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Ms. Hillary Salo
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Financial Accounting Standards Board
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Agenda request — Application of ASC 470 to sales or transfers of receivables that arise from contracts with customers

Dear Ms. Salo,

Ernst & Young LLP (EY US) appreciates the opportunity to submit an agenda request to the Emerging Issues Task Force (EITF). We request that the EITF address the application of Accounting Standards Codification (ASC) 470, *Debt*, to the sale or transfer of a receivable when revenue has not been recognized pursuant to ASC 606, *Revenue from Contracts with Customers*.

We are aware that entities have reached different conclusions about whether the guidance in ASC 470-10-25-1 through 25-2 is applicable when evaluating the accounting for a sale or transfer of a receivable arising from a contract with a customer when revenue has not been recognized. Some entities may believe that the sale or transfer of the receivable should be evaluated under the sale of future revenue guidance in ASC 470-10-25-1 through 25-2, which would result in the receivable remaining on the entity's balance sheet and cash received from the investor recorded as either debt or deferred income. Other entities may conclude that ASC 470 is not applicable because the transfer involves a receivable, which is a financial asset, that has been recognized pursuant to ASC 606 and should be evaluated for derecognition under the guidance in ASC 860, *Transfers and Servicing,* regardless of whether revenue has been recognized.

ASC 606-10-45-4 describes a receivable as "an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due." An entity may enter into noncancelable contracts that provide unconditional rights to payment from the customer for services that the entity has not yet completed providing or services it will provide in the near future (e.g., advance billings related to a service or maintenance arrangement). An entity that enters into this type of contract would record the following journal entry[1]:

Dr. Receivable
    Cr. Contract liability

If the entity sells or transfers the receivable to a third party in exchange for consideration, an entity could reach different conclusions about the accounting for that transfer or sale.

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1 See ASC 606-10-55-285 (excerpted in the Appendix).

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Application of ASC 470 — View A

An entity that applies ASC 470-10-25-1 through 25-2 would evaluate whether the proceeds from the investor should be classified as debt or deferred income based on an evaluation of the specific facts and circumstances of the transaction. This is based on the view that if an entity has not yet satisfied the criteria to recognize revenue under ASC 606 for the underlying sales transaction, the transfer to a third party of the rights to future cash receipts arising from that transaction represent future revenues yet to be earned and recognized by the entity. Proponents of this view believe, consistent with the view expressed by a Securities and Exchange Commission (SEC) staff member,[2] that revenue recognition for the transaction underlying the receivable is an important condition in order to apply ASC 860. In this circumstance, the entity would record the following journal entry for the cash received from the investor:

Dr. Cash from investor
    Cr. Debt (or deferred income)

The accounting for the receivable arising from the contract with the customer would not be affected by the sale or transfer of that receivable. The receivable would be derecognized upon receipt of consideration (e.g., cash) from the customer, and the contract liability would be recorded as revenue when (or as) the entity satisfies its performance obligations in the contract. Note that the investor is entitled to the cash received from the customer as "repayment of the debt."

Application of ASC 860 — View B

An entity that applies ASC 860 would need to consider whether the transfer of the receivable meets all of the requirements in ASC 860-10-40-5 (i.e., legal isolation from the transferor, the transferee's right to pledge or exchange the receivable, and the transferor not maintaining effective control). If all the criteria are met, the entity would account for the transfer as a sale, which would require the entity to derecognize the receivable and recognize any resulting gain or loss in earnings in accordance with ASC 860-20-40-1A through 40-1B. In this circumstance, the entity would record the following journal entry:

Dr. Cash from investor
Dr. Loss on sale (as applicable)
    Cr. Receivable
    Cr. Gain on sale (as applicable)

If any of the requirements in ASC 860-10-40-5 are not met, the entity would continue to recognize the receivable and would account for the cash received as a secured borrowing (financing) with a pledge of collateral in accordance with ASC 860-30-25-2. In this circumstance, the entity would record the following journal entry:

Dr. Cash from investor
    Cr. Obligation under secured borrowing arrangement (liability)

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[2] Joseph D. McGrath, "Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments," 2009, https://www.sec.gov/news/speech/2006/spch121106jdm.htm.

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To illustrate the different interpretations regarding the application of ASC 470 and ASC 860 that we have observed, assume the same facts as Example 38, Case B from ASC 606-10-55 (see Appendix). The entity transfers the receivable to an unrelated third-party investor in exchange for $1,000.

View A

The entity applies the guidance in ASC 470-10-25-1 through 25-2 and concludes that the cash received from the investor should be recorded as debt due to the entity's significant continuing involvement in the generation of the cash flows due to the investor (e.g., active involvement in the generation of the revenues from the contract with its customer).[3] The entity believes ASC 470-10-25-1 through 25-2 apply to this transaction based on the description in paragraph 25-1:

- The entity received cash from an investor.
- The entity agreed to pay the investor using cash received from the contract with its customer.
- Immediate revenue recognition at the time of the transfer of the receivable was not appropriate because the entity had not satisfied its performance obligation to the customer.

The entity also notes that transactions that arise from contracts with customers are not excluded from the scope of ASC 470-10.

View B

The entity determines that the transfer is in the scope of ASC 860 because the receivable represents a financial asset. The entity believes that once a receivable is recognized pursuant to the guidance in ASC 606 (i.e., it represents a right to consideration that is unconditional — only the passage of time is required before payment of that consideration is due), any transfer of that receivable is in the scope of ASC 860 because the receivable is a financial asset. Upon making that determination, the entity then considers the requirements in ASC 860-10-40-5 to determine whether the transfer should be accounted for as a sale.

