

Applying the Five-Step ASC 606 Revenue Model

Ready to put the five-step revenue model into practice? This course takes a closer look at how each step of the ASC 606 framework works in real-world application. Designed for accounting and tax professionals who need to move beyond theory, this course helps bridge the gap between understanding the model conceptually and applying it accurately to contracts and transactions. A solid grasp of the introductory material is helpful before diving in.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify two methods that are used to record revenue in Step 5 of the revenue standard.

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Publication Date: January 2026

TABLE OF CONTENTS

CHAPTER

01

Section 4 4

1.01 Step 5: Recognize Revenue - Entity Satisfies A Performance Obligation.
4

1.02 A. General Rules In Applying Step 5 4

1.03 B. Control Transfers Over Time- Step 5 9

1.04 C. Control Transfers At A Point In Time- Step 5 34

1.05 D. Special Right-To-Invoice Practical Expedient- Step 5 39

1.06 E. Onerous Contract Rules 41

Test Your Knowledge..... 44

Final Exam Copy..... 52

Glossary..... 49

Index

Section 4

Chapter Objective

After completing this assignment, you should be able to:

- Identify two methods that are used to record revenue in Step 5 of the revenue standard.

STEP 5: RECOGNIZE REVENUE - ENTITY SATISFIES A PERFORMANCE OBLIGATION

A. GENERAL RULES IN APPLYING STEP 5

Step 5 is the last step in the five-step process required to recognize revenue under ASC 606's new revenue model.

Once an entity has allocated *the transaction price to each performance obligation* in Step 4, the final step is to recognize revenue as each performance obligation is completed.

The general rule in ASC 606 is that:

*"An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer."**

Control transfers to a customer either *over time* or *at a point in time*.

ASC 606 provides the following guidance in implementing Step 5:

1. An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the *customer obtains control* of that good or service.
2. Control of an asset refers to the *ability to direct the use of*, and obtain *substantially all of the remaining benefits from*, the asset.
 - a) Control also includes the *ability to prevent other entities from directing the use of*, and obtaining the benefits from, an asset.
 - b) The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
 - Using the asset to produce goods or provide services (including public services)
 - Using the asset to enhance the value of other assets
 - Using the asset to settle liabilities or reduce expenses
 - Selling or exchanging the asset

- Pledging the asset to secure a loan
- Holding the asset

Note

When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset.

- The customer satisfies a performance obligation (customer obtains control) under one of two scenarios:
 - Over time, or
 - At a point in time.
- For each performance obligation identified in Step 2, an entity shall determine at contract inception whether it satisfies the performance obligation (and the customer obtains control) *over time* or *at a point in time*.
 - If an entity *does not* satisfy a performance obligation over time, the performance obligation is satisfied *at a point in time*.
- Measuring revenue over time:
 - An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue *over time* if *one of the following criteria is met*:
 - The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
 - The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
 - The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.
 - An entity shall recognize revenue for a performance obligation satisfied *over time* only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation.

Note

An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

- c) Methods that can be used to measure an entity's progress toward complete satisfaction of a performance obligation satisfied over time include the following:
 - Output methods
 - Input methods
- d) Output methods: An entity recognizes revenue based on direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract, and include:
 - Surveys of performance completed to date
 - Appraisals of results achieved
 - Milestones reached, time elapsed, and
 - Units produced or units delivered.
- e) Input methods: An entity recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation, including:
 - Costs incurred
 - Resources consumed
 - Labor hours expended
 - Costs incurred (similar to percentage of completion method)
 - Time elapsed, or
 - Machine hours used relative to the total expected inputs to the satisfaction of that performance obligation.

Note

If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

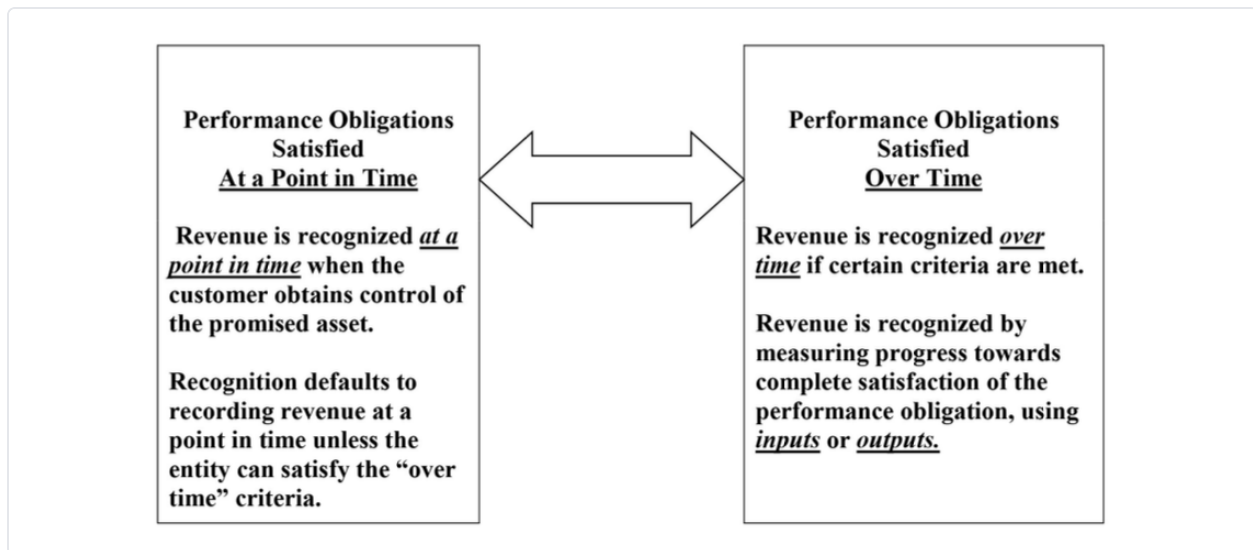
A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity should exclude from an input method the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation.
- When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation.

