Accounting in ASC 606 or IFRS 15

Accounting in ASC 606 or IFRS 15 1
Introduction 2
ASC 606 and IFRS 15: Some Basics 2
Contracts: Performance Obligation and the Right-to-bill Asset 2
Net Contract 2
Contracts - Your Promises to the Customer 2
Contract Valuation 3
Promise Valuation 3
Revision to Contracts – Modification versus Estimate and Accrual Revisions 3
And Eventually, Invoicing 3
Logical Process called out in ASC 606 and IFRS 15 3
Review at Inception 3
Order to Revenue 3
At Inception 3
Accounting Events – Recognition & Derecognition of Liability, Assets and Revenue 4
Order to Revenue 4
Order to Cash (branch) 4
When Either Party Performs: Recognition of the Performance Obligation and the Right-to-Bill Asset 4
You – the seller 4
Your customer 4
A simple example 5
Example use case - device & service 5
Review at Inception 5
Successful Transfer to customer: Revenue Recognition on a PIT Promise 6
Successful Transfer to customer: Revenue Recognition on an OT Promise 7
Invoicing: Receivables Recognition of an Invoice and Derecognition of the Right to Bill Asset 8
Month End – Balances for External Reporting 9
When Either Party Performs: Recognition of the Performance Obligation and the Right-to-Bill Asset - Third Promise 10
Recognition and Derecognition through the end of the Contract. 11
Order to Cash 12
Illustrated Flow 13
Conclusion 14

Introduction

There are broadly three classifications of revenue defined by the FASB and the IASB. One is banking income, covered in the banking standards, but applicable to anyone who lends or invests for others. The second is leasing, covered by ASC 842 and IFRS 17, and applicable to sales where you provide the right to use an asset over which you retain legal ownership. The third is revenue from contracts with customers, which are all other sales, and are covered by ASC 606 and IFRS 15. (It can be difficult to determine which applies: is Cloud Software a right to use an asset over which the vendor retains legal ownership, that is, a lease; or is it the delivery of a service, that is, a contract with a customer? The answer will depend on the terms and conditions of the sale.)

ASC 606 and IFRS 15: Some Basics

Contracts: Performance Obligation and the Right-to-bill Asset

ASC 606 and IFRS 15 require you to accrue for your debt to customers in respect of goods and services they have ordered when either you or the customer have committed to the order by performing in reliance on it. This accrual is referred to as a "performance obligation" (liability). The performance obligation accrual is drawn down by recognizing revenue as you successfully transfer control of the goods and services to the customer.

The offset to the accrual is your right to bill for the delivery when appropriate. The offset is referred to as the right to invoice (asset). The right to bill asset is drawn down as you issue invoices on credit or receive cash consideration.

Initially, the accrual and the asset net to zero: the net contract balance is zero.

In other words, ASC 606 and IFRS 15 require you to accrue for your sales orders at the time you commit to your promises by performing against them, by estimating your exposure to deliver and your right to consideration.

Net Contract

As revenue is recognized on successful transfer to customers, while invoices are issued following contract terms, following models like subscription, following transaction tax rules such as VAT tax point or Sales Tax or GST regulations, or following other similar factors, the net can be either an asset or a liability at any one time.

Contracts- Your Promises to the Customer

The unit of account (that which you must account for) is your promise to the customer: a self-defined determination of when you decide you will have satisfied the customer.

- The only definition of promise required is that it be distinct.
- There can be many promises in a contract. Promises become obligations when either party performs in reliance on them.
- Promises that are delivered "all at once" are classified as "Point in Time" (PIT). Otherwise they are "Over Time" (OT). Revenue on PIT promises is recognized on completion of the successful transfer of the whole promise. Revenue on OT promises is recognized periodically.

Depending on your commitment to the customer (can they walk away?), which is a matter of fact, OT promises can be defined as multiple durations. A 2-year cell phone contract might be considered as 730 daily OT promises, 24 monthly promises, or two 1-year promises depending on the mutual agreement. The definition of the duration is sometimes referred to as "devolution" of the promise term.

