FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

Memo No.	**1**
Issue Date	**March 12, 2015**
Meeting Date(s)	**BM: March 18, 2015**

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Project	**Revenue Recognition—Collectibility**
Project Stage	**Agenda Decision, Deliberations, and Permission to Ballot**
Issue(s)	**Accounting for Cash Received (Step 1 Collectibility Threshold)**

Purpose

1. The March 18, 2015 Board meeting is a decision-making meeting. The purpose of the meeting is for the Board to:
   - (a) Decide whether to add a project to its technical agenda to modify the guidance on collectibility in Step 1 of ASU 2014-9, *Revenue from Contracts with Customers* (the new revenue standard or Topic 606)
   - (b) Select an approach for modifying the guidance on collectibility, and
   - (c) Depending on the approach selected by the Board, either grant the staff permission to begin drafting a proposed ASU for vote by written ballot or provide the staff with input about additional research and outreach to perform.
2. This paper is structured as follows:
   - (a) Background
   - (b) Staff Analysis, Alternatives, and Recommendations
   - (c) Effective Date
   - (d) Appendix A – Issue 3 from the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) Memo 13

(e) Appendix B – Excerpt from the FASB-IASB Joint Board Memo 7C/175C from October 2013 on Collectibility, specifically the collectibility threshold.

Questions for the FASB
1. Does the FASB want to add a project to its technical agenda to enact revisions to the collectibility guidance in the new revenue standard? 2. Does the FASB select Alternative A, or instead, Alternatives B and/or C? **3.** If the Board selects Alternative A, is there additional research or outreach the Board would like? **[The staff only recommends the following questions if the Board selects Alternatives B and/or C.]** 4. Have all relevant issues been deliberated? 5. Have Board members received sufficient information and analysis to make informed decisions on those issues? If not, what other information or analysis do they need? 6. Subject to what we learn through comment letters and other stakeholder outreach, do the expected benefits of the change justify the perceived costs of change? 7. Should the staff proceed to drafting a proposed ASU for vote by written ballot? If yes, what is the length of the comment period?

Background

3. At the January 26, 2015 TRG meeting, the TRG discussed four implementation questions raised by stakeholders about how to apply the collectibility threshold in Step 1 of new revenue standard. The implementation questions were included in TRG Memo 13.

4. Issue 3 in that TRG paper (see Appendix A for the section from that paper that discusses Issue 3) described a circumstance in which an entity had a contract with a customer that initially met the criteria for identifying whether there was a

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 contract are not probable of being collected and, therefore, the entity no longer has a contract with the customer under the new revenue standard.

5. The staff noted during the TRG meeting that if the entity concludes that the contract no longer meets the criteria in paragraph 606-10-25-1[9], but the entity continues to receive some consideration from the customer, then the following guidance in paragraph 606-10-25-7[15] applies:

> …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.

6. The primary issue raised during the January 2015 TRG meeting and in subsequent discussions the staff had with stakeholders relates to a fact pattern in which an entity signs a contract with a customer with low credit quality (or the customer's credit quality deteriorates after the contract is signed) to provide goods and/or services for an extended period (for example, more than one year). Due to the customer's low credit quality, the contract does not meet the collectibility threshold in step 1. Despite the contract not meeting the collectibility threshold, the entity receives some (or substantially all) consideration from the customer for performance to date.

7. While the staff does not think an entity frequently would enter into arrangements in which the collectibility threshold is not met (the Boards acknowledged this in paragraph BC44 of the Basis for Conclusions), it might occur, for example, in the following circumstances:
   (a) An entity has little risk of loss (beyond the consideration promised in the contract) because there are minimal incremental costs to fulfilling the

promise in the contract (for example, access to a health club, telecommunication service, or a license to intellectual property)

(b) An entity can terminate the contract if the customer does not make periodic payments for goods and/or services transferred (for example, a service for which monthly payments are required)

(c) An entity receives some nonrefundable consideration upfront and service can be terminated in the future if the customer does not pay the remaining consideration in accordance with the terms of the contract

(d) The customer's credit quality deteriorates after contract inception (for example, the customer files for bankruptcy protection and the bankruptcy laws prevent the entity from stopping performance for a period of time).

