Collectibili

ity, A Revenue Recognition Condition

By Josef Rashty

In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released their standard for revenue recognition. The new guidance may constitute the biggest accounting change ever for some companies. This recently issued guidance is a converged standard with the aim of fostering consistency in accounting practices globally. Companies in all industries and around the world will use the new five-step model for recognizing revenues from contracts with customers.

This article focuses on the criterion of collectibility in revenue recognition guidance and identifies a key major difference between the new standard (ASC 606) and the existing guidance (ASC 605).

In August 2015, FASB issued ASU 2015-14 to defer the effective date of the new revenue standard by one year, but also permitted entities to adopt one year earlier if they choose to do so (i.e., the original effective date). The deferral would result in the new revenue standard being effective for public business entities for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2018. The nonpublic entities would be required to apply the new revenue standard for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2019.

Current U.S. GAAP Revenue Recognition

In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 104, *Revenue Recognition* (codified under Topic 605), which outlines the general principles of revenue recognition under the existing guidance. SAB 104 has remained the point of reference for revenue recognition guidance since then. The guidance per se does not create anything new, but simply summarizes the staff's views on applying the existing revenue recognition guidance.

ASC 605 requires the following four criteria for revenue recognition:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been performed.
- The seller's price to the buyer is fixed and determinable.
- Collectibility is reasonably assured.

Assessment of collectibility is the fourth and final criterion for revenue recognition. The nature of this assessment is similar to assessment that a company makes to determine whether certain accounts receivable has become uncollectible and subject to a bad debt provision.

If, at the outset of an arrangement, a company assesses that collectibility of the debt from a customer is questionable, it cannot recognize any revenues until it receives the amount due or the circumstances change so that collectibility becomes reasonably assured. Thus, in certain instances, a company can use a cash-basis method to satisfy the collectibility condition of revenue recognition.

New Revenue Recognition Guidance

The core principle of the new guidance is that revenue recognized should reflect the transfer of promised goods or services to customers in an amount that reflects the consideration for transfer of such goods

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or services. The revenue recognition criteria under ASC 606 are as follows:

- Identification of contract(s) with customers (ASC 606-10-25-1 through 25-13).
- Identification of performance obligations (ASC 606-10-25-14 through 25-22).
- Determination of the transaction price (ASC 606-10-32-2 through 32-27).
- Allocation of the transaction price to performance obligations (ASC 606-10-32-28 through 32-41).
- Recognition of revenue as the company satisfies performance obligations (ASC 606-10-25-23 through 25-30).

In the earlier version of the new guidance exposure draft, any reference to collectibility criterion was conspicuously missing. FASB's subsequent outreach to constituents supported the idea that collectibility criterion has a place and plays a role in revenue recognition. As a result, in the final guidance, one of the conditions for a bona fide contract is its collectibility. Paragraph (e) of ASC 606-10-25-1 states that in a contract, it should be probable that an entity will collect the consideration that it is entitled to collect. U.S. GAAP defines probable as "likely to occur" – generally a threshold of 75 percent to 80 percent. IFRS, on the other hand, defines probable as "more likely than not" – generally a threshold greater than 50 percent under IFRS 15, *Revenues from Contracts with Customers*. In evaluating whether collectibility of an amount consideration is probable, an entity shall consider the ability and intention of the customer to pay the amount of consideration when it is due.

ASC 606 requires that companies assess the probability of collection at the inception of the contract, based on the customer's ability and intent to pay the amount due. If a company determines that collection is not probable, it cannot recognize any revenues, even if it receives cash, until either of the following conditions is met (ASC 606-10-25-7):

- The customer has no remaining obligations and all, or substantially all, of the contract's consideration has been received and is nonrefundable.
- The contract has been terminated and the amount received deemed to be nonrefundable.[1]

The collectibility assessment is based on transaction price (the amount that the entity is entitled to receive) rather than contract price. Variability is an element that makes the contract price different from transaction price. There are instances when variability is explicitly stated in the contract; for example, if certain events occur, the company may offer a transaction price concession (ASC 606-10-32-7(a)). There may also be other facts and circumstances present that indicate a company's intention to offer a transaction price concession to the customer; for example, due to unfavorable economic conditions, the company may decide to offer a transaction price concession to the customer (ASC 606-10-32-7(b)).

In these scenarios, the company estimates the amount of variable consideration (the transaction price) based on "the expected value" or "the most likely amount" (ASC 606-10-32-8). The collection assessment must be made based on the amount of variable consideration (transaction price) and the company's expectation for a price concession and accepting a lower amount of consideration from the customer (ASC 606-10-55-100).

The new guidance highlights a major difference in collectibility criterion in ASC 606, as compared to existing guidance (ASC 605) – the cash-basis method can no longer be used for revenue recognition purposes. It can be argued that elimination of the cash-basis method better reflects the economic substance of transactions when collection is deemed to be not probable since the objective of a collectibility assessment is to evaluate whether the contract as a whole is valid and reflects a genuine transaction.