6. Measuring revenue at a point in time:

- a) If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time (when a customer obtains control).
- b) To determine the point in time at which a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity should consider indicators of the transfer of control, which include, but are not limited to, the following:
 - The entity has a present right to payment for the asset.
 - The customer has legal title to the asset.
 - The entity has transferred physical possession of the asset.
 - The customer has the significant risks and rewards of ownership of the asset.
 - The customer has accepted the asset.

The following chart compares performance obligations satisfied over time and at a point in time.



7. Special practical expedient- right-to-invoice:

- a) As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity may recognize revenue in the amount to which the entity has a right to invoice.

Example: A entity with a service contract bills a fixed amount for each hour of service provided. The value of the invoice corresponds directly with the value to the customer. In such a case, the entity is permitted to recognize the invoice amount as its revenue and bypass the revenue computation in Step 5.

Can an entity that recognizes revenue at a point in time under the pre-ASC 606 revenue recognition guidance be required to recognize revenue over time under the new ASC 606 revenue standard?

Yes.

In TRG Memo 56, the FASB staff concluded:

“In the staff's view, an entity that currently recognizes revenue at a point in time should not presume it will recognize revenue at a point in time under Topic 606.

An entity should perform an assessment of its specific facts and circumstances on the basis of the guidance in the new revenue standard. An entity only recognizes revenue at a point in time if it does not meet the over time criteria in the new revenue standard.”

Thus, an entity that recognizes revenue at a point in time under pre-ASC 606 GAAP must perform a new assessment under new ASC 606 to determine whether it should recognize revenue over time or at a point in time.

B. CONTROL TRANSFERS OVER TIME- STEP 5

For some entities, it is critical that they qualify for transferring control of a good or service over time in applying Step 5. If they do not qualify for over-time treatment, revenue is recognized at a point in time.

Certain industries with long-term contracts, such as construction, must ensure they record their revenue over time in Step 5 so that they can recognize revenue over the construction or manufacturing time frame. Otherwise, they default to using a point in time approach which is similar to a completed contract method under existing GAAP.

In order to recognize revenue over time in Step 5, one of three criteria has to be satisfied:

Specifically, an entity transfers control of a good or service over time and should recognize revenue over time if one of the following three criteria is met:

Criterion 1: The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

Criterion 2: The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

Criterion 3: The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

Each of these three criteria are discussed in more detail below.

CRITERION 1: The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

ASC 606 offers some guidance as to when a customer is deemed to simultaneously receive and consume the benefits provided by an entity's performance as the entity performs.

The ASC 606 essentially offers two categories of transactions that might satisfy Criterion 1 by demonstrating that a customer simultaneously receives and consumes the benefits provided by the entity's performance as that entity performs.

1. Contracts in which the entity's performance is immediately consumed by the customer.

Examples include routine or recurring services (such as a cleaning service or a payroll-processing service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

Note

In Paragraph BC125 of ASU 2014-09, the FASB notes that in many typical “service” contracts, an entity’s performance creates an asset only *momentarily* because the asset is simultaneously received and consumed by the customer. In such cases, the simultaneous receipt and consumption of the asset means the customer obtains control of the entity’s output as the entity performs. Thus, the entity’s performance obligation is satisfied over time.

2. Contracts in which an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date (e.g., could step in) if that other entity were to fulfill the remaining performance obligation to the customer.

a) In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

- Disregard potential *contractual restrictions* or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity.
- Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently *controlled by the entity* and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

Note

In Paragraph BC126 of ASU 2014-09, the FASB observed that there may be service-type contracts in which it is unclear whether the customer receives and consumes the benefit of the entity’s performance over time. This is because the notion of “benefit” can be subjective. The example given is a freight logistics contract in which the entity has agreed to transport goods from Vancouver to New York City. The FASB concluded that the customer does benefit from the entity’s performance as it occurs because if the goods were delivered only part way (for example, to Chicago), another entity would not need to substantially reperform the entity’s performance to date—that is, another entity would not need to take the goods back to Vancouver to deliver them to New York City. The FASB observed that in those cases the assessment of whether another entity would need to substantially reperform the performance completed to date can be used as an objective basis for determining whether the customer receives benefit from the entity’s performance as it is provided.

Example: Customer Simultaneously Receives and Consumes the Benefits – Criterion 1: [From Example 13 of ASU 2014-09]