8. Consider the following example (which is analyzed in the *Assessment of the collectibility threshold in Topic 606[IFRS 15]* section below):

> An entity enters into a contract with a low quality credit customer for the supply of a good and the provision of a subsequent service for 3 years. The contract price is CU460, payable as follows:
>
> CU100 at contract inception when the good is transferred to the customer
>
> CU10 payable at the end of each month for the next 3 years as the service is provided
>
> The contract prices for the good and monthly service are CU100 and CU10, respectively. Those prices are equal to the stand-alone selling prices.
>
> At the end of year 1, the customer has paid CU220 (CU100 for the good at contract inception and CU10 each month during the first year). In the first month of the second year, the customer stops paying consideration when it is due. In response, the entity stops providing the service to the customer and pursues collection for the 1 month of unpaid service.

9. At contract inception, an entity would assess the probability of collection as part of Step 1 of the new revenue standard. Paragraph 606-10-25-1(e)[9(e)] provides the following guidance on making that assessment:

> 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).

10. The staff had multiple discussions with preparers from several different industries (including telecommunication and cable, electronic equipment, media and entertainment, and IT services) and accounting firms to determine how stakeholders are applying paragraphs 606-10-25-1(e)[9(e)] and 606-10-25-7[15] to the fact pattern noted above and other similar fact patterns.

11. Additionally, the staff reviewed the board papers and minutes for Board meetings in which collectibility was discussed during redeliberations of the revised Exposure Draft, *Revenue from Contracts with Customers,* that was issued in 2011 (2011 ED). The staff also spoke with current and former members of the FASB and the IASB staff that worked on the 2011 ED and the new revenue standard.

Assessment of the collectibility threshold in Topic 606[IFRS 15]

12. Step 1 of the new revenue standard specifies five criteria that must be met before a contract qualifies to be assessed under the remainder of the revenue recognition model. These criteria are included in paragraph 606-10-25-1[9], which states:

> An entity shall account for a contract with a customer that is within the scope of this Topic 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 (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

(e) It is probable[1] 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). (referred to as the *collectibility criterion*)

13. The assessment of those criteria is performed at contract inception. Paragraph 43 of the basis for conclusions clarifies that the purpose of this evaluation is "to assess whether the contract is valid and represents a genuine transaction."

14. If a contract meets all of the criteria in paragraph 606-10-25-1[9] at contract inception, paragraph 606-10-25-5[13] states 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."

15. If a contract fails any of the five criteria in paragraph 606-10-25-1[9], including the collectibility criterion in paragraph 606-10-25-1(e)[9(e)], paragraph 606-10-

[1] 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").

25-6[14] states that "an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1[9] are subsequently met."

16. In the event the collectibility criterion in paragraph 606-10-25-1(e)[9(e)] is not met, paragraph 606-10-25-7[15] specifies when the entity should recognise any consideration received as revenue as follows:

> When a contract with a customer does not meet the criteria in paragraph 606-10-25-1[9] and an entity receives consideration from the customer, 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 nonrefundable.
> >
> > b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

17. In considering whether the contract meets the collectibility criterion, an entity should not simply assess the probability of collecting *all* of the consideration promised in the contract (which would be inconsistent with the words included in paragraph 606-10-25-1(e)[9(e)]). Rather an entity should consider 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*) pursuant to paragraph 606-10-25-1(e)[9(e)].

18. This assessment requires the entity to consider the relative position of the entity's contractual rights to the consideration and the entity's performance obligations. In other words, it is a forward looking assessment that considers the entity's exposure to the customer's credit risk and the business practices available to the

entity to manage its exposure to credit risk throughout the contract, such as stopping providing goods or services, or demanding advance payment(s).[2]

19. Recall that the objective of this assessment ultimately is about assessing whether the contract is valid and represents a genuine transaction. Considering the relative position of the entity's contractual rights to the consideration and the entity's performance obligations is consistent with that objective.

