BillingPlatform

5 Common Challenges in Revenue Accounting

and how BillingPlatform's Revenue Recognition solution can solve them

Revenue Accounting doesn't have to be complicated

In principle, revenue accounting comes down to recognizing revenue when realized and earned, not when cash is received. Sounds easy enough if your company sells one-time products, but if your sales involve bundled contracts, it can become more complicated.

Managing contracts with customers likely means you are offering a combination of products and services with varying delivery schedules. Contracts are also open to discounts, changes and renegotiations. Tracking these factors manually can become a significant task and actually lead to errors when recognizing revenue.

To help standardize the process of revenue recognition, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) jointly issued Accounting Standards Codification (ASC) 606 and International Financial Reporting Standard (IFRS) 15, a uniform framework for recognizing revenue from contracts with customers.

The result of this framework is a 5-step process to satisfy the revenue recognition principle. In this paper, we break down the key challenges with the 5 step framework and explain how automation and flexibility can help to overcome these challenges.

Background

The Financial Accounting Standards Board (FASB) issued the new revenue accounting standard in May 2014. The goal of issuing the new revenue accounting standard was to converge the revenue accounting principles under IFRS and US GAAP along with enhancing the revenue recognition framework to improve the comparability and consistency of revenue reporting across organizations.

Per ASU 2014-09, The FASB and International Accounting Standards Board (IASB) pursued development of the new revenue recognition standard for the following reasons:

ASU 2014-09 Summary

Accordingly, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) initiated a joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRS that would:

1. *Remove inconsistencies and weaknesses in revenue requirements.*
2. *Provide a more robust framework for addressing revenue issues.*
3. *Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.*
4. *Provide more useful information to users of financial statements through improved disclosure requirements.*
5. *Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.*

To meet those objectives, the FASB is amending the FASB Accounting Standards Codification® and creating a new Topic 606, Revenue from Contracts with Customers, and the IASB is issuing IFRS 15, Revenue from Contracts with Customers. The issuance of these documents completes the joint effort by the FASB and the IASB to meet those objectives and improve financial reporting by creating common revenue recognition guidance for U.S. GAAP and IFRS.

As described in ASU 2014-09, the core principles of the new standard center around the fact that organizations should "*recognize 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 in exchange for those goods or services.*"

The new revenue recognition standard provides 5 steps to achieve this core principle, whereby:

ASU 2014-09 Summary

An entity should apply the following steps:

- *Step 1: Identify the contract(s) with a customer*
- *Step 2: Identify the performance obligations in the contract*
- *Step 3: Determine the transaction price*
- *Step 4: Allocate the transaction price to the performance obligations in the contract*
- *Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*

Since the issuance of ASU 2014-09, public and private companies alike have invested significant resources towards determining the accounting impacts of the new revenue standard on their financial statements. The transition process from ASC 605 to ASC 606 was challenging for many organizations due to the many complex aspects of the new revenue standard.

Furthermore, business models are constantly evolving, leading to new technical accounting challenges to work through on a recurring basis. This whitepaper explores some of these specific technical accounting challenges and how BillingPlatform's Revenue Recognition solution can deliver flexibility and automation in operationalizing your organization's revenue accounting under the new revenue recognition standard.

ANALYSIS

Step 1: Identify the Contract with a Customer

Per the new standard, a contract from an accounting perspective under ASC 606 is "*an agreement between two or more parties that creates enforceable rights and obligations...In some cases, an entity should combine contracts and account for them as one contract.*"

Specifically, ASC 606-10-25-1 introduces this concept of a contract for revenue accounting purposes. These contracts can be "*written, oral, or implied by an entity's customary business practices,*" and represent a framework for grouping enforceable rights and obligations together in a bundled arrangement from an accounting perspective. Further, the task of grouping enforceable rights and obligations within the construct of a bundled arrangement has important ramifications to the timing, amount and pattern of revenue recognition determined later in the 5 step framework.

BillingPlatform's solution includes Revenue Recognition contracts within the platform, which provides the construct of bundled arrangements for revenue recognition purposes. In addition, a suite of automation features enables the ability to automate the creation of bundled arrangements at scale and remove time-intensive manual processes.

Step 2: Identify the Performance Obligations in the Contract

The next step in the revenue accounting framework includes identifying the distinct performance obligations in the bundled arrangement. Determining which goods and services in the arrangement are distinct requires careful consideration of the following criteria set forth in ASC 606:

ASC 606-10-25-19

A good or service that is promised to a customer is distinct if both of the following criteria are met:

a) *The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).*

b) *The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).*

The primary complexity to cut through here is to determine how the various goods or services in the arrangement should be separated and/or grouped to constitute distinct performance obligations. For example, a SaaS company may sell a software license + server access to a customer. Are the software license and server access distinct performance obligations or should they be combined into one distinct performance obligation?

With a traditional SaaS model, these goods and services are typically combined into one SaaS subscription performance obligation even though they could be different line items on the invoice. This outlines a common challenge whereby the separate goods and services listed in the invoice may be combined or separated into distinct performance obligations differently for accounting purposes than how they are invoiced.

