TECHNICAL ACCOUNTING

ASC 606 Revenue Recognition: What Growing Companies Get Wrong

Revenue recognition is the highest-audit-risk area for most growing companies — not because the math is wrong, but because the documentation does not hold up. Here are the five areas where errors concentrate and what audit-ready documentation looks like in each one.

Why Revenue Recognition Is Your Highest-Audit-Risk Area

ASC 606 replaced decades of industry-specific revenue guidance with a single five-step model. The flexibility built into the standard is also the source of its audit risk: every judgment you make about performance obligations, variable consideration, or principal-versus-agent classification requires documentation that can withstand scrutiny from your auditors.

> *Auditors do not audit your revenue number. They audit your revenue recognition process. A correct number supported by weak documentation creates the same finding as an incorrect number.*

1. Contract Modifications Without a Documented Analysis

A contract modification is any change in scope or price — including an informal one communicated by email. ASC 606 requires you to assess whether the modification creates a new contract, modifies the existing one, or terminates and replaces it. The most common error is not choosing the wrong treatment — it is failing to document that a modification was identified and assessed at all.

What audit-ready looks like:

- A contract modification log maintained and reviewed each close period
- Each modification assessed against the three-scenario framework: new contract, modification to existing, or termination and replacement
- The conclusion documented in writing with a reference to the specific contract and accounting outcome
- Revenue impact calculated and tied to the journal entry
- A contract modification policy in your accounting policy manual

2. Variable Consideration Estimated Without a Constraint Analysis

Variable consideration includes discounts, rebates, refunds, credits, price concessions, performance bonuses, and penalties. The standard requires you to estimate variable consideration and then constrain it to the amount that is probable of not being significantly reversed. Most growing

companies either ignore variable consideration entirely or estimate it without the constraint analysis — both are errors.

What audit-ready looks like:

- All variable consideration elements identified and listed by contract type
- Estimation method selected — expected value or most likely amount — and documented with a reason for the choice
- Constraint analysis documented each period: what is included in the transaction price and why
- Actual vs. estimate comparison performed and documented to support the methodology
- Cumulative catch-up adjustments identified, calculated, and supported

3. Bundled Contracts With No Performance Obligation Analysis

When a contract includes more than one promised good or service, you must identify each distinct performance obligation and allocate the transaction price based on standalone selling price. The most common scenario: a software or services company that sells implementation, the core product, training, and support in a single contract — then recognizes all of it at implementation completion.

What audit-ready looks like:

- Performance obligation identification documented for each contract type your company sells
- Standalone selling prices (SSPs) established and documented — ideally with observable price evidence from separate sales
- SSP allocation methodology documented if observable evidence is not available
- Software, implementation, training, and support unbundled appropriately in all contracts where each element has standalone value
- SSP analysis refreshed when pricing changes materially

4. Principal vs. Agent Classification Not Evaluated

Principal vs. agent classification determines whether you recognize revenue gross or net. The standard requires a control analysis: does your company control the promised good or service before it is transferred to the customer? Errors here are high-visibility — they inflate or deflate the revenue line and gross margin, and they are immediately visible to anyone using your financial statements.

What audit-ready looks like:

- Principal vs. agent analysis performed and documented for all arrangements involving third-party fulfillment
- The three control indicators evaluated: inventory risk, pricing latitude, and primary obligation to the customer
- Conclusion documented and tied to the revenue presentation in the financial statements
- Analysis revisited whenever new arrangements are established or existing ones change materially

5. Sales Commissions Expensed When They Should Be Capitalized

ASC 340-40 requires capitalization of incremental costs to obtain a contract — primarily sales commissions — when you expect to recover them through the revenue earned. For many growth-stage companies, this is material and frequently either missed entirely or expensed under a practical expedient that has never been formally evaluated.

What audit-ready looks like:

- Commission capitalization policy documented, reviewed, and formally approved
- If using the practical expedient: the evaluation is documented, including analysis of contract terms and renewal rates
- If capitalizing: a contract cost asset rollforward prepared each period with amortization schedule by cohort
- Amortization period documented by contract type and tied to the expected revenue recognition period
- Impairment assessment performed each reporting period

What Your Auditors Will Ask For

Document	Purpose
Revenue recognition policy memo	Documents your five-step ASC 606 analysis and the accounting policies that result from it
Contract population listing	Complete list of all in-scope contracts for the audit period
Performance obligation workpaper	Identifies and evaluates distinct obligations in each contract type
Standalone selling price documentation	Supports your SSP conclusions and allocation methodology
Variable consideration workpaper	Estimates, constraint analyses, and true-up calculations by period
Contract modification log	All modifications identified, assessed, and concluded during the period
Contract cost rollforward	Capitalized costs by cohort, amortization schedule, and impairment assessment

Need a revenue recognition policy or technical memo?

VAO CPA helps growing companies build the ASC 606 documentation framework that survives an audit — from policy design through workpaper preparation and ongoing close support.

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