Accounting Treatment of Customer's Credit Risk under Revenue Recognition Project: The development in an erratic circle

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Abstract: *Accounting for customer's credit risk is a relatively minor accounting issue, however, with a potentially important impact on the usage and usefulness of accounting information for decision-making of external users of financial statements. The topic comprises of two fundamental problems: how to estimate the amount of uncollectible sales on credit and how to present the estimated amount on the face of income statement. The paper describes accounting treatments for customer's credit risk raised within the Revenue Recognition Project and analyses the economic consequences of each proposal for alternative functions of financial reporting.*

Keywords: customer's credit risk; revenue; IFRS, Revenue Recognition Project

JEL codes: M41

1 Introduction

In May 2014, the IASB issued IFRS 15 Revenue from Contracts with Customers, together with the introduction of Topic 606 into the FASB's Accounting Standards Codification. IFRS 15 replaces current standards on revenue recognition (IAS 18 and IAS 11) alongside with the related interpretations (SIC-31, IFRIC 13, IFRIC 15, IFRIC 18). The new standard raised a lot of controversies (Procházka, 2011), (Wagenhofer, 2014) and was a subject of intensive lobbying pressures (Procházka, 2015). One of the proposals facing the strongest opposition from the preparers related to the amended treatment of customer's credit risk.

Chapter 2 summarises the suggested models of customer's credit risk raised within the Revenue Recognition Project (RRP). Chapter 3 analyses the economic consequences of each proposal, using decision-usefulness vs contracting perspective. Final chapter concludes.

2 Methodology

The analysis of accounting for customer's credit risk reviews the current practice on this issue (as outlined in IAS 18) as well as each proposal of new guidance introduced in the discussion paper, and in the both exposure drafts within the Revenue Recognition Project. The summary of actual and proposed approaches is presented in Figure 1, which also contains the direct reference to corresponding parts of all documents.

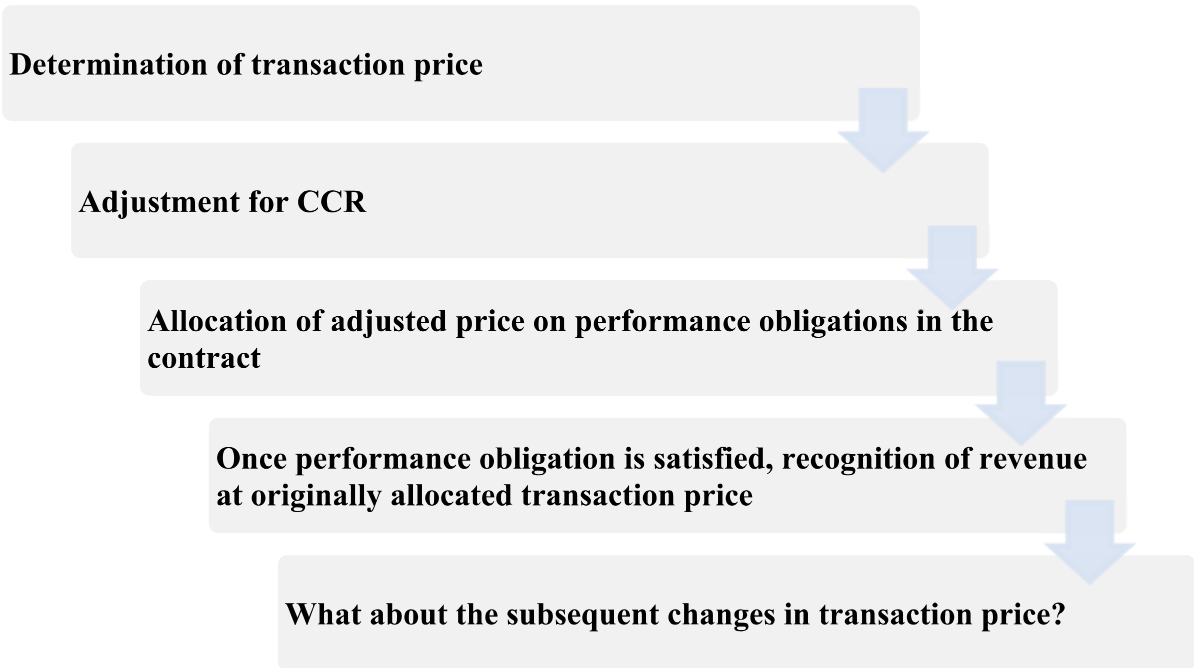
Under IAS 18, the uncollectibility is treated as a threshold for the recognition of revenue. This approach was criticised by Boards for its arbitrary nature and inconsistencies among different sources of revenue recognition standards. Furthermore, both initial and subsequent changes in customer's credit risk are presented as expense, which was repeatedly opposed by users in comment letters for its low value when evaluating a company's selling performance and cash collection. The Discussion Paper does not deal with the issue of CCR at all. However, the ED presents a substantial move in this area by requiring recognition of revenue at the probability-weighted amount of consideration that the entity expects to receive (i.e. to measure revenue after deducting the uncollectibility because of a customer's credit risk); the uncollectibility is treated as measurement principle. The main weak point of this proposal is hidden in treatment of subsequent changes in CCR. The Boards require that any changes in original estimate of CCR are not adjustments to revenue, but they shall be presented as other income/expense.