20. Consider the following example in which a portion of the contract price is prepaid (other stakeholder views for this example are included in the *Stakeholder Interpretations* section below) :

> 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 3 years. The contract price is CU460, payable as follows:
>
> At contract inception, CU100 for the transfer of the good and CU30 which is a payment in advance for the first 3 months of service.
>
> At the end of month 4 and each month thereafter, CU10 for the monthly service.
>
> The contract prices for the good and monthly service are CU100 and CU10, respectively. Those prices are equal to their stand-alone selling prices.
>
> At contract inception, it is not probable that the entity will collect all of the remaining (CU330) specified in the contract.

21. Presume that the customer pays CU130 at contract inception, but stops paying in the fourth month of the first year. In response, the entity stops providing the service to the customer and pursues collection for the 1 month of unpaid service.

22. In this example, the evaluation of the collectibility criterion would consider that:

    (a) the customer is required to pre-pay part of the consideration, and

[2] The notion that entities would demand advance payments is consistent with the boards' intent in paragraph 43 of the basis for conclusions. It is also consistent with some conversations that the staff has held with preparers to discuss their business practices when there are concerns about collectibility.

(b) the entity has the ability to stop providing the service thereby reducing its collectibility risk.

23. Paragraph BC46 of the basis for conclusions explains the Boards' intent with respect to this latter point:

> In addition, the Boards specified in paragraph 606-10-25-1(e)[9(e)] that an entity should only assess 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).

24. An entity also would need to consider the term of the contract in accordance with paragraph 606-10-25-3[11] which states "An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have ***present enforceable rights and obligations***" (Emphasis added). For instance, in a "three-year" service contract that either party could terminate with two months' notice without penalty, the evaluation of the collectibility 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, paragraph 606-10-25-3[11] would require an entity to account for it as a two-month contract, which is consistent with the clarification provided in paragraph 391 of the basis for conclusions.

25. In addition, many entities 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 (that is, requiring advance payment). In that regard, the staff 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. This is consistent with the notion included in paragraph 43 of the basis for conclusions which states "entities ***generally only enter into contracts***

in which it is probable that the entity will collect the amount to which it will be entitled" (Emphasis added).

26. Overall, it was not the Boards' intention for many contracts to fail the collectibility criterion, which is acknowledged in paragraph BC44 of the basis for conclusions:

> 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 606-10-25-1(e)[9(e)] would be small***. (Emphasis added)

Stakeholder Interpretations

27. In the example described above in paragraph 20, many auditors and preparers believe that the collectibility assessment should be based on the transaction price of CU460 (which is the entire contractual amount to which the entity expects to be entitled). Those stakeholders conclude that the contract fails step 1 of the new revenue standard because it is not probable that the entity will collect CU460 from the customer with poor credit quality.

28. Those stakeholders believe that the collectibility assessment is required to be made based on the customer's ability to pay the CU460 because the introduction in paragraph 606-10-25-1[9] for applying Step 1 of the new revenue standard states that an "entity shall account for a ***contract*** with a customer that is within the scope of this Topic only when all of the following criteria are met…" Additionally, they note that paragraph 606-10-25-7[15], which provides the guidance on accounting for consideration received from the customer when collection is not probable, states that if "a ***contract*** with a customer does not meet the criteria in paragraph 606-10-25-1[9] and an entity receives consideration from

a customer…" Because those paragraphs refer to the term "contract", the preparers and auditors conclude that the collectibility assessment should be based on the transaction price in the entire contract.

29. Additionally, those stakeholders' views are not consistent on when an entity should recognize revenue for the nonrefundable consideration received from the customer when the collectibility threshold is not met in step 1. Specifically, they have different interpretations of the term "terminated" in paragraph 606-10-25-7(b)[15(b)], which requires an entity to recognize revenue when "the ***contract*** has been ***terminated***, and the consideration received from the customer is nonrefundable."

30. Some think that a contract is terminated when the entity decides not to provide (or stops providing) further goods or service to the customer when the customer does not perform (that is, pay the consideration). Those stakeholders note that once a customer stops paying consideration, the entity does not have an obligation to provide future goods or services and the contract is terminated when the entity decides to stop providing the future goods or services specified in the contract.

