THE ULTIMATE GUIDE TO ASC 606

Chargebee RevRec

Overview

This white paper helps you decipher the complexities of ASC 606 and understand what it means for your company using a 3-pronged approach.

Understanding ASC 606

First, on the technical front, we clear up the ambiguity in the Five-Step Model outlined in the standards and technical components of each step. Understanding these five steps is essential, so we've taken the technical language into a simple "what does it mean?" format.

If you are already familiar with the technical aspects of ASC 606 and don't need a refresher, **click here** to go directly to the Implementation Challenges of ASC 606.

Implementation

Secondly, we address the implementation challenges imposed on corporate accounting and finance teams. Implementation goes beyond a technical understanding of the standards. It focuses on the day-to-day tasks of capturing contract data, applying the five-step framework, recognizing revenue, and, more importantly, having the right tools and automation to track and report revenue transactions.

In this white paper, we offer a practical resource of what you should expect and identify the challenges companies face in complying with the new standards.

Automating ASC 606 Revenue Recognition

Finally, we discuss why spreadsheets fail as a means to automate revenue recognition and set the stage for what it takes to be a genuinely automated ASC 606 solution.

Section 1

ASC 606 Revenue Recognition Overview

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While the standards apply to all companies with varying revenue types, this paper focuses on the software, software-as-a-service (SaaS), and subscription + other revenue types such as services or hardware (SaaS+). As with all GAAP standards, the purpose is to provide principle-based rules that attempt to align the recognition of revenue with the timing of when products and services are transferred to customers.

The standards define rules for how overall contract revenue for a customer gets allocated among the “performance obligations” outlined in the contract. Though this may seem intuitive and straightforward, it is a significant change to how SaaS companies operate, manage revenue, and ultimately value their companies.

The standards outline a five-step process:

Identify the contract(s) with a Customer

Identify the Performance Obligations in the Contract

Determine the Transaction Price

Allocate the Transaction Price to the Performance Obligations in the Contract

Recognize Revenue When (or as) the Performance Obligation is Satisfied

Most companies find steps 1 & 3 easy - identifying the elements of a contract and determining the transaction price. The challenge typically comes with steps two and four due to technical considerations:

Identifying the performance obligations in the contract: This requires evaluating the promises in a contract and determining which promises represent separate and distinct performance obligations. For example: In cases of bundled arrangements, all product and service offerings should be considered in identifying separate performance obligations.

Allocation of transaction price: This requires allocating the transaction price to each separate and distinct performance obligation. The stand-alone selling price (SSP) for each performance obligation is used to allocate the arrangement fee and is determined based on data such as historical sales, marketplace information, or management estimates and is crucial to comply with ASC 606.

The next section will outline each step and explain what it means for a SaaS+ company. It's important that you collaborate with your independent auditors as you establish your company's accounting policy for ASC 606. This will mitigate the risk of year-end surprises.

5 Steps of ASC 606 and What They Mean

1. Identify the contract(s) with a customer

What it says:

- Parties must approve and be committed to contract terms.
- The party's rights to goods and services are identified.
- Payment terms are identified.
- The contract has commercial substance.
- Evaluation of the probability that the entity will collect the consideration it is entitled to.

What it means:

Most companies' policies and processes will comply with the requirements of step one.

> Most of it is common sense. Does a signed agreement exist? Have you committed to providing products or services? Do you have a reasonable likelihood of getting paid?

Although this seems straightforward, some circumstances may add complexity (e.g., modifications, multiple contracts treated as a single contract, free trials, handling upgrades, and add-ons) to the situation. SaaS+ companies will need to look at their standard contract clauses and pricing structures to determine whether they impact this step.

2. Identify the Performance Obligations in the Contract

What it says:

- The revenue recognition standard defines a performance obligation as a promise in a contract with a customer to transfer a good or service to the customer.

- At contract inception, an entity should assess the goods or services promised in a contract with a customer and identify them as a performance obligation (this could be multiple performance obligations). Each should be:

    a. **Distinct** – The customer can benefit from the goods or services.
    b. **Separable** – The promise to transfer goods or services is separately identifiable from other promises in the contract.

