

# STAFF PAPER

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## Purpose

1. This memorandum addresses four questions that were raised by stakeholders about different interpretations of the guidance on collectibility in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the “new revenue standard”). The staff plans to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition for their views on each of the topics included in this paper.

## Background

2. Some of the questions addressed in this paper arise because some stakeholders are uncertain about how to evaluate the collectibility guidance in the new revenue standard as compared to existing guidance. The notion of collectibility is codified in current GAAP in topic 605-10-S99-1 from SEC guidance in Staff Accounting Bulletin (SAB) Topic 13. The guidance includes criteria that must be met in order for a public entity to recognize revenue. Additionally, nonpublic entities may analogize to this guidance.

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3. One criterion is that collectibility must be reasonably assured. If collectibility is not reasonably assured, then no revenue may be recognized on the transaction. IAS 18 *Revenue* also includes a notion of collectibility. A fundamental condition for revenue recognition in IAS 18.14(d) is that it is probable that the economic benefits associated with the transaction will flow to the entity.
4. Like current GAAP and IFRS, under the new revenue standard, collectibility is initially assessed to determine how to account for a contract with a customer. If an entity concludes that it is not probable that it will collect the consideration to which it will be entitled, then revenue would not be recognized when the entity satisfies a performance obligation. An entity in this circumstance would continue to assess the contract to determine whether the collectibility criterion is subsequently met.
5. Under the new revenue standard, the collectibility assessment is based only on the customer's ability and intention to pay the amount of consideration when it is due. It is not an assessment of whether an entity may collect less than the stated price in the contract due to other factors (for example, variable consideration related to a bonus that will only be awarded if certain performance targets are achieved).
6. The amount of consideration to which an entity will be entitled may be less than the stated price in the contract if the entity offers the customer a price concession. In this case, an entity would assess collectibility of the contract based on the consideration amount that includes the price concession.
7. The new revenue standard does not change the accounting for receivables. An entity accounts for a receivable in accordance with Topic 310, Receivables or IFRS 9 *Financial Instruments*. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Topic 310 or IFRS 9 and the corresponding amount of revenue previously recognized shall be presented as an expense (for example, as a bad debt expense).
8. This paper addresses the following topics related to collectibility:
  - (a) How should an entity assess collectibility for a portfolio of contracts?
  - (b) When should an entity reassess collectibility?

- (c) How should an entity recognize revenue on contracts that are subsequently reassessed as not probable of collection (that is, after being assessed as collectible at contract inception)?
- (d) How should an entity assess whether a contract includes a price concession?

**Question 1: How should an entity assess collectibility for a portfolio of contracts?**

- 9. The first implementation question relates to how an entity should apply Step 1 (Identify the Contract with the Customer) to contracts in which the entity has historical experience that it will not collect consideration from some customers in a portfolio of contracts.
- 10. Consider the following example:

An entity has a large volume of homogenous revenue generating customer contracts for which billings are done in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to ensure that it is probable that the customer will pay the amounts owed. If these procedures result in the entity concluding that it is not probable that the customer will pay the amounts owed, the entity does not accept them as a customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts billed.

- 11. If the entity in the example above bills CU100 to its customers in a particular month and there are no other issues that would preclude recognition of revenue for that amount in the month it is billed, how much revenue should the entity recognize given that historical evidence indicates that it will collect only 98% of amounts billed? For purposes of this example assume that the entity has satisfied its performance obligations as of the billing date.
- 12. Stakeholders have reported two views on this example. One view is that the entity should recognize revenue of CU100 and bad debt expense of CU2 (when the

conditions in Topic 310 [IFRS 9] for recognition of an impairment loss have been met), while the other view is that the entity should recognize revenue of CU98 (that is, zero bad debt expense).

13. Paragraph 606-10-25-1 [9]<sup>1</sup> provides criteria that a customer contract must meet in Step 1 of the new revenue standard, including an assessment of the probability of collection, before the remaining steps of the new revenue standard can be applied. Specifically, paragraph 606-10-25-1(e)[9(e)] includes the following criterion on collectibility:

It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7[52]).

14. If any of the criteria in paragraph 606-10-25-1[9] are *not* met, revenue is not recognized until specified events have occurred, as described in paragraph 606-10-25-7[15].
15. The Boards described the purpose of the collectibility threshold in Step in the following paragraph from the Basis for Conclusions:

BC43. The Boards decided that a collectibility threshold is an extension of the other guidance in paragraph 606-10-25-1[9] on identifying the contract. In essence, the other criteria in paragraph 606-10-25-1[9] require an entity to assess whether the contract is valid and represents a genuine transaction. The collectibility threshold is related to that assessment because a key part of assessing whether a transaction is valid is determining the extent to which the customer has the ability and the intention to pay the

promised consideration. In addition, entities generally only enter into contracts in which it is probable that the entity will collect the amount to which it will be entitled.