31. Conversely, other stakeholders think that the contract is terminated when the entity stops pursuing collection from the customer. Those stakeholders note that the entity still has an enforceable right to receive consideration from the customer and, therefore, the ***contract*** is not terminated.

32. Some stakeholders assert that the guidance is unclear about whether the term "contract" refers to the legal contract or the accounting contract per Topic 606[IFRS 15]. If the term refers to the legal contract, then the contract might not be terminated because, for example, the entity is pursuing collection and this may occur for an extended period of time. If the term refers to the accounting contract under Topic 606[IFRS 15], then stakeholders question how the contract could be terminated when Topic 606[IFRS 15] states there is no contract (the entity is applying paragraph 606-10-25-7[15] *because* it concluded it does not have a valid contract under Topic 606[IFRS 15]).

Staff Analysis, Alternatives, and Recommendations

Development of Alternatives

33. The staff thinks there are three potential collectibility issues that exist which are reflected in each of the alternatives below.

34. Alternatives B and C are not mutually exclusive.

Genesis for Alternative A- Dissatisfaction with the collectibility threshold in Step 1 of the model

35. The collectibility threshold was added to Step 1 of the new revenue standard because the Boards concluded that a collectibility assessment is an extension of the other guidance on identifying the contract with the customer. Assessing collectibility in Step 1 is a key factor in determining whether a contract is valid and represents a genuine transaction with commercial substance.

36. Alternative A addresses situations in which an entity has transferred some of the goods or services promised in the contract and received some consideration from the customer when the customer is a high credit risk. Some feel that entities should be able to meet Step 1 of the model in those circumstances as it best reflects the economics of the transaction.

Genesis for Alternative B –Clarification to the language included in paragraph 606-10-25-7

37. Stakeholders have different views about whether paragraph 606-10-25-7[15] is referring to the legal contract or the accounting contract under Topic 606[IFRS 15]. In addition, there are differing views about when the termination condition in paragraph 606-10-25-7(b)[15(b)] would be met, which some view as when a contract is legally terminated, and others view as satisfied when an entity has stopped providing goods or services to a customer.

Genesis for Alternative C –Clarification to the collectibility criterion in paragraph 606-10 25-1€

38. Since there are some interpretations of the collectibility criterion held by stakeholders that default to the consideration for entire contract, rather than the consideration "to which it will be entitled in exchange for the goods or services that will be transferred to the customer" there is a potential to clarify how the collectibility criterion should be evaluated on the basis of what the boards' intended for the new revenue standard. As explained in more detail below, this approach might include, for example, including some of the discussion in the basis for conclusions in the standard.

Alternative A

39. When consideration is received by the entity, Alternative A would amend the new revenue standard so that an entity is required to recognize revenue for the lesser of (a) the non-refundable consideration received from the customer and (b) the amount that would have been allocated to a satisfied performance obligation. This requirement would apply when the contract fails the collectibility criterion in paragraph 606-10-25-1(e)[9(e)], but it meets all of the other criteria for a contract in paragraph 606-10-25-1(a)-(d)[9(a)-(d)].

40. Proponents of Alternative A think that an entity should be required to meet the criteria for a contract in paragraph 606-10-25-1[9] other than the collectibility threshold criterion in 606-10-25-1(e)[9(e)] because the criteria are meant to assist an entity in determining whether it has a valid contract with a customer. Proponents of this Alternative think that if a contract did not meet those other criteria, then it would not be feasible to apply Alternative A. This is because it is unclear how an entity would be able to determine (and an auditor would be able to verify) that the consideration is non-refundable, that the relevant promised goods or services have been identified, and that the performance obligations have been identified properly so that the consideration could be allocated properly.

41. Some stakeholders might disagree with the assessment above because they think the collectibility criterion in 606-10-25-1(e)[9(e)] is meant to assist an entity in determining whether there is a valid contract and it is not an unrelated criterion. In

fact, the Boards made this assertion in BC 42-43. That said, if the Board were to propose Alternative A, the Board could explain that it changed its thinking about the application of the collectibility criterion based on recent feedback from stakeholders about the financial reporting outcomes that might result from the collectibility threshold in the new revenue standard. In essence, Alternative A would be closer to the model that is applied today in which revenue is recognized on a cash basis for the deposit method or if all of the following conditions exists: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, and (3) the seller's price to the buyer is fixed or determinable.

