is recognized until a reassessment concludes that collectibility is probable/reasonably assured or either (1) collection of all expected amounts and complete performance or (2) termination or cancellation of the contract.

Other current methods used in U.S. GAAP (Subtopic 360-20, formerly FAS 66)

Cost recovery method	0	1	2	3	4	5	6	7	8	9	10	Total
Revenue	250	100	100	100	100	100	100	100	100	100	100	1,250
Expense	250	100	100	50	-	-	-	-	-	-	-	500
Profit	-	-	-	50	100	100	100	100	100	100	100	750

Installment method	0	1	2	3	4	5	6	7	8	9	10	Total
Revenue	250	100	100	100	100	100	100	100	100	100	100	1250
Expense **	100	40	40	40	40	40	40	40	40	40	40	500
Profit	150	60	60	60	60	60	60	60	60	60	60	750

** Under the installment method, the expense is calculated to recognize a constant margin as cash is received and revenue recognized.

Example 2—Pharmaceutical drug sale

OUTCOME IS THE SAME WITH OR WITHOUT A THRESHOLD

An entity sells 1,000 units of a prescription drug to a customer in a region of the world that is experiencing significant economic difficulty. The promised consideration is a fixed amount of $1 million and the entity does not accept product returns. At the time of the first sale to a customer in the region, the entity expects to collect only $400,000. This estimate is based on the entity's

assessment of the customer's creditworthiness and current economic conditions in the country. Despite the potential of not collecting $600,000, the entity expects the economy in the region to recover in the next 24–36 months and thinks that a relationship with the customer can help it to forge relationships with other potential customers in the region. In addition, the entity's cost of sales is low (only $100,000), so the entity still expects to make a profit on the sale.

The entity evaluates paragraph 12 and notes all the necessary criteria have or been met (approval, rights and payment terms identified, commercial substance, and commitment). The entity also evaluates the commitment criteria in paragraph 12(e) and notes that there is significant doubt about collecting the contract price, $1 million. The entity considers paragraph 50 and 53.2(b), specifically noting that it expects at contract inception to provide a price concession and accept a lower amount of consideration from the customer. Accordingly the entity concludes that the transaction price is not $1 million. The entity therefore estimates its transaction price in accordance with paragraph 55 and the constraint in paragraph 56.1 and determines the amount that is probable [IFRS: highly probable] of not being subject to a significant reversal is $400,000.

At the point in time when the conditions in paragraph 37 are met, the entity recognizes $400,000 as revenue for the sale of the drugs.

The entity would evaluate future changes and appropriately account for future changes as either a change in variable consideration in accordance with paragraph 77 or as an impairment of the receivable in accordance with Topic 310, *Receivables* [IFRS 9, *Financial Instruments*], as required by paragraph 106.1.

Example 3—Health care

OUTCOME IS THE SAME WITH OR WITHOUT A THRESHOLD

An entity, a hospital, provides a medical service to an uninsured patient who is unconscious upon arrival at the hospital and when the service is provided. Although the entity's historical cash collections from uninsured patients are only 10 to 20 percent, the entity is required by law to provide medical services to all emergency room patients. The entity has not previously provided medical services to this patient. The entity invoices the patient at the standard rate of $10,000 for the medical services performed. However, the entity assesses the patient as belonging to a class of customers designated as self-pay (meaning they do not have insurance) and generally the entity collects significantly less than the standard rate for services provided to this class of customers. As a result, the entity expects at contract inception to provide a price concession and accept a lower amount of consideration from the customer.

The entity considers paragraph 50 and 53.2(b), specifically noting that it expects at contract inception to provide a price concession and accept a lower amount of consideration from the

customer. Accordingly the entity concludes that the transaction price is not $10,000. The entity therefore estimates its transaction price in accordance with paragraph 55 and the constraint in paragraph 56.1 and determines the amount that is probable [IFRS: highly probable] of not being subject to a significant reversal is $1,000. Upon meeting all the other conditions necessary for revenue recognition, the entity recognizes revenue and a corresponding receivable of $1,000.