16. In the example above, because the entity concluded as a result of its procedures (around the acceptance of new customers) that it is probable the customers will pay the amounts owed, the contracts meet the collectibility threshold in Step 1 of the new revenue standard. When the entity satisfies the performance obligations in the contracts, it would recognize revenue of CU100 and a corresponding receivable representing its right to consideration that is unconditional. The guidance in the new revenue standard would not support the view that revenue of only CU98 should be recognized in this example because the entity concluded that it is probable that the customer will pay the amount to which the entity will be entitled of CU100.
17. The entity would evaluate the receivable for impairment as described in paragraph 606-10-45-4[108]:

...An entity shall account for a receivable in accordance with Topic 310[IFRS 9]. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Topic 310[IFRS 9] and the corresponding amount of revenue recognized shall be presented as an expense (for example, as an impairment loss).

## **Question 2: When should an entity reassess collectibility?**

18. Under the new revenue standard, if a contract with a customer meets the criteria in paragraph 606-10-25-1[9] at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in facts and circumstances. Some stakeholders have questioned how to perform this evaluation as it relates to the collectibility criterion.
19. Paragraph 606-10-25-5[13] includes the following example. If a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether

it is probable that the entity will collect the consideration to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer. When an entity determines that a previously-identified contract no longer meets the criteria in Step 1 (identify the contract) of the revenue model, paragraph 606-10-25-7[15] provides guidance on when to recognize consideration received from the customer as revenue (**note:** Question 3 in this paper further addresses the accounting for consideration received from the customer in this scenario).

20. Example 4 in paragraphs 606-10-55-106 [IE14] through 109 [IE17] illustrates the application of this guidance. In this example, the customer meets the criteria in paragraph 606-10-25-1[9] at the inception of a multi-year contract. However, in the second year of the contract the customer's "financial condition declines" and its "access to credit and available cash on hand are limited." In the example, the entity continues to recognize revenue in the second year and evaluates any receivables recognized as a result in accordance with Topic 310 [IFRS 9]. In the third year of the contract, paragraph 606-10-55-109 [IE17] indicates that "the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates." As a result, the entity re-evaluates the criteria in paragraph 606-10-25-1 [9] and concludes that collectibility is no longer probable. Based on that conclusion, the entity does not recognize revenue for that customer in the third year.
21. The new revenue standard emphasizes that the determination of whether there is a significant change in facts or circumstances will be situation-specific and will often be a matter of judgment. Additionally, Example 4 in the new revenue standard illustrates that the change in the customer's financial condition is so significant that it is an indication that the contract is no longer valid and it fails Step 1 of the new revenue standard. Example 4 demonstrates that it was not the Boards' intent to capture changes of a more minor nature (that is, those that do not call into question the validity of the contract) that might reasonably fluctuate during a contract term, especially a long-term contract.

**Question 3: How should an entity recognize revenue on contracts that are subsequently reassessed as not probable of collection (that is, after being assessed as collectible at contract inception)?**

22. The third question arises in the scenario where an entity has a contract with a customer that initially meets the criteria for identifying the contract with the customer (that is, the entity has passed Step 1 of the new revenue standard). Subsequently the entity determines that the remaining amounts due under the arrangement are not probable of being collected and, therefore, the entity no longer has a contract with the customer under the new revenue standard.
23. Assume that the entity received cash that is non-refundable in exchange for performance to-date, and the entity chooses (or may be legally required) to continue to provide services to the customer under the original terms of the contract. Because there is a significant change in facts and circumstances, the entity reassesses the criteria in paragraph 606-10-25-1[9], including whether it is probable that the entity will collect the consideration to which it will be entitled.
24. If the entity concludes that the contract no longer meets the criteria in paragraph 606-10-25-1[9], but continues to receive some consideration from the customer, then the guidance in paragraphs 606-10-25-7[15] and 25-8[16] applies. Paragraph 606-10-25-7[15] provides the following guidance on accounting for consideration received from the customer when the contract fails Step 1 of the new revenue standard:
- ...the entity shall recognize the consideration received as revenue only when either of the following events has occurred:
- (a) The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable.
  - (b) The contract has been terminated, and the consideration received from the customer is nonrefundable.