Contract Valuation

Contracts are valued at "expected consideration": what you estimate you will get for it. As the performance obligation is an accrual, that estimate, like any other accrual, is continually reviewed and revised. In the beginning, every contract is estimated; by the end of the contract, the actual values have replaced the estimated ones.

Promise Valuation

The expected consideration is assigned to the promises in the beginning and at each re-valuation of the accrual in proportion to the selling price you could receive for each promise in a similar and separate standalone sale. That is, if you sold the collection of promises for $80 but you could have received $100 if you sold them separately, there is a 20% discount on each promise versus its own SSS-SSP. The SSS-SSP is based on either recent actual sales, or market-based estimates. The intention is to normalize the sale with the context of the actual contract value.

Revision to Contracts – Modification versus Estimate and Accrual Revisions

Revisions to contracts are expected. Those that are a function of trading are classified as "contract modifications" and are reportable in the management comments on the filing. Those that are a function of revising the estimated expected consideration are not reportable. Valuation uses the original contract date SSS-SSPs.

And Eventually, Invoicing

Invoicing other than trade invoices on credit are problematic. An invoice representing a deposit is offset by a refund liability until that liability expires (rather than clearing the right-to-bill asset). An invoice that is conditional on delivery or anything else other than the passage of time is defined by the Receivable standards as "not a receivable" and is usually offset by a contra to receivables until the condition is resolved.

Logical Process called out in ASC 606 and IFRS 15

Review at Inception

In order to accommodate all this, the standard prescribes, several times, a "review at inception". You must review at inception and identify the contract. You must review at inception and identify the promises. You must review at inception and value the contract. You must review at inception and value the promises. You must review at inception and classify the promises as PIT or OT.

The FASB & IASB believe that businesses already review at inception, as part of approving the customer's order, and that the data required was usually captured in their CRM and ordering systems. There is a certain truth to that; but much of the data required is new and is not captured in pre- ASC 606 or IFRS 15 ERP systems.

Order to Revenue

Assuming that the data is available, the ASC 606 and IFRS 15 Order to Revenue process looks like the following. (Note: Order to Cash is quite different.)

At Inception

When the order is taken (there is no precise definition of "at inception"), you must execute the review at inception and:

1. Identify the accounting contract (including merging related legal contracts, and less often, distinguishing separate accounting contracts combined in one legal contract.)
2. Identify the distinct promises contained in that contract; that is, identify your revenue goals and

billing plans.

3. Value the contract at expected consideration. This is an accrual estimate.
4. Assign that valuation to each promise on the basis of the total selling price you would get if you sold the promises separately to in similar deals (to similar customers under similar circumstances) based on your existing sales or market conditions (defined set of estimation rules). (The standard does not include vendor specific objective evidence or internally evidenced SSPs either explicitly or by grandfathering previous GAAP.)

And then wait until recognition criteria arise. Neither ASC 606 nor IFRS 15 wish to change the previous GAAP: that mere open orders do not appear on the balance sheet. This continues to be perceived as fraud on investors.

Accounting Events – Recognition & Derecognition of Liability, Assets and Revenue

Recognition events are occasions on which you record the events in your ledger and serve as the basis for your accounting and accountability to owners (investors). Accounting standards address two concerns - recognition, and valuation. We will look at the following events:

Order to Revenue

Recognition and derecognition of the Performance Obligation, a liability.
Recognition and derecognition of the Right to Bill Asset, an asset.
Recognition and derecognition of the Net Contract, the net of the asset and liability
Recognition of the Revenue
Recognition of the Receivable

Order to Cash (branch)

Derecognition of Receivable, Recognition of Cash.

When Either Party Performs: Recognition of the Performance Obligation and the Right-to-Bill Asset

You – the seller

The accounting process begins when either party performs. Normally, performance begins with you irreversibly executing against the order: you, say, dig the foundation, lay the keel, send a consultant on site, put goods in a box and ship them, process the activation code, allow people to put groceries in the cart, check people in, accept goods for repair, serve them food, include their franchise in advertising material, buy stock on their behalf, give them keys, train their staff....

