# WATCHING THE "TOP LINE"

## Areas for Investor Scrutiny on Revenue Recognition Changes

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Reported revenue heavily influences investors' overall view of reporting companies' prospects. The IASB and FASB have both issued new and largely converged revenue recognition standards that will take effect by 2018. In this paper, we highlight aspects of the new guidance that are worthy of investor attention as well as discuss the implications of these aspects on the amount, timing, uncertainty, and presentation of reported revenue. We also emphasize the importance of investors being aware of reporting outcomes that could arise from transition requirements and the need for them to monitor revenue trends before and after the standard takes effect.

## EXECUTIVE SUMMARY

Recent stock market reactions to news flow about either established or "under investigation" cases of revenue misreporting (e.g., Valeant, IBM, Boeing, and Tesco) signal the importance that investors attach to revenue as a performance measure, a valuation input, and an indicator of management's stewardship effectiveness and integrity. Concurrently, both the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) issued new and largely converged revenue recognition standards in 2014 that will take effect by 2018. Many investors may see the updated revenue recognition principles as highly conceptual and challenging to precisely translate to possible changes in reporting outcomes (e.g., timing of revenue). This paper highlights important reasons for investors to closely track revenue reporting prior to and on adoption of the new standards. We review five particular issues, namely: transition requirements, multiple deliverables within a contract, licenses, gross versus net presentation of revenue, and customer credit risk. We highlight the implications of these issues for investors. A follow-up paper will address long-term contracts and uncertain revenue.

## MOTIVATION FOR UPDATING REVENUE RECOGNITION REQUIREMENTS

Reported revenue amounts and growth trends are "top line" indicators of potential economic-value creation under any business model. Hence, revenue is arguably the most important and pervasive company performance metric because it is also the starting point for defining other key performance measures. For

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example, revenue affects key income statement analytical ratios and related metrics (e.g., return on equity and return on assets) as well as balance sheet–based ratios that gauge asset utilization, solvency, and working capital management. In addition, for early stage growth companies, which typically experience negative profitability in their first few operating years, revenue rather than net income tends to be the key input for related valuation methodologies.

The pervasiveness of revenue as an input for valuation and bottom-line performance analysis probably explains the prevalence and seemingly unending high-profile episodes of egregious revenue misreporting scandals, from Enron Corporation and Xerox Corporation in the early 2000s to more recent episodes, such as Toshiba Corporation and Tesco PLC. These accounting failure episodes reveal a wide variety of revenue recognition misreporting practices. They also highlight how revenue misreporting can undermine the integrity and information efficiency of capital markets.

One area of misreporting occurs when a company inappropriately presents revenue on a gross instead of net basis. Groupon, an innovative internet-based retailer (e-tailer) whose business model entailed facilitating subscriber customer purchases and obtaining bulk purchase discounts from suppliers, exemplifies the incentives by early stage companies with less mature business models to overstate revenues premised on management anticipating favorable capital market valuations. From 2009 to 2011, Groupon inflated its reported revenues by presenting revenue on a gross basis rather than the more appropriate net basis. During that period, the company boasted of a seemingly astronomical revenue growth trend (from $14.5 million in 2009 to $1.6 billion in 2011) accompanied by strong stock price performance (Dutta, Caplan, and Marcinko 2014).

The US Securities and Exchange Commission (SEC) probed the appropriateness of Groupon's accounting practices, which led to the company restating revenues on a net basis. A significant decline in the stock price followed. The Groupon case is similar to that of Priceline, another e-tailer that overstated revenue in the early 2000s via gross as opposed to net revenue presentation.