What it means:

This is a critical concept of ASC 606 and is at the heart of the implementation of the standards for two reasons:

- The bundling of multiple products and services ("performance obligations") within a single contract (e.g., sales order).

- The negotiated pricing of the multiple products and services is included in the contract.

It's common for a single contract to include multiple products and services. For example, a SaaS+ company may typically offer implementation and training as part of its subscription offering. This would represent various line items in a contract and multiple performance obligations. Contract line items that are distinct and separable often will be satisfied at various times.

Understanding and recognizing each performance obligation is critical since revenue is not earned until the performance obligation is met.

3. Determine the Transaction Price

What it says:

- The transaction price is the amount of consideration (e.g., fees) which the company expects to receive in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., sales taxes.)

- To determine the transaction price, an entity should consider the effects of:

    a. Variable consideration
    a. Constraining estimates of variable consideration
    a. Existence of significant financing component
    a. Non-cash consideration
    a. Consideration payable to the customer

What it means:

In general, these are the total fees for performance obligations to be satisfied during the term of the contract. In other words, include everything you expect to receive from the customer. A major sticking point for many SaaS+ companies is “What constitutes the contract term?” Just because a contract says it’s a one-year term doesn’t mean it’s truly one year. If there’s no or very limited deterrence for the customer to terminate during the contract term, then it’s likely not a one-year term. Complexity is also added for arrangements that include discounts, rebates, and other variable considerations.

4. Allocate the Transaction Price to the Performance Obligations In the Contract

What it says:

- If a contract has more than one performance obligation, an entity should allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation.

- To allocate an appropriate amount of consideration to each separate and distinct performance obligation, an entity should determine the stand-alone selling price at contract inception of the distinct goods or services underlying each performance obligation.

- Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period(s) in which the obligation is satisfied.

What it means:

Let's look back at step two, where we determined the distinct and separate performance obligations.

Once the distinct and separable performance obligations are identified, the amount of revenue to be recognized (when the obligation is met) must be determined for each such performance obligation.

This is not as simple as identifying the multiple performance obligations included in the contract and recognizing revenue based upon the contract price.

> This is due to the fact that multiple performance obligations are often included in a single contract. During the negotiations, these performance obligations may be “bundled” and offered at a combined price in a single contract.

It’s routine during the negotiations to offer discounts for multiple years, multiple services or simply to land the deal. If bundled items are discounted, the standards require the seller to allocate the discount to each product and service offered. The standards do not rely on the price for each item as outlined in the contract.

The idea is to allocate revenue across performance obligations based upon “Stand-Alone Selling Price” or “SSP”. SSP is the price a customer would pay for a product or service if sold by itself. The price is determined through the analysis of historical data. It’s normally estimated by management but ultimately, outside auditors must be in agreement with the Stand-Alone Selling Price for each product and service and agree with the methodology to determine its price.

Using SSP, a company is then able to allocate the transaction fees to a product or service based upon a relative selling price allocation. This essentially allocates the discount in an arrangement to each performance obligation based upon its SSP. This is done on a pro-rata basis.

For example

Product A	$10,000
Product B	$5,000
Service 1	$8,000
Service 2	$7,000
Total Contract	**$30,000**

Each of these represents a distinct and separate performance obligation. As mentioned, it may be improper under ASC 606 to simply recognize the income for each product and service as the obligation is met based on the contract price. Instead, the fee must be allocated based upon the Stand-Alone Selling Price for each distinct and separate performance obligation.

Using the items included in the Contract Example above, assume that the Stand-Alone Selling Price (SSP) for each of these items are as follows:

Performance Obligation		Percentage of Relative Stand-Alone Selling Price
Product A	$14,000	38%
Product B	$7,000	19%
Service 1	$9,000	24%
Service 2	$7,000	19%
Total Contract	**$37,000**	**100%**

In this example, the total price of the items if sold on a stand-alone basis would be $37,000 while the contract price is $30,000.

