HOW DO I RECOGNIZE

REVENUE IN MY SUBSCRIPTION BUSINESS?

Managing and tracking revenue has always been an integral part of subscription-based service. Take the most traditional example of a subscription business: a magazine company.

The customer pays their annual subscription fee upfront, and in exchange, the magazine business promises to deliver a new issue to the customer every month for 12 months.

The subscription business model fundamentally changes the nature of the interaction between a business and a customer. The distinction is that a business charges customers a fee in advance for services to be delivered over a period of time. The transaction moves from a one-time exchange of goods for cash to an ongoing cash flow interaction

When a business charges money for a service it intends to deliver in the future, certain accounting rules must be followed to ensure the money is properly accounted. There are revenue recognition rules that must be obeyed.

Revenue Recognition is often known as "rev rec" or sometimes called deferred revenue.

How does revenue recognition work?

Let's take a look at an imaginary business called MovieWatch that offers a video streaming service.

MovieWatch Inc. is a software as a service (SaaS) business that makes movie streaming software. A customer can use MovieWatch to watch movies and television shows.

The business charges a monthly subscription fee of $19.99 as well as an additional setup fee of $100 as a part of its sign-up process.

At the start of each new month, MovieWatch charges its customers another $19.99. As long as a customer continues to pay, MovieWatch will continue to provide access to the service.

On day one, MovieWatch has collected $119.99—the subscription and setup fee for one customer. The money is in its bank account. But not all of this money can be recognized as revenue because the business hasn't yet delivered the services to that customer. If MovieWatch decides tomorrow to stop providing the service, the customer will have paid $119.99 for 30 days of access and only received one day. For such an instance, Financial Accounting Standards Board (FASB) accounting rules require MovieWatch to defer the revenue.

When the customer pays for their first month of service along with their setup fee, MovieWatch needs to account for the service portion of that money by placing the balance in a deferred revenue account. The accounting ledger entries would look this:

Account	Debit	Credit
Accounts Receivable	119.99	
Earned Revenue		100.00
Deferred Revenue		19.99

When the month has passed and the service has been delivered, MovieWatch can finally say it has delivered the service in full. This means it can recognize the full amount of that sale as revenue. The ledger entries would look something like this:

Account	Debit	Credit
Deferred Revenue	19.99	
Earned Revenue		19.99

NOTE: *Different companies could require different revenue recognition rules and may decide to accrue revenue on a daily or monthly basis depending on the level of accuracy required. From a financial reporting perspective, a business should be able to see at any given time how much money it has collected from customers for subscription revenue, how much of that money is still in a deferred revenue account because the service has not been fully delivered, and how much of that revenue has actually been recognized, because a portion of goods or services has been delivered.*

Why is revenue recognition important?

There are a number of reasons businesses should track their revenue according to generally accepted accounting principles (GAAP).

Visibility:
Many small- to mid-sized businesses don't account for deferred revenue because they think only internal parties will ever need to see their financial statements. This overlooks the external parties that might need access to the business's financial statements, such as banks, investors, a board of directors, or minority shareholders.

Business intelligence:
Deferred revenue is a liability, not an asset. This is because it's dependent on a commitment to deliver the business services. Therefore, deferred revenue must be properly tracked to get an accurate picture of a business's revenue and cash flow.

Businesses looking to go public:
Some companies have long-term strategies that include going public. In preparation for going public, a business with subscription services and revenue recognition implications must show financial statements that track deferred and recognized revenue properly.

Clear identification of refunds for canceling:
Although most monthly services are generally non-reimbursed, the same cannot be said for annual subscriptions. By accurately tracking deferred revenue, it becomes possible to handle customer cancellations quickly and efficiently.

Corporate tax calculations:
A company's corporate revenues can be dramatically impacted by the amount of deferred revenue it carries forward into future periods.

ASC 606:
Revenue recognition is the key focus of ASC 606 standards, which determine the specific conditions under which income becomes realized as revenue. These new standards took effect in 2018 for public companies and in 2019 for private companies.

How do businesses implement deferred revenue and revenue recognition?

The approach to managing deferred revenue and revenue recognition depends on the scale of the business and the complexity of the scenarios. In general, businesses tend to take one of four approaches to rev rec management:

Do nothing:
For all the reasons discussed above, this isn't a recommended approach.

Spreadsheets:
Many businesses will use a combination of Excel spreadsheets and sticky notes to track their deferred and recognized revenue. In general, spreadsheets have several issues, including:

- no audit trail
- reliance on formulas
- limited reporting/forecasting capabilities, and
- a "flat" structure rather than data stored in a relational database.

Stand-alone rev rec software:
The output is generally the journal entries to be entered into the accounting/ERP software—either manually or via an import. These tools are often better than Excel spreadsheets, but they only partially bridge the gap to the company's financial statements. In addition, these options can have many high internal costs in terms of initial development and ongoing maintenance.

Integrated rev rec software:
Some accounting packages (Intacct, Oracle, SAP, etc) have built-in revenue recognition modules available. These are tightly integrated to the ERP/accounting system, which provides better overall visibility into transaction history and reporting. However, these systems tend to be costly,
and are frequently out of reach for medium-sized businesses looking to introduce more mature accounting practices.

What's the solution?

Acquiring a recurring billing platform that automates your revenue recognition will help you manage and keep your recurring revenue business on track.

Customized subscription management platforms like Fusebill are specifically designed to help manage and track all aspects of subscription billing, including revenue recognition for subscription models.

Platforms specifically designed to meet the needs of modern, online businesses adopting the recurring revenue model can provide the best balance between cost and benefit.

Fusebill's feature-rich platform has given us a powerful way to seamlessly manage our entire subscription business from billing to account management. Fusebill is the Swiss Army of billing.

CHRIS FOWLER
CoFounder and CEO,
ClearPathGPS

Read the Case Study

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