BillingPlatform's Revenue Recognition solution provides the flexibility needed to group products within the construct of performance obligations within each bundled arrangement in the system. The standalone selling price (SSP) for each performance obligation can be easily populated right within the product catalog, with the ability to change the SSP for a particular performance obligation once assigned within specific arrangements. Powerful features such as formula-based SSP calculations can help automate the determination of standalone selling price in situations where SSP for a particular promised good or service changes based on variables such as seasonality, customer type, geographic region, etc.

Step 3: Determine the Transaction Price

Once the accounting team has 1) identified the contract with the customer, and 2) identified the distinct performance obligations with the contract, the next step in the framework requires accounting teams to determine the transaction price of the total bundled arrangement. If you think of performance obligations as buckets, the contract's transaction price is the total amount of revenue for the contract that will eventually be divided up into pieces and placed within each bucket.

Determining the transaction price can become a challenging task depending on the facts and circumstances of the contract and the organization's customary business practices.

ASC 606 defines transaction price as follows:

ASC 606-10-32-2

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both

At a high level, the contract's transaction price constitutes the amount of consideration the organization expects to receive for providing the promised goods and services in the contract.

The transaction price can be impacted by the following items:

- Fixed cash consideration
- Variable consideration
- Nonrefundable fees
- Noncash consideration
- Consideration payable to a customer
- And more…

The key takeaway here is the fact that several factors impacting transaction price (e.g., variable consideration) are estimated by the accounting team based on an evaluation of the particular facts and circumstances of that arrangement. The result of this estimation process may impact the transaction price of the arrangement to be something different than the invoiced amounts.

BillingPlatform's Revenue Recognition solution provides the flexibility needed to capture these complexities while streamlining the process through automation. Expected billings for performance obligations are automatically populated with the fixed cash consideration via data from provisioned products. However, the system also provides the ability to update these values manually or on an automated basis to accurately capture the impacts to the contract's transaction price from the estimation process.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

Once the transaction price has been determined for the overall bundled arrangement, Step 4 of the framework requires the transaction price to be divided up and allocated to each distinct performance obligation in the contract based on a performance obligation's relative standalone selling price in the context of the contract.

ASC 606-10-32-29
To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis

For example, let's say we have a bundled arrangement that includes the following 3 performance obligations:

1) SaaS Subscription (SSP is $10,000, invoiced amount is $9,000)
2) Support Services (SSP is $5,000, invoiced amount is $5,000)
3) Access to premium virtual training (SSP is $1,000, invoiced amount is $0)

There was no challenging estimation needed to calculate the transaction price, so the total contract transaction price was determined to be $14,000 ($9,000 + $5,000 + $0). ASC 606 says we must now allocate this $14,000 amongst the three performance obligations based on relative SSP %. This is done by performing the following calculation:

- SaaS Subscription SSP %: $10,000 / $16,000 = 62.50%
- Support Services SSP %: $5,000 / $16,000 = 31.25%
- Virtual Trainings SSP %: $1,000 / $16,000 = 6.25%

The revenue allocated to each of these performance obligations is then calculated as follows:

- SaaS Subscription Revenue: $14,000 * 62.50% = $8,750
- Support Services Revenue: $14,000 * 31.25% = $4,375
- Virtual Trainings Revenue: $14,000 * 6.25% = $875

Many companies end up performing these calculations manually in spreadsheets, which leads to increased resources/costs to maintain dated manual processes. However, with BillingPlatform's Revenue Recognition solution, these calculations are fully automated in the system while maintaining compliance with ASC 606.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The final step in the revenue recognition model includes recognizing the revenue allocated to each performance obligation in a pattern consistent with the delivery of those performance obligations to the customer. ASC 606 defines this process as:

ASC 606-10-25-23 through 606-10-25-24

25-23 *An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.*

25-24 *For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.*

Based on the guidance above, the two main types of recognition include 1) point in time and 2) over time. There are endless permutations of the timing and pattern of recognition within these two recognition types due to the fact that revenue recognition needs to align with the timing and pattern of how the performance obligation is satisfied.

This is where BillingPlatform's powerful rule-based revenue recognition engine comes into play. Rev rec rules can be created to automate revenue journal entries booked to the GL based on configurable business logic that references any data within the platform to trigger automated revenue recognition entries.

Conclusion

Staying in compliance with the revenue recognition standard requires time and attention. Doing this manually puts the burden on your accounting staff to do this accurately. Regardless of the business model you operate or the revenue generation method chosen, your finance team requires tools that serve the needs of an entire business.

With BillingPlatform, you can comply with the 5-step process laid out by ASC 606 / IFRS 15. BillingPlatform automatically assigns financial transactions and executes revenue recognition in real-time as events happen. Rule-based revenue scheduling gives finance teams the flexibility to automatically allocate transactions to specific GL accounts, not to mention eliminating error-prone and time-consuming manual processes. They can then specify how and when revenue will be recognized. All of which makes it possible for companies to stay compliant and keep their business running profitably regardless of industry, geography or strategic objective.