Apart from these company-specific revenue misreporting episodes, several other aggregate-level headline statistics point to the significant misstatement risk associated with revenue, including the following:

- The 2016 International Forum of Independent Audit Regulators (IFIAR) report (IFIAR 2016) noted that revenue was one of four areas with the most auditor inspection findings.
- A 2013 Center for Audit Quality study (Scholz 2014) reported that a significant proportion of restatements in the United States are related to revenue recognition—14% in a 10-year period.
- A review of SEC Accounting and Auditing Enforcement Releases (AAER) from 1982 to 2005 revealed that revenue was the most frequently affected item, with alleged manipulations in 54% of 676 firms with misstatements (Dechow, Ge, Larson, and Sloan 2011).
- The Financial Reporting Council (FRC) "Extended Auditor's Reports: A Further Review of Experience" showed that auditor reports frequently identify revenue as a key risk area (FRC 2016).

- The 2015 FRC *Corporate Reporting Review Annual Report* identified revenue as one of the top 10 areas with issues raised (FRC 2015).

Notwithstanding the importance of revenue and associated misreporting risk, both International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) revenue recognition requirements are characterized by numerous deficiencies and complexities. For instance, in the United States, there are more than 200 pieces of revenue guidance literature and these are often industry specific and inconsistent. Investors thus have a difficult time analyzing companies' financial statements across sectors because they have to learn the nuances of each sector's revenue recognition model. The US GAAP guidance has been respectively defined by the FASB, SEC, and FASB's Emerging Issues Task Force.

At the same time, under existing IFRS revenue recognition requirements defined in IAS 11: Construction Contracts and IAS 18: Revenue, there is incomplete guidance related to accounting for customer contracts with multiple deliverables. The result is that several IFRS reporting companies (e.g., software companies) have had to rely on US GAAP for reporting revenue.[1] Concurrently, there are hardly any informative revenue-related disclosures provided across both US GAAP and IFRS reporting companies. These noted deficiencies, as well as the objective of creating globally comparable revenue, contributed to the FASB's and IASB's decision to undertake a joint revenue recognition project aimed at enhancing existing guidance. The resulting issuance of new US GAAP and IFRS standards, in FASB Accounting Standards Codification (ASC) 606 and IFRS 15, took place in May 2014.

# MAIN ELEMENTS OF UPDATED REVENUE RECOGNITION REQUIREMENTS

Under existing US GAAP guidance, revenue recognition is based on the following principles:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The fee is fixed and determinable.
- Collectability is probable.

IFRS principles are substantively similar to US GAAP principles, and these principles effectively result in revenue being recognized when "earned" and "realized or realizable." Existing guidance also emphasizes the transfer of the associated "risk and reward" of goods or services as a criterion for recognizing revenue.

[1]IAS 8 allows companies, after exhausting the evaluation of analogous IFRS standards and the framework, to apply other national accounting standards. For example, several IFRS reporting companies (e.g., SAP SE and Sage Group) apply US GAAP for revenue recognition.

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The newly issued IASB and FASB revenue recognition guidance is premised on recognizing revenue when control transfers from a seller to a customer. Often described as a "five-step model," the guidance consists of the following five interdependent steps:

1. Identify the contract.
2. Identify separate performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price.
5. Recognize revenue as (or when) the performance obligations are satisfied.

Steps 1 through 4 help identify the seller's promises to the customer (i.e., performance obligations), the amount of the purchase price attributable to each promise, and whether there is a bona fide contract. Essentially, the first four steps determine the amount of revenue to be recognized for each distinct promise of goods, services, or licenses. Step 5 determines the timing of revenue recognition based on the pattern of the transfer of control of goods, services, or licenses from sellers to customers. Revenue can be recognized at a point in time or over time. The notion of recognizing revenue over time is analogous to the percentage of completion approach often applied for long-term construction contracts under current revenue recognition guidance.

For many investors, the five-step model will appear to be highly conceptual and not necessarily readily translatable to possible changes in reporting outcomes across different sectors. That said, it is worth emphasizing that for most business models, including such individual consumer-focused businesses as "brick and mortar" retailers, restaurants, and personal service businesses for which cash tends to be received at the point of sale of goods or services, not much will change. Revenue recognition is fairly straightforward for these business types, which tend to have oral contracts, short-term transactions, and minimal time between the sale and cash collection. Nevertheless, investors would be well served to pay attention to the implications of the new guidance for complex business models, such as those with long-term contracts (e.g., aerospace, defense, engineering, and construction) or those with multiple deliverables (e.g., software and biotech). For such business models, the new guidance could significantly affect the amount and timing of reported revenue.

