BUSINESS GUIDE

The CFO's Guide to Recurring Revenue: 5 Major Obstacles and the Keys to Overcome Them

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From Software-as-a-Service (SaaS) and movies on demand, to subscription boxes and online memberships, recurring revenue models are changing the nature of business, creating new opportunities for some and disrupting others. The benefits for those able to adapt include improved cash flow and increased valuations.

But implementing a recurring revenue strategy isn't without its challenges. Success requires a steady stream of new customers and the ability to retain them month after month. To do either, you need to have the right people and processes in place, especially in finance, because how you bill customers and when you collect payment have significant implications for accounting.

So whether you're planning a new venture, transforming an established company or trying to develop an additional sales channel, it's important to understand how adopting a recurring revenue model impacts your business.

Accounting Challenges

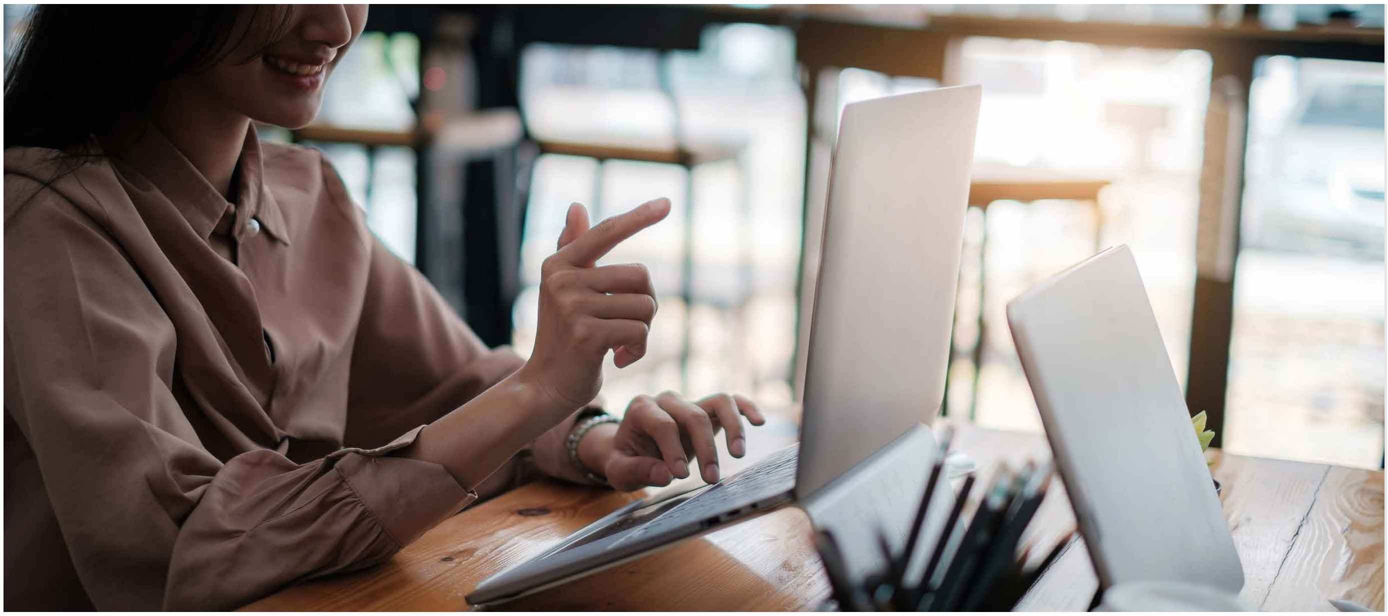
One way that recurring revenue impacts businesses is the complexity it introduces into the accounting process. That includes how it's billed, forecasted, recognized and reported. Here are some of the common challenges:

- Billing Frequency. Adding a source of recurring revenue, such as a subscription offering, changes the billing process. In a traditional sales model, customers receive a fixed number of invoices. They may be billed once, when goods are shipped or incrementally during a project, but the billing cycle has a definite end. In a recurring revenue model, however, customers are billed repeatedly, as often as once per month. This means more work for the accounting team, who now have to generate more invoices more often. Managing this workload becomes harder as the number of subscribers increases.

