



**ASC 606 AND SUBSCRIPTION BUSINESSES—
WHY COMPLIANCE CAN'T WAIT**

THE RULES ARE CHANGING

Revenue is the key indicator of your company's financial performance and health. That's not news. What is news? The accounting rules you must follow to recognize and report on that revenue are about to change. ASC 606 creates a major shift in how your business handles its accounting—particularly if you have a subscription-based business that derives revenue from contracts with customers.

What's the big deal? For starters, the impact of the change extends beyond a mere tweak to your accounting methods. It necessitates changes to your tracking, processes, and internal controls. The purpose of this guide is to highlight the basics of ASC 606, what it means for your business, and the risks of not taking action.

For a more detailed overview of how to plan your path to compliance, be sure to read *Regulation Roulette: Part II: Six rules for ASC 606 readiness*.



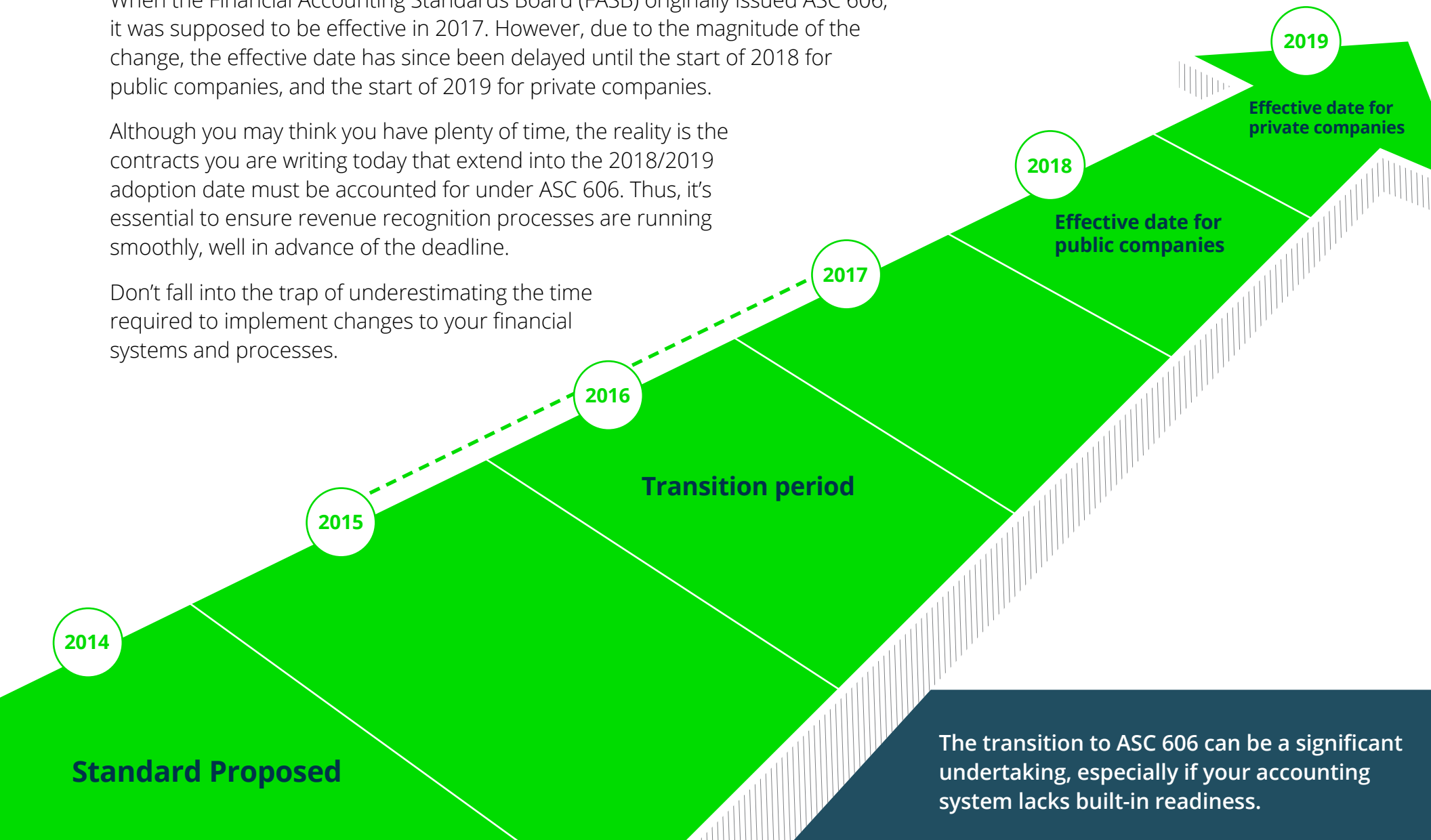
You might also hear about IFRS 15—the international standard that has similar implications to the U.S. standard, ASC 606.