Figure 1 Accounting for uncollectibility from IAS 18 to IFRS 15

	IAS 18 (1993/201)	**DP (2008)**	**ED (2010)**	**R-ED (2011)**	**IFRS 15 (2014)**
Amount of revenue	"Full" transaction price	Not discussed	"Reduced" by CCR estimate	"Full" transaction price	"Full" transaction price
(Un)collectibility	Recognition threshold	Not discussed	Measurement principle	Measurement principle	Recognition threshold
Initial CCR presentation	Expense	Not discussed	Included in revenue	Adjacent line to revenue	Expense
Subsequent changes in CCR	Adjustment to expense	Not discussed	Other exp./income	Adjacent line to revenue	Adjustment to expense
	References to the text of documents				
Negative revenue vs. expensing	IAS 18.18	DP 6.14	ED.43	R-ED.69 R-ED.BC.165-173	BC259–BC 265
Meas. principle vs. rec. threshold	IAS 18.14d IAS 18.20b IAS 18.29a		ED.BC.98		IFRS 15.9e IFRS 15.BC42

Source: own elaboration

Figure 2 The Exposure Draft revenue recognition model



Source: own elaboration

To elucidate the problem, a short illustrative example is developed.

Example:
Transaction price is €100; the probability of non-payment by a customer is 10%; there are 4 performance obligations in the contract having the same stand-alone selling prices. Afterwards two performance obligations have been satisfied; the entity reassesses the CCR to be only 5%, as the general economic situation has considerably improved.
Hypothetical solution under current practice: (1) The ED requirement on initial measurement The total amount of revenue to be allocated is €90 (transaction price reduced by the estimate of CCR) and revenue for each performance obligation shall be measured at €22.5 (€90 / 4). The reassessment of CCR results in a new consideration expected to be received, i.e. €95. (2) Hypothetical treatment of subsequent changes under IAS 8 The question is how the adjustment shall be accounted for. To comply with IAS 8, the reassessment shall be dealt as a change in estimate. As two performance obligations are already satisfied, a half of the change (i.e. €2.5) shall be credited to revenue in the period, the reassessment is made. Remaining €2.5 shall be allocated on performance obligations to be satisfied yet.

The above described solution is not, although, required by the ED, which prefers the adjustment of the whole amount of change in estimate through other expense/income. The Basis for Conclusions (ED.BC.101) explains why this approach is chosen. The reasoning is somewhat inconsistent, as the initial measurement is justified by the attempt to depict the amount of revenue correctly, but the subsequent changes are driven by a correct measurement of receivables. In other words, earnings approach in the initial phase is abandoned in favour of asset/liability approach in the later stage of contract. The Boards make thus the same inconsistency, which they criticised for a long time and which was one of the main reasons for launching the RRP. Their inconsistency has two major consequences to financial statements:

- changes in estimates in the amount of revenue are treated differently to other changes in estimates (i.e. the changes in estimate are not recognised in the same line item as initial amount was recognised);
- some revenue might be "lost".