Under ASC 606, the total contract price must be allocated to each of the products and services offered based on its pro-rata relationship with the SSP for each of these products. As a result, the income to be recognized for each item is as follows:

Revenue Reallocation	
Product A	$11,400
Product B	$5,700
Service 1	$7,200
Service 2	$5,700
Total Contract	**$30,000**

Notice that the allocated revenue to be recognized equals the total contract price. This should always be the case.

Now, let's look at the contract price compared to the allocated revenue to be recognized under ASC 606.

Contract Revenue		Price Reallocation
Product A	$10,000	$11,400
Product B	$5,000	$5,700
Service 1	$8,000	$7,200
Service 2	$7,000	$5,700
Total Contract	**$30,000**	**$30,000**

As you can see, the revenue to be allocated for each line item is different from the price included in the contract.

The allocation of the contract price as determined in step four is the revenue that will be recognized in accordance with the requirements in step five. And as we will see in step five, depending on how and when the revenue is recognized, revenue in any particular period can be significantly impacted.

5. Recognize Revenue When (Or As) the Entity Satisfies a Performance

What it says:

- Revenue is recognized when/as an entity satisfies each performance obligation.
- Satisfaction occurs when control of goods/services transfers to the customer.
- Control is the ability to direct use of and obtain all remaining benefits from an asset (or prevent others from doing so).
- An obligation is satisfied over time if it meets one of the following criteria:

    a. The customer receives and consumes the benefits as the entity performs (as described in FASB ASC 606-10- 55-5 through 55-6).
    a. The performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
    b. The performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

- If the obligation does not meet any of the criteria to satisfy a performance over time, the obligation is satisfied at a point in time.

What it means:

In step four, the amount of revenue to be recognized is allocated to your identified performance obligations. Step five outlines when (during the term of the contract) the revenue will be recognized.

Generally, revenue is either recognized pro-rata over the term of the contract, point in time (e.g. delivery of software or equipment), or on an input basis (i.e. proportional performance) or output basis (units delivered) .

If you are delivering an asset and have no further performance requirement after the transfer of that asset to the customer, you will be recognizing revenue at a point in time.

> The best way to think of this is to ask yourself "How are you satisfying your performance obligation and is the obligation completely or partially satisfied?"

In summary, ASC 606 follows a clear path of identifying a contract, identifying the performance obligations of the contract, determining the contract price, allocation of the performance obligations based on Stand-Alone Selling Price, and finally, recognizing the income as the obligation is satisfied.

Sounds simple when boiled down into the individual components, but there are technical challenges as well as operational challenges. Once the technical issues are resolved, companies must deal with the excruciating details of implementation.

Section 2

Implementing ASC 606

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As companies move from understanding ASC 606 and determining the technical components of revenue recognition, the next step is implementing the requirements into the day-to-day processes of the accounting department.

Detailed Steps

New Contracts/Sales Orders:

- Gather Relevant Information
- Monitor Existing Contracts for Modifications

Accounting Function:

- Analyze Contract Details
- Apply Revenue Recognition Rules
- Determine the Revenue to be Recognized
- Record the Revenue Earned
- Determine the Commission to be Capitalized or Expensed
- Record the Commissions
- Track Balance Sheet Accounts
- Determine the Impact of Modifications and Cancellations
- Assess the Reasonableness of the Established Stand-Alone Selling Price
- Support the Year-End Audit

These are the activities that need to be considered each accounting period for proper recognition. Individually and collectively, these steps take time and are often difficult to manage.

Let's look at each individual step and the challenges they present.

New Contracts/Sales Orders

Gather Relevant Information – The information needed for revenue recognition resides in various departments and frequently within multiple systems. Gathering this information is normally time-consuming. Often, schedules are created to track the financial impact for input into the company's accounting package. This information includes the following items:

- Contract Price
- Commission Earned
- Contract Terms (Length of Contract)
- Performance Obligations of the Contract
- Performance Obligations Satisfied During the Current Period
- Relevant Contract Clauses (e.g., Termination) to Evaluate Impact

Monitor Existing Contracts — Changes to existing contracts must be identified and the impact of these changes must be evaluated for proper treatment in the current period. This may include cancellations of contracts, merging of contracts, etc.