# NECESSARY AREAS OF INVESTOR SCRUTINY

The following sections cover transition requirements, revenue recognition issues, and other key areas that are important for investors to be aware of during the transition to the new standard.

## Transition Requirements

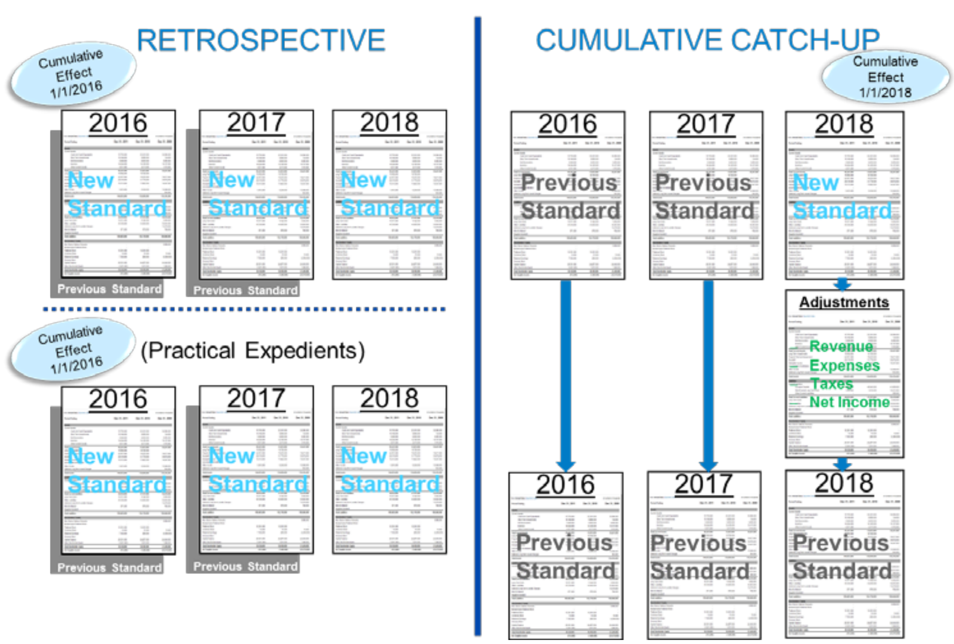
The new standard will take effect on 1 January 2018 under IFRS and after 15 December 2017 under US GAAP. Both IFRS and US GAAP allow early application. The standard allows preparers to choose between providing retrospective transition (i.e., 2018 and all prior years presented for comparison in 2018 financial statements), retrospective transition with practical expedients, and cumulative catch-up transition (2018, no prior year, a cumulative catch-up in opening equity, and disclosure of what current year revenue would have been under the old guidance). See Figure 1 for a visual of the transitions.

At face value, there seem to be only three transition options (full retrospective, retrospective with several practical expedients, and cumulative catch-up). However, the retrospective with practical expedients creates more than three overall options because different entities may select different permutations of the practical expedients. Hence, the retrospective approach with practical expedients could pose an added challenge in comparing the multiyear revenue trend data for reporting entities. Furthermore, through subsequent clarifications, IASB and FASB have allowed further practical expedients, and this will further exacerbate a lack of comparability of reported revenue during the transition and adoption years.

During a 2014 webcast cohosted by CFA Institute, IASB, and FASB, a poll of the participants highlighted their preferences for information in the run-up to the effective dates for the new standard and during the transition period. The following key messages came through:

- **Investor preference for retrospective data.** Two-thirds of the respondents (67%) said they preferred three years of comparative data, and 21% expressed a preference for five years of comparative data. Five years of transition data is prescribed by SEC Staff Accounting Bulletin 74 (SAB 74). Only 5% favored the prospective method. In its past commentary, CFA Institute has supported the need for a full retrospective transition that can provide investors with comparable multiyear revenue trend data.