Your customer

Customers may perform by accepting your invoice as payable without any conditions. This is slightly more unusual, as the condition of delivery must be met, and delivery would have been you performing.

When you (or the customer) have performed, you accrue the liability on the promise. You book the estimated liability of the performance obligation. This provides the "begin situation" for your disclosure note on revenue activity.

The offset to the accrual is the estimated right-to-bill asset. You book an asset representing your right to invoice for the goods and services depending on the billing side of your contract - whether it be credit invoices, milestone billing, a subscription plan, consolidated invoices. The initial entry provides the "begin situation" of the expected cash flow disclosure note.

A simple example

Both sides of the entry are valued at the promise's valuation - its share of the expected consideration of the contract, allocated on the basis of the relationship of the contract total to the similar and separate sale selling price total.

Example use case- device & service

(Hearing Aid & Medical service; Computer & Software; Machine & Training; Cable Box & TV; Cell phone & data; Automobile & maintenance; Coffee & points; Franchise signage & subsequent service, Operation and recuperation, and many more implementations)

Let us say we sell a good and a subsequent service together for 80% of our regular standalone selling price. The service takes six months, but the client has one option to quit at the end of three, so we define two promises each as a three-month obligation. The good comes from inventory and sells for §20 standalone; the service is §80 in total.

The valuation is 80% of §20, that is §16 for the good. The service is 80% of §80, that is §64 for the service, or §10.67 for each month, §32 for each 3-month period.

Billing is slated to be §27 every two months: §80 divided by three.

Review at Inception

Date	*Description*	*Expected Consideration*	*SSS-SSP*	*Contract % of SSS-SSP*	*Obligation & Revenue*	*Dates*	*Billing*
EPP	*PIT POb*		*20*	*80%*	*16*	*Day 1*	*3 invoices of §26.66*
EPP	*OT POb*		*40*	*80%*	*32*	*Day 1- 60*	
Mth 3	*OT POB*		*40*	*80%*	*32*	*Day 61--120*	
Expected Consideration		*§80*			*§80*		
SSS-SSP Total			*§100*	*80/100*			
Contract Discount			*§20*				

Current: §, the example currency.

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	

Illustration 1: Accrue when either party performs

Successful Transfer to customer: Revenue Recognition on a PIT Promise

The goods are provided to the customer on the same day as either party performs, as they are taken from inventory and transferred that day. Revenue is recognized immediately.

On successful and complete delivery of goods as promised, we derecognize the obligation to provide those goods, and recognize the revenue on them. Partial delivery against a promise does not invoke revenue recognition. If you promised a "computer system" and only delivered part, you must wait until you complete the delivery. If you promised 10 chairs and only deliver 5, you must wait until you deliver the other 5. You manage this through careful promising.

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue			16	16	(16)

Illustration 2: Recognition of PIT Revenue with Derecognition of the Performance Obligation

At this point, the ledger reflects (a) an obligation to deliver 3 months of service for §32, (b) a right to invoice for the goods and for three months of service of §48, and (c) revenue of §16 in respect of the goods. If Day 2 were year-end, you would report §16 net contract of the balance sheet; and §16 revenue on the P&L. Your disclosures would be that from a contract beginning of §48 billable, you had §48 remaining to bill cash flow wise, and from a contract beginning of §48 due in goods and services you had §342 remaining to fulfill.

Note that in the example, the recognition of the liability and its derecognition in respect of the PIT promise were on the same day.

Successful Transfer to customer: Revenue Recognition on an OT Promise

At the end of the first month, you recognize revenue on the service in respect of that month. (For simplicity, we are recognizing a full month of service.)

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue on delivery of PIT Obligation			16	16	(16)
End of First Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)

Illustration #3: Recognition of OT Revenue with Derecognition of the Performance Obligation

If the end of the first month on this contract was a reporting period, we would report:

On the P&L: §27 YTD revenue

On the Balance sheet: §27 net contract asset,
- made up of (16-16)=0 plus (32-11=21) total (21) performance obligation, being two months of service outstanding (with rounding),
- offset by §48 yet to be invoiced.

