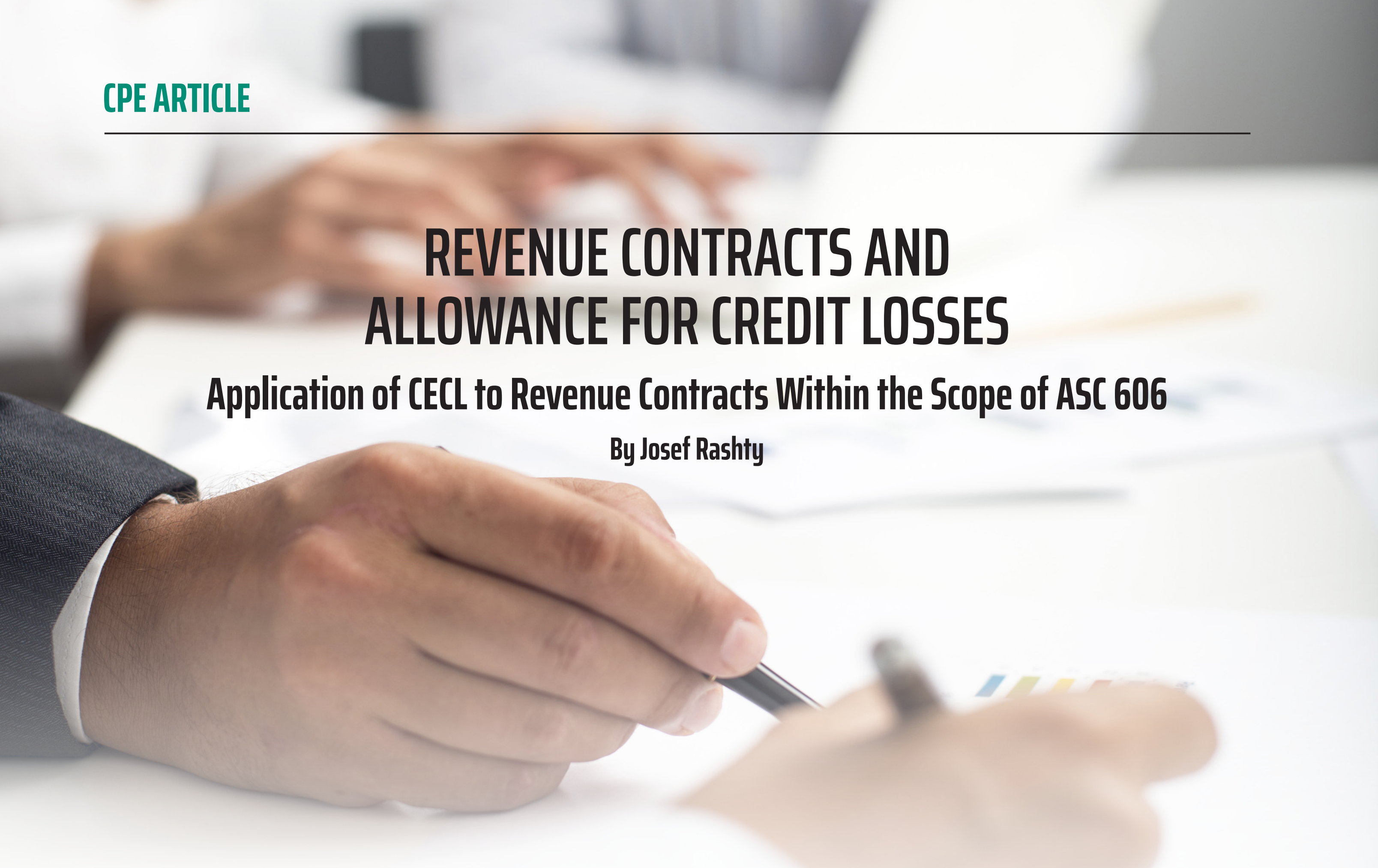

REVENUE CONTRACTS AND ALLOWANCE FOR CREDIT LOSSES

Application of CECL to Revenue Contracts Within the Scope of ASC 606

By Josef Rashty

CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: Public practice and business and industry

