
THE RECURRING REVENUE MODEL —CHALLENGES AND BEST PRACTICES



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One of the most interesting business model shifts in the past two decades has been the rise and success of subscription services. Amazon has clobbered competitors by replacing order-by-order shipping charges with an all-you-can-use, \$99 a year subscription. Netflix killed Blockbuster not with its technology, which at the time involved little more than shipping DVDs by snail-mail, but with a flat monthly subscription fee that replaced one-off rental and late charges. Financial services, music, software and other businesses also have added subscription services to their non-subscription businesses, creating for themselves long-term customer relationships, and usually, more stable income streams.

As a vendor, it is easy to see the appeal of adding a recurring revenue stream. But for success in this business model, it's important to think through some significant operational considerations before selling that first subscription. Great subscription businesses are built first by steadily booking new business and then by consistently retaining those customers.

The ability to achieve each of these goals will be greatly affected by the systems and processes the company puts in place from the start.

Building a recurring business means processing a (hopefully growing) stream of subscription orders. Each of those orders will need to kick off a process to set up a subscription period, provision the service offering, generate one or more invoices and recognize revenue. Ultimately, it should also remind you to terminate that subscription at the end of the period—or better yet, help you renew it. That process is significantly more complex than the one order = one shipment = one bill = one revenue posting world of the one-off model.

And, since the second key factor is to retain (i.e. renew) those customers, you're going to want a lot more data about them than you might need in the one-off world. How often does this particular customer use the product? Does he pay his bill? How much does it cost us to deliver our service to him? What leading indicators should we watch as signs that an account might be about to churn, or be ready for upsell? Which customers are most valuable, and what do they have in common? Reliable data about existing accounts can be one of your company's best sales tools.



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In other words, recurring revenue businesses create more complexity in the process and more demand for data than traditional businesses. They require sophisticated, integrated systems for handling the throughput, capturing the data and facilitating the analysis. It's important to set up an infrastructure in the beginning that can manage the complexity and evolve with your company, allowing you to react competitively and to expand into new areas as you grow. Below are a few practical recommendations for establishing a recurring revenue business that can grow and adapt for years to come.

Integrate Orders, Billing and Revenue Recognition

When it comes to billing, the subscription model introduces significantly more complexity than a single-sale model. While all negotiated transactions can potentially end up with non-standard terms, the subscription model forces a kind of "persistence of complexity" that means you'll have to live with those terms (provided you have decent retention) for a long, long time. There is no longer such a thing as a one-off arrangement. Every sale with a funky structure you did in the early days, every quarter-end special, every one-time-only arrangement you make with a hard-negotiating customer has the potential to affect the way you invoice the customer and recognize revenue for years and years to come. Moreover, the subscription model generally brings higher transaction volumes. There is a revenue recognition event for every customer, every month (not just customers signed that month). And a single order may generate dozens of invoices.

Some companies try to take a multi-system approach and address this with a 'dumb' general ledger connected to a stand-alone billing solution. Since neither system can handle the complexities of revenue recognition, that approach also requires a third system (or some significant Excel work) to get revenue recognized. Even in the relatively simple one-off model, the multi-system approach requires a lot of potentially error-prone work to move and synchronize data among the different systems, as well as to ensure reconciliation of the accounting across them. With the many variables and high volumes involved in a recurring revenue model, this manual work becomes even more risk-prone, time-consuming and costly. Moreover, this approach simply will not scale as the business grows in volume and complexity.

At NetSuite, we use an integrated order processing system. As subscription orders are processed, the related subscription term, invoicing schedule and revenue recognition schedule are set up. After that, the system takes care of telling us when it's time to invoice, post revenue or approach the customer about renewals. We will need to recognize revenue each month over the term and we may need to generate multiple invoices, but if we set up that initial order correctly no human will need to keep track of any of that. Better yet, there will be no need to reconcile in one system (e.g. core GL) a process that was done in another system (e.g. separate billing system).



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Automate Revenue Recognition

Revenue recognition can be technically complex and operationally cumbersome in almost any business, but it can become hellishly so in the recurring model. In a traditional business, every quarter starts with a clean slate with revenue to be booked from zero. In the subscription model, each quarter's performance reflects not just the results of that period's efforts, but rather a culmination of all of the transactions in the company's history. In the recurring revenue world, every contract signed, every customer gained or lost, every upsell or downsell has the potential to impact revenue not only in the quarter in which it occurs, but every quarter thereafter. Forever.

Revenue recognition needs to run correctly not just on that initial order, but often on multiple periodic invoices from that order, as well as on renewals of that order in perpetuity (if all goes well). This creates a persistence, even a compounding, of complexity over time. A lot of finance organizations try to deal with this complexity by using manual processes and spreadsheets (lots and lots of spreadsheets). Some even forego trying to get revenue right on each order, and instead run a massive Excel exercise at period-end to do a single adjustment to correct revenue recognition in the aggregate. This work—running those manual processes and building and maintaining those spreadsheets—should be a serious concern to any CFO from an accuracy, consistency, auditability and scalability point of view. It also puts a real strain on those in your organization who have to work with them every day. Automating the revenue recognition process at the order and invoice level, and making it part of an integrated financial systems infrastructure, will do more than save countless manpower hours as the company grows, it should help you sleep better at night.