- Billing Complexity. Applying the correct pricing can also be a challenge. There are several different approaches—fixed rate, volume-based and tiered pricing for instance. Billing may even be based on consumption, like mobile phone service or include a combination of fixed and variable charges. Promotional discounts and trial offers introduce more complexity, as billing needs to reflect start and end dates. Keeping track of this information manually is next to impossible, and legacy billing systems aren't designed to handle all of these variables.

- Forecast Accuracy. One of the attractions of recurring revenue models is that they provide stability by giving companies more consistent cash flow. But they can also add complexity to forecasting models. Multiple pricing plans, promotional discounts and free trials have to be factored into the equation. You not only need to know what existing customers are paying, you'll need to know whether they're paying full price or taking advantage of a free trial or promotional discount. For those taking advantage of free or discounted pricing, you'll also need to know when promotional rates expire and how likely you are to convert them to a full-price plan.
- Revenue Recognition. Revenue recognition is technically challenging and operationally cumbersome for many business. A recurring revenue model can make it even more so—especially for companies that have traditionally sold products rather than services. In the standard product-sales model, revenue can be recognized once control of purchased goods has been transferred from the seller to the buyer. In other words, once an order has been delivered.

  From an accounting standpoint, however, most recurring revenue streams are treated as services. This changes how revenue is recognized, and depending on the billing cycle, means carefully tracking accruals or deferrals. A lot of accountants try to do this in spreadsheets, manually entering revenue numbers into the accounting system at month end. Not only is the approach labor intensive, it also increases the risk of data entry mistakes and other errors.
- Income Tax. Moving to a recurring revenue model can also have tax implications. To comply with generally accepted accounting principals (GAAP), companies must recognize revenue a specific way. GAAP also applies to the treatment of expenses and other financial transactions. The Internal Revenue Service, however, has its own set of rules and they don't always agree with GAAP. As a result, the amount of pre-tax income reported on GAAP-based financial statements isn't necessarily the same as would be reported if tax rules were used instead. Understanding the difference between IRS and GAAP requirements, and how they affect taxes, is essential. Not knowing the difference can be costly.



- Sales Tax. Subscriptions are one of the most common sources of recurring revenue, and historically, few states have collected sales tax on them. This is changing, however, as companies in more industries begin transitioning to subscription-based business models. For instance, a number of states now require sales tax on Software-as-a-Service (SaaS), and the list of those that do is growing. This is a heavy burden for companies that aren't used to collecting sales tax. Not only do the rules on what is and isn't taxed vary from state to state, but the rate varies as well. Keeping track of these details and ensuring that the correct rates are applied is extremely difficult, especially when you're using spreadsheets to do it.

Overcoming the Challenges

There are different ways to deal with the challenges that recurring revenue can create for the accounting department and beyond. They can include new processes, software and understanding the latest regulations. Here are some of the most important steps to overcoming the challenges of revenue recognition:

- Automate the billing process. Recurring revenue will significantly increase the volume and complexity of billing processes. To address these challenges, organizations should begin by automating subscription and billing management. Automation simplifies the billing process and, with the right system, puts subscription and billing data in one place, improving data quality and helping ensure accurate billing.

  Subscription plans that combine flat monthly rates with variable charges or one-time fees can create billing nightmares that immediately impact the customer experience. Billing problems can be one of the most frustrating for customers. An effective billing management solution should support multiple pricing options, including fixed and consumption-based rates, with the ability to customize rate plans for individual subscribers.