25. Additionally, paragraph 606-10-25-8[16] states that any consideration received from a customer should be recognized as a liability until one of the events in paragraph 606-10-25-7[15] occurs or until the criteria in paragraph 606-10-25-1[9] (Step 1) are met.
26. Paragraphs BC47 and BC48 provide the Board's basis for that guidance. Paragraph BC 47 states:

The Boards decided to include the guidance in paragraphs 606-10-25-6[14] through 25-8[16] in response to questions from some respondents about how an entity should account for its rights and obligations when a contract does not meet the criteria in paragraph 606-10-25-1[9]...

27. Paragraph BC47 notes that the Boards were concerned about entities analogizing to the new revenue recognition model without further guidance for contracts that fail Step 1 of the new revenue recognition standard.
28. In paragraph BC48, the Boards noted:

The guidance in paragraph 606-10-25-7[15] is consistent with the Boards' rationale for paragraph 606-10-25-1[9], which is to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognizing revenue for those contracts would not provide a faithful representation of such transactions. The guidance therefore precludes an entity from recognizing any revenue until the contract is either complete or cancelled or until a subsequent reassessment indicates that the contract meets all of the criteria in paragraph 606-10-25-1[9]. The Boards noted that this approach is similar to the "deposit method" that was previously included in U.S. GAAP and that was applied when there was no consummation of a sale.

29. Some stakeholders have questioned whether in those scenarios an entity should recognize revenue when consideration is received from the customer (that is, the cash basis of accounting). However, the revenue standard provides two criteria in



paragraph 606-10-25-7 [15] that must be met in order to recognize the consideration received as revenue. As such, the new revenue standard does not allow for cash basis accounting in this scenario without meeting one of the criteria. The standard concludes in this scenario that a contract is no longer valid and that no revenue can be recognized because the terms and conditions against which performance can be assessed are not known. Accordingly, any consideration received from the customer is recognized as a liability until one of the conditions in paragraph 606-10-25-7 [15] occurs or until the conditions in Step 1 (paragraph 606-10-25-1[9]) are subsequently met.

30. The nature of the contract may also affect the accounting that would result from this reassessment scenario. For example, in a services contract, an entity might conclude that this reassessment scenario merely shortens the contract duration to the period from inception to the reassessment date (that is, the reassessment effectively “terminates” the original contract and the condition in paragraph 606-10-25-7(b)[15(b)] has been met). Between those two dates (contract inception and contract “termination”), a valid contract, for accounting purposes, existed. If an entity concludes that a contract has been terminated, then any goods or services transferred under that contract during that period should result in revenue (subject to other requirements in the new revenue recognition standard). Any consideration received from the customer that is not attributable to those goods or services (for example, consideration received in advance of services to be provided subsequent to the reassessment date) either before or after the reassessment date would be subject to the guidance in paragraphs 606-10-25-7 [15] and 606-10-25-8 [16]. Whether consideration is attributable to goods or services transferred under the shortened contract would be based on the original determination of the transaction price and the allocation of the original transaction price.
31. If an entity concludes that a contract is no longer valid prior to transferring any goods or services, all consideration received from the customer would be subject to the guidance in paragraphs 606-10-25-7 [15] and 606-10-25-8 [16].

**Question 4: How should an entity assess whether a contract includes a price concession?**

32. An area of judgment in the new revenue standard is determining whether a situation in which an entity determines that it will collect less than the stated contract price is the result of a collectibility issue or a price concession. If an entity determines that it will collect less than the stated contract price due to a price concession (regardless of whether the price concession is implicit or explicit), then that amount is accounted for as a reduction of the transaction price. That is, the amount is considered to be variable consideration that is subject to the constraint on variable consideration in determining the transaction price (Step 3 of the new revenue standard) rather than an input into the collectibility assessment in Step 1. Therefore, the determination about whether something is a price concession or a collectibility adjustment may have a significant effect on an entity's revenue recognition
33. If an entity concludes that it is offering a price concession, then the entity would estimate the transaction price in accordance with paragraph 606-10-32-8[53] and constrain some or all of the amount of variable consideration, as applicable, in accordance with paragraphs 606-10-32-11[56] and 32-12[57].
34. Paragraph 606-10-32-7[52] provides guidance on what factors to consider in determining whether an entity has offered a price concession. This suggests that an entity's past experience provides evidence in assessing whether a price concession has been offered to a customer. For example, it states:
- ...the customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the prices stated in the contract. That is, it is expected that the entity will offer a price concession.
35. Example 3, *Implicit Price Concession*, in the Illustrations to the new revenue standard provides further guidance on evaluating whether an entity has offered an implicit price concession. In the first paragraph of Example 3, the entity provides services before the entity has assessed whether the customer is committed to the

contract; and therefore, before the criteria in Step 1 have been met. Specifically, the paragraph states:

606-10-55-102 [IE10] An entity, a hospital, provides medical services to an uninsured patient in the emergency room. The entity has not previously provided medical services to this patient but is required by law to provide medical services to all emergency room patients. Because of the patient's condition upon arrival at the hospital, the entity provides the services immediately and, therefore, before the entity can determine whether the patient is committed to perform its obligations under the contract in exchange for the medical services provided. Consequently, the contract does not meet the criteria in paragraph 606-10-25-1[9], and in accordance with paragraph 606-10-25-6[14], the entity will continue to assess its conclusion based on updated facts and circumstances.