After several quarters, the invoice is unpaid and overdue. The patient has also refused to pay the invoiced amount of $1,000 for the medical services. In accordance with Topic 310, *Receivables* [IFRS 9 *Financial Instruments*], the hospital writes off the receivable and recognizes an impairment loss of $3,000. The entity presents or discloses the impairment loss in accordance with paragraph 108B.

Example 4—Seller–based financing of real estate

OUTCOME IS LIKELY THE SAME, BUT COULD BE DIFFERENT WITHOUT A THRESHOLD

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The customer pays $50,000 (5 percent of the promised consideration) at inception of the contract and enters into a financing agreement with the entity for the remaining 95 percent of the contract consideration. The financing arrangement is provided on a non–recourse basis, which means that if the customer defaults the entity can seize the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is $600,000.

The customer obtains control of the building at contract inception. Accordingly, the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset and the customer can also prevent other entities from directing the use of or obtaining the benefits from the asset. This includes the entity, provided the customer continues to meet their obligations under the contract and, as such, the entity does not have the present right to repossess the asset.

In assessing whether the contract meets the criteria in paragraph 12, specifically in assessing whether the parties are committed to perform their respective obligations in accordance with 12(e) [and whether collectibility is probable in accordance with 12(f)], the entity considers the following:

a. The buyer plans to open a restaurant in a highly competitive market.
b. New restaurants in the area generally close within two years of opening.
c. The buyer does not own other restaurants and has little previous experience in the restaurant industry.

d. The buyer has limited financial resources and is principally relying on income from the restaurant to pay the remaining 95 percent of the consideration.

e. The buyer presented a detailed business plan which included possible contingency plans based on how well the restaurant is received;

f. The entity's mortgage note contains customary payment terms, a market rate of interest, and is secured by the property;

g. The entity intends to enforce its contractual rights; and

h. The entity has no participation in managing the property.

The entity concludes that the criteria in paragraph 12 are not met because [the customer is not committed to the contract?] [and the entity concludes in accordance with paragraph 12(f) that collectibility of the consideration is not probable]. Because the entity has no remaining goods or services to transfer under the contract the entity accounts for the nonrefundable $50,000 down payment as a deposit liability until such time as the entity reassesses paragraph 12 and concludes that the customer is committed [and the collectibility threshold is met] or either in accordance with paragraph 15.3(a) all consideration has been received since all performance is complete or (b) the contract is cancelled or terminated. Any future payments of principal and interest received from the customer will increase the deposit liability until either the criteria in paragraph 12 or paragraph 15.3 are met.

Example 5—Usage based royalty

OUTCOMES MAY DIFFER, COLLECTIBIITY THRESHOLD LIKELY TO APPLY

An entity sells a patent to a highly specialized process to a customer for $1 million and a usage based royalty. The customer will use the patent in its development of a new product and eventually in the manufacturing process of this new product any successive products. The customer is a development stage company and does not currently have any reported revenue but expects to have a product ready for sale in 3-4 years. There are no other performance obligations in the contract and the distinct license is a right that transfers to the customer at a point in time. At contract inception, the customer pays the $1 million and the contract meet all the criteria in paragraph 12, including customer commitment [and the collectibility threshold]. All other conditions for revenue recognition are met and the entity recognizes $1 million as revenue upon transfer of the patent but does not record any revenue for the usage based royalty. The entity will continue to recognize revenue as and when the uncertainty associated with the consideration is resolved (ie when it receives quarterly reports of the customer's usage).

Throughout the first year of the contract, the customer provides quarterly reports of usage and pays within the agreed upon period (that is, 30 days after quarter end).

During the second year of the contract, the customer continues to use the entity's patent but its financial condition worsens as another product under development has a significant setback. The

customer's funding and available cash on hand are significantly depleted but in its attempts to remain in business the customer continues accelerated efforts on its product development that uses the entity's patent. The customer paid the first quarter's royalties but made not further payments by year end (that is, quarters 2-4 are unpaid). As a result during the entity's year-end reporting it has recorded a full impairment against all amounts due for quarters 2-4.

During the third year of the contract, the entity continues product development, including the use of the entity's patent which would require royalty payments to the entity, but the likelihood that the customer will receive sufficient funding to continue operations is remote. At the start of the third year, the entity discontinues recognition of any revenue as there is an indication of a significant change in facts and circumstances such that the contract fails the criteria in paragraph 12.