- Improve KPI tracking. When forecasting is difficult, incorporating additional metrics can make it easier to evaluate business performance. Monthly recurring revenue (MRR) is an important KPI. There are many ways to evaluate MRR. Understanding the ratio of revenue from net-new customers and upgrades versus revenue lost due to downgrades or cancelations, for instance, can improve forecasting. Monitoring how the ratio changes from month to month also provides an early warning sign of potential trouble. Tracking changes in monthly churn rates, customer acquisition costs, average customer tenure and average revenue per account will also provide insights into future performance.

- Simplify revenue recognition. Perhaps the most well-known challenge is properly recognizing revenue according to current accounting standards. ASC 606 has provided more uniform guidance for reporting revenue, regardless of the industry in which a company functions, which has helped simplify financial statement presentations and provided more comparability across industries and capital markets. Having rules set up in the accounting software to implement this guidance is crucial—and legacy software isn't always set up to handle it.

- Evaluate GAAP and IRS rules. The easiest way to see how different accounting options affect financial results is generating two income statements, one based on GAAP and one using IRS rules. For the greatest accuracy, both rulesets should be applied to each transaction. If recording every transaction twice isn't feasible, then using a subtotal will work in some cases. Where there are significant differences, however, entries will need to be duplicated. Depreciation is just one example where this may be necessary. Reentering even a limited set of transactions manually is inefficient and increases the risk of data entry errors. An accounting system that does this automatically is ideal.

- Automate sales tax collection. Because of the complexity of sales tax rules, it's crucial to automate the process as much as possible. Managing sales tax calculations with your accounting system will save time and increase accuracy. Some solutions also keep tax codes up to date and automatically exclude tax-exempt customers from sales tax.

Managing Recurring Revenue With NetSuite

Adding a recurring revenue stream has a lot of potential upside, but it's not without challenges. Success requires fundamental changes across the organization, especially for accounting. Legacy systems can't support the complex requirements of today's subscription economy. And relying on manual, spreadsheet-based processes is both inefficient and error prone.

NetSuite is a unified system that helps companies overcome these challenges with an accounting solution designed for recurring revenue business models.

By automating labor-intensive billing processes, for instance, NetSuite SuiteBilling eliminates many of the repetitive tasks accounting staff dread. This reduces their workload and leaves more time to focus on higher-value activities. And because recurring revenue often involves complex rating scenarios, SuiteBilling supports transaction, subscription, usage-based and hybrid pricing models. So instead of relying on spreadsheets or another application to calculate invoice amounts, these calculations are performed by the accounting system, reducing the risk of pricing errors and billing disputes.

As with billing, revenue recognition can be complicated when recurring revenue is involved. Depending on the goods and/or services being provided, how those goods and services are delivered, and how customer agreements are structured, revenue from a single contract might be recognized all at once, over a few months or stretched out for several years. Developing a separate revenue recognition schedule for every customer isn't scalable. With NetSuite Revenue Management, revenue rules are created for each product or service a company offers and then linked to the individual line items in a contract. Revenue is then recognized automatically based on the assigned schedule for each item, helping improve compliance by ensuring revenue rules are applied consistently. And because Revenue Management is on the same platform as NetSuite's other solutions, the close process runs more smoothly.

NetSuite also simplifies many tax calculations. With multi-book, companies can easily evaluate different accounting models by creating a separate book for each set of standards they want to apply. NetSuite automatically posts transactions to the appropriate books simultaneously, so accounting personnel no longer have to enter data multiple times or make manual adjustments. And NetSuite's sales tax solution, SuiteTax, helps businesses meet complex tax collection and reporting requirements, reducing the risk of errors by automating sales tax calculation. SuiteTax also improves accuracy by keeping sales tax rates up to date and using nine-digit postal codes (ZIP+4) to ensure the correct rate is applied to each transaction.

The growth of subscription-based services is leading more organizations to look for ways to add recurring revenue to their business model. NetSuite's cloud-based financial management solutions can make this transition easier by helping companies operate more efficiently, ensure accuracy and compliance, and build stronger, longer-lasting customer relationships.

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