Accounting Function

Analyze Contract Details – This review identifies the separate and distinct performance obligations. However, there are other things to consider. For example:

- Billing Schedule
- Discounts
- Free Trial Periods
- Multi-Year Contract
- Tiered Pricing Schedules

Each of these items can impact the revenue recognition under ASC 606 and each has nuances under the standards.

Apply Revenue Policy to Transactions – A company's revenue recognition policy consists of procedures to apply to revenue transactions to identify performance obligations, allocate the arrangement fee and recognize revenue. These rules are determined by management and should be reviewed by the company's independent auditors.

Accounting for revenue transactions is time-consuming and error-prone when you consider the fact that all products and services in a contract must be cross-referenced to match the revenue recognition policy.

Determine the Revenue to be Recognized – as previously mentioned, ASC 606 may require a "reallocation" of revenue when you conclude there is more than one performance obligation. In these instances, ASC 606 does not follow the pricing as outlined in the contract. Rather, any discount is allocated across the performance obligations based upon the Stand-Alone Selling Price of each item. In addition to the impact of "bundling", the revenue to be recognized can be impacted by the term of the contract. For example, assume the following:

A noncancellable 36-month contract provides a discount in the first year and an escalation in the third year.

Revenue	
Year 1	$6,000
Year 2	$14,000
Year 3	$16,000
Total	**$36,000**

In this example, the total contract price for the 36-month contract would be amortized over 36 months resulting in monthly revenue of $12,000 per month. Notice that this amount is different from simply amortizing each year's amount over 12 months.

To understand the challenge, consider tracking revenue to be recognized when you have the following:

- Multiple Customers
- Multiple Contracts with Multiple Products and Services
- Multiple Contract Terms
- Discounts

Record the Revenue to be Recognized – Once the revenue to be recognized is determined, the revenue must be recognized at a point in time or overtime in the proper accounting period.

This is based on the Revenue Recognition Policy established by management. Let's review an example of allocating the arrangement fee over multiple performance obligations:

Contract			
Item	Price	SSP	Reallocation
Subscription	$10,000	$14,000	$11,400
Hardware	$5,000	$7,000	$5,700
Implementation	$9,000	$7,200	$8,000
Training	$7,000	$7,000	$5,700
Total	**$30,000**	**$37,000**	**$30,000**

Notice that the contract price equals the re-allocated revenue. Also, notice that the revenue associated with the multiple products and services under ASC 606 are different. Since revenue for each of these may be recognized differently, this impacts the timing of the revenue recognized. In this example assume the following:

- Subscription revenue is recognized on a pro-rata basis over the term that services are provided.
- Hardware revenue is recognized when the hardware control passes to the customer (often times when shipped).
- Implementation and training revenue is recognized as performed.

As the performance obligation is satisfied, the revenue is recognized in that period. As a result, you will need important information such as:

- Start date and end date of the contract
- The shipping date of the hardware
- Information related to implementation and training (e.g. hours)

With this information, you can determine the revenue to be earned for each performance obligation and record such revenue to your accounting system.

Determine the Commission to be Expensed — ASC 606 requires that companies identify the costs incurred to obtain a contract, such as commission expense. Costs that are determined to be properly deferred under ASC 606 must be tracked and recorded in the proper period to each line item and the expense recorded as the revenue is recognized. The goal is to better match commission expenses to the associated revenues.

Record the Commissions to be Expensed – The recording of commission expense is determined by your revenue recognition rules. In general, commissions associated with subscription revenues are expensed over the average life of a customer.

This average life is determined by historical data and reviewed by your outside auditors. However, it is one more item to track and record to ensure compliance with ASC 606.

Track Balance Sheet Accounts – In general, balance sheet items related to revenue are created when invoicing for your services does not match the period when revenue is actually earned.