42. From a practical perspective, the staff thinks in a majority of circumstances in which the entity has some performance and the customer provides some consideration, the contract would meet the other criteria in paragraph 606-10-25-1[9]. This is because entities generally do not perform (or even begin to substantively perform) if the arrangement lacks genuine substance.

43. Example 1 in the new revenue standard would need to be deleted or modified because it would be inconsistent with Alternative A (either the conclusion or the reasons for the conclusion). Example 1 follows:

> 606-10-55-95 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 building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.
>
> 606-10-55-96 The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess 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.
>
> 606-10-55-97 In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect the consideration to which it is entitled in exchange

for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).

b. The customer lacks other income or assets that could be used to repay the loan.

c. The customer's liability under the loan is limited because the loan is nonrecourse.

606-10-55-98 Because the criteria in paragraph 606-10-25-1 are not met, the entity applies paragraphs 606-10-25-7 through 25-8 to determine the accounting for the nonrefundable deposit of $50,000. The entity observes that none of the events described in paragraph 606-10-25-7 have occurred—that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 606-10-25-8, the entity accounts for the nonrefundable $50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability and does not derecognize the real estate asset. Also, the entity does not recognize a receivable until such time that the entity concludes that the criteria in paragraph 606-10-25-1 are met (that is, the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 606-10-25-7 has occurred. The entity continues to assess the contract in accordance with paragraph 606-10-25- 6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

44. Under Alternative A, the entity would evaluate whether the contract in Example 1 meets the criteria in paragraph 606-10-25-1(a)-(d)[9(a)-(d)] (that is, other than the collectibility criterion in 1(e)[9(e)]).

45. If the entity concludes that the contract does not meet the criteria in paragraph 606-10-25-1(a)-(d)[9(a)-(d)], then the accounting outcome in Example 1 under Alternative A would <u>not</u> change. The entity would recognize a liability for the $50,000 deposit and periodically reassess the contract to determine whether the criteria are subsequently met.

46. If the entity concludes that the contract does meet the criteria in paragraph 606-10-25-1(a)-(d)[9(a)-(d)], then the accounting outcome in Example 1 under Alternative A would change. The entity would recognize revenue for the lesser of

(a) the non-refundable consideration received from the customer and (b) the amount of the transaction price that would be allocated to a satisfied performance obligation. As it relates to (a), the example states the $50,000 deposit is non-refundable. As it relates to (b), the example describes one performance obligation (the building) and the example states that the entity transfers control of the building at contract inception. Based on those facts and assumptions in Example 1, the entity would conclude that all of the consideration relates to the one performance obligation and it would conclude that it satisfied the one performance obligation (the entity transferred control of the asset). Consequently, the entity would recognize revenue of $50,000 and derecognize an asset with a book basis of $600,000, resulting in a significant loss on the contract in the period. When (or if) the customer makes additional non-refundable payments for that performance obligation, the amount would be recognized as revenue in the amount of those cash proceeds.

47. The staff is not convinced the example in the previous paragraph is a particularly realistic fact pattern. This is because it is not clear why the entity would enter into an arrangement like Example 1 in which (a) a customer has low credit quality and the entity finances substantially all of the purchase price over a long term and on a nonrecourse basis and (b) the entity would be willing to transfer control of the building. We think it is more likely that the entity would find ways to reduce its risk in a fact pattern like this one (for example, entering into a lease). In addition, if an entity did enter into such an arrangement it might not meet the criteria in 606-10-25-1(a)-(d)[9(a)-(d)] anyway.

48. The staff thinks there are other fact patterns that might be more realistic and the financial reporting outcome that would result under Alternative A is a more reasonable outcome. One example is a 12-month health club membership that requires the customer to pay $75 per month at the end of each month when the customer is not credit worthy. However, the staff thinks that the collectibility threshold in the new revenue standard would be met at the end of each month. While the entity may not have a contract per Topic 606[IFRS 15] on day 1, at the end of each month if $75 is received, the collectibility threshold would be met.

