

Memo No. **2A****MEMO**Issue Date **June 10, 2024**Meeting Date **PCC Meeting June 24, 2024**

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Project	PCC Agenda Priorities		
Project Stage	Pre-agenda Research		
Issues	Credit Losses—Short-term Trade Accounts Receivable and Contract Assets		

Memo Purpose

1. During the PCC's discussion of its agenda priorities at its April 2024 meeting, one of the four issues that the PCC supported conducting preliminary research on was the application of the guidance in Topic 326, Financial Instruments—Credit Losses (CECL) to short-term accounts receivables and contract assets.
2. The purpose of this memo is to provide information on Topic 326 to facilitate the June 2024 PCC meeting discussion. Cover memo (memo 2) outlines the information that will be provided in this memo (to the extent the information is known or estimable) and includes discussion questions for the PCC. An estimated timeline, including major milestones, is included in an accompanying slide deck.

Description of the Issue

3. Trade accounts receivable (Trade AR) are short-term financing arrangements (typically between 30–90 days but can be longer) for a customer's payment on the purchase of nonfinancial assets after an entity (seller) provides goods or services. Generally, a seller recognizes a contract asset when or as it transfers goods or services to a customer and recognizes a receivable when the seller has an unconditional right to payment (consideration) on demand.
4. Trade AR can be considered economically similar to a traditional revolving line of credit (LOC) offered by a commercial bank if a seller has regularly recurring transactions with a single customer. However, there are fundamental characteristics that differentiate Trade AR. For example, the Trade AR balance due from a single customer is a fixed amount payable as consideration for specified goods or services. The seller's (creditor's) risk of loss is limited to that amount due and only increases as the seller

continues transacting with the customer and allows discrete fixed amounts payable to accumulate. In contrast, a LOC provides a borrower with unilateral access to liquidity up to a specified dollar amount for a specified period, and accrues interest based on a specified rate. The entire amount borrowed (principal) plus accrued interest is due before maturity, however, the borrower will typically be required to make some amount of payment in regular intervals (monthly or quarterly). The principal amounts repaid before the LOC matures are available for the borrower to access again at their discretion.

5. In connection with the ongoing post-implementation review (PIR) of Update No. 2016-13—*Financial Instruments—Credit Losses (Topic 326)*, stakeholders have provided feedback to highlight certain concerns about implementing CECL for Trade AR and contract assets. Nonpublic commercial entities, specifically, have questioned whether the costs of applying the CECL guidance are justified by the perceived benefits.
6. PIR feedback from nonpublic entity preparers has highlighted that historical loss experience from Trade AR tends to be very limited or zero. Certain principles of CECL may become operationally burdensome to apply or difficult to understand when financial assets have limited loss experience *and* are short-term in nature (for example, the requirement to adjust historical loss experience for current conditions and reasonable and supportable forecasts). In response to the December 2012 proposed Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*, comment letter respondents also requested that the Board provide additional guidance or clarification on how to implement an expected credit loss methodology for Trade AR. The PCC raised the same issue, and the Board included that feedback in paragraph BC31 of Update 2016-13, which is as follows:

The Board also met with the Private Company Council (PCC) to discuss its views on applying an expected credit loss model. The PCC requested additional clarification on how an expected credit loss model would apply to trade receivables and how one would measure expected credit losses for certain related-party loans. Some related-party loans may be viewed as a capital contribution rather than a loan to be repaid. The Board responded to those concerns by providing an illustration to show how the amendments in this Update should be applied to trade receivables and removing from the scope those loans among counterparties that are under common control.