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Allow for Flexible Pricing

There is an infinite variety of pricing models for subscriptions, but most models involve either a straight subscription fee, usage-based charges or some combination of the two. Straight subscription is just what it sounds like: a flat annual, monthly or yearly fee for the use of the service, like Netflix's all-you-can view, \$7.99 a month streaming subscription. The usage model bases the monthly charge on some running variable like minutes used, storage size or consumption amount (think utilities). The combination of the two is pretty common as well. Your cell phone bill is a straight subscription until you go over your minutes then the overage is usage-based.

Managing the order processing, invoicing and revenue recognition using a single pricing model is complex in itself. But many businesses don't stick solely with one type of pricing, opting to migrate between models as the business develops, or to experiment with different models for different offerings. When each model has its own pricing, billing calculations and revenue recognition requirements, the complexity is again compounded. It's important to ensure from the beginning that systems put in place to support the first version of the company's subscription model have the flexibility to evolve and handle other pricing models. You don't want system constraints to prevent you from adopting a pricing model that fits your new offering. And you don't want to have to do major systems heart surgery every time you consider a change.

Understand the Value of Each Customer

One of the biggest threats to a recurring revenue business is churn. Without a high level of customer retention, a subscription business isn't a subscription business; it is a series of one-off deals gone wrong. The rate of churn is such a powerful lever that it not only impacts the rate at which the company can grow, it mathematically limits how large the company can ever get, for any set rate of new customer signup. You spend a massive amount of effort finding prospect customers and convincing them to try your service. It makes sense to use every available tool to make sure they stay. Well-managed data will give you numerous ways to predict when customers are at risk of leaving, as well as when they might be in need of even more of what you're selling.

The key, however, is the "well-managed" part. If you have one system that knows whether your customer is paying his bills, another that manages renewals, a third that shows how usage is trending, a fourth that tracks support issues by customer, and a separate CRM system that lists current opportunities in the pipeline with this customer, pulling that information together into a meaningful, actionable view is nearly impossible. Without easy access, even the most comprehensive data won't help your professionals who need it most. It's a set-up for missed opportunities and embarrassing mistakes. Sales will try to close an upsell 'opportunity' with a customer who has outstanding support issues and an open balance that is four months past due. They will overlook an account that meets three of your best leading indicators for upsell because the account isn't due for renewal yet and no one is paying attention. You'll lose an account a week before introducing the one feature that would have solved their biggest support issue because the

renewal rep tried to renew them without any idea they had an open issue or that the new feature would solve it. No one will notice that large customer with the big past-due balance and a renewal coming up next quarter. Or that customer who is halfway through his license period but already pushing the upper limit on usage; an upgrade opportunity lost. The beauty of a well-integrated system in this business model is that it can pull together a wide variety of information that will help you predict and prevent churn, and spot opportunities for upselling.

At NetSuite, we know this first hand. By using just one system for the whole integrated process—from lead generation through order processing, provisioning, billing, support and account management—we get a holistic view of the customer. It pulls together live data on usage, outstanding balances, our own cost for servicing the client, support information, sales opportunities and more onto a single customer record. Data can be analyzed to identify key predictive indicators of churn or upsell. Automated alerts can let an account management rep know if metrics on an account in her territory are trending in a worrisome direction or in one that might portend a new opportunity. Putting everything we know about a client into a single place, and establishing reports and alerts customized by role, allows us to focus resources on retaining customers and growing accounts.

Conclusion

The subscription revenue model can offer significant benefits over a business built on a series of one-off transactions. However, the model also brings with it some significant complexity and serious data requirements. It requires some thoughtful investment in infrastructure to make it work.

The right system to manage a subscription business includes:

- A single integrated system across order processing, billing and revenue recognition that facilitates efficiency and scale. It also, by virtue of the potential mistakes it eliminates, gives the CFO some peace of mind.
- Flexibility to grow as the business grows. It should handle multiple pricing models, including those you haven't yet thought of.
- The ability to handle the complexities of subscription revenue and multi-element allocation on an order-by-order, invoice-by-invoice basis.
- Easily accessible customer data that helps you both predict and prevent churn and identify changes that are leading indicators of opportunity.

In short: automate everything you can and do it in a system that can evolve with your business. Doing so early on will save your company countless man-hours and frustration and allow you to collect invaluable data for spotting selling opportunities and preventing churn. For a recurring revenue business, good systems, managed well, are fundamental to success.

About the Author

As CFO, Ron Gill guides NetSuite's global financial strategy and operations. Before joining NetSuite in 2007, he held a variety of executive financial positions with several of the world's largest technology companies, including SAP, Dell and Sony.