That is because, the consideration "to which ***it will be entitled*** in exchange for the goods or services that ***will be transferred*** to the customer" has been received and the entity would not continue to provide services to a customer that did not pay. In this example, the entity would terminate services upon non-receipt of payment. Therefore, the services that "will be transferred" takes into consideration the entity's available and probable actions in the event of non-payment by the low credit quality customer. Overall, the staff does not think there are many scenarios in which low credit quality customers are not required to prepay for goods and services or that an entity would continue to provide goods or services to a low credit quality customer that is not making payments.

49. The Board could decide to limit the circumstances in which Alternative A would be applied. For example, Alternative A could be limited to performance obligations satisfied over time. The advantages of this approach include (a) sales of completed real estate (which was a significant concern of the Boards during deliberations of the new revenue standard) would not qualify for the alternative, and (b) it might mitigate the risk that the alternative is applied in fact patterns in which the entity would recognize a loss at the inception of the contract (for example, a piece of expensive equipment). Disadvantages of this approach include (a) it might be difficult to justify the conceptual basis for this change to step 1 in which the application depends on step 5 (point in time or over time), and (b) it would exclude some point in time transactions in which the book basis of the asset being transferred is not significant (for example, some licenses of intellectual property). The staff understands that the Boards previously considered such an approach (that is, limiting the collectibility criterion to certain types of transactions), but the Boards were not particularly attracted to such an approach.

50. If the Board would like to pursue Alternative A, including various ways to limit the application of Alternative A, then the staff suggests we perform outreach with stakeholders to (a) identify cost-effective alternatives and (b) understand the advantages, disadvantages, and consequences of those alternatives. The staff thinks that stakeholders would perceive Alternative A as a significant change to

the new revenue standard, and consequently, there would be a certain amount of concern and questions about the alterative even if it ultimately were appropriate.

51. Alternative A would apply to the widest range of scenarios that have been discussed in this paper when compared to Alternative B. For example, it would apply even in the scenarios in which an entity chooses or is required to keep performing (providing goods or services) in accordance with the contract when collection of further consideration is not probable, such as when a customer is in bankruptcy. Therefore, Alternative A would be most responsive to stakeholders that recommended adding a "cash-basis" alternative for revenue recognition when collectibility is not probable and the entity receives some non-refundable consideration from the customer in exchange for the entity's performance. Those stakeholders have noted that their interpretation of the new revenue standard results in accounting that does not reflect the economics of the transaction when an entity has performed and received some consideration from the customer that is non-refundable.

52. However, Alternative A would represent a significant change to the new revenue standard. Some stakeholders think this alternative would be confusing in a model with a collectibility threshold in step 1. In other words, those stakeholders think this alternative would be a fundamental change to the model and that the collectibility threshold effectively is being moved to step 5.

53. Other stakeholders, however, observe that even though the new revenue standard might declare the contract is not valid, the contract seemingly is a valid contract from a legal perspective. They think it is a valid legal contract because the entity is satisfying some of its performance obligation(s) and the customer is paying the entity some of the consideration. The staff thinks, however, that in some of those situations, the transaction might meet the collectibility threshold in Topic 606[IFRS 15] currently.

54. Finally, the staff observes that some stakeholders might perceive Alternative A as one of the significant differences, if not the primary significant difference, between Topic 606 and IFRS 15.

Alternative B

55. As mentioned above, some stakeholders have different interpretations about the guidance in paragraph 606-10-25-7[15] about when an entity should recognize revenue for consideration received from a customer despite the contract not meeting the criteria in paragraph 606-10-25-1[9]. Paragraph 606-10-25-7[15] states:

> When a contract with a customer does not meet the criteria in paragraph 606-10-25-1[9] and an entity receives consideration from the customer, 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 nonrefundable.
>
> b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

56. Stakeholders' questions include:

    (a) Is paragraph 606-10-25-7[15] referring to the legal contract or the accounting contract (that is, a contract in the scope of Topic 606[IFRS 15])? The lead in to paragraph 606-10-25-7[15] seems to be referring to the accounting contract because it cites paragraph 606-10-25-1[9], which is about the scope of contracts to which Topic 606[IFRS 15] applies. Event (a) in paragraph 606-10-25-7(a)[15(a)] is one in which there are no remaining obligations and substantially all of the consideration has been received and is non-refundable. If the guidance in paragraph 606-10-25-7(a)[15(a)] is referring to the accounting contract, then stakeholders question how they could assert there are no remaining obligations and that the consideration is non-refundable when the very reason they are applying this paragraph is that Topic 606[IFRS 15] essentially declares the entity does not have a contract. If the guidance is referring to the legal contract, then stakeholders question how to apply paragraph 606-10-25-7(b)[15(b)], as described below.