As a simple example, assume that a customer purchased only one item (an annual subscription) and has agreed to be invoiced annually for $10,000. When the first quarter invoice is billed, no services have been performed. As a result, the following entry is made:

Accounts Receivable	$10,000	
Unearned Revenue		$10,000

Each month, as revenue is recognized, an entry is made to recognize revenue and reduce unearned revenue:

Unearned Revenue	$833	
Revenue		$833

On an individual basis, this is easy to track. However, with multiple customers, this task becomes more difficult. Now let's add in the complexity of ASC 606.

Invoicing terms are based on the sales price stated in the contract; however, under ASC 606, the revenue recognized on a particular line item may not be the same as stated in the contract and not the same as the invoice sent to the customer. If we look at the example above, we can illustrate the challenge:

	Contract Price	Re-allocated Revenue
Subscription	$10,000	$11,351
Hardware	$5000	$5,676
Implementation	$8000	$7,296
Training	$7000	$5,677
Total Contract	**$30,000**	**$30,000**

If we just look at the Subscription portion of the contract, the following entry is recorded:

Accounts Receivable	**$10,000**	
Unearned Revenue		**$10,000**

At the end of the month, one month of subscription services have been provided. But the one month of revenue is NOT 1/12th of the contract price, rather it is 1/12th of the "re-allocated" revenue (under ASC 606):

Unearned Revenue	**$945**	
Revenue		***$945**

*$11,357/12 = $945

Further looking at the example, the revenue recognized for the items (e.g. hardware, implementation, and training) will recognize revenue that is different from what is invoiced according to the contract sales price. When all of the products and services are delivered, the total amount invoiced will be $30,000 and the revenue recognized will be $30,000.

We have simplified this example for illustrative purposes but each of the line items must be tracked and their revenue needs to be recorded differently than what is stated on the contract. This tracking and reconciliation are not simple tasks.

Determine the Impact of Modifications and Cancellations — Each of these items directly impacts the monthly journal entry for revenue recognized and deferred revenue. The actual impact is based on the terms of the contract and your company's policies, but each of these items must be monitored and their impact evaluated.

Assess the Reasonableness of the Established Stand-Alone Selling Price — Stand-Alone Selling Price is an estimate. It's based on historical sales data. As markets for certain products mature, the estimated Stand-Alone Selling Price can also change. Companies must monitor actual sales to the estimated SSP and make adjustments when appropriate.

This entails a review of all contract prices of items sold compared to the established Stand-Alone Selling Price and is something that your outside auditors will want to review.

Support the Year-End Audit — Yes, the dreaded audit preparation. Revenue recognition is one of the highest risk areas for auditors, so expect your auditors to dive deep into what you have done. All of the items discussed thus far have implications for the auditors. They will want to see sample transactions to ensure proper compliance with your revenue recognition rules and ASC 606. It may only be once a year (if you are lucky), but it can feel like an eternity.

Summary

In this section, we properly acknowledge what many are forgetting — that understanding ASC 606 from a technical perspective is one thing, but understanding the implementation challenges is a whole different ball game. Consider the responsibilities of the accounting and finance team outlined thus far. Add to its management's need for key metrics and analytics and welcome to "ASC 606 Hell"

Section 3

Real Automation is Key

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If this does not make your head spin, it will make your finance team's head spin. After all, they are tasked with handling financial reporting. Unfortunately, it's the CFO that is held accountable if it does not happen correctly.

Think of these steps—including maintaining a massive spreadsheet—as "moving parts." In our house, we do not buy gifts with lots of moving parts because moving parts break. The more moving parts, the more likely something will fail.

So, the goal of efficiently complying with ASC 606 is to focus on eliminating moving parts.

This is where automation comes in. By automating the revenue recognition process, companies save time and money, in addition to significantly reducing the risk of errors.

Automation

There are several steps that can be automated. In fact, all of the detailed steps listed above can be automated. But beware—not all "automated solutions" are automated. Many solutions focus only on the allocation of the contract price after you have determined the allocation outside of the solution. As such, these solutions still require you to

- Gather the information needed for new bookings and modifications.
- Identify the distinct and separable performance obligations.
- Cross-reference these items to the Stand- Alone Selling Price.
- Manually allocate the revenue to each performance obligation.