7. The Board addressed this feedback by incorporating *Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule* in paragraphs 326-20-55-37 through 55-40 of the final Update. The FASB staff also developed two question and answer documents (FASB Staff Q&As) to respond to frequently asked questions about (a) acceptable methods to measure expected credit losses for smaller, less complex pools of assets and (b) using historical loss information, developing reasonable and supportable forecasts, and reverting to historical loss information. Example 5 from the final Update and links to the FASB Staff Q&A documents are included in Appendix A.
8. Some nonpublic entity preparers have noted that measuring expected credit losses under CECL was significantly more complex than their previous methodologies to measure incurred losses and did not result in a materially different allowance amount estimated. Conversely, several public commercial

entities participated in staff outreach during the second half of 2021 and indicated that Trade AR was not a particularly problematic asset type for them. That outreach was done in the context of applying CECL to assets acquired in a business combination (however, the staff thinks it is reasonable to suggest that similar feedback would be provided about the application of CECL to Trade AR outside of a business combination).

9. During its April 2024 meeting, PCC members referenced the ongoing annual costs of applying CECL, and the immaterial financial statement effect of measuring expected credit losses as compared to the application of the incurred loss model. Seven PCC members supported pre-agenda research in this area; specifically, a private company simplification that would help reduce the ongoing costs. For example, the PCC has preliminarily discussed a potential private company practical expedient that would allow credit losses to be estimated based on historical losses (that is, the previously applied incurred loss model) without adjusting for current conditions or reasonable and supportable forecasts. The staff also understands that some PCC members have raised questions on the nature of contract assets and whether collectibility is relevant because the amounts have not yet been billed to the customer. That is, some PCC members have asked whether credit risk for counterparty nonperformance exists for a contract asset if legally enforceable collection rights do not yet exist.

Past Considerations by the PCC and/or FASB and the Outcome of Those Considerations

10. The Board considered feedback on Trade AR during its redeliberations on Update 2016-13 and addressed stakeholder concerns by incorporating the aforementioned Example 5 in the final Update at paragraphs 326-20-55-37 through 55-40. More broadly, the Board developed CECL to be flexible and scalable for entities of all sizes and, to that end, the guidance is intentionally nonprescriptive to afford management the ability to apply judgment in considering entity-specific facts and circumstances. That intent is evident throughout the basis for conclusions, but the Board did not modify the scope, recognition, or measurement principles of CECL to address any implementation or application issues specifically related to Trade AR.
11. Similarly, contract assets were not specifically considered in the initial and redeliberations of Update 2016-13. Contract assets are subject to CECL because Topic 606, Revenue from Contracts with Customers, requires an entity to assess a contract asset for credit losses in accordance with Subtopic 326-20, Financial Instruments—Credit Losses, Measured at Amortized Cost. Topic 606 was codified by Update No. 2014-09—*Revenue from Contracts with Customer (Topic 606)*, issued in May of 2014, prior to Update 2016-13.

12. However, the Board did consider collectibility to be an important part of determining whether a contract is valid in the guidance in Update 2014-09.¹ Paragraph 606-10-25-1(e) requires an entity to assess whether it is “*probable* that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred...” as one of the criteria that must be met for a contract to be accounted for by Topic 606. In that context, collectibility serves as a threshold for *recognition*, principally because the Board was concerned that an entity might recognize revenue that is substantially offset by bad-debt expense (that is, “grossing up” the income statement) when significant credit risk exists at contract inception.²
13. If an entity concludes it is probable to collect substantially all consideration and subsequently recognizes revenue with a corresponding contract asset, an entity is then required to apply paragraph 606-10-45-3³ and Subtopic 326-20 to measure credit losses.⁴ Beyond this broader interaction between collectibility and revenue recognition, the Board has not specifically considered any CECL implementation or application issues specifically related to contract assets.
14. The Board has an active project for purchased financial assets (PFA) that was added to its agenda to address PIR feedback related to the acquisition accounting for financial assets required by Topic 326. A proposed Update, [*Financial Instruments—Credit Losses \(Topic 326\), Purchased Financial Assets*](#) was issued in June 2023 with the objective of aligning the acquisition accounting approach for all financial assets. The proposed amendments eliminate *more-than-insignificant deterioration of credit* as the criterion for assets to be classified as purchased with credit deterioration (PCD) and accounted for using the gross-up approach.⁵ Instead, all financial assets would be within the scope gross-up approach upon acquisition, with limited exceptions for available-for-sale debt securities and in-substance originations.⁶
15. During its initial deliberations and redeliberations on PFA, the Board specifically considered whether Trade AR and contract assets should be excluded from the scope of the proposed Update. As of the date of this memo, the Board has tentatively decided not to treat those assets differently from other

