Risks in Revenue Reporting

FINANCIAL EXECUTIVE BENCHMARKING SURVEY

Risk Edition

RevenueRecognition.com
Revenue Management Resources for Today's Financial Executive

TABLE OF CONTENTS

EXECUTIVE SUMMARY

RevenueRecognition.com in association with International Data Corporation (IDC) recently surveyed senior financial professionals from 586 businesses about risk and complexity in revenue reporting. The survey was conducted in June 2008 by email and all responses were on an anonymous basis. More than 75% of respondents are senior finance executives including CFOs and Controllers. 101 responses were from companies with revenues of $1 billion or more.

(References to the data and narrative in this report should be sourced: www.RevenueRecognition.com and IDC, 2008)

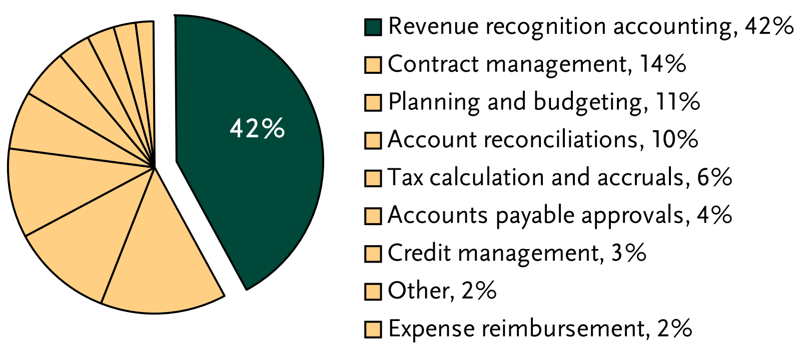
Key Findings:

- Among nine key finance and accounting processes, **revenue recognition accounting represents the:**
  - **Greatest risk** of errors and inaccuracies
  - **Most complex** managerial challenge
  - **Highest risk of material error on** financial statements.
- **Business complexity and infrastructure weakness** are key drivers of overall risk and error.
- **Business related drivers include:** multi-element contracts, subscription/usage based billing, and royalty/licensing models.
- **Infrastructure weakness is due to fragmentation:** the Higher Risk Group requires more than 11 revenue sources to support an audit.
- **92% of public companies use spreadsheets for key revenue accounting tasks**, the same percentage we found in 2006.

REVENUE REPORTING RANKS HIGHEST FOR RISK OF ERRORS AND INACCURACIES

One of the objectives of our survey this year was to measure the relative risk and complexity in revenue processes compared to other major financial and accounting functions. The first question we asked was about errors and inaccuracies. As shown in Figure 1 below, more than 40% of all respondents rated revenue as the having the greatest risk in this regard – three times more than any other process on the list. The proportion was even higher for companies with more than $200 million in revenue.

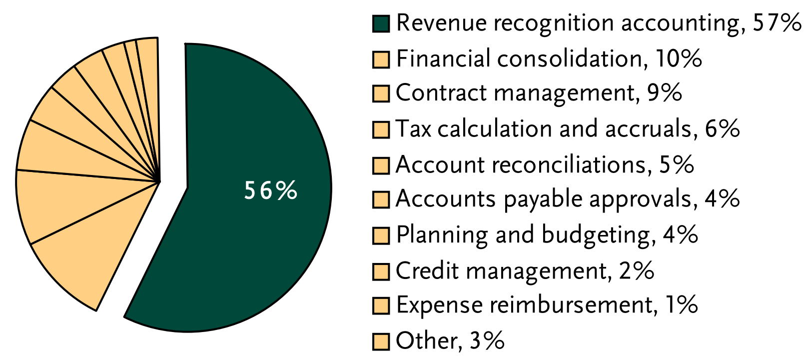
Figure 1
In your business, which process represents the **greatest risk of errors/inaccuracies?** (n= 596)



HIGH MATERIALITY AMPLIFIES RISK IN REVENUE REPORTING

Errors and inaccuracies are one dimension of concern, but the level of urgency depends on the potential for them to impact financial statements. When we asked about the relative materiality of errors in these processes, we found that revenue recognition accounting is five times more likely to result in a material error than other key accounting processes.

