

ASC 606 (*Revenue from Contracts with Customers*) establishes a single, comprehensive principles-based framework that replaces legacy industry-specific revenue recognition rules. Its core principle is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled.

The 5-Step Framework

1. **Identify the contract with a customer:** Confirm the agreement has commercial substance, approved terms, identified rights/payment terms, and probable collectibility.
2. **Identify the performance obligations (POBs):** Identify distinct promises to deliver goods or services.
3. **Determine the transaction price:** Determine the total consideration expected, accounting for variable consideration, significant financing components, and non-cash amounts.
4. **Allocate the transaction price:** Allocate transaction price to each separate POB based on relative standalone selling prices (SSP).
5. **Recognize revenue:** Recognize revenue when (or as) the entity satisfies a performance obligation by transferring control to the customer.

Core Applications: Services vs. Finished Products

The primary technical divergences between service entities and tangible goods manufacturers appear in **timing of control transfer**, **defining deliverables**, and **variable compensation**.

1. Point-in-Time vs. Over-Time Recognition (Step 5)

- **Finished Products:** Control typically transfers at a distinct **point in time**—defined by shipping terms (FOB shipping point/destination), physical delivery, transfer of legal title, or passage of significant risks and rewards.

- **Services:** Almost always qualify for recognition **over time** because they meet at least one of three ASC 606-10-25-27 criteria:
 - **Simultaneous Receipt and Consumption:** The customer simultaneously receives and consumes the benefits as the provider performs (e.g., outsourced accounting, routine maintenance, payroll processing, advisory retainers).

 - **Asset Creation Under Customer Control:** The provider creates or enhances an asset that the customer controls as it is created (e.g., custom software development on the client's infrastructure).

 - **No Alternative Use + Enforceable Right to Payment:** The provider creates a customized deliverable with no alternative use (e.g., specialized audit or consulting engagement) and maintains an enforceable right to payment for performance completed to date (including cost plus a reasonable margin) if terminated for convenience.

2. Progress Measurement for Service Delivery

When recognized over time, service providers must select a method that reliably measures progress toward complete satisfaction of the POB:

- **Input Methods:** Progress based on provider effort expended relative to total expected effort (e.g., direct labor hours incurred vs. total estimated hours, costs

incurred vs. total estimated engagement costs). Common in professional services, engineering, and fixed-fee consulting. Requires frequent re-estimation to prevent front-loaded margin distortion.

- **Output Methods:** Progress based on direct measurements of the value delivered to the customer (e.g., milestones achieved, units delivered, appraisals).
- **As-Invoiced Practical Expedient:** If a service firm has a right to consideration in an amount directly corresponding to the value of performance completed to date (e.g., hourly time-and-materials billing), it may recognize revenue equal to the invoiced amount without complex input/output modeling.

3. Bundled Deliverables & Standalone Selling Price (Steps 2 & 4)

- **Bundled Offerings:** Service contracts often package distinct components—such as implementation, customization, platform access, training, and ongoing technical support.
- **Distinct Goods/Services:** If a service (e.g., implementation) significantly modifies software or is critical to the customer's ability to benefit from the platform, it is not distinct and must be bundled into a combined POB. If routine and available from third parties, it is distinct and recognized separately over its own delivery period.
- **Allocation via SSP:** Where list prices do not exist for bespoke services, providers must estimate SSP using methods like adjusted market assessment, expected cost plus a margin, or the residual approach (restricted use).

4. Variable Consideration & Constraints (Step 3)

- Service agreements frequently include performance bonuses, service-level agreement (SLA) penalties, milestone success fees, or volume discounts.

- Providers must estimate variable consideration using either the **expected value** (probability-weighted) or the **most likely amount** method.
- **The Constraint:** Variable amounts can only be included in the transaction price to the extent it is *probable* that a significant reversal of cumulative revenue will not occur once the contingency is resolved (e.g., success-fee-only M&A or litigation support revenue cannot be recognized until closing/judgment).

5. Contract Costs (ASC 340-40)

- **Capitalization of Commissions:** Service companies must capitalize incremental direct costs of obtaining a contract (primarily sales commissions) if the amortization period exceeds one year, expensing them over the estimated customer life/relationship period rather than taking an upfront hit at contract signing.
- **Fulfillment Costs:** Costs incurred directly to fulfill an anticipated or signed service contract that generate or enhance resources used in satisfying future obligations are capitalized as assets and amortized as the services are rendered.