IT'S GO TIME

When the Financial Accounting Standards Board (FASB) originally issued ASC 606, it was supposed to be effective in 2017. However, due to the magnitude of the change, the effective date has since been delayed until the start of 2018 for public companies, and the start of 2019 for private companies.

Although you may think you have plenty of time, the reality is the contracts you are writing today that extend into the 2018/2019 adoption date must be accounted for under ASC 606. Thus, it's essential to ensure revenue recognition processes are running smoothly, well in advance of the deadline.

Don't fall into the trap of underestimating the time required to implement changes to your financial systems and processes.



The transition to ASC 606 can be a significant undertaking, especially if your accounting system lacks built-in readiness.

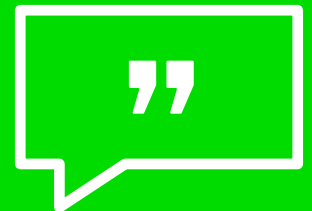
IMPLICATIONS OF THE NEW STANDARD

Whether you are seeking additional funding, planning an acquisition, or planning to go public, the new standard has the potential to reshape your revenues and valuation.

Subscription-based businesses must take special care with ASC 606. The standard has broad ramifications based on how you structure your agreements with customers—the terms, bundling, discounting, and more.

“Since [ASC 606] requires significantly more extensive disclosures, technology entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.”

-Deloitte



WHAT MAKES YOU SO SPECIAL?

If you have a subscription-based business, you likely enter into complex contracts and agreements with customers. The new standard requires your company to capture and report on this information, which your accounting system may not currently track. As a result, you need to identify and remedy critical data gaps.

Five factors that make ASC 606 tricky for subscription businesses:



1. Contracts

Multiple agreements, modifications, and renewals



2. Payment terms

Variable discounting and special renewal terms



3. Collectability

Minimum thresholds for collectability, reseller arrangements



4. Fees

Including activation and added services



5. Expenses

Sales commissions and royalties

FIVE STEPS TO RECOGNIZE REVENUE

Preparing your business for the shift will be a time-consuming process—especially if your accounting system lacks built-in readiness. Anticipate significant time and resource contributions on the part of your management, accounting, and IT teams. The good news is, the earlier you identify the implications of the new standard, the better positioned you will be to ease the transition.

FASB has issued guidelines for what your business must do to adopt the new standard. You can see the details for each of these steps on the following pages.



1

IDENTIFY CONTRACTS AND THRESHOLDS

For the purpose of revenue recognition, the new ASC 606 standard requires businesses to treat multiple related contracts with customers effectively as one contract.

In addition, you'll need to track the likelihood that the revenue in a contract will actually be collected. You can't recognize this revenue until it meets the collectability threshold—or the contract is amended.

Bottom line:

Under ASC 606, your accounting system now needs to be “contract-aware,” ideally with contract management capabilities built into it. You'll need to be able to look at the group of contracts pertinent to a customer and have clear transparency when the need arises.

2

MANAGE PERFORMANCE OBLIGATIONS AND RENEWALS

A performance obligation is a promise to deliver a good or service. Identifying performance obligations has an important impact on when and how much revenue will be recognized.

