ASC 606 Overview: Understanding the Revenue Recognition Standard

What is ASC 606?

ASC 606: **Revenue from Contracts with Customers** is the US GAAP standard that establishes **how and when to recognize revenue**. It replaced many industry-specific rules with a **unified, 5-step model**.

Core Principle:

A company must recognize revenue **when it transfers control** of goods or services to a customer, **in an amount that reflects the consideration** it expects to receive.

The 5-Step Revenue Recognition Model

1. **Identify the contract** with a customer
2. **Identify the performance obligations** in the contract
3. **Determine the transaction price**
4. **Allocate the transaction price** to performance obligations
5. **Recognize revenue** when (or as) the performance obligation is satisfied

Step 1: Identify the Contract

A contract is enforceable if it creates legal rights and obligations. It can be written, oral, or implied. To apply the revenue recognition model, **all** of the following must be met:

1. **Approval & Commitment**: Both parties have approved and committed.
2. **Identifiable Rights**: Each party's rights to goods/services are clear.
3. **Identifiable Payment Terms**: The payment terms can be determined.
4. **Commercial Substance**: The contract has a real economic impact.
5. **Probable Collection**: It's probable the seller will collect consideration.

If These Are Not Met?

Any consideration received is recorded as a **liability (e.g., unearned revenue)** until the criteria are satisfied.

Contract Modifications

If terms change after the contract starts (e.g., new products added, price changes), it could be a:

- **Separate contract** (if new performance obligation + price reflects standalone selling price), or
- **Modification of existing contract** (adjust existing transaction price & allocation)

Step 2: Identify Performance Obligations

A **performance obligation** is a **promise** in a contract to transfer to a customer, a **distinct good** or **service.** Contracts may contain **one** or **multiple** performance obligations (POs).

When Is a Good or Service "Distinct"?

It must meet **both** of the following criteria:

Criterion	Explanation
Capable of being distinct	The customer can benefit from it on its own or with resources they already have.
Separately identifiable	The good/service is not bundled in a way that's highly interrelated with other promises.

Examples of Performance Obligations

Scenario	Performance Obligations (PO)
Sell a machine + installation	1 PO if installation is essential to function. 2 POs if it's a standalone add-on
Subscription + customer support	Typically, 2 POs (subscription + support)
Software license + updates	Could be 1 or 2 depending on whether updates are essential

What If Not Distinct?

If a good/service is **not distinct**, it should be **combined** with other goods/services until a distinct bundle is formed. Revenue will then be recognized as the bundle is delivered.

Identifying too few POs = overstatement of early revenue
Identifying too many = delays recognition & complicates tracking

Bundled vs Unbundled Performance Obligations (PO) – More Examples

Scenario	Distinct?	# of POs	Notes
Software license + customer support	Yes	2 POs	If the support is optional, it's distinct.
Smartphone + 2-year service contract (telco)	Yes	2 POs	The device and service are functionally distinct.
Design and build custom equipment	No	1 PO	Design & build are highly interrelated / inseparable.
Gym membership with unlimited classes	No	1 PO	Services are not distinct; combined into a continuous service.
CRM subscription + implementation service	Depends	1 or 2 POs	If implementation is simple/onboarding only → 2 POs. If system can't be used without it → 1 PO.
Luxury hotel stay with daily breakfast included	Yes	2 POs	Stay and meals are distinct—can be consumed separately.
Delivery and installation of a home appliance	Depends	1 or 2 POs	If installation is complex and required for functionality (e.g., gas stove) → 1 PO. If plug-and-play (e.g., microwave) → 2 POs.
Enterprise software license + ongoing updates	No	1 PO	If updates are critical to function (e.g., SaaS model), it's a combined obligation.
Marketing campaign + content creation	Yes	2 POs	Creating assets vs executing campaigns are mostly separable.

How to Think About It:

1. Can the customer **benefit from the product/service on its own**?
2. Is the service **integrated or interdependent** with other deliverables?

If both answers point to independence = unbundle.
If they work **together as one combined output** = bundle.

Step 3: Determine the Transaction Price

The **transaction price** is the amount of consideration (cash or non-cash) that an entity expects to receive in exchange for transferring goods or services to a customer. This isn't always a simple number—it often involves **judgment and estimates**.

Key Factors to Consider

1. **Fixed Consideration**: Straightforward price (e.g., $5000 flat fee).
2. **Variable Consideration**
   - Includes discounts, rebates, bonuses, penalties, usage-based fees, etc.
   - Two estimation methods:
     - **Expected Value** (probability-weighted)
     - **Most Likely Amount** (used when there's only one likely outcome)
3. **Constraint on Variable Consideration**: Only include variable amounts if it's **probable** you won't have to reverse them later (the "constraint" principle).

   Example: You run a performance-based consulting contract: $50,000 base + $10,000 bonus if a project completes before March.

   - Most Likely Amount: $60,000 if early completion is likely.
   - If the bonus is uncertain, apply constraint and only recognize $50,000 until it becomes probable and can be estimated reliably.
4. **Significant Financing Component**
   - Adjust if payment timing implies a financing element (e.g., advance payments or deferred collection over 12+ months).
   - Time value of money must be considered.

   Example: Customer pays $120,000 two years after delivery. You must discount that amount using a reasonable interest rate to reflect present value.
5. **Non-Cash Consideration**: Measured at **fair value** on the contract date.
6. **Consideration Payable to Customer**: If you give something back (e.g., coupons, incentives), it **reduces** the price.

Step 4: Allocate the Transaction Price

If a contract includes **more than one performance obligation**, you must **allocate the total transaction price** to each PO based on **relative standalone selling prices** (SSPs).

Allocation = (PO's SSP ÷ Total SSP of all POs) × Total Transaction Price

Standalone Selling Price (SSP)

The price the entity **would sell the good/service for separately** under similar conditions. It can be:

- Directly observable (e.g., regular price list)
- Estimated using:
    - **Adjusted Market Assessment** (what customers would pay)
    - **Expected Cost + Margin**
    - **Residual Approach** (only when other POs' prices are clearly known)

Example: Software Bundle

Component	SSP
Software License	$1,000
Installation	$500
1-Year Support	$500
Total SSP	$2,000
Contract Price	$1,800 (discounted bundle)

Allocation:

- License: ($1,000 / $2,000) × $1,800 = **$900**
- Installation: ($500 / $2,000) × $1,800 = **$450**
- Support: ($500 / $2,000) × $1,800 = **$450**
- Allocate **proportionally** unless you can **specifically link** a discount or variable amount to one PO (rare but allowed under ASC 606-10-32-40).

Step 5: Recognize Revenue

Two Revenue Recognition Methods

Method	When Used	Examples
Over Time	Revenue is recognized gradually, as performance occurs	Subscriptions, SaaS, construction, retainers
At a Point in Time	Revenue is recognized at once when control transfers	Product sale, equipment delivery, one-time services

Example Scenarios

1. **12-month website maintenance contract:** Revenue recognized **over time**, monthly
2. **Delivery of office furniture**: Recognize **at point of delivery**, when customer accepts
3. **Custom construction project with monthly progress billing: Over time**, using input method based on costs incurred

Key Takeaways for Small Businesses

- ASC 606 applies to **almost every business**, not just public companies
- Document **contracts and performance obligations** clearly
- Use consistent **allocation methods**
- Be careful not to recognize revenue **too early or too late**