OBJECTIVES: To provide a fundamental understanding of estimating credit losses for revenue contracts

KEY TOPICS: Current expected credit loss (CECL), revenue contracts, accounts receivable and contract assets

PREREQUISITES: None

ADVANCED PREPARATION: None

In June 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*, which amends the earlier Board's guidance on the impairment of financial instruments. ASC 326 replaces the legacy GAAP's "incurred loss" model with the "current expected credit loss" (CECL) impairment model. The latter requires companies to consider a broader range of information to estimate expected losses over the lifetime of their financial assets. This may create challenges for some companies, since they need to gather and analyze new information to estimate, for example, their expected losses over the life of their accounts receivable.

The new guidance affects not only banks and financial institutions, but also all other industries and is applicable to a wide variety of financial assets, including accounts receivable and contract assets. This article focuses on the impact of CECL and the recently issued ASU 2019-04 on accounts receivable and contract assets from sale of goods and services to customers within the scope ASC 606, *Revenue from Contracts with Customers*. The article explicates some of the intricacies of the new guidance and argues that credit losses' estimates have become more judgmental and prophetic under the new guidance.

Effective Date

Public business entities (PBEs) that are SEC filers adopt this guidance for interim and annual periods in fiscal years beginning after Dec. 15, 2019. The PBEs that are not SEC filers adopt this guidance

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for interim and annual periods in fiscal years beginning after Dec. 15, 2020. All other entities adopt this guidance in fiscal years beginning after Dec. 15, 2021. FASB permits early adoption for fiscal years beginning after Dec. 15, 2018 (ASC 326-10-65-1).

In response to feedback from stakeholders, FASB has recently proposed the deferral of the effective date of this standard for certain companies. As of the date of this publication, FASB has not issued its final standard yet.

Scope of CECL

This guidance primary affects banks and financial institutions; however, other entities that perform any lending activities or invest in any debt securities may also be affected. Furthermore, this guidance impacts entities that have trade receivable (that result from revenue transactions within the scope of ASC 606), reinsurance recoverable and loan to equity method investees. Topic 326 has two different subtopics: credit losses for financial assets measured at amortized cost (ASC 326-20) and credit losses for available-for-sale securities (AFS) (ASC 326-30). The former subtopic is the focus of this article.

ASC 326-20 applies to financial assets measured at amortized cost (e.g., accounts receivable and contract assets that result from revenue transactions), net investment leases, and off-balance sheet credit exposures not accounted for as insurance. ASC 326 provides companies significant flexibility in how to estimate their credit losses for the financial assets that are within its scope. The goal of this guidance is to rely on management judgment to improve financial reporting and presentations of companies.

CECL requires recognition of up-front losses upon initial recognition of contract assets and trade accounts receivable and revise them as needed in the subsequent periods. However, CECL does not provide prescriptive guidance on how to develop an estimate for credit losses; therefore, management makes the decision to select a methodology in implementing the CECL model. Management needs to document its rationale (including commentary on alternatives it considered and rejected) for its selection.

Contracts with Customers

Topic 606 initially stated that an entity assesses its accounts receivable and contract assets for impairment under Topic 310; however, the amended guidance requires that companies estimate their credit losses for both accounts receivable and contract assets under Subtopic 326-20:

- Accounts receivable are unconditional rights to consideration – the payment becomes due only after the passage of time (ASC 606-10-45-4).
- Contract assets, on the other hand, are conditional rights to consideration. In this scenario, the company transfers the agreed upon goods and services to customers; however, the right is conditional on something other than the passage of time (ASC 606-10-45-3). For example, the contract may have the provision for a customer to evaluate the delivered goods and services prior to final commitment for payment. A company that has contract asset balances is more exposed to expected credit losses than a company that has only short-term trade receivables.

If the duration of accounts receivable and contract assets is relatively short, switching to new guidance from an incurred loss model to a lifetime expected loss model may not be that complicated or have a material impact, and companies may continue to use some of the models that they currently use to estimate the allowance for bad debt accounts to estimate credit losses under ASC 326-20.

