

STAFF PAPER

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Project	Revenue from Contracts with Customers		
Paper topic	Collectability discussions	considerations—issues emerging from TRG	
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Purpose of the paper

1. The purpose of this paper is to obtain input and direction from the IASB on issues regarding collectability highlighted during the Revenue Transition Resource Group (TRG) discussions in January 2015.
2. This paper accompanies FASB Memo No. 1: *Collectability: Accounting for Cash Received*, which discusses the following issues:
 - (a) the application of the collectability criterion in Step 1 of the new revenue Standard; and
 - (b) the requirements for when a contract does not meet that collectability criterion.
3. The FASB memo has been distributed to IASB members and should be read in conjunction with this paper.
4. The IASB is not being asked to make decisions at this meeting. It will be asked to make decisions at a future meeting after considering the decisions made by the FASB and, if applicable, any discussion with IFRS stakeholders on the effect of those decisions in the context of IFRS 15 *Revenue from Contracts with Customers*.

Background

5. Step 1 of the new revenue Standard specifies five criteria that must be met before a contract qualifies to be accounted for under the remainder of the revenue recognition model. Those five criteria are set out in paragraph 9 of IFRS 15 as follows:

9 An entity shall account for a contract with a customer that is within the scope of this Standard 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) and are committed to perform their respective 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 (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and
- (e) 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 collectability 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.

6. The assessment of these criteria is performed at contract inception. Paragraph 43 of the Basis for Conclusions explains that the criterion in paragraph 9(e) is 'an extension of the other requirements in paragraph 9...In essence, the other criteria in paragraph 9

require an entity to assess whether the contract is valid and represents a genuine transaction.’

7. If a contract meets all of the criteria in paragraph 9 at inception, paragraph 13 specifies that an entity ‘shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For 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 the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer’.
8. If a contract fails any of the five criteria in paragraph 9, including the collectability criterion in paragraph 9(e), paragraph 14 requires an entity to ‘continue to assess the contract to determine whether the criteria in paragraph 9 are subsequently met’.
9. In the event of failing the criteria in paragraph 9, paragraph 15 specifies when the entity should recognise any consideration received as revenue as follows:
 - 15 When a contract with a customer does not meet the criteria in paragraph 9 and an entity receives consideration from the customer, the entity shall recognise 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; or
 - (b) the contract has been terminated and the consideration received from the customer is non-refundable.
10. Although both the IASB and FASB versions of the new revenue Standard use the term ‘probable’ in the collectability criterion, that term has a different meaning in IFRS and US GAAP. Under IFRS, probable is defined as ‘more likely than not’ whereas under US GAAP it indicates a higher threshold (under US GAAP, the term was initially defined in Topic 450 Contingencies as ‘likely to occur’). Although the Boards did not think that this difference in the meaning of probable would have a significant practical effect on outcomes, that difference might potentially affect

stakeholders' perceptions about the prevalence of the issues in this paper under IFRS and US GAAP.

Staff analysis

11. The staff think that there are two dimensions to the issues arising from TRG discussions described in the FASB memo:
 - (a) questions about (i) how to apply the collectability criterion in paragraph 9(e) and (ii) how termination should be determined in paragraph 15(b). These questions suggest that there is some uncertainty about how the Boards intended paragraphs 9(e) and 15 to be interpreted. These are discussed in paragraphs 12–25 below.
 - (b) questions about whether the accounting required by paragraph 15, for consideration received on contracts that initially or subsequently fail the collectability criterion, is in all cases a faithful depiction of the economics. These are discussed in paragraphs 26–31 below.

