Ramp Up to the New Revenue Standards in the Subscription World: Zuora

Preparing You for ASC 606 / IFRS 15

ZUORA REVPRO

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Businesses within the subscription sector require a new way of thinking, a new business model. The focus within the SUBSCRIPTION ECONOMY needs to be on long-term recurring customer relationships rather than one-time isolated transactions. Along with that shift comes a whole host of new challenges including new data requirements, pricing structures, price billing models and accounting needs.

The importance placed upon proper measurement and tracking of how your corporation relates to its customers cannot be stressed enough.

Heap upon this the seismic changes required of corporations across the globe in the form of ASC 606/IFRS 15, "Revenue from Contracts with Customers," the newly converged revenue guidance by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), scheduled to be mandatory by the 2017 fiscal reporting period.

All businesses face challenges today in determining how best to compute their revenue. For subscription businesses, those challenges are magnified.

What is Zuora?

Zuora is a Silicon Valley-based technology firm offering an order-to-cash solution for subscription-centric businesses. Your company's product marketing, sales, operations, and finance teams are aided by Zuora's pricing and packaging, quoting, subscriber management, billing, finance and analytics capabilities. Using such offerings, your staff can not only price and package integrated product offerings, but sell across multiple channels and manage throughout the subscription life cycle, including renewals, up-sells, cross-sells, suspensions, add-ons and cancellations.

What is RevPro®?

Zuora recently acquired Leeyo Software and added RevPro to the Zuora product family. RevPro is the most complete revenue management software suite on the market today. RevPro automates and manages every process facing a revenue team, including revenue allocation, revenue scheduling, and revenue accounting.

What is the "New" in the New Standards for Subscription Businesses?

The good news is the existence of these "new" standards requires every company to do a thorough self-examination of business practices and financial systems in order to assess the impact and the potential for changes in how revenue is recognized and recorded. The not-so-good news is this task is no small chore.

Whereas the previous collection of industry-specific standards required four conditions to be met in order to recognize revenue, the new revenue standard introduces a principles-based accounting concept focused on the economic substance of the transaction itself. In sum, revenue must be recognized once promised goods or services are delivered to the customer, regardless of whether the customer has been billed.

For subscription businesses with recurring revenue, the impact of these new guidelines will vary, depending on the specific business model and type of product and/or services sold.

In the new standard, a performance obligation (POB) is defined as the distinct goods or services within the realm of a contract. These are substantially the same with the same pattern of transfer to the customer so that the performance obligation may be satisfied at a specific point in time.

Under current GAAP, one must identify if an element in an arrangement—that is, deliverables in the contract—has standalone value. That element may or may not be the same as the performance obligation in the new guidance. The answer may impact both the timing and amount of revenue to be recognized.

Next, consider usage-based pricing. Within the existing guidance, price must be fixed or determinable. It can be allocated to each unit of accounting. When a customer is charged based on the usage or consumption, it is generally not allocated until realized, which may result in revenue being recorded on the entire arrangement. Under new guidance, you are expected to estimate the variable consideration and allocate the transaction price across the entire performance obligation. Revenue is recognized as each performance obligation is satisfied.

This particular topic remains somewhat muddled at this point in time as FASB continues to review for possible clarifications.

With regard to subscription amendments, the accounting treatment for amendments in the new standard is very prescriptive in nature, as opposed to the lack of clear guidelines for amendments in current standards.

There will be differences when it comes to costs to obtain a contract. Whereas it may be common practice today to expense certain costs to acquire a contract—sales commissions, for example—such costs must be capitalized under new guidance.

Lastly, consider the changes with regard to one-time upfront charges. If you were to have selling price, such revenue would typically be recognized over the life of the initial subscription. Yet, under new guidance, if a customer has a multi-level right to renew such a contract following the initial subscription period, then you may be required to recognize that revenue well beyond the initial subscription contract duration and/or renewal period as well.

In all scenarios discussed here, significant judgment must be applied since many changes are likely to influence your company's financial reporting.

How Best to Address Those Changes?

Given an understanding of at least some of the potential implications of the new standards on subscription businesses, the question you are likely asking yourself is how does one go about addressing these new revenue standards?

Zuora offers two unique revenue recognition solutions that work separately and in tandem.

Zuora's Deferred Revenue Reports

Zuora's platform provides Deferred Revenue Reports out of the box. That means a customer can
- schedule revenue recognition over a period of time,
- trigger revenue recognition primarily based on invoicing and other events,
- report on deferred revenue / earned revenue and generate journal entries.

Businesses using the subscription model understand a subscription lifecycle can have multiple upgrades, downgrades and other amendments which may impact revenue downstream. Zuora automates the process of tracking and accounting for all these events with minimal to no manual intervention.

Zuora provides an open data model and APIs that enable creation of revenue schedules and distributing revenue across accounting periods based upon any invoicing event.

As part of a comprehensive set of feature to automate revenue recognition for subscription-based business models, Zuora is able to display and present the MRR, ratable revenue distributions in both a graphical and tabular format. The process of creating the summary journal entries can be automated so that those entries can be downloaded and imported back using the system of choice.

The RevPro Product Line

Think of the revenue recognition capabilities within Zuora's RevPro as completely configurable, that is, not beholden to a specific customer or business vertical. RevPro provides a complete framework allowing you to configure your RevRec rules from a management perspective or from an allocation perspective.

Just a few of the various configurations supported by RevPro include bundle deals and the ability to allocate between bundles, determination of standalone selling price (SSP) price through a variety of methods as well as the setting and applying of treatments across performance obligations.