**FIGURE 1. TRANSITION: INVESTOR CONSIDERATIONS (COMPARABILITY)**

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- **Time for investors' attention.** Most poll respondents (64%) said they would pay greater attention to the revenue recognition standard in the 12- to 30-month period prior to its effective date. A majority also said management should begin disclosing in financial statements the potential impact of the change before the new rules take effect, with 88% preferring such disclosures in the 12 to 30 months prior to the standard's effective date.

# Selection of Key Revenue Recognition Issues

The following sections highlight areas of reporting that will affect the timing, amount, presentation, and disclosure of recognized revenue, all of which deserve investor scrutiny. The following issues are addressed: customer contracts with multiple deliverables, licensing revenue, gross versus net presentation of revenue, and customer credit risk.

## *Customer Contracts with Multiple Deliverables*

The number of companies using complex business models, characterized by the delivery of a combination of products, licenses, and services spread across multiple reporting periods, continues to grow. Examples of multiple-element contract business models include the following:

- Software sales with regular updates
- Equipment sales that include maintenance services
- Sales that have financing elements
- Mobile phone contracts that provide a handset and telecommunication services during a specified period
- Pharmaceutical companies that license drug compounds and provide research and development or manufacturing services

A review of the features of the highly innovative software industry showcases the complexity associated with reporting revenue for multiple-element contracts. The software industry has a broad spectrum of continuously evolving business models with complex, multiple-element customer contracts, and these features contribute to the complexity in accounting for revenue from such contracts. Notably, software industry companies have the following features and trends that affect the nature, amount, timing, and reliability of revenue.

- **Revenue streams from different activities.** As described in industry publications,[2] software company business models tend to derive revenue from a range of different intellectual property (IP) and related business activities, including the following:
    - IP creation

[2]See Karl Popp's website for more information (www.drkarlpopp.com/BusinessModelsintheSoftwareindustry.html#.Vu_x9-KLTIU).

- IP distribution
- IP leasing (i.e., when the accounting is governed by the revenue and not leasing guidance)
- IP brokerage

For example, revenues for the software company SAP SE spread across each of these business activities.

- **Increasing service-related revenue streams.** Software companies' overall product versus service mix has changed, with service-related revenues increasing as a component of overall revenue streams (Cusumano 2008).
- **Reduced upfront revenue recognition as a result of increased deployment of the SaaS business model.** A notable shift has occurred from software as a product (SaaP) to software as a service (SaaS) business models. Under the SaaP business model (e.g., SAP and Microsoft Corporation[3]), contracts with customers usually encompass 1) product sales revenue recognized at a point in time (e.g., perpetual licenses) and 2) ratable revenue recognized over time (e.g., services, maintenance). A customer typically pays for the software usage rights, support maintenance, and operations, and the pricing structure distinguishes between upfront software installation fees and subsequent-period license maintenance and upgrade fees. In contrast, in the SaaS business models (e.g., Salesforce.com and Workday, Inc.) the customer receives both access to the software and usage rights, but the software vendor carries the cost of software support, maintenance, and operations.[4] Compared with SaaP archetypes, SaaS business models result in a greater proportion of ratable revenue (i.e., revenue recognized over time).

The ever-increasing complexity of business models within the software industry creates a challenge in developing accounting requirements that ensure software companies' reported revenue faithfully reflects the pattern of transfer of economic benefits to their customers. The challenge in determining an appropriate accounting approach arises whenever reporting companies have incentives to accelerate revenue recognition or conversely whenever conservatism in accounting requirements could result in revenue deferral in a manner that distorts the representation of an entity's value creation.

The newly issued guidance aims to provide a robust framework to ensure that companies are reflecting their business models' true economics. The following are notable aspects of IFRS 15 and ASC Topic 606 requirements for accounting for multiple-element contract revenue:

1. allocating revenue across distinct performance obligations, including unfulfilled performance obligations (such as software upgrades), and
2. allowing the use of estimated selling prices when actual transaction prices of unfulfilled performance obligations are still undetermined. The use of estimated selling prices differs from the more conservative requirements in place in the United States since 1997 under SOP 97-2, which require vendor-specific objective evidence prior to allocating revenue amounts to future deliverables.