CECL Valuation Allowance

CECL requires companies to create a valuation allowance account, which is a contra account for the amortized cost basis of the financial assets (ASC 326-20-30-1). This is similar to legacy GAAP that requires asset valuation allowances for losses such as those on accounts receivable and investments be deducted from the assets or groups of assets to which the allowances relate (ASC 210-10-45-13).

What is different is that CECL allowance represents the portion of the financial assets' balance that the company does not expect to collect over its future contractual life, based not only on historical events but also a reasonable forecast on current and future economic conditions. The objective is to recognize an allowance for expected credit losses such that companies reflect the net amount of financial assets that they expect to collect in their financial statements accurately. Furthermore, at each reporting date, companies need to evaluate and adjust this valuation account (ASC 326-10-35-1).

CECL vs. Legacy GAAP

ASC 326, similar to legacy GAAP, permits application of a variety of methods for calculation of expected credit losses, such as discounted cash flow method or any other method (ASC 326-20-30-3).

ASC 326, unlike the legacy GAAP, requires companies to consider lifetime future credit losses that may incur even if the risk of loss is remote. The guidance specifically requires that companies cannot rely solely on past events to estimate expected credit losses since historical experiences may not fully reflect the future expectations (ASC 326-29-55-4). As a result, companies may recognize credit losses earlier under CECL and experience more volatility in credit loss expenses. Furthermore, they may need to implement additional processes and controls to implement to the new guidance.

The legacy GAAP permits, but does not require, pooling of assets as unit of measurement, whereas Subtopic 326-20 requires application of pooling method (ASC 326-20-30-2) when assets share common risk characteristics (ASC 326-20-55-5). This requires management judgment to determine whether assets grouped in a pool continue to share similar risk characteristics at each measurement date. Furthermore, the entity shall evaluate whether such a financial asset in a pool continues to exhibit similar risk characteristics in subsequent periods (ASC 326-2-35-2).

ASC 326, unlike the legacy GAAP, requires companies to measure expected credit losses over the contractual life of assets (ASC 326-20-30-6). This provision may be challenging for some companies if their accounts receivable do not have specific payment terms or those for which customers often make payments subsequent to due dates.

Estimating credit losses under ASC 326 is highly judgmental, much more so than estimating bad debt valuation allowances under the legacy GAAP system when an entity relies solely on past events to estimate expected credit losses (ASC 326-2-30-9). The new guidance, mainly due to its scope and futuristic view, makes the estimate subjective. Furthermore, ASC 326-20 does not prescribe a specific method for estimating credit losses that makes the guidance even more judgmental.

Internal Controls

ASC 326 requires companies to evaluate their system of internal controls for estimating their credit losses. Companies should develop appropriate internal controls, from modeling to estimating credit losses and external reporting. Estimating credit losses is often a team effort; therefore, management must ensure that adequate segregation of duties exists, and a process of review and approval is in place. Management also needs to put adequate controls in place over the data that it has used in formulating its assumption.

A weakness in the system of internal controls for estimating credit losses may result in deficiencies or even material weakness. The standard for measuring whether an internal control deficiency is a material weakness for financial reporting purposes is that a deficiency or combination of deficiencies could result in a material misstatement of a company's financial statements.

Disclosures

Many public companies disclose their policies for estimating their bad debt allowance under existing guidance in their significant and critical accounting policies in their Forms 10-Ks and 10-Qs. However, after adoption of ASC 326, companies need to expand their disclosures to include the additional following information:

- Methodology that they have used to estimate the expected credit losses (e.g., a discounted cash flow methodology).
- Process of estimating the historical and expected future credit losses.
- Process of developing forecasts for future economic conditions.
- PBEs must present the amortized cost basis of their accounts receivable (except those due in one year or less) by year of origination (vintage year) (ASC 326-20-50-6 and ASC 326-20-50-9).