We can track a change in attitude in the R-ED. It calls for recognising revenue in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (i.e. no customer's credit risk is reflected in the measurement of revenue). Moreover, the customer's credit risk shall be accounted for and presented as a separate line adjacent to revenue item. The modified approach retains the advantage of the ED treatment, i.e. a direct link between revenue and uncollectible (uncollected) consideration from customers. Furthermore, it hinders from losing the revenue in other line items of income statement. From the users' perspective, presentation of the impact of customer's credit risk on a line adjacent to revenue line brings the highest benefits, as users are able to precisely evaluate both selling performance and collection performance of an entity.

However, a departure from the R-ED guidance occurs in the approved official version of the standard. The collectibility has been mandated once again as one of criteria for identification of contract and thus for recognition of revenue. Furthermore, initial measurement and subsequent changes in CCR are presented under (operating) expenses, not necessarily on separate line.

3 Discussion

A fundamental theoretical framework for the assessment of different methods proposed, how to reflect the customer's credit risk, shall be introduced. As the concept of revenue is subordinated to the concept of income and its determination (Belkaoui, 2004), the following analysis will further rest, if appropriate, on fundamental theories of income (profit) defined esp. by the "German school" and (Edwards and Bell, 1961). Furthermore, the assessment of each approach within the theoretical framework will rest on the ordinal classification of accounting systems outlined by Gjesdal (1981). The assessment will be made with reference to findings of accounting research on distinct features of revenue reporting for investors' decision-making and for contracting (Scott, 2011).

The following perspectives are subject of classification:

- Decision-usefulness:
    - o the users' perspective in their investment decision-making
- Contracting:
    - o the users' perspective in the assessment of management effort under agency contract (i.e. separation of selling activity and cash collection from sales)
    - o the perspective of opportunistic preparers pursuing the maximisation of the company value (and thus their compensation) in contracting

The users' perspective in terms of decision-usefulness of information on revenue refers to the users' demand for the valuation of a company's selling performance. The ordering of alternative models is then based on the precision of accounting model, as far as the transformation of economic reality in accounting numbers concerns. The higher degree of accuracy of an accounting system in users' assessment of selling effort of an entity, the better ranking from the users' perspective.

The contracting perspective has to be examined separately for users and preparers, as they interests differ in this setting. The users demand such kind of information, which enables them to assess separately the volume of sales and the rate of their cash collection. This information is capable to provide the users (principles) to detect the contribution of managers' (agents') effort to the increase in cash receipts generating from the sales and their riskiness.

Finally, a companies' perspective view is a function of the company value, which is attributed to company's results by users under agency contracts. Opportunistic companies would prefer (a) less information on mutual relationship between revenue and collectibility, (b) higher presented revenue, and (c) lower presented (or even hidden) information on customer's credit risk. The ranking of accounting models reflecting customer's credit risk and its changes is sketched in Figure 3.

Figure 3 Ordinal ranking of the B1/B2/B3 Models proposed during RRP

Perspective	Formation of users' expectations	Ranking
Decision-usefulness (accuracy)	Full users' rationality	
	Limited users' rationality	
Contracting (magnitude and composition)	Full users' rationality	
	Limited rationality – users' ranking	
	Limited rationality – preparers' ranking	

Source: own elaboration

If users are fully rational, accounting choices, which do not change the distribution of cash flows, cannot influence the market valuation of companies (Beaver, 1973). Although the presented items on income statement differ among the models, a rational investor would investigate the corresponding disclosures in notes to obtain all relevant information. A different presentation of customer's credit risk cannot then influence the valuation of an entity's selling performance by users. The limited rationality of users offers more interesting conclusions. Their derivation, however, requires a benchmark, against which each model is evaluated and ranked. The Schmalenbach (1919)'s concept of "Totalgewinn des Unternehmens", i.e. "Total Business Profit" (further TBP) will be used. According to this concept, the true profit can be computed only upon the termination of all business activities. TBP is defined as the difference between the terminal cash amount of liquidated net assets and the opening cash investment into a firm adjusted for all owner's contributions to and disbursements from equity. The practical problem of TBP is that it is not operational during the existence of company. Therefore, a convention allocating (unknown) TBP into particular periods has to be chosen. Either accrual or cash basis (i.e. either causes or consequences of earnings process) can be applied. Although both bases may produce different results for a single period, the totals for whole life of a firm have to be the same. Moreover, cash receipts have to be equal to accrual revenue and cash outlays have to equal to accrual expenses. The Framework OB15-20 confirms this view by combining accrual and cash basis as a joint measurement of financial performance under the integrated objective "Changes in economic resources and claims". TBP is thus a simple, yet conceptual criterion, how to assess the quality of accounting information on revenue in both investment and contracting settings and how to compare the competing accounting politics for customer's credit risk.