[3]SAP and Microsoft derive most but not all of their revenue from the SaaP business model.
[4]See Karl Popp's website for more information (www.drkarlpopp.com/BusinessModelsintheSoftwareindustry.html#.Vu_x9-KLTIU).

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## Implications for Investors

As Figure 2 illustrates, it is important to understand the connections among deployed business models, customer contracts, and resulting revenue streams. It is also important to understand the correlation between gross margins and cash flow from operations. To contextualize revenue recognition patterns resulting from the new guidance, investors ought to monitor the following:

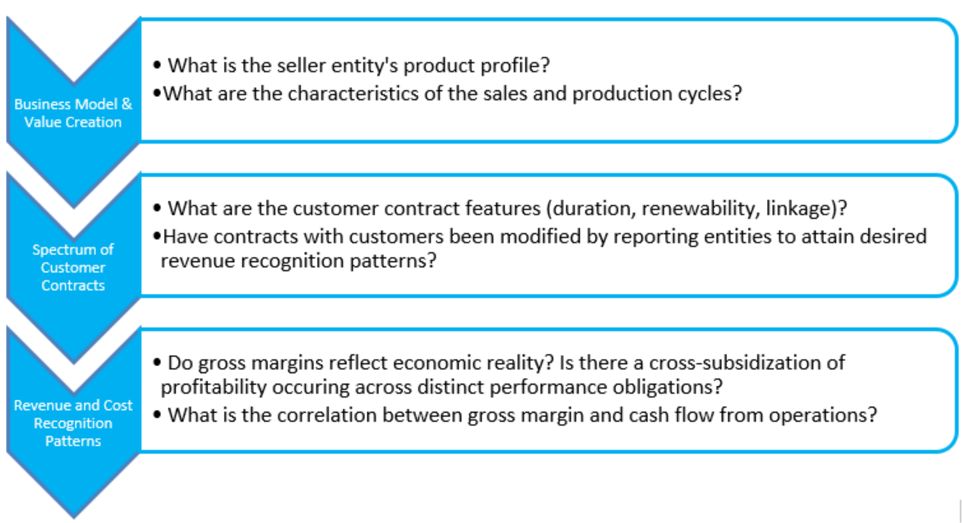
- **Changes in business practices or contracts.** Contracts may be altered and business models may evolve to allow desired revenue recognition patterns. For instance, within the software industry, the following could occur:

  - Separation of SaaS subscription services into software and hosting arrangements
  - Split of maintenance fees into upgrade rights and support

  As depicted in Figure 2, when reviewing revenue patterns and trends, investors need to evaluate the interaction of the business model, the spectrum of customer contracts, and the resulting effect on revenue recognition patterns.

- **Contract cost recognition patterns.** As noted earlier, revenue tends to be an input for valuing early stage, high-growth companies. An article on the valuation of SaaS business models (Kupor and Kasireddy 2014) illustrates why any misalignment between contract revenue and contract cost recognition can distort the interpretation of reporting SaaS companies' patterns of economic value creation. The risk of misinterpreting the value creation arises because investors often assume gross margin to be predictive of future cash flows. Under existing guidance, customer acquisition costs for SaaS providers tend to be expensed when incurred, whereas revenue is recognized on a subscription basis (i.e., over

FIGURE 2. FRAMEWORK FOR REVIEWING REVENUE RECOGNITION PATTERNS IN MULTIPLE-ELEMENT CONTRACTS



time). Hence, high-growth SaaS providers will likely have a loss-making pattern in the first few years that does not reflect their long-term profitability potential.

The question is, to what extent will cost recognition change with the new standards? The new contract cost recognition requirements are as follows:

- Entities are required to recognize an asset for the incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered.
- Costs of fulfilling a contract are capitalized only when they are 1) directly related to a contract, 2) generate or enhance resources that will be used to satisfy performance obligations, and 3) are expected to be recovered.