If the criteria in ASC 860-10-45-5 are met, the entity records the transfer as a sale by derecognizing the receivable and recording any resulting gain or loss in earnings. If the criteria in ASC 860-10-45-5 are not met, the entity recognizes the cash received as a secured borrowing (financing) with a pledge of collateral in accordance with ASC 860-30-25-2.

The entity believes that ASC 470-10 is not applicable because it is transferring a receivable that was recorded based on the guidance in ASC 606-10-45-4 and ASC 606-10-55-285. In this fact set, the entity's right to consideration from its customer is unconditional (as evaluated under ASC 606), and therefore, the entity's satisfaction of the performance obligation does not affect the future cash flows that the investor will receive.

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[3] ASC 470-10-25-2(b).

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Application of View A versus View B could result in a different financial statement presentation for the cash received from the sale or transfer of a receivable. In addition, View A would result in debt recorded on the balance sheet, whereas View B could result in the derecognition of a receivable prior the entity's recognition of revenue.

In summary, based on the existing guidance, constituents have reached different conclusions regarding the application of ASU 470-10. We believe that the Financial Accounting Standards Board (FASB) should add this issue to the EITF's agenda to reduce diversity in practice in this area.

If you have any questions, please contact Paul Beswick, Alison Spivey or Lan Ming.

Sincerely

Ernst & Young LLP

Appendix — Relevant FASB Accounting Standards Codification guidance

606-10-45 Other Presentation Matters

45-4 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of revenue recognized shall be presented as a credit loss expense.

606-10-55 Implementation Guidance and Illustrations

Example 38 — Contract Liability and Receivable

Case A — Cancellable Contract

55-284 On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	$	1,000		
Contract liability			$	1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$	1,000		
Revenue			$	1,000

Case B — Noncancellable Contract

55-285 The same facts as in Case A apply to Case B except that the contract becomes noncancellable on January 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. January 31, 20X9 is the date at which the entity recognizes a receivable because it has an unconditional right to consideration.

Receivable	$	1,000		
Contract liability			$	1,000

b. The entity receives the cash on March 1, 20X9.

Cash	$ 1,000	
Receivable		$ 1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$ 1,000	
Revenue		$ 1000

55-286 If the entity issued the invoice before January 31, 20X9, the entity would not recognize the receivable and the contract liability in the statement of financial position because the entity does not yet have a right to consideration that is unconditional (the contract is cancellable before January 31, 20X9).

470-10-25 Sales of Future Revenues or Various Other Measures of Income

25-1 An entity receives cash from an investor and agrees to pay to the investor for a defined period a specified percentage or amount of the revenue or of a measure of income (for example, gross margin, operating income, or pretax income) of a particular product line, business segment, trademark, patent, or contractual right. It is assumed that immediate income recognition is not appropriate due to the facts and circumstances. The payment to the investor and the future revenue or income on which the payment is based may be denominated in a foreign currency.

25-2 While the classification of the proceeds from the investor as debt or deferred income depends on the specific facts and circumstances of the transaction, the presence of any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

a. The transaction does not purport to be a sale (that is, the form of the transaction is debt).

b. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment).

c. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.

d. The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.

e. Variations in the entity's revenue or income underlying the transaction have only a trifling impact on the investor's rate of return.

f. The investor has any recourse to the entity relating to the payments due the investor.

860-10-40 Derecognition

40-5 A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

a. Isolation of transferred financial assets. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a bankruptcy-remote entity is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it shall be consolidated (see paragraphs 860-10-40-7 through 40-14 and the guidance beginning in paragraph 860-10-55-18). A set-off right is not an impediment to meeting the isolation condition.

b. Transferee's rights to pledge or exchange. This condition is met if both of the following conditions are met:

    1. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.

    2. No condition does both of the following:

        i. Constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange

        ii. Provides more than a trivial benefit to the transferor (see paragraphs 860-10-40-15 through 40-21).

    If the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 860-10-40-5(b) is met.

c. Effective control. The transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (see paragraph 860-10-40-22A). A transferor's effective control over the transferred financial assets includes, but is not limited to, any of the following:

    1. An agreement that both entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity (see paragraphs 860-10-40-23 through 40-25)

2. An agreement, other than through a cleanup call (see paragraphs 860-10-40-28 through 40-39), that provides the transferor with both of the following:

   i. The unilateral ability to cause the holder to return specific financial assets

   ii. A more-than-trivial benefit attributable to that ability.

3. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see paragraph 860-10-55-42D).

860-20-40 Derecognition

40-1A Upon completion of a transfer of a participating interest that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

a. Allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair values at the date of the transfer:

   1. The participating interest(s) sold

   2. The participating interest that continues to be held by the transferor.

b. Derecognize the participating interest(s) sold

c. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale

d. Recognize in earnings any gain or loss on the sale

e. Report any participating interest(s) that continue to be held by the transferor as the difference between the following amounts measured at the date of the transfer:

   1. The previous carrying amount of the entire financial asset

   2. The amount derecognized.

40-1B Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

a. Derecognize the transferred financial assets

b. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale

c. Recognize in earnings any gain or loss on the sale

If the transferred financial asset was accounted for under Topic 320 as available for sale before the transfer, item (a) requires that the amount in other comprehensive income be recognized in earnings at the date of transfer.

860-30-25 Recognition

25-2 The transferor and transferee shall account for a transfer as a secured borrowing with pledge of collateral in either of the following circumstances:

a. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in paragraph 860-10-40-5

b. If a transfer of a portion of an entire financial asset does not meet the definition of a participating interest.

The transferor shall continue to report the transferred financial asset in its statement of financial position with no change in the asset's measurement (that is, basis of accounting).