RevPro also allows for contract modification and multi-element arrangements—critical pieces of the new guidance —through a set of rules to keep track of contract amendments. Additionally, RevPro provides for the ability to estimate costs, adjust costs and handle other costs related to your commissions, royalties and others based on business case.

The requirement under the new guidance to forecast revenue is handled through RevPro's forecasting module, which uses a state-of-the-art rules engine to project revenue and costs under multiple sets of books.

RevPro provides a solution covering a wide range of revenue recognition situations and options. While many subscription models can be simplified, other companies have varied models, multiple product lines, divisions and geographies that require a very robust solution to automate the revenue recognition process for the entire company. RevPro provides this automated functionality and can simplify and reduce the time needed to accurately recognize complex revenue situations.

The Five Steps—Configured

1. Identify the contract or contracts with the customer
2. Identify the separate performance obligations (POBs)
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize the revenue when a performance obligation is satisfied

This new five-step revenue recognition model is, at this point, familiar to all tasked with transitioning to the new standard. Let's examine each step in the context of specific configuration within RevPro.

Identify the contract

RevPro uses a concept called a revenue contract grouping rule, a key setup used to identify different transaction lines across a deal. RevPro customers use this to identify their radius data points, and within those grouping rules not only specifies data points based on PO number, but also allows for grouping of transaction lines based on incoming events in order to create a new revenue contract deal. Essentially, this would be a first level of grouping within the product.

Identify the performance obligations

The next level of grouping within RevPro is for the performance obligations using the Performance Obligation (POB) Configurator. There are two aspects to this: identify customer needs to determine if the product characteristic is distinct in nature or non-distinct, and then tell the system whether it is at a specific point in time or over time.

Whereas current guidelines allow for release of revenue on a transaction line, the new guidelines don't offer a comparable concept, instead requiring deferral and release of revenue on a POB. Accounting is technically created at the line level, but rolled up at the POB level so that when reporting on all of it, the deferred balance or contract liability balance at that date for a specific POB is visible, giving insight into revenue activity within that month for a specific POB.

Those data points become essential from a disclosure reporting standpoint. The POB, it's treatment and the lines associated with it are included in a 360 degree view of what is happening in and around that particular POB.

Defining the performance obligation templates helps capture information such as revenue triggers, revenue treatment and whether to calculate on a daily basis, partial monthly or fixed monthly schedules.

In addition, RevPro has allowed for cost to be either dependent or independent of revenue assets. As part of the new guidance, a cost practical expedient states if the revenue cycle falls below 12 months, the costs need not be capitalized and can be recognized immediately.

Let's look at some specific scenarios:

Scenario 1: A performance obligation has four lines at the inception of a contract, but a month down the line, a new line comes in from the source system. Based on the grouping rule, that line is expected to be added to the same POB. How does RevPro handle this situation?

That scenario is called a contract amendment, whether it is a new line coming in and getting associated with that POB of the contract or a change of an existing line within the POB. RevPro includes a number of predefined contract amendment rules.

Scenario 2: A price change takes place, and if that price change is only for the future, it can be identified as prospective in nature. Within RevPro, as long as the appropriate allocation method is selected to handle prospective changes, the correct computations will be performed.

Determine the transaction price

At a simple level, adding up the selling price for all performance obligations essentially determines the transaction price. However, given the potential for variables such as retroactive discounts or volume discounts at the contract inception, transaction price may not be clear at that point, or may change over time.

Variable considerations (VC) are a new requirement to factor in with the new guidance, and on a judgement basis. Essentially, discounts need to be estimated upfront as part of the contract. Within RevPro, a VC framework has been defined in which a user may set up the VC type, capturing data points including what the VC is, impact on allocation and accounting, when to accrue and when not to accrue. RevPro provides a framework to upload stratification values. The system will accrue the available consideration and then perform accounting across the application.

Scenario: In a volume discount example, let's say variable consideration has been calculated at the inception of a contract. Two quarters down the line when the volume target has been met, the VC is subject to change.

In RevPro, the adjustments to the VC are tracked, in that the system looks at that particular point in time within that contract for review and to re-book those entries to post back to the GL.

Allocate the transaction price

In the new guidance, vendor-specific objective evidence (VSOE) is in essence replaced by standalone selling price (SSP). RevPro offers an SSP analyzer, which analyzes historical transactions and comes up with a price point for use on allocations. If historical transaction amounts are not available for analysis, RevPro also allows users to upload a price to the system. In addition, RevPro can use a formula-based approach from incoming transaction lines to determine price.

The three methods RevPro uses to determine SSP are the analyzer, manual upload or formula-based SSP.

Recognize the revenue

Once the contract is defined, POBs identified, transaction price determined and variable consideration and SSP calculated, the allocation can be performed. Revenue can be recognized when the goods and services are delivered.

In a typical subscription order, trigger points for revenue recognition are often in the form of an invoice, meaning at the end of the period or simply at the end of a particular date or end of an accounting period, the customer can be billed and the company can recognize the revenue.

RevPro provides a framework within which users define the triggering event. Whether revenue is to be released based on a specific event, amount or quantity, users must define data points to come from upstream systems in order to release the revenue.

Such events are tied back to the POB template, highlighting the fact that performance obligations truly are the heart of the entire revenue contract as that is going to determine the treatment across costs or revenue or any variable considerations coming into the picture.

INPUTS TO REVPRO

RevPro is designed to accept data required for revenue recognition from multiple systems. Whether you are using Zuora's Central platform for order-to-cash, or whether you are using other systems such as, Oracle, SAP, Salesforce etc for order management, RevPro can ingest orders data, billings data, payment data, project data, usage data, payment data etc from one or more upstream systems and automate the process of revenue recognition based on rules that act on that data.