Applying the collectability criterion and determining termination

Collectability criterion

12. Some stakeholders have expressed concerns that many common contracts might routinely fail the probability criterion in paragraph 9(e) of IFRS 15. They are therefore concerned that instead of applying the general revenue recognition model (ie Steps 2-5), the entity would apply the accounting that is specified in paragraph 15 for a contract that fails the criteria in paragraph 9 (ie fails Step 1). Consequently any non-refundable consideration would not be recognised as revenue until the contract is essentially complete or terminated.
13. For instance, paragraph 20 of the FASB memo sets out an example in which an entity enters into a non-cancellable contract to provide a low credit quality customer with a good and a service for three years. The customer pays for the good and the first quarter's service in advance, but subsequent payments for the services are due monthly in arrears. However, the entity has the flexibility to stop providing the

service in the event of the customer not paying. Some conclude that this contract would fail Step 1 of the new revenue Standard because it is not probable that the entity will collect *all* of the consideration from the customer.

14. Other contracts about which similar concerns have been expressed include health club membership or telephone services contract.
15. However, the above example in the FASB memo is instructive in highlighting that, in considering whether the contract passes the collectability criterion, an entity should not simply assess the probability of collecting *all* of the consideration promised in the contract. Rather, the entity considers the probability of collecting the consideration ‘to which it *will be entitled* in exchange for the goods or services that *will be transferred* to the customer’ (emphasis added). This requires the entity to consider the relative position of the entity’s contractual rights to consideration and the entity’s performance obligations. In other words, it is a forward looking assessment that considers the entity’s exposure to credit risk and the tools available to the entity to manage that exposure to credit risk throughout the contract (such as stopping providing goods or services, or demanding payment in advance).
16. In this example, the evaluation of the collectability criterion would reflect that:
 - (a) the customer is required to prepay part of the consideration, and
 - (b) the entity has the ability to stop providing the service thereby reducing its collectability risk.
17. Paragraph BC46 explains the Boards’ considerations with respect to this latter point:

BC46 In addition, the boards specified in paragraph 9(e) of IFRS 15 that an entity should assess only the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer. Therefore, if the customer were to fail to perform as promised and consequently the entity would respond to the customer’s actions by not transferring any further goods or services to the customer, *the entity would not consider the likelihood of payment for those goods or services that would not be transferred* (emphasis added).

18. An entity would also need to consider the term of the contract in accordance with paragraph 11 of IFRS 15. For instance, in a “three-year” service contract that either party could terminate with two month’s notice without penalty, the evaluation of the collectability criterion would reflect only the non-cancellable term of the contract (which is two months). Importantly, although the contract is described as a three-year contract, the new revenue Standard would require an entity to account for it as a two-month contract.
19. In addition, an entity would be expected to have well established procedures in place to evaluate the credit worthiness of its customer and to take the necessary actions in case of credit risk (eg requiring advance payment). In that regard, we would expect it to be rare that an entity would enter into a contract with a low credit quality customer that requires payments to be made only after work has been performed. For this reason, as well as the factors set out above in paragraphs 15–18, the staff think that the population of contracts that would fail Step 1 of the new revenue Standard should be narrow.
20. In that regard, paragraph BC44 is helpful in explaining that it was not the boards’ intention for many contracts to fail the collectability criterion:

BC44 In addition, the boards observed that in most transactions, an entity would not enter into a contract with a customer in which there was significant credit risk associated with that customer without also having adequate economic protection to ensure that it would collect the consideration. Consequently, the boards decided that there would not be a significant practical effect of the different meaning of the same term because the population of transactions that would fail to meet the criterion in paragraph 9(e) of IFRS 15 would be small.

Termination

21. TRG discussions have also highlighted some diversity of views about when a contract that fails the criteria in paragraph 9 should be considered to be terminated under paragraph 15 of IFRS 15 (set out in paragraph 8 of this paper) so that any non-refundable consideration received can be recognised as revenue. The main question that has arisen is the following:

Is a contract terminated when the entity ceases to provide further goods and services or only when the entity stops pursuing collection of the consideration that it is owed?

22. There is no further guidance in the new revenue Standard about termination. However, the staff note that:
- (a) paragraph 15 applies to a contract with a customer that has failed the criteria in paragraph 9. A contract that fails the collectability criterion in paragraph 9(e) is still a legal contract.
 - (b) contracts often specify that the entity has rights to terminate a contract in the event of non-performance by the customer and that this would not affect the entity's rights to recover amounts owed (or repossess an asset).
 - (c) an entity's decision to stop pursuing collection would not typically affect the entity's rights and the customer's obligations under the contract with respect to the amounts owed under the contract. Those rights and obligations persist, potentially until laws of limitations apply.
23. Accordingly, this indicates that it should be reasonable to conclude that termination does not refer to the point at which an entity stops pursuing collection of the consideration that it is owed.