In the disclosure notes:

Revenue: Of the §48 accrued, §27 has been recognized and §21 has yet to be recognized.
Cash Flow: Of the §48 accrued, none has been invoiced and §48 remains to be invoiced.

Invoicing: Receivables Recognition of an Invoice and Derecognition of the Right to Bill Asset

The first invoice for §27 is issued at the end of the second month. Management may define this invoice in different ways: 100% for the goods at their SSS-SSP (with all the customer facing discount applied to the service); §16 for the goods and §11 for the service; an unspecified subscription of §27 out of the §80, a specific case consolidated invoice, or many other choices.

As the accrual valued the asset at the obligation and revenue valuation, we could assign the invoice pro-rate (§27 out of the expected consideration of §80 = 33%) to each obligation, and that would be standard behavior on a regular credit invoice, to facilitate reconciliation.

When the invoice is an unspecified subscription or a mixed case consolidated invoice, there is not sufficient data to do this, and we will just apply it to the total right-to-bill asset.

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue on delivery of PIT Obligation			16	16	(16)
End of First Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Second Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	

Illustration #4: Recognition of Receivable and Derecognition of Right To Bill on invoicing

The invoice increments receivables and decrements the right to bill asset. The invoice was issued under contractual and regulatory requirements that no longer interfere with revenue recognition, as the revenue was recognized when the goods and services were transferred to the customer, quite independently of billing. Of course, if they were done simultaneously - if revenue and billing were on the same date, and in the same amount, and for the same detail, the asset would be created and cleared on the same date.

At this point, the asset is reduced from §48 to §21, the remaining balance on the promise for goods and the promise for the first three months. As the second month is not over, you would not be reporting to shareholders at this date.

Month End – Balances for External Reporting

To complete the month, we should recognize another month's revenue, as we did at the end of month one. (No additional commentary).

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue on delivery of PIT Obligation			16	16	(16)
End of First Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Second Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	
End of Second Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)

Illustration #5: Recognize Receivable on a Subscription Invoice, Derecognize Right To Bill asset

The balances at the end of the second month, if you had to do external reporting, are:

P&L, YTD Revenue: §38. That is: §16 on Goods and §22 on Services.

Balance Sheet:
Receivables: §27, as billed.
Right to Bill Asset: §21: §16 accrued on goods, §32 accrued on services, less §27 billed.
Performance Obligation: §16 minus §16 = §0 on goods; §32 minus §22 rev-rec'd on services = §10 (rounded down).
Net Contract: §21 asset and §10 liability = §11 asset.

Disclosures:
Cash Flow: Of the §48 accrued, no increases, §27 billed, §21 remaining to be billed.
Performance obligation: Of the §48 accrued, no increases, $10 remaining to deliver on services.

When Either Party Performs: Recognition of the Performance Obligation and the Right-to-Bill Asset-Third Promise

Assuming the customer is satisfied and does not quit at the end of the third month, in the fourth month, the third promise, which is service for the second three months will be accrued. The value is §32, and it will be recorded as an obligation and an asset.

Before that, revenue will have been booked for the third month, and the second subscription invoice will have been recorded in the fourth month.

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue on delivery of PIT Obligation			16	16	(16)
End of First Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Second Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	
End of Second Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
End of Third Month	Recognize Revenue on Delivery of OT Obligation			10	10	(10)
Beginning of Fourth Month	Accrual & Offset on second three months service		32	(32)	0	
Fourth Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	
End of Fourth Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)

Illustration #6: Accrue Remaining Promise when Either Party Act on It. Recognize Liability to Perform and Right to Receive Consideration

When the fourth month is an external reporting month, the balances will support the following situation:

P&L Revenue: §(16+32+11) = §59 - goods, first service promise and first month of second service promise.