(b) What does it mean that the "contract has been terminated"? Stakeholders usually think about contract termination in a legal context. However, they observe that it would be exceedingly rare for an entity to terminate a contract when a customer still owes the entity some of the consideration under the arrangement. Those stakeholders also are confused about whether the Board is referring to the accounting contract for the same reasons noted above.

57. Alternative B would improve the articulation of the guidance in paragraph 606-10-25-7[15] by:

(a) Making the guidance clear that paragraph 606-10-25-7(a)[15(a)] should be evaluated with respect to the legal contract.

(b) Making the guidance clear that a contract termination in paragraph 606-10-25-7(b)[15(b)] means the entity (i) has the ability (under the contract or the law) to stop transferring additional promised goods or services to the customer and (ii) has actually stopped transferring goods or providing services to the customer. We might also make it clear in the basis for conclusions that the Board is aware that in some cases this assessment will require the use of judgment because, for example, how an entity terminates a service can vary from one context to the next and attempting to define that line might add complexity to an assessment that inherently will require some measure of judgment anyway.

(c) Explaining in the basis for conclusions the similarities and differences between the collectibility threshold in step 1 and the guidance in paragraph 606-10-25-7[15] (when an entity does not pass step 1). This might be particularly useful if the Board decides to make the changes described in Alternative C.

58. The staff thinks those improvements would reduce application cost and complexity and improve the consistency of reporting for economically similar transactions.

59. However, the staff observes that Alternative B would not address the concerns of some stakeholders about not being able to recognize revenue on a cash basis for a contract that fails step 1 if the entity continues to perform either (a) because it elects to continue to perform despite the customer's lack of performance or (b) because the entity is contractually or legally required to continue to perform (for example, a bankruptcy court compels the entity to perform).

60. The staff acknowledges that Alternative B would not address the concerns of stakeholders that prefer the cash basis, and Alternative A would address those concerns. However, the staff does not think contracts with those circumstances would be frequent or that the circumstance often would persist for an extended period.[3] Additionally, there are some fact patterns for which some stakeholders assert that the contract fails step 1(for example, an arrangement for which the incremental cost of the contract is not significant – such as a health club membership or a telephone service) that might actually meet the collectibility threshold. The staff thinks part of the issue is that the stakeholders do not understand the Boards' intention with the collectibility test in step 1 (this issue could be addressed with Alternative C).

61. The staff further notes that Alternative B represents a clarification of the standard. It would be a clarification that the staff thinks underlies the intent of the Boards in developing the collectibility criterion in paragraph 606-10-25-1[9] and the guidance on when an entity should recognize consideration received without a contract. Alternative A, in contrast, is a fundamental change to the model because it effectively would move the collectibility threshold to step 5 of the model.

Alternative C

62. Alternative C would involve improving the articulation of the guidance for the collectibility threshold in step 1. The improvements could take the form of amendments to the standard (such as including guidance from the basis for

[3] However, the staff recognizes that some bankruptcy proceedings can last for years.

conclusions in the standard), adding implementation guidance, and/or adding or amending examples.

63. Alternative C could include amending the standard (including paragraphs 606-10-25-1(e)[9(e)] and 606-10-25-3[11]) to clarify the following:

    (a) In considering whether the contract meets the collectibility criterion in paragraph 606-10-25-1(e)[9(e)], an entity should not simply assess the probability of collecting *all* of the consideration promised in the contract. Rather an entity should consider 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. Therefore, as noted in paragraph BC 46 "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."