The ASC 606 criteria for determining whether a good or service is a performance obligation include:

- 1. Capable of being distinct:** The customer can benefit from the good or service either on its own or together with other resources that are readily available.
- 2. Distinct within the contract:** The promise to transfer the good or service is separately identifiable from other promises in the contract.

Bottom line:

You need to establish uniformity in how you handle performance obligations and renewals. Once again, contract intelligence and automation in the accounting system is essential, so those revenue recognition terms can be flagged, separated if necessary, and allocated accordingly.

2

PERFORMANCE OBLIGATION EXAMPLE

Before we address Steps 3-5, let's pause to examine how a software company might identify performance obligations in a contract.

Let's assume: You enter into a two-year contract to deliver a software subscription. The contract also has a services component as a standard part of your delivery and it requires significant customization and modification to the product.

- Since the software license cannot function as agreed to without the customizations, you may need to treat the subscription and services as one arrangement under the new rule, not separate arrangements.
- Similarly, if add-ons and technical support are delivered as part of the subscription, you likely will need to treat these as related arrangements as well.

In this case, you would recognize revenue for the subscriptions, services, add-ons, and support together.

3

DETERMINE THE TRANSACTION PRICE

For most businesses, the transaction price is basically what the company expects to be paid in exchange for its goods or services. For companies with complex contracts and terms (like subscription companies), matters become more difficult under ASC 606. Establishing processes and controls around valuation methods will become critical. Common variables that affect transaction prices include:

- Refunds
- Credits
- Rebates
- Penalties
- Performance-based incentives
- Customer-specific terms
- Bundling discounts
- Flexible financing

Bottom line:

Before adoption, you need to identify variable pricing terms in contracts and understand the impact to revenue under the new guidelines. After adoption, you'll want to automate transactions by applying variable consideration using consistent methods and flagging contracts that have non-standard terms.

4

ALLOCATE THE TRANSACTION PRICE

The fourth step to ensuring ASC 606 compliance is to allocate a portion of the transaction price (Step 3) to each performance obligation (Step 2) based on the relative standalone sales price. The standalone price is the price you would sell a good or service to a customer on its own. Two methods you can use to determine this price are:

- **The observable price when you sell it separately.**
- **For a good or service not sold separately, an estimate based on market prices or benchmarks.**

Bottom line:

Allocating transaction prices will require a complex rules-based approach that is beyond the scope of most accounting solutions used by organizations today. Organizations that attempt to allocate on a per arrangement basis using spreadsheets expose the business to risk, and the accounting team to significant headaches.

5

RECOGNIZE REVENUE

Under ASC 606, subscription-based companies will recognize revenue over time as the performance obligation is delivered to the customer. The new standard specifies that an entity transferring control of its service over time must recognize revenue when one of the following criteria is met:

1. **The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.**
2. **The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.**
3. **The entity's 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.**

Source: <https://asc.fasb.org/imageRoot/00/51801400.pdf>

Companies also need to consider how they amortize expenses over the term of a contract. With the new standard, you may need to amortize costs (such as commissions and royalties) based on the delivery of products and services to customers, ensuring your amortization is linked with timing of satisfying the performance obligation.

Bottom line:

For organizations operating under complex billing arrangements, like usage based billing, it's incredibly important that billing and revenue recognition systems work in sync, so that when the customer consumes the benefits of the performance obligations, your organization can recognize it.

YOUR PATH TO COMPLIANCE STARTS HERE

As you can see, ASC 606 affects your revenue recognition and financial processes from top to bottom. Unlike previous rule changes where adding new intelligence to the accounting system was enough, this rule is about contracts and deliverables with customers—information that often originates outside the accounting system.

Businesses unable to handle complex contracts within their ERP/accounting system—or by tightly integrating with their CRM—will quickly get overwhelmed with spreadsheets and subjective decisions. To maintain efficiency, and not increase risk, technology is the only answer to this new standard.

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The time to plan your path to ASC 606 compliance is **NOW**.
Take advantage of this additional resource to get started:

- [ASC 606 Resource Page](#)