  That said, investors will most likely still find it challenging to readily discern whether and how cost recognition patterns may change under the new guidance. Hence, investors may need to seek this information from the management of reporting entities in case this information is not comprehensively reported within the disclosures.

- **Entity-specific judgments and disclosures.** High-quality disclosures will become increasingly important to enable investors to assess the link between revenue and the value created. As necessary, investors should be prepared to probe management's revenue-related assumptions.

### *Licensing Revenue*

A license is an arrangement that establishes a customer's rights related to an entity's IP. Licenses are common in the following industries (PwC 2014):

- Technology: software and patents
- Entertainment and media: motion pictures, music, and copyrights
- Pharmaceutical and life sciences: drug compounds, patents, and trademarks
- Retail and consumer: trade names and franchises

The US Department of Commerce's 2012 report on *Intellectual Property and the U.S. Economy* (Economics and Statistics Administration and United States Patent and Trademark Office) indicated that the sale of IP licenses is a key component of revenue for a significant number of business models. Table 1, excerpted from that report, highlights a selection of key industries with significant IP-intensive revenue.

The timing of revenue recognition from the sale of IP licenses depends on whether the license is deemed to have granted the following rights:

- Right of access: Revenue will be recognized over time
- Right of use: Revenue is recognized up front

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**TABLE 1. ILLUSTRATIVE DISAGGREGATION OF IP REVENUE FOR SELECTED INDUSTRIES**

| Sector | IP-Related Revenue ($ millions) | IP Revenue Intensity |
|---|---|---|
| Lessors of nonfinancial intangible assets | 24,473 | 74.3% |
| Motion picture and video industries | 51,132 | 64.1% |
| Cable and other subscription programming | 17,256 | 38.4% |
| Software publishers | 12,868 | 9.5% |
| Scientific research and development services | 8,532 | 9.0% |

*Note:* IP revenue intensity = (IP revenue/Total revenue).

As was evident from the IASB and FASB joint transition resource group for revenue recognition (TRG),[5] accounting for license revenues was an issue that required further implementation clarification.[6] Because of the impact on revenue timing for IP creator, distributor, and lessor business models, investors should also consider this topic to be important.

## FASB vs. IASB Differences

To address stakeholder concerns, both the FASB and IASB issued exposure drafts (EDs)[7] in 2015 to clarify the accounting for license revenue (i.e., where the license is a distinct component of the contract's performance obligation). The IASB ED focused mainly on clarifying the application of the core principle and refining the illustrative examples. In its clarifying guidance, FASB introduced an additional concept of the nature of a license (i.e., functional versus symbolic) as the criterion for determining whether to recognize revenue "over time" or at a "point in time." The following explains the distinction between functional and symbolic licenses:

- **Functional licenses.** The notion of "standalone functionality" of licenses relates to the ability of IP to process a transaction, perform a function or task, or be played or aired. It frequently applies to software, biological compounds or drug formulas, completed media content (films, television shows, or music), and patents for specialized manufacturing processes. For most functional IP sales, revenue is fully recognized at the time of sale.

[5]TRG is a group of predominantly preparers and auditors with the mandate of identifying unforeseen IFRS and US GAAP implementation challenges for IFRS 15 and ASC Topic 606.

[6]IFRS 15 and ASC Topic 606 issued in 2014 require an assessment of the following three conditions: 1) whether the seller of a license undertakes post-sale activities (e.g., maintenance or upgrades) that can alter the IP's function, form, and utility in a manner that affects the economic benefits derived by the customer; 2) whether rights granted expose the customer to negative or positive effects of the sellers' activities that affect the IP; and 3) whether those activities do not result in the transfer of goods or services as those activities occur. This assessment was meant to be a condition for determining that only right of access had been granted to the customer and for recognizing revenue over time. A failure to meet all three conditions results in "at point in time" revenue recognition.

[7] The EDs also clarified that sales- and use-based royalties constraints apply to contracts in which licenses are the predominant component.