Figure 2
Were errors to occur, in which process would they have the **highest level of materiality** to your financial statements? (n= 596, 204)

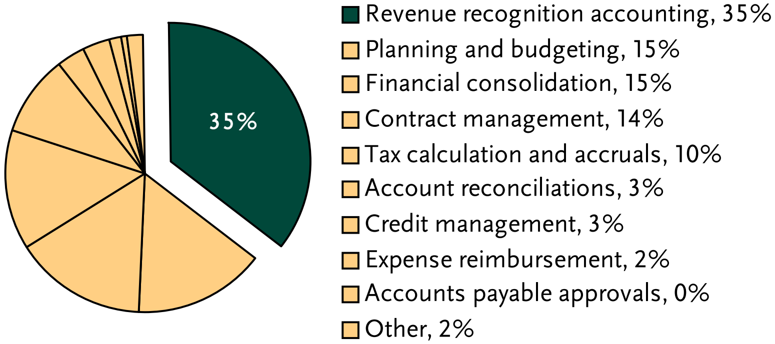


COMPLEXITY PLAGUES REVENUE REPORTING

It is critical to effectively manage revenue processes in order to mitigate risk of error or fraud, but this is difficult for many organizations. As shown in Figure 3, revenue recognition accounting was rated the most complex process for most respondents to manage.

While there are many complex management issues associated with each of the processes below, revenue is unique in that is has high levels of both internal and external management challenges. Internally, there are many different data sources and business events that must be monitored against numerous revenue recognition criteria. Externally, accounting guidelines and compliance requirements demand difficult judgment calls to be made on how to treat every element of every contract.

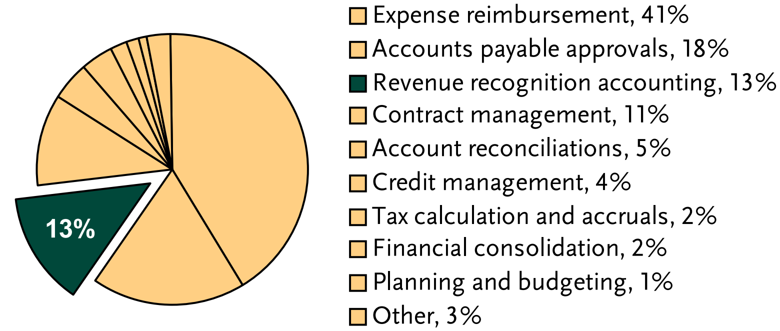
Figure 3
In your business, which process is the **most complex to manage**? (n= 596, 204)



REVENUE IN TOP THREE FOR RISK OF FRAUD

In our last question comparing major financial processes, we asked about the potential for fraud. In this case, 41% of respondents identified expense reimbursement as a key area. Revenue recognition ranked third with 13% of all respondents and 17% of respondents from companies with $200M or more in revenue. However, due to the potential magnitude of fraud in revenue accounting it is much more likely to have devastating ramifications for companies and their executives. Organizations must remain vigilant at all times, especially when performance threatens to slow after long stretches of record breaking numbers. This is when most companies are most vulnerable to bad decision making. International operations are another area that requires special attention in terms of revenue fraud.

Figure 4
In your business, which process represents the **greatest risk of fraud**? (n= 596, 204)