    (b) This assessment requires the entity to consider the relative position of the entity's contractual rights to the consideration and the entity's performance obligations. In other words, it is a forward looking assessment that considers the entity's exposure to the customer's credit risk and the business practices available to the entity to manage its exposure to credit risk throughout the contract, such as stopping providing goods or services, or demanding advance payment(s). The assessment would include considering legal rights and obligations as well as past practice (for example, terminating a service if the customer does not pay). The objective of the assessment is to help the entity determine whether there is a valid contract under Topic 606.

64. Alternative C would include clarifying how paragraph 606-10-25-3[11] about the contract duration relates to (or does not relate to) the collectibility assessment in the scope guidance. The staff does not think anything in Alternative C should alter the contract term that is considered in applying the remainder of the guidance in

Topic 606 once an entity determines that the contract is valid based on the scope guidance. For example, the staff does not think Alternative C should affect the contract term for purposes of determining or allocating the transaction price. Evaluating the collectability threshold in step 1 is about considering the entity's credit risk and the possible actions it can take to mitigate credit risk. However, this assessment for the purposes of the collectability test does not change the presently enforceable rights and obligations in the contract.

65. Alternative C also could include adding an example (or an example with two or three changes to the facts or assumptions) to illustrate how guidance should be applied.

66. The staff thinks Alternative C would reduce cost and complexity because the requirements of Topic 606 would be clearer to stakeholders. In addition, the staff thinks Alterative C would lead to consistent accounting for economically similar transactions.

Staff Recommendation on Alternatives

67. The staff recommends both Alternatives B and C. The staff thinks that both Alternatives B and C are improvements to Topic 606 that will address two different stakeholder concerns. The staff does not think Alternatives B and C are significant changes to the guidance; we think the changes would be narrow and would involve clarifications of the Boards' intention. However, we think the clarifications could reduce cost and complexity (because the requirements would be clearer to stakeholders) and we think the clarifications would improve the consistency of the application. The staff thinks Topic 606 and IFRS 15 would remain largely converged in this area even if the IASB decides not to make any changes to the guidance at this time.

Staff Recommendation on Next Steps

68. If the Board would like to pursue Alternatives B and/or C, the staff suggests the Board vote whether to grant the staff permission to ballot at the March 18, 2015

Board meeting. The staff will draft the potential improvements to Topic 606 and seek input from the Board and perform a fatal flaw review. The objective of the fatal flaw review would be to ensure stakeholders think the changes improve the operability of the guidance. The improvement could be included in an Exposure Draft with other improvements to Topic 606 that the Board might decide to make at the March 18, 2015 Board meeting.

69. If the Board would like to pursue Alternative A, the staff suggests the Board not vote whether to grant the staff permission to ballot at the March 18, 2015 Board meeting. Instead, the staff suggests we perform additional research and outreach with stakeholders, which might include discussing draft improvements to Topic 606. After the staff completes the additional outreach and research, we would return to the Board with the input from stakeholders and seek permission to ballot at that time. The reason for the different suggested approaches is the staff is concerned about unintended consequences of Alternative A (for example, interactions with other parts of the new revenue standard). The staff also thinks we would be informed by input from stakeholders on the specific change(s) the Board decides to make under Alternative A. Finally, the staff is aware that the collectibility threshold was among one of the more controversial issues later in the revenue project and we think some stakeholders might immediately have concerns about the proposed change because it is new and it would be occurring fairly quickly.

Effective Date

70. The issues described in this paper relate to updates of guidance that is not yet effective. Therefore, the staff proposes that the effective date of any proposed update resulting from this project would be identical to the new revenue standard.

Appendix A – Issue 3 from TRG Memo #13

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)?

A1. 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.

A2. 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.

A3. 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.

A4. 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.

A5. 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]…

A6. 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.

A7. 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.

A8. 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. 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.

A9. 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 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.

A10. 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].

Appendix B – Excerpt from Joint Board Paper 7C/175C from October 2013 on the Collectibility Threshold

How should the threshold apply?

1. 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).

2. 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.

3. 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.[4]

(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 (e.g. 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

[4] 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.

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.

4. 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 (i.e. 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.

5. 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.
6. 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.