Balance Sheet:
Receivables: §54, both subscription invoices. We have not yet discussed collection.
Right to Bill Asset: Contract is accrued in full §(16+32+32 = 80) less two of four subscription invoices §54 = §26 due.
Performance Obligation: Goods are accrued and cleared at §16; First service promise is accrued and cleared at §32, second service promise is accrued at §32 and cleared by §11; the balance is accordingly §22 (two open months.)

Disclosure:

Cash Flow: Of the contract §80 accrued, §54 has been billed and §26 remains to be billed.
Revenue: Of the contract §80 accrued, §59 has been recognized and §21 (two periods of service) remain to be satisfied.

Recognition and Derecognition through the end of the Contract.
The revenue recognition entries illustrated above, and the receivables recognition entries illustrated above, repeat themselves through the end of the contract, so that the contract balances are cleared at the end of the contract period.

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
Inception	No Entry					
Either Party Performs	Accrual & Offset on delivery of goods		16	(16)	Zero	
	Accrual & Offset on First three months service		32	(32)	Zero	
Delivery of PIT Obligation	Recognize Revenue on delivery of PIT Obligation			16	16	(16)
End of First Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Second Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	
End of Second Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
End of Third Month	Recognize Revenue on Delivery of OT Obligation			10	10	(10)
Beginning of Fourth Month	Accrual & Offset on second three months		32	(32)	0	

Date	Description	Accounts Receivable	Right-to-Bill Asset	Performance Obligation	Net Contract	Recognized Revenue
	service					
Fourth Month	Recognize Receivable on Subscription Invoice	27	(27)		(27)	
End of Fourth Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Fifth Month	Recognize Revenue on Delivery of OT Obligation			11	11	(11)
Sixth Month	Recognize Revenue on Delivery of OT Obligation			10	10	(10)
	Recognize Receivable on Subscription Invoice	26	(26)		(26)	
Contract Close	Balances	80	0	0	0	(80)

Illustration #7: Complete Contract at End

This is the basic accounting discussed in the presentation Section of ASC 606 and IFRS 15, together with the disclosure discussed in the disclosure section. Revisions through contract modifications (customer discussions) or expected consideration estimation revisions (corrections to your initial expectations within the contract parameters) are also required, but not illustrated here.

Order to Cash

ASC 606 and IFRS 15 discuss Order to Revenue, not Order to Cash. ASC 310 discusses receivables and collections. ASC 606 and IFRS 15 treat the accepted invoice as consideration received, and the extension of credit as just that, a loan.

In the example above, it would be normal business to collect the receivables 30 days after billing, in which case §27, §27 and §26 would have been collected in months three, five and seven respectively, derecognizing the receivable and recognizing cash.