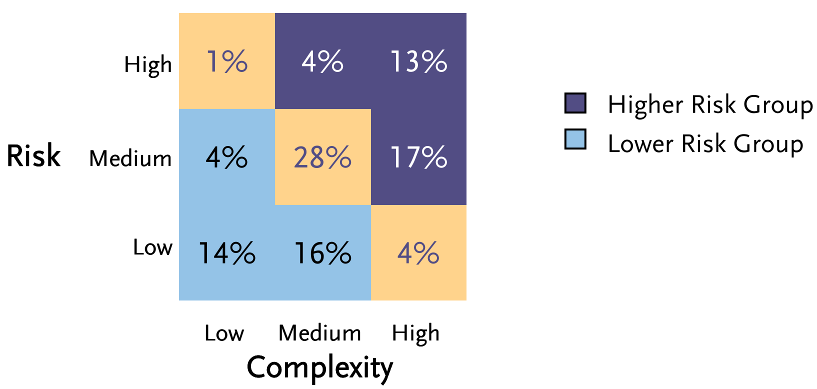
LEVELS OF RISK AND COMPLEXITY IN REVENUE REPORTING

Respondents were asked to rate the levels of risk and complexity in their revenue reporting processes. The results are depicted in Figure 5. Complexity is highly correlated with risk, especially when automation capabilities are lacking. Therefore, we defined two groups for comparative purposes. As shown in Figure 5, the Higher Risk group includes those who described their revenue reporting processes as High Risk with High or Medium Complexity, and those that rated their Complexity High with Medium Risk, as high complexity tends to increase risk over time. The Lower Risk group comprises the opposite three quadrants on the chart.

Companies in the **Higher Risk** group tend to be larger (more than $200M in revenue), public, with two or more business models. Business complexity, fragmented IT infrastructure and inadequate revenue accounting automation are challenges for this group.

Companies in the **Lower Risk** group tend to be smaller (revenue $200M or less), private, with one or two business models.

Figure 5
Segmentation by Revenue Reporting Risk and Complexity

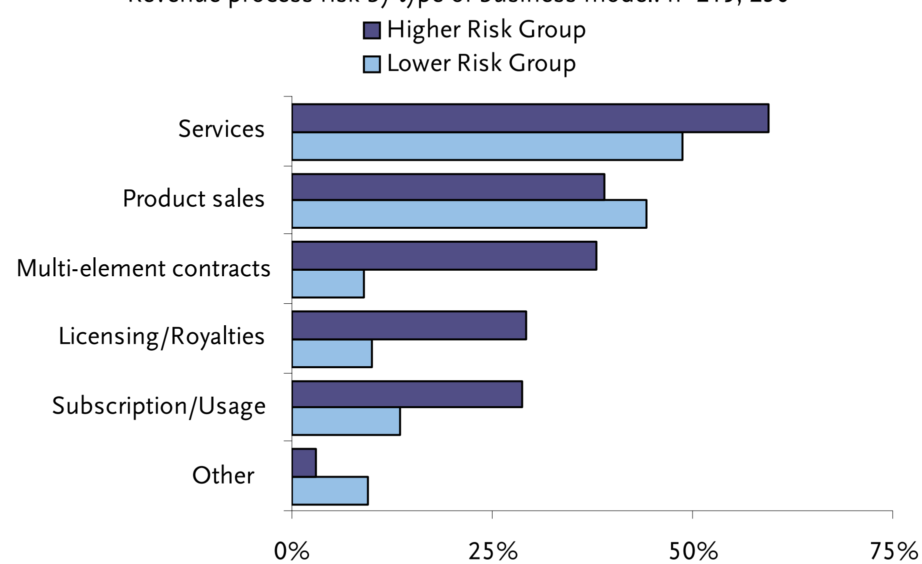


WHAT'S DRIVING RISK AND COMPLEXITY IN REVENUE REPORTING?

55% of the Higher Risk group operates multiple models while only 17% of the Lower Risk group does. But as shown in Figure 6, the nature of the models is as influential as the number. The Higher Risk group is far more likely to use multi-element contracts, licensing/royalty arrangements and innovative models such as subscription and usage based billing

These models involve deferred revenues that are recognized based on a variety of criteria – time periods, delivery, performance levels, and volume to name only a few. These models vastly complicate revenue for several reasons – the number of business events that determine when revenue can be recognized, the review and approval process for recognizing revenue, and the separation of revenue and billing.

