Introduction to Revenue Recognition for your “As-A-Service” Journey

Article

Reading time: 5 minutes

GROWTH BEAM
www.growthbeam.eco

Contents

Introduction to Revenue Recognition in EaaS and Subscription Models 2

Revenue Recognition Basics in EaaS and Subscription Models 2

Critical Timing of Revenue Recognition 2

Importance of Accurate Revenue Recognition 2

Understanding EaaS and Subscription Business Models..3

Challenges in Revenue Recognition...3

Understanding Accrued and Deferred Revenue 4

The Revenue Recognition Process 4

Revenue Recognition in Accounting Ledgers..5

Adherence to Accounting Standards 5

Best Practices and Compliance: 5

Key Takeaways 5

Introduction to Revenue Recognition in EaaS and Subscription Models

Understanding how revenue is recognized when exploring how to sell your equipment in "As-A-Service" (EaaS) business model is vital for accurately reporting financial performance. These models require a spread-out approach to recognizing revenue, as opposed to the traditional sales models where revenue is recognized at the point of sale. In EaaS and subscription services, companies recognize revenue gradually, aligning it with the service delivery period. This ensures financial statements reflect the actual income earned during specific periods.

Revenue Recognition Basics in EaaS and Subscription Models

Revenue recognition in these models is based on earning revenue over time, as customers pay a recurring fee for ongoing access to services or equipment. The revenue is recognized incrementally, matching the period of service provision, which helps in portraying a company's financial health accurately.

Critical Timing of Revenue Recognition

The essence of timing in these models is to recognize revenue as the service is provided or as the customer benefits from the equipment, rather than upfront or at the end. For example, revenue from a year-long rental agreement is recognized monthly, reflecting the continuous service provision.

Importance of Accurate Revenue Recognition

Accurate revenue recognition is essential for compliance with accounting standards like IFRS 15 and ASC 606, reflecting true financial performance, and building investor and stakeholder confidence. It highlights the ongoing customer relationships characteristic of these business models.

Understanding EaaS and Subscription Business Models

EaaS and subscription models offer a significant shift from traditional sales, focusing on recurring payments and continuous customer engagement. EaaS allows customers access to equipment based on a recurring payment structure, while subscription models offer ongoing access to a product or service. These models foster stronger customer relationships, offer predictable revenue streams, and provide flexibility and customization:

Equipment as a Service (EaaS): This model provides customers with access to physical equipment without requiring a full purchase. Customers pay a recurring fee to use the equipment, which often includes maintenance, upgrades, and sometimes even operator training. EaaS is particularly beneficial for expensive or specialized equipment that may be financially prohibitive to own outright or may require frequent updates.

Subscription Models: These models grant customers ongoing access to a product or service for a regular payment. Unlike EaaS, subscriptions typically involve intangible products like software, digital platforms, or services rather than physical equipment. If a subscription is applied to a physical product, that would be of low value (compared to expensive or specialized equipment). Subscriptions ensure continuous access to the latest features, support, and updates, which can be crucial for software and services that evolve over time.

In essence, while both models involve recurring payments, EaaS specifically pertains to physical equipment, often with added value services, whereas subscriptions generally provide access to digital products or services.

Challenges in Revenue Recognition

EaaS and subscription models face unique challenges in revenue recognition due to recurring payments, changing contract terms, and bundled offerings.

Addressing these challenges is crucial for accurate financial reporting and compliance with standards like IFRS 15 and ASC 606.

Understanding Accrued and Deferred Revenue

In EaaS and subscription models, Accrued Revenue refers to revenue that has been earned but not yet received. This situation arises when goods or services have been delivered to a customer, but payment has not yet been made. Accrued revenue is recorded as an asset on the balance sheet, specifically as a receivable, because it represents money that is owed to the company. For example, a company completes a service in March but doesn't receive payment until April. The revenue earned from the service provided in March is recorded as accrued revenue in March's financial statements.

In contrast, Deferred Revenue, also known as unearned revenue, occurs when payment is received before the goods or services are delivered. This revenue has not yet been earned and therefore cannot be recognized as such until the service or product delivery is complete. Deferred revenue is then recorded as a liability on the balance sheet because it represents an obligation to provide a product or service in the future. For example, a customer pays in advance for a one-year software subscription in January, but the company will deliver the software services over the course of the year. The payment received in January is recorded as deferred revenue, and the revenue is recognized gradually as the service is provided over the year.

Managing these revenues is critical for accurate financial records and compliance with accounting standards.

The Revenue Recognition Process

This process involves identifying performance obligations, determining the transaction price, allocating the transaction price to obligations, and recognizing revenue as obligations are satisfied. It aligns with guidelines from ASC 606 and IFRS 15, ensuring accurate reflection of service delivery over the subscription period.

Revenue Recognition in Accounting Ledgers

For providers, initial revenue is recorded as deferred revenue, which is then recognized over time as services are rendered. Adjustments may be made for contract changes. From the customer’s perspective, advance payments are recorded as prepaid expenses and expensed over the subscription period.

Adherence to Accounting Standards

Following ASC 606 and IFRS 15 standards is imperative for companies in EaaS and subscription models. These standards provide a framework for accurate revenue recognition, enhancing financial transparency and comparability across industries.

Best Practices and Compliance:

Implementing automated systems, regularly updating financial teams, maintaining detailed documentation, monitoring customer behavior, and ensuring compliance with accounting standards are best practices for efficient and accurate revenue recognition.

Key Takeaways

Gradual Revenue Recognition: Unlike traditional sales models where revenue is recognized at the point of sale, EaaS (Equipment-as-a-Service) and subscription models recognize revenue over time, aligning with the period of service provision. This approach ensures that financial statements accurately reflect income as it is earned.

Alignment with Service Delivery: Revenue in EaaS and subscription models is recognized as services are rendered or as customers utilize the equipment. This method ensures that revenue recognition accurately portrays the company's financial health and mirrors the ongoing provision of services.

Compliance with Accounting Standards: Adhering to accounting standards such as IFRS 15 and ASC 606 is crucial in EaaS and subscription models. These standards provide guidelines for revenue recognition, ensuring legal and financial compliance, and reflecting true financial performance.

Ongoing Customer Relationships: EaaS and subscription models emphasize continuous customer engagement and recurring payments, fostering stronger customer relationships, and providing predictable and stable revenue streams.

Challenges in Revenue Recognition: These models face unique challenges, including managing recurring payments, handling contract modifications, and accounting for bundled offerings. Addressing these challenges is essential for accurate financial reporting and compliance.

Managing Accrued and Deferred Revenue: Understanding and correctly handling accrued (income earned but not yet invoiced) and deferred revenue (payments received in advance for services yet to be delivered) is crucial for maintaining accurate financial records.

Revenue Recognition Process: The process involves identifying performance obligations, determining transaction prices, allocating transaction prices to obligations, and recognizing revenue as obligations are satisfied, in compliance with ASC 606 and IFRS 15.

Accounting Ledgers and Financial Reporting: Proper recording and recognition of revenue in accounting ledgers are essential for both providers and customers. This includes adjusting for contract changes and ensuring that revenue or expenses match the period in which services are rendered or consumed.

Adherence to ASC 606 and IFRS 15: Following these accounting standards is imperative for accurate revenue recognition, enhancing financial transparency, and ensuring compliance with international accounting norms.

Best Practices for Compliance: Implementing automated systems, updating financial teams regularly, maintaining detailed documentation, and monitoring customer behavior are recommended practices for efficient and compliant revenue recognition.