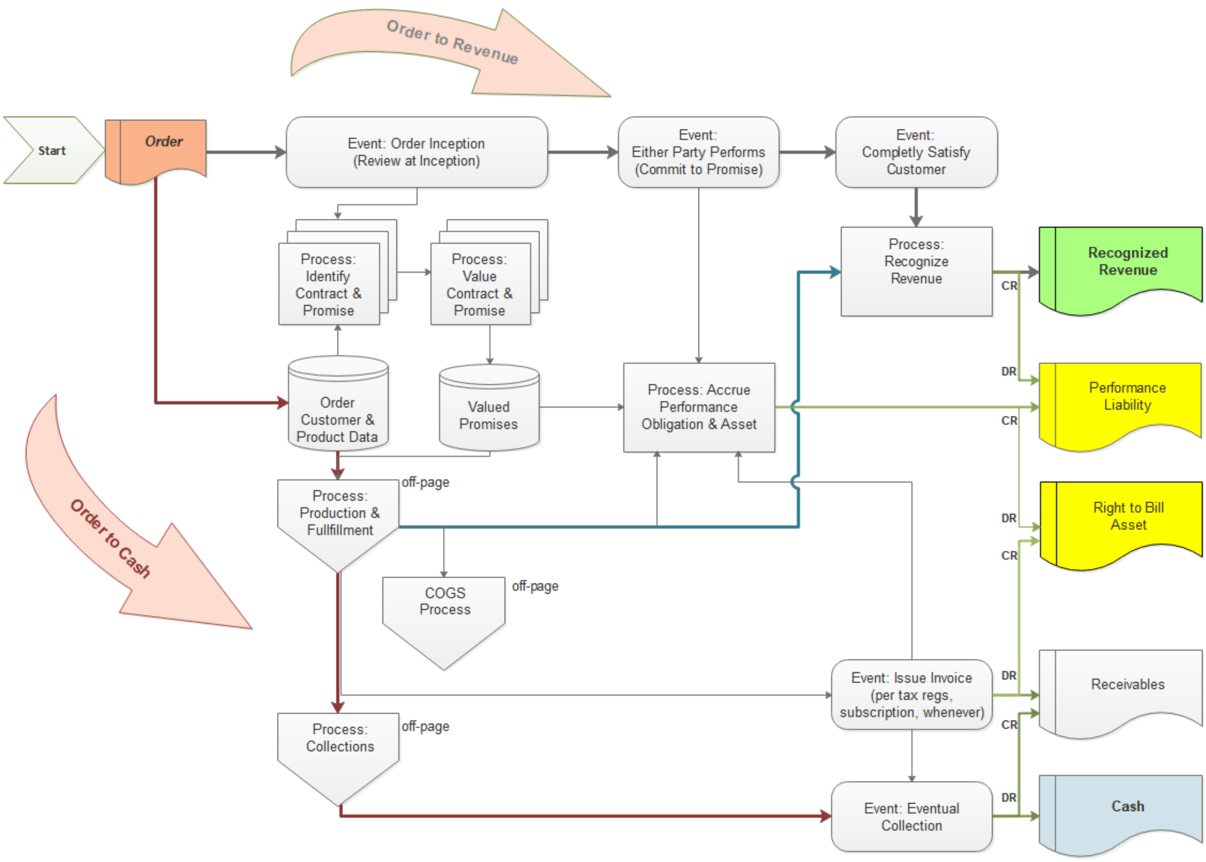
In a consumer business, it might be more normal to take a credit card amount on the date of invoice, while in a capital project, it might be more normal to extend a greater number of days credit.

Illustrated Flow

This image outlines the order to revenue (P&L) flow and the order to cash (Balance Sheet) flow in an ASC 606 or IFRS 15 adoption.

Illustration #8 Audit Diagram of Generic ASC 606 – IFRS 15 Flows

Legend :
Rectangle: in focus processes
Rounded Rectangle: Business Events
Drums: Data storage
Inverted Pentagons: processes not in focus
Pages: Accounting Output, Ledger Accounts
Line Arrows: Process direction or data usage
  Heavy Black: Order to Revenue
  Heavy Burgundy: Order to Cash
  Heavy Green: Undetailed production & fulfillment processes
  Light Green: Accounting Entries



The flow starts at the top left-hand side, with the order, and flows…

- From the inception of the contract (orders, articulated or not) through the identification and valuation of the contract and promises at inception
- To the accrual of the performance obligation when either party performs – you though your production or fulfillment process, or the customer by accepting their liability in respect of your promise unconditionally.
- And then to the recognition of revenue when the goods or services are transferred to the customer.

A separate, related flow, not illustrated in detail, develops your production and fulfillment activities, driving two important relevant revenue events – your activities in terms of either party performing, and you completion of the transfer of goods and services to the customer.

The production and fulfillment processes also drive the valuation of the cost of your revenue, which is recognized at the same time as the revenue. The fulfillment process may also drive your invoicing, ("bill on shipping") although other processes, such as subscription or utility-style billing, may serve this function too.

The collection process is also not expanded. Once an invoice is issued and accepted by a customer as being unconditional, it can be recognized as a receivable; subsequent collection will convert it to cash.

Conclusion

While this document is neither a summary nor an interpretation of ASC 506 or of IFRS 15, I hope it is helpful in understanding how the principles that the Standards articulate play out in a systematic way.

September 2020
Seamus Moran