Latest Development

In April 2019, FASB issued ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments (the Amendment). FASB issued this Amendment as part of its ongoing project to improve accounting codification standards. In May 2019, FASB issued ASU 2019-05, Financial Instruments –

Credit Losses (Topic 326). This guidance provides certain optional targeted transition relief for certain financial instruments accounted for under Subtopic 326-20. Companies that have financial instruments measured at amortized cost can elect to irrevocably account for them at fair value according to ASC 825-10. This guidance is not applicable to accounts receivable and contract assets (discussed in this article), since companies often do not use the fair value option to account for such assets.

Summary of ASU 2019-04

The following summarizes the Amendment's key improvements to Subtopic 326-20:

- It permits companies to separately measure an allowance for credit losses of accrued interest receivables from other components of the amortized cost basis and permits companies to make certain accounting policy elections regarding calculation of credit losses for accrued credit receivables.
- It requires that companies take into account contractual extensions and contract's renewal option to determine the contractual term over which they measure their credit losses.
- It requires that companies include recoveries of the amounts that they expect to write off and those that they have previously written off. The following example clarifies this concept.

A company has a bad debt allowance for $1,000 based on legacy GAAP. The allowance includes write off of $200 debt. (The company has provided full provision for the expected write off.) The company historically has recovered approximately 10% of such write offs. However, considering the future economic conditions and other circumstances, the company estimates that recovery from such write offs would be approximately 15%. Therefore, the company estimates that amount of recovery for write offs is approximately $30 ($200 times 15%) and as a result, allowance for credit losses would be $970 ($1,000 less $30).

Effective Date of ASU 2019-04

For entities that have not yet adopted ASU 2016-13, the effective dates and transition requirements for this Amendment are the same as the effective dates and transition requirements for ASU 2016-13.

For entities that have already adopted ASU 2016-13, this Amendment is effective for fiscal years after Dec. 15, 2019, including interim periods within those fiscal years. FASB permits early adoption of this Amendment. Entities should apply this Amendment on a modified-retrospective basis by means of a cumulative-effect adjustment to opening balance of retained earnings.

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Figure 1. Illustration

Entity A sells a computer and an enterprise license, plus three years maintenance for $1,800. It allocates the contract based on stand-alone price of element of the contract as follows:

Hardware	$1,000
Software	$ 500
Maintenance	$ 300 for three years ($100 per year)

The contract stipulates that the customer is liable for the software only if it is successfully implemented by the end of the first year and customer has accepted its functionality. Entity A estimates the credit losses for customer assets at 10% and for accounts receivable at 1%. Entity A delivers the hardware and software at the beginning of the year and determines that collection is probable.

The journal entries are as follows:

Accounts receivable	$ 1,000	
Contract assets	$ 500	
Revenue for hardware		$ 1,000
Deferred revenue for software		$ 500*

**Entity A does not record the maintenance as deferred revenue since it has not performed the services.*

Credit losses	$ 60	
Allowance		$ 60*

**($1,000 x 1% plus $500 x 10%)*

A New Framework for Estimating Credit Losses

CECL applies to financial assets measured at amortized cost, including loans, held-to-maturity debt securities, net investment in leases, and reinsurance and trade receivables, as well as certain off-balance sheet credit exposures, such as loan commitments and available-for-sale debt securities. CECL instigates a new framework for estimating credit losses that goes above and beyond traditional historical data analysis and relies on prophetic estimates in addition to past loss experiences and current economic situations. This guidance is more than a continuum of erstwhile standards and it heralds a new era for FASB where it may very well expand the CECL concept to other loss estimate provisions.

The focus of this article was to provide guidance for estimating credit losses for Topic 606 financial assets. The author conjectures that CECL may not have a drastic impact on calculation of credit losses for accounts receivable and contract assets (within the scope of Topic 606) that have relatively short life spans. Furthermore, some companies may continue using some of the techniques that they currently use for estimating their bad debt allowance accounts.

Nevertheless, this is not a trifling guidance and companies need to make an assessment to determine the impact of this standard and its Amendment (particularly the recovery of write offs) on their accounts receivable and contract assets that meet the criteria of Subtopic 326-20. In some instances, adoption of this guidance may cause companies to post higher expenses in the earlier periods and as a result, experience higher volatility on their earnings.

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