Figure 6
Revenue process risk by type of business model. n=219, 230



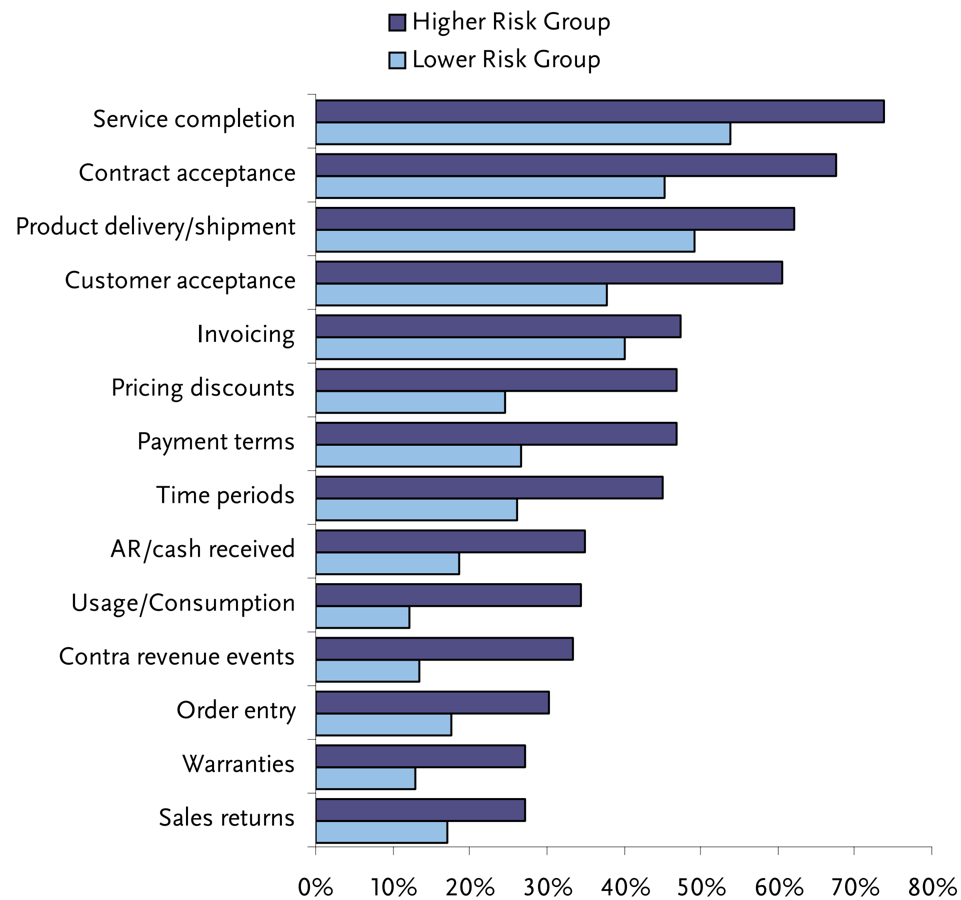
BUSINESS EVENTS THAT IMPACT REVENUE

Business events are the operational triggers that satisfy the conditions for revenue recognition. In a large company, these events occur every day in every customer facing department – sales, customer service, shipping, support, etc. The activity and reporting of partners and customers can also have substantial impact on whether revenue recognition criteria are met and documented. The challenge for revenue accounting is in monitoring all this activity; matching it to contractual terms in each customer agreement (which can be unique to every customer, product, and service), then analyzing it against the revenue policy to determine which revenue elements can be recognized when and why.

When asked about events that impact revenue recognition, four issues stood out for both groups: service completion, contract acceptance, shipping and customer acceptance. In the bottom half of Figure 7, we also see big differentials between the groups with respect to issues such as: pricing, payment terms, time periods, cash, usage/consumption, contra revenue events (rebates and royalties), and warranties. These issues are particularly tricky as they can result in reallocation and negative revenue affecting multiple periods.

The average number of events that impact revenue recognition was 4.0 for the Lower Risk group. For the Higher Risk group it was 6.4. That is a substantial difference, especially since each additional event typically involves monitoring the activities of a different operational group with its own line of business application(s).