Preliminary staff assessment

24. The staff's preliminary assessment is that the issues raised above regarding the collectability criterion in paragraph 9(e) of IFRS 15, at most, require clarification of the requirements. We would hope that any such clarifications could highlight that the collectability criterion does not inappropriately 'gate' or 'filter out' more contracts than was intended by the boards (as discussed in paragraphs BC44 and BC46). That clarification could perhaps take the form of an additional example(s), for instance to further illustrate the explanation in paragraph BC46.
25. The FASB memo discusses and recommends some possible clarifications in respect of:
- (a) the application of the collectability criterion in paragraph 9(e)—see Alternative C in paragraphs 62–66 of the FASB memo; and

- (b) the guidance in paragraph 15 clarifying when non-refundable consideration in a contract that fails paragraph 9 should be recognised as revenue—see Alternative B in paragraphs 55–61 of the FASB memo.

Accounting required by paragraph 15 for consideration received on contracts that fail the collectability criterion

26. As explained earlier in this paper, if an entity receives consideration on a contract that fails the collectability criterion, the entity is precluded from recognising that consideration as revenue until either of the following 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; or
 - (b) the contract has been terminated and the consideration received from the customer is non-refundable.
27. Some have asserted that, in some cases, this accounting might be punitive and not accurately reflect the economics of a transaction when (a) an entity has received non-refundable payments from the customer and (b) the contract is not being terminated. For instance, assume that an entity has a long-term service contract and, because there is a significant change in facts and circumstances, the entity reassesses the collectability criterion in paragraph 9 and determines that future payments are no longer probable. Further assume that the entity has received cash that is non-refundable in exchange for performance to date (and that has not already been recognised as revenue), and the entity chooses (or may be legally required) to continue to provide services to the customer under the original terms of the contract. In accordance with paragraph 15, the entity would be precluded from recognising revenue for non-refundable consideration it has received for performance.
28. Regardless of any clarifications that might be provided (as discussed above in paragraphs 12–25 of this paper), the staff think that some may continue to assert that the accounting required by paragraph 15 does not reflect the economics of some transactions.

29. The staff note that the Boards reached their conclusions about the requirements in paragraph 15 of IFRS 15 with the following in mind:

- (a) Paragraph BC48 explains that ‘the requirements in paragraph 15 are consistent with the Boards’ rationale for paragraph 9 of IFRS 15, which is to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognising revenue for those contracts would not provide a faithful representation of such transactions’.
- (b) The staff recall concerns about including guidance in Step 1 of the revenue recognition model that would permit an entity to recognise revenue for partial payments received, particularly instalment payments on an asset sale. This is because the related asset derecognition guidance in other Standards may not always permit a partial derecognition of the asset and, thus, recognising an instalment payment as revenue may result in inappropriate *profit* recognition.
- (c) There were also concerns about the complexity that might arise from developing requirements that would require, in specified cases, an entity to recognise non-refundable consideration for partial performance (when the contract had not been terminated). This was especially the case given that the Boards did not envisage that paragraph 15 would be triggered in many cases.

Preliminary staff assessment

- 30. The IASB staff think that it might be helpful to do some further work to better understand (a) the extent of the contracts that might fail the collectability criterion after considering the clarifications to the guidance discussed earlier in the paper, and thus (b) how paragraph 15 applies to those contracts.
- 31. Nonetheless, if the IASB were to decide to address this concern about the application of paragraph 15, the staff think that this would entail a significant *change*, rather than a clarification, to IFRS 15. Paragraphs 39–54 of the FASB memo discuss possible changes to the new revenue Standard as Alternative A. The FASB staff suggest that, if the FASB wish to pursue Alternative A, then additional research and outreach should be undertaken.