36. After providing the services, the entity assesses if the criteria in Step 1 have been met and determines that it does have a contract with the customer. The entity assesses the amount of consideration to which it will be entitled to and whether the reduction from the standard billing rate is due to collectibility issues or due to an implicit price concession. The remaining paragraphs in Example 3 discuss the factors that lead the entity to conclude that a price concession has been offered to the customer. Those factors include additional information about the patient's intention and ability to pay, and the entity's intentions with regards to the services provided and acceptance of consideration, which are highlighted in the following paragraphs from Example 3:

606-10-55-103 [IE11] After providing services, the entity obtains additional information about the patient including a review of the services provided, standard rates for such services, and the patient's ability and intention to pay the entity for the services provided. During the review, the entity notes its standard rate for the services provided in the emergency room is \$10,000. The entity also reviews

the patient's information and to be consistent with its policies designates the patient to a customer class based on the entity's assessment of the patient's ability and intention to pay. The entity determines that the services provided are not charity care based on the entity's internal policy and the patient's income level. In addition, the patient does not qualify for governmental subsidies.

606-10-55-104[IE12] Before reassessing whether the criteria in paragraph 606-10-25-1[9] have been met, the entity considers paragraphs 606-10-32-2[47] and 606-10-32-7(b)[52(b)]. Although the standard rate for the services is \$10,000 (which may be the amount invoiced to the patient), the entity expects to accept a lower amount of consideration in exchange for the services. Accordingly, the entity concludes that the transaction price is not \$10,000 and, therefore, the promised consideration is variable. The entity reviews its historical cash collections from this customer class and other relevant information about the patient. The entity estimates the variable consideration and determines that it expects to be entitled to \$1,000.

606-10-55-105[IE13] In accordance with paragraph 606-10-25-1(e)[9(e)], the entity evaluates the patient's ability and intention to pay (that is, the credit risk of the patient). On the basis of its collection history from patients in this customer class, the entity concludes it is probable that the entity will collect \$1,000 (which is the estimate of variable consideration). In addition, on the basis of an assessment of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1[9] also are met. Consequently, the entity accounts for the contract with the patient in accordance with the guidance in this Topic.

37. The Basis for Conclusions to the new revenue standard also discusses how an entity should consider its intentions and not only refer to past experience in assessing if a price concession has been granted to a customer. Paragraph BC193 states:

BC193. The Boards decided that an entity also should consider all facts and circumstances to determine whether the entity will accept a lower amount of consideration than the price stated in the contract. For example, an entity might enter into a contract with a new customer with a strategy to develop the customer relationship. In that case, although there may not be past evidence that the entity will provide a price concession, there may be other factors present that result in the entity concluding that it will accept a lower price than that stated in the contract.

38. While the new revenue standard provides examples of factors to consider in the illustrations and Basis for Conclusions, the Boards also acknowledged that it may be difficult in some cases to distinguish between a price concession and customer credit risk. Consistent with current GAAP and IFRS, entities might need to apply judgment. In BC194, the Boards noted:

BC194. The Boards observed that in some cases it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (that is, customer credit risk). The Boards noted that an entity should use judgment and consider all relevant facts and circumstances in making that determination. The Boards observed that this judgment was being applied under previous revenue recognition guidance. Consequently, the Boards decided not to develop detailed guidance for differentiating between a price concession and impairment losses.

39. The new revenue standard indicates that an entity should look to past practice as well as the entity's intentions when entering into the contract with a customer. The

determination of whether a reduction in consideration is due to concerns about collectibility or as a result of a price concession will require an assessment of the specific facts and circumstances and require significant judgment, which is consistent with current GAAP and IFRS.

**Question for the TRG Members**

1. For each of the questions above about collectibility, the staff has provided in this paper the applicable guidance in the new revenue standard, including the Basis for Conclusions and related examples. The staff also has observed where judgment will be necessary, similar to existing GAAP and IFRS. Are there other considerations not included in the staff's analysis that might be helpful to stakeholders' understanding of how to apply the new revenue standard?