Formation of TRG

FASB and IASB formed a Joint Transition Resource Group (TRG) to solicit, analyze and discuss stakeholders' issues regarding implementation of new revenue recognition guidance, and to inform FASB and IASB of such issues. In its January 2015 meeting, the TRG discussed 11 issues related to the new revenue recognition guidance, including the criterion of collectibility. TRG members generally concluded that FASB's staff position on the issue of collectibility was reasonable.

However, some TRG members commented that the elimination of the cash-basis method may not properly reflect the economic substance of certain transactions. For example, in a long-term contract where services are performed monthly and the customer has a poor credit record and pays for amounts due on services monthly, the vendor cannot recognize any revenues until the contract is complete or terminated. They argued that such interpretation of guidance does not fully conform to the substance of the transaction. FASB and IASB may decide to discuss this issue further or conduct an outreach with stakeholders.

Latest Development

On Sept. 30, 2015, FASB issued an exposure draft titled *Narrow-Scope Improvements and Practical Expedients* for Topic 606; comments were due on Nov. 16, 2015. In this exposure draft, among other things, FASB clarifies the objective of collectibility criterion in revenue recognition.

The exposure draft would add a new clarity to paragraph 606-10-25-7 that allows an entity to recognize revenue in the amount of consideration (cash) received when the following conditions exist: (1) the entity has transferred control of the goods or services; (2) the entity has stopped transferring additional goods or services; (3) the entity has no obligation to transfer additional goods or services; and (4) the consideration (the amount of cash) received from customer is nonrefundable.

Thus, this exposure draft confirms the original intention of FASB in ASC 606 and the consensus of the TRG regarding collectibility condition. The author believes that FASB will approve and finalize the guidance in this exposure draft in early 2016.

Illustration

In this illustration, Entity A enters into a contract at the beginning of the first quarter to sell 1,000 units of product A to Entity B (an underfunded startup company) at $1,000. Entity A determines at the outset that collection is not probable (ASC 606 terminology) or probability of collection is not "reasonably assured" (ASC 605 terminology).

Entity A ships 600 units of product A to entity B during the first quarter in good faith and Entity B pays Entity A $500 (non-refundable), but collectibility at the end of the first quarter still remains not probable.

The following scenarios occur in the second quarter:

Scenario A: Entity B cannot secure any additional financing and decides to close its business. Entity A does not ship any additional products to Entity B during the second quarter and terminates the contract.

Scenario B: Entity B secures additional financing and Entity A deems collection to be probable at the end of the second quarter. Entity A does not ship any additional product to Entity B during the second quarter.

Scenario C: Entity A ships the additional 400 units to Entity B. Entity B does not secure any additional financing, but manages to pay the remaining $500 of the contract to Entity A before the end of the quarter. Entity A considers the contract complete upon receipt of second payment.

Table 1 includes the journal entries that reflect the transactions described in this illustration.

Table 1:

	ASC 605		ASC 606	
1st Quarter	Dr. Cash	$500	Dr. Cash	$500
	Cr. Revenue	$500	Cr. Deferred revenues	$500
2nd Quarter	None		Dr. Deferred revenues	$500
Scenario A			Cr. Revenues	$500
2nd Quarter	Dr. Accounts Receivable	$100	Dr. Accounts receivable	$100
Scenario B	Cr. Revenues	$100	Dr. Deferred revenues	$500
			Cr. Revenues	$600
2nd Quarter	Dr. Cash	$500	Dr. Deferred revenues	$500
Scenario C	Cr. Revenues	$500	Dr. Cash	$500
			Cr. Revenues	$1,000

Bad Debt Provision

If collectibility is probable at the outset, but subsequently facts and circumstances change such that collection from the customer is no longer probable, the amount of the debt deemed to be uncollectible should be written off as a bad debt expense or the company should provide a bad debt provision for the account, as it is appropriate. Topic 450, *Contingences,* provides guidance to determine if it is probable that amounts will or will not be collected. The company should account for any impairment of its existing receivable in accordance with Topic 310, *Receivables*.

"THE NEW GUIDANCE HIGHLIGHTS A MAJOR DIFFERENCE IN COLLECTIBILITY CRITERION – THE CASH-BASIS METHOD CAN NO LONGER BE USED FOR REVENUE RECOGNITION PURPOSES."

Final Remarks

The new revenue recognition guidance is a principle-based standard. Therefore, for revenue recognition to occur, a contract must exist and for a contract to exist, the collectibility must be probable. As a result, partial cash collection per se does not establish the collectibility status of the whole contract, since if probability of collectibility is not assured, the existence of the contract cannot be determined. Therefore, partial cash collection can be a criterion for revenue recognition if and only if the contract is completed or terminated, as defined by FASB ASC 606 and its recently issued exposure draft.

The author believes that accommodating the view of minority TRG members regarding long-term contracts with customers that have poor credit records (discussed earlier in this article) is against the spirit of the guidance and changes a principle-based standard to another rule-based standard, and that is exactly what FASB and IASB have been trying to avoid.

Footnote

1. Termination **means** that an entity can stop a contract based on the terms of the contract or through legal means; for example, by ceasing to transfer the remaining goods or deliver remaining services to customers. Thus, termination has an accounting rather than a legal connotation. In this context, termination implies that a company is allowed to recognize revenues for the amount of cash collected and meanwhile can pursue collection of the remaining balance, if any.

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