Figure 7
Which of the following impacts your revenue recognition decisions?
(Multiple answers accepted.) n=230, 219

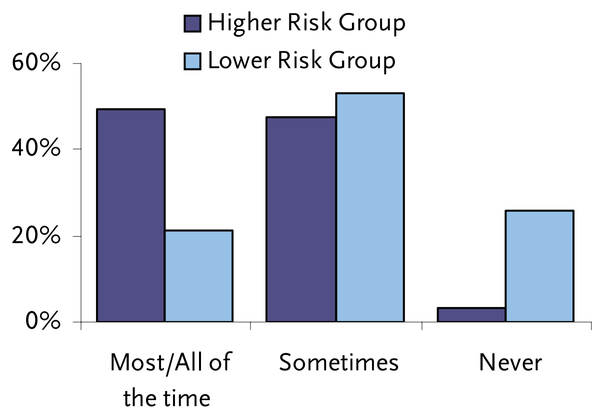


OPERATIONAL CHALLENGES OF COMPLEX REVENUE

Separating Billing and Revenue Recognition

Among the many accounting issues that occur when innovative business models are used, separating billing and revenue recognition can have a significant operational impact. The reason is that when revenue and billing are separated, the typical IT infrastructure based on an ERP and/or Financials application is unable to process the revenue cycle. A completely independent set of criteria will govern how revenue flows from contract to reporting that most existing infrastructures are not set up to manage. The result is a process laden with manual intervention and spreadsheets.

Figure 8
How often do invoicing and revenue recognition require independent processing or schedules? n=230, 219

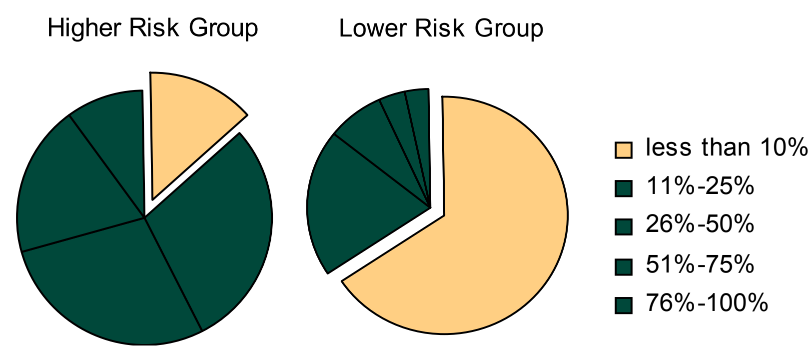


Reviewing Revenue Transactions

When the complexity of revenue transactions increases, the review and approval process must evolve accordingly to ensure each line item is processed in compliance with the company's revenue policy. Figure 9 shows the dramatic difference in the percentage of monthly transactions that the two groups review. Two-thirds of companies in the Lower Risk group review 10% or less. While 86% of the Higher Risk group review 11% or more.

Reviewing this many transactions is time and labor intensive. It adds risk and complexity as more internal controls must be implemented to ensure the separation of duties, the audit integrity of each transaction, and the documentation available to support each revenue decision.

Figure 9
What percent of monthly transactions require additional review due to revenue risk issues? n=230, 219



REVENUE DATA IS FRAGMENTED ACROSS THE ENTERPRISE

As a measure of how revenue data is managed, we asked respondents to tell us how many different sources of information they require in order to support an audit of their revenue transactions. Respondents were provided a list that included: spreadsheets, ERP modules, in-house custom systems, billing systems, order management systems, project management systems, financial system modules, CRM modules, price books, word docs, and a space to enter other sources.

The selections presented were "none", "one", and "two or more". As a result, the average numbers shown below are extremely conservative. Large companies could easily have hundreds of sources.

	Higher Risk Group	Lower Risk Group
Minimum number of revenue data sources needed to support an audit on average.	11.1	7.6

And yet, the numbers still reveal a great deal of fragmentation. Overall, nearly a quarter (22%) of all respondents need 16 or more sources. As shown in Figure 11, respondents in the Higher Risk group are far more likely to have many more sources that those in the Lower Risk group.