- **Symbolic licenses.** Symbolic licenses are the residual category. In other words, if a license is not functional, then it is considered symbolic and revenue is recognized over time.

Both the FASB and IASB have clarified that the licensing guidance applies only when licenses are the predominant component of customer contracts.

### Implications for Investors

IP-related business models are becoming even more pervasive in the modern economic environment. Thus, the new accounting guidance related to license revenue could have widespread ramifications within and across a wide variety of industries.

A practical application challenge remains for investors because, even with the illustrative examples, the guidance is principally conceptual—especially because the new standard's effects on licensing revenue have not been articulated in a manner that makes it easy for investors to discern which sectors will be most affected. Investors ought to do the following in order to understand the implications of the license revenue guidance on specific companies' reporting outcomes:

- **Engage with corporate managers during run-up to adoption date.** An ongoing engagement between investors in and corporate managers of companies that deploy business models with IP-related revenue streams will be necessary to discern 1) any significant changes in the pattern and timing of revenue recognition for these business models and/or 2) whether contract types will change as a result of the newly issued guidance.

- **Pressure entities for high-quality disclosures.** The new guidance also reinforces the need for robust disclosures that inform investors about 1) the nature of revenue and 2) the judgments that managers make that influence the observed pattern of revenue recognition.

## *Identifying Principal vs. Agent: Gross vs. Net Presentation of Revenue*

As mentioned in the introduction, Groupon's presentation of revenue on a gross rather than net basis during the 2009–11 reporting periods proved misleading and resulted in a significant capital market correction of its valuation after the SEC enquiry and Groupon's restatement (Dutta, Caplan, and Marcinko 2014). The SEC particularly probed Groupon on whether it 1) was the primary obligor and bearer of credit risk and 2) bore inventory risk. Following the SEC's enquiry, Groupon restated its financials. Table 2 shows the effect of the restatement on Groupon's income.

The Groupon case study and other similar instances of misleading presentation of gross revenue (e.g., Priceline) highlight the revenue presentation implications depending on whether a business categorizes itself as either principal or agent. Furthermore, the proliferation of intermediation-oriented "agency" type e-commerce businesses heightens the need for investor alertness in regard to the criteria applied by such companies in determining whether they are principals or agents in their business model value chain. It is also unsurprising that the "principal versus agent" distinction arose as one of the topics for clarification during the TRG deliberations, which resulted in the FASB and IASB issuing clarification EDs in 2015.

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**TABLE 2. ABRIDGED INCOME STATEMENTS FOR GROUPON**

| ($ millions) | 2009 | | 2010 | |
|---|---|---|---|---|
| Income Statement Account | Gross | Net | Gross | Net |
| Revenue | $30.4 | $14.5 | $713.4 | $312.9 |
| Cost of sales | 19.5 | 4.4 | 433.4 | 32.5 |
| Gross margin | 10.9 | 10.1 | 280.0 | 280.4 |
| Marketing expense | 4.6 | 4.9 | 263.2 | 284.3 |
| General and administrative expense | 7.5 | 6.4 | 233.9 | 213.3 |
| Other expenses | | | 203.2 | 203.2 |
| Net loss | 1.34 | 1.09 | 413.4 | 420.1 |
| Net loss to common shareholders | 6.92 | 6.92 | 456.3 | 456.3 |
| EPS (basic) | (0.04) | (0.04) | (2.66) | (2.66) |

*Note*: This information was obtained from Groupon's S-1 filing with the SEC on 2 June 2011 and the amended filing (Amendment No. 4) on 7 October 2011.

The updated final clarification issued in 2016 asserts that the principal needs to control goods or rights to service. The clarification also emphasizes the importance of appropriately identifying distinct goods or bundles of goods and/or services (i.e., nature of promise) prior to making a judgment on transfer of control. The principal *must control* goods and/or rights to services before the customer acquires those goods and/or services. Answers to the following questions will help preparers assess whether they are either principals or agents and whether the principal controls the good or service before the customer acquires control:

- Which party bears inventory risk?
- Which party has order fulfillment responsibility?
- Which party has pricing discretion?