¹ [Update 2014-09, paragraphs BC42 through BC46.](#)

² [Update 2014-09, paragraph BC265.](#)

³ Paragraph 606-10-45-3 “A contract asset is an entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20....”

⁴ In this paragraph, Update 2014-09 initially referred to “Topic 310, Receivables” and that reference was subsequently amended by Update 2016-13 to refer to Subtopic 326-20.

⁵ The gross-up approach refers to the accounting required by paragraphs 326-20-30-13 through 30-15 and 310-10-35-53B and 35-53C that currently applies to purchased financial assets with credit deterioration (PCD). The gross-up approach requires acquired financial assets to be measured by adding the allowance for credit losses as of the acquisition date to the purchase price to calculate the amortized cost basis. Any remaining noncredit premium or discount is subsequently amortized or accreted to interest income using the interest method.

⁶ In-substance originations refers to assets not deemed to be *seasoned* based on criteria introduced by the proposed Update on Purchased Financial Assets.

financial assets upon acquisition. The facts and circumstances relevant to that consideration are not directly analogous to those referenced by the PCC in prioritizing the issue discussed herein; however, any standard setting by the PCC in this area will likely be more effective to the extent it maintains consistency with other related Board decisions.

Past Challenges Identified in Addressing the Issue

16. The staff is not aware of any prior efforts by the PCC or the Board to simplify the recognition and measurement objectives in Topic 326 for specifically identified financial assets.

Work to Be Done to Bring a Research Paper to the PCC

17. The staff would need to perform outreach with various private company stakeholder groups to develop a more detailed understanding of the issue, how it currently affects practice, how private companies are specifically affected, what financial assets would be included within the scope of the guidance (since trade AR is not a defined term), and what benefits are expected from simplification. Additional technical research would then be performed based on those questions; the staff would identify any potential solutions and prepare an analysis for the PCC to consider the expected benefits and costs of any viable alternatives for simplification.

Proposed Suggested Solutions (Not Yet Evaluated)

18. PCC members have previously suggested a solution to this issue could be a practical expedient that permits private companies to measure expected credit losses without adjusting their historical loss experience for reasonable and supportable forecasts (consistent with an incurred loss model). The staff would need to perform additional research on this potential solution, and possibly identify additional alternatives, if the PCC decides to move forward with pre-agenda research on this issue.

Next Steps

19. Based on the discussion at the June 2024 PCC meeting, the staff will perform additional research to identify potential alternatives for a solution. A memorandum of that research accompanied by staff analysis of the alternatives will be provided to the PCC at its September 2024 meeting, should the PCC determine it wants to move forward with this issue.

Appendix A

> Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule

326-20-55-37 This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

326-20-55-38 Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

- a. 0.3 percent for receivables that are current
- b. 8 percent for receivables that are 1-30 days past due
- c. 26 percent for receivables that are 31-60 days past due
- d. 58 percent for receivables that are 61-90 days past due
- e. 82 percent for receivables that are more than 90 days past due.

326-20-55-39 Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

326-20-55-40 At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	\$ 5,984,698	0.27%	\$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	<u>\$ 5,997,794</u>		<u>\$ 18,681</u>

[FASB Staff Q&A—Topic 326, No. 1: Whether the Weighted-Average Remaining Maturity Method Is an Acceptable Method to Estimate Expected Credit Losses](#)

[FASB Staff Q&A—Topic 326, No. 2: Developing an Estimate of Expected Credit Losses on Financial Assets](#)