Figure 10
Average number of sources for revenue data (minimum) n=586

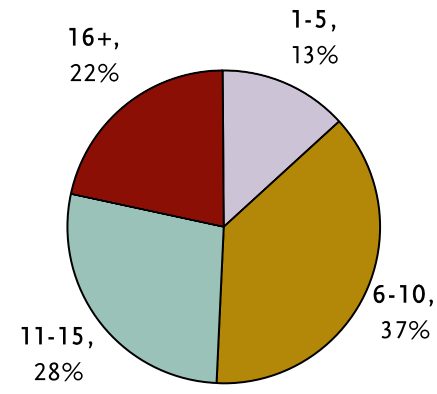
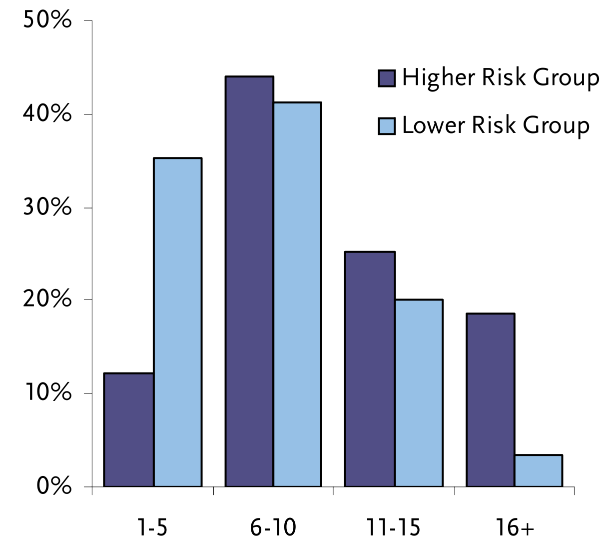


Figure 11
How many of each source needed to support an audit? n=219, 230



SPREADSHEETS ARE PERVASIVE IN REVENUE REPORTING

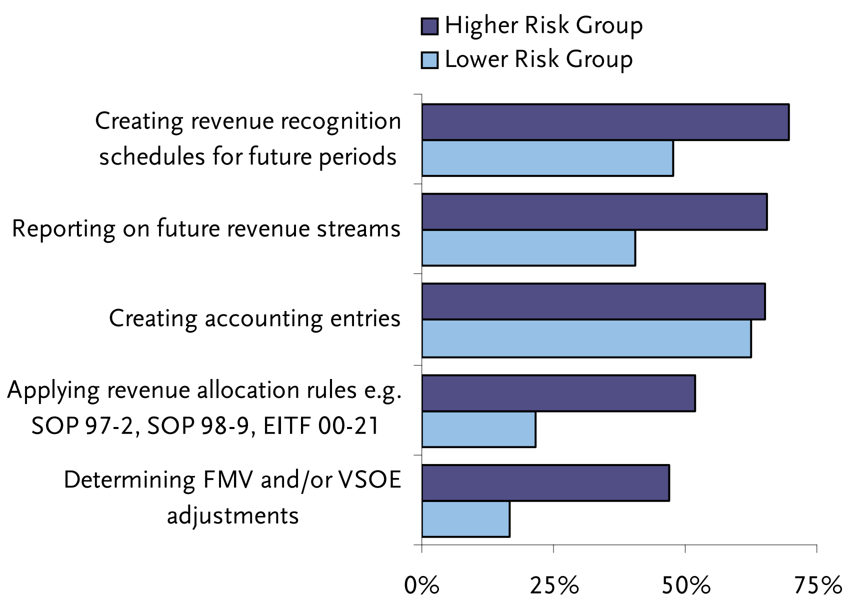
In keeping with the theme of fragmentation, we inquired about the use of spreadsheets for revenue accounting activities. As in our 2006 survey, we again found that:

> 92% of respondent from public companies use spreadsheets for one or more critical revenue accounting activities.

That this number is unchanged from two years ago suggests that companies have not made any headway in lowering the risk in their revenue processes. The Higher Risk group is much more likely to rely on spreadsheets for scheduling and forecasting revenue – two activities that are critical for understanding the deferred revenue backlog.

