ASC 606 Revenue Recognition 5-Step Model Master Guide

Core GAAP Framework, Performance Obligations, Standalone Selling Price & Journal Entries | US GAAP & IFRS 15

1. THE 5-STEP REVENUE RECOGNITION FRAMEWORK

Step	Step Name	Key Criteria & GAAP Requirements	Practical Exam Check
Step 1	**Identify Contract with Customer**	Enforceable agreement exists if: approved by parties, commercial substance, payment terms identified, and collection is probable (>50%).	If collection not probable → deposit is a Contract Liability.
Step 2	**Identify Performance Obligations**	A promise to transfer a *distinct* good or service. Must be: 1) capable of being distinct (benefit on its own), and 2) distinct within context of contract.	Significant integration or customization → combined bundle.
Step 3	**Determine Transaction Price**	Amount of consideration expected. Must evaluate: Variable consideration (apply constraint), Significant financing component (time value), and Non-cash fees.	Variable consideration only included if reversal unlikely.
Step 4	**Allocate Price to Obligations**	Allocate total transaction price to each distinct performance obligation based on relative **Standalone Selling Price (SSP)** at contract inception.	Discounts allocated proportionately unless specific.
Step 5	**Recognize Revenue When Satisfied**	Recognize when customer obtains *control* of asset. **Over Time** if: 1) customer receives benefits as performed, 2) creates/enhances customer asset, or 3) no alt use with right to payment.	If criteria not met → recognize at a **Point in Time**.

2. BALANCE SHEET CLASSIFICATION: CONTRACT ASSETS VS. LIABILITIES

Account Title	Financial Definition	Key Triggering Condition
Contract Asset (Unbilled Receivable)	An entity's right to consideration in exchange for goods/services transferred to customer when right is **conditional** on something other than passage of time.	Work completed on performance obligation A, but billing requires completion of performance obligation B.
Accounts Receivable (Billed Receivable)	An unconditional right to payment. Only the passage of time is required before payment of that consideration is due.	Invoice issued according to contract payment schedule.
Contract Liability (Deferred / Unearned Rev)	An entity's obligation to transfer goods/services for which the entity has received consideration (or consideration is due) from customer.	Upfront customer cash advance or subscription received prior to service delivery.

3. PRACTICAL MULTI-ELEMENT BUNDLE CASE STUDY & ENTRIES

Scenario: TechCorp sells a software license + 1-year technical support bundle for **$100,000** cash. Standalone Selling Prices (SSP): Software = **$80,000**; Support = **$40,000** (Total SSP = $120,000).
Step 4 Allocation: Software = ($80k / $120k) × $100k = **$66,667** (Point in Time). Support = ($40k / $120k) × $100k = **$33,333** (Over Time).
Day 1 Entry: Dr. Cash $100,000 • Cr. Software License Revenue $66,667 • Cr. Contract Liability (Deferred Support) $33,333.
Monthly Entry: Dr. Contract Liability $2,778 ($33,333 / 12) • Cr. Service Support Revenue $2,778.

CPA Exam Traps: 1) **Customer Right of Return:** Does NOT prevent revenue recognition; record estimated gross revenue, a Refund Liability (for expected refunds), and an Asset for Recovery of Inventory. 2) **Principal vs. Agent:** If entity controls good before transfer → recognize Gross Revenue. If entity only arranges transaction → recognize Net Fee/Commission. 3) **Contract Costs:** Incremental costs to obtain contract (e.g. sales commissions) MUST be capitalized as an asset if amortization period > 1 year.

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