In making the principal versus agent determination, there is no longer a need for preparers to consider 1) who bears credit risk, which was a question that the SEC posed to Groupon, or 2) the form of consideration (i.e., fee income).

## Implications for Investors

- **Monitor disclosures.** As noted earlier, investors ought to closely monitor disclosures of management judgments underpinning the application of gross versus net presentation of revenue, and whether there are any changes in how revenue is presented under current guidance.

## *Credit Risk of Revenue Contracts*

Evaluating the credit risk associated with revenue contracts is a critical factor in enabling investors to predict realizable revenue–related cash inflows. Under the new guidance, Step 1 (Identify Contract) requires an assessment of the consideration that is expected to be collected (i.e., entitled consideration). Revenue is then recognized only if it is probable[8] that the entitled consideration within customer contracts will be collected. The entitled revenue can depend on price concessions and/or customer credit risk, as determined in Step 3 (Determine Transaction Price). There will still be a bad debt expense incurred for credit risk associated with already recognized revenue and this expense will be presented as a separate line item on the income statement. But it is worth noting that the bad debt expense does not include any consideration specified in contracts but excluded from revenue recognition because of the poor credit quality of customers (i.e., via Step 1).

Because of considerable variation in proposals by the IASB and FASB on the treatment of revenue-associated credit risk, during and between the consultative period and finalization of IFRS 15 and ASC Topic 606, it is likely that many investors are not fully aware of the boards' final decisions with respect to the treatment of revenue recognition credit risk. FASB board member Hal Schroeder notes the following in the FASB ED for ASC Topic 606 (FASB 2015):

> *Guidance before adoption of Update 2014-09 [Topic 606] also includes a collectibility threshold; therefore, some stakeholders, including many investors, may not view collectibility as a significant concern. He [Schroeder] believes this is because some portion of credit losses is effectively hidden from view by being netted against revenue. Therefore, Mr. Schroeder thinks investors may not fully understand how much credit risk an entity is taking and how that risk changes over time.* (p. 46)

In general, many investors will likely still be unclear as to whether the final standard results in a change in the threshold of recognizing credit risk compared with existing reporting requirements.

### TRG Clarifications

The TRG deliberations highlighted stakeholder questions about whether consideration from poor credit quality contracts should be recognized as revenue. The FASB has clarified that some revenue from poor credit quality contracts may be recognized, insofar as the reporting company is applying credit risk management measures within its customary business practices. The IASB has not further clarified its collectibility risk guidance, however, taking the view that IFRS 15 guidance is adequate and that there has been no indication of concern with this issue from preparers across IFRS reporting jurisdictions. In addition, the IASB considered that the population of contracts to which the clarifications apply would be small.

[8]It is worth noting that although both IFRS 15 and ASC Topic 606 required collection of consideration within contracts to be "probable" prior to companies recognizing revenue, this word has different meanings under US GAAP (most likely or >75% likely) and IFRS (more likely than not or >50%).

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### Implications for Investors

- Clarify with management whether there are any changes, relative to current guidance, in the reported gross revenue amount (i.e., prior to the recognition of bad debt expense).
- Clarify whether there are any changes in the basis of determining bad debt expense—for example, whether it has changed from being based on "contract price" to "entitled consideration" and whether there are any arising effects from such changes.
- Be alert to, and enquire from management regarding, the amounts and period-to-period changes in amounts in customer contracts that have not been recognized as revenue because of poor customer credit quality.
- Aim to discern the extent to which write-downs of consideration that are specified in customer contracts, while determining the entitled consideration, result from either customer credit risk or price concessions.

## Other Key Areas

We have highlighted a selection of key issues that affect the amount, timing, uncertainty, and presentation of reported revenue. A follow-up paper will address revenue recognition and disclosure around the following key areas: 1) long-term contracts (e.g., aerospace, defense, engineering, and building construction contracts) and 2) uncertain revenue, including such revenue that arises from price risk (e.g., price concessions, discounts, and penalties) and quantity risk (customer returns and bill-and-hold arrangements).

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