Only the model proposed under Revised Exposure Draft complies with the TBP condition. Therefore, the R-ED model should yield the most accurate association between accounting numbers and users' valuations under restricted rationality of users' decision-making.[1] This treatment of CCR should be preferred by Boards, if their priority is the investors' decision-usefulness of financial statements. Ex-ante differentiating between the IAS18 and ED models is impossible, as the preciseness depends (a) on a distance of users' estimate[2] and true uncollectibility; and (b) the persistence[3] of this contagion over the time. However, one remark should be made. If the correction of CCR in the ED model were adjusted via sales and not via other operating expenses/income as proposed by the Boards, it would meet the TBP condition. Consequently, the ED model would produce comparable results to the R-ED model, i.e. it would generate the same accuracy of users' assessment of an entity's selling effort.

Under assumption of non-cooperative preparers' behaviour, the assessment of accounting systems for contracting is supposed to generate (partly or entirely) opposite rankings from the users' and companies' perspective, as it is shown in Figure 3. In general, the best system for users is the worst for opportunistic prepares and vice versa. In users' perspective, the most conductive system is that introduced in R-ED (i.e. the R-ED model), which separates the amount of revenue and the correction for CCR directly in income statement. Such presentation of information enables users to judge the factors influencing the course of revenue generating process. The comparison of the IAS18 and ED model is infeasible, as the information on CCR is hidden either within operating expenses or in revenue line.

Switching to the preparers' perspective, the IAS18 model offers the greatest discretion for the managers, as (a) allowances for customer's credit risk are detached from sales and hidden; and (b) model presents the highest amount of revenue. The first factor causes that an entity's success rate in collection cannot be assessed. The second factor

[1] For the simplicity, we assume that not-fully-rational users obtain information only from the financial statements and ignore disclosures in notes.
[2] As there is no direct information on CCR in income statement and the users do not investigate the notes (see our assumption in the previous note, a priori ordering of these two models is not possible.
[3] It depends on a type of extrapolative models of expectations formation (Pesaran and Weale, 2006)

leads to the inflation of revenue; moreover the users are unable to uncover the variables influencing the trend (higher sales; higher prices; more risky customers). This model results in better financial ratios on activity, which may be beneficial in debt contracting. On the other side, gross profit margin is worse, but this ratio is not commonly used in contracting.

The comparison of ED and R-ED models is ambiguous. The ED model gives information on lower revenue, but without a clear structure of sales and allowances. On the other side, the R-ED model presents higher revenue, but it also informs exactly about the uncollectibility. Favourability for preparers depends on the type of users' partial rationality once again. In this context, the above-outlined remark on the ED model shall be recalled. If the correction of CCR in the ED model were adjusted via sales, then the R-ED model would be unequivocally worse for opportunistic preparers, as it would present the same net sales, but separated into sales and allowances for CCR. The detailed presentation depicts both dimensions of selling performance exactly and reduces thus the extent of preparers' discretion over accounting figures and their impact on assessment of contracts fulfilment.

4 Conclusions

The paper analyses economic consequences of three different approaches to the presentation of estimated losses stemming from customer's credit loss in income statements, which were discussed within the preparation of a new standard on revenue recognition under the IASB's and FASB's Revenue Recognition Project. Despite the Boards had introduced a model, enhancing the usefulness of accounting information both for investors' decision-making and contracting purposes, they finally decided to maintain the current practice suffering from several drawbacks. Future research shall address the reasons for this failure and the impact on lobbying parties on the final content of IFRS 15 (Topic 606 respectively).

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