All of this information must be manually entered for new orders, and existing orders must be manually updated for current period activity, modifications, and cancellations.

Spreadsheet-based Automation

Companies that attempt to tackle this through spreadsheets and memorandum are in for a big surprise. We always tell people, “Spreadsheets never start out complicated. They just end up that way.”

In this case, this spreadsheet starts out complex and inherently becomes more complex with each sales order.

In addition, spreadsheets present a number of other issues that cannot be overlooked, such as:

- They are normally created and managed by one person, causing chaos if this person leaves or changes positions.
- They are subject to human error and/or manipulations.
- TFormulas can change or be wrong, making it difficult to check and for auditors to audit.
- Spreadsheets have limited reporting capabilities. All of this information is in the spreadsheet, but it is hard to pull meaningful, dynamic reports.

The following infographic highlights only a few of the challenges that are presented with data recognition in spreadsheets:

Anatomy of a Data Recognition Spreadsheet

1 Companies have lots of customers

Sales orders

2 Customers generate lots of sales orders

Line Item	Line Item	Line Item
Line Item	Line Item	Line Item
Line Item	Line Item	Line Item

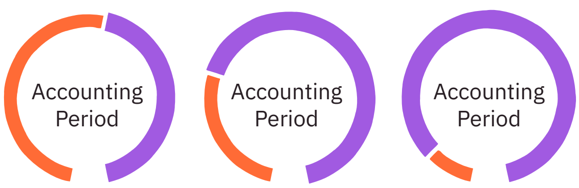
3 Sales orders have lots of line items

Stand Alone		Stand Alone	
Line Item	xxxxx	Line Item	xxxxx
Line Item	xxxxx	Line Item	xxxxx
Line Item	xxxxx	Line Item	xxxxx

4 Line items must be matched to lots of products and services

Sales Price Allocation

5 Revenue must be tracked and reorganized over lots of periods



6 Revenue must be tracked and reorganized over lots of periods

Real Automation

A real automated solution one which does the following:

- Automatically update when a new order is received or when an order is modified or canceled.
- Identify the products and services offered in each contract and automatically populate the Stand-Alone Selling Price and revenue recognition.
- Calculate the revenue to be recognized based on this information.
- Allocate the revenue to distinct and separate performance obligations
- Automatically pull the services performed during the period and recognize the revenue in that period.
- Create a journal entry that recognizes revenue and the changes in the deferred revenue and unbilled receivable accounts.
- Track active sales orders and generate revenue forecasts.
- Easily handle modifications and cancellations.
- Track and alert internal teams of contract renewals.
- Efficiently utilize all of the information that it has to generate customizable reports for management.

How Chargebee RevRec Solves Your ASC 606 Pain Points

To help you better understand how Chargebee RevRec provides these benefits, allow us to share with you some background and features of Chargebee RevRec:

- Developed by accountants based on the real-life challenges that our clients were experiencing. We have consulted and led the implementation and audited ASC 606. We know what the issues are.
- Commitment to full automation. Our goal is to eliminate spreadsheets and manual input, and as a result, reduce the risk of human error.
- Built on an open API platform that allows our software to pull the information from wherever it resides. This can be done through integration or through the export of the data to an excel spreadsheet, which is then uploaded. (Sometimes, IT people get nervous when outside vendors tie directly into their systems. We understand!)
- Stand-Alone Selling Price Library™ is populated with all of your products and services, the Stand-Alone Selling Price for each of these products and services, and the proper revenue recognition Methodology.
- When a new order is identified, Chargebee RevRec automatically matches the product or service to information in the Stand-Alone Selling Price Library™, eliminating the need for cross-referencing.
- Calculates the revenue to be recognized for every line item on every contract.
- Chargebee RevRec is able to pull information from your project management system to recognize revenue based on the performance during the period.
- Our algorithms identify changes in the price, contract dates, items included in a contract, and other modifications and updates.
- The Chargebee RevRec reporting package provides dynamic reporting capabilities. All the information is there—Chargebee Revrec ensures it is used effectively.
- We know that implementation must be simple and have developed the fastest implementation process in the industry. You really need to see it for yourself.