Figure 12

Do you use spreadsheets for any of the following activities? n=230, 219

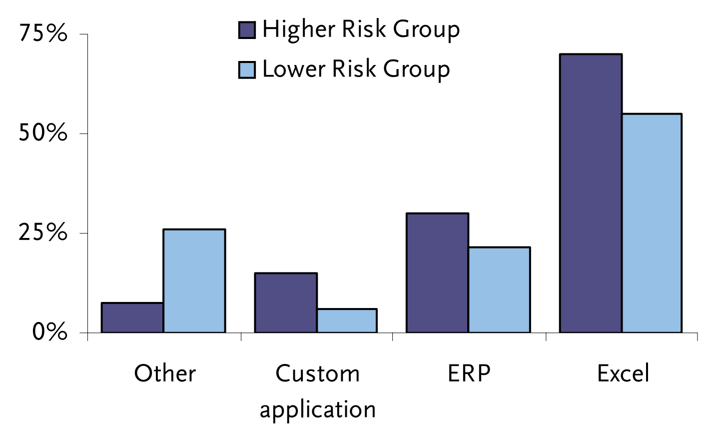


Deferred revenue is a key resource for executives, as well as financial and operational managers, but it is also the area with the least automation support. As shown in Figure 13, nearly three-quarters of the Higher Risk group use spreadsheets for some or all of the tasks related to this single area of revenue accounting.

This greatly inhibits their ability to understand issues fundamental to improving revenue performance, including: How much revenue is aging due to operational issues such as delivery or acceptance? Which contracts can be accelerated or delayed by changing the way specific elements are provided to the customer? These questions are critical for executives to utilize their deferred revenue "banks" as effectively as possible in managing to investor expectations.

Figure 13

In what application(s) are your deferred revenue (DR) schedules created and managed?
(Multiple answers accepted.) n=230, 219

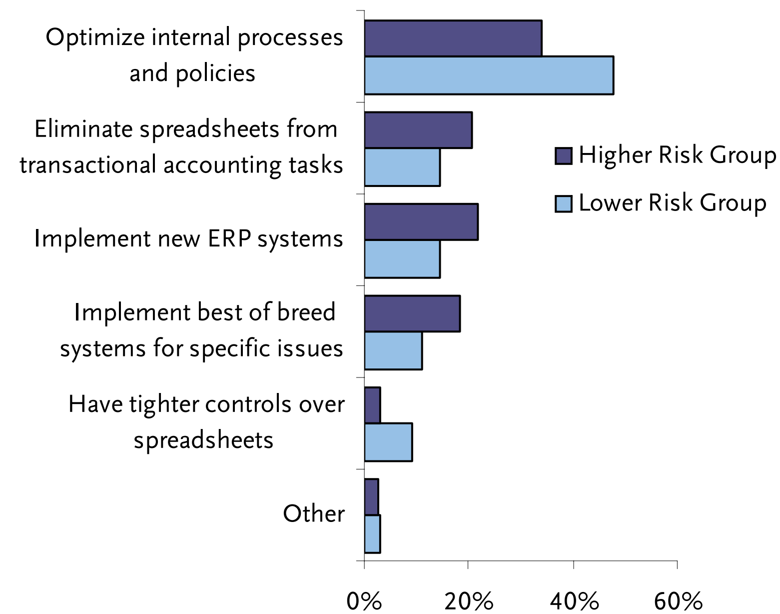


IMPROVING REVENUE REPORTING PROCESSES

With all the risk, complexity, and fragmentation associated with revenue reporting processes, the question is, how can companies improve the way they manage revenue? Given a choice of five approaches (and a write in option), respondents indicated that optimizing their internal processes and policies is the preferred choice. No surprise there of course, but the rankings for the next three choices are curious. With the pervasive use of spreadsheets and the known risks they introduce, it is surprising that more companies are not focusing on eliminating them.

The explanation may be in the rakings for the other technology options – implementing new ERP systems and best of breed systems. We believe there is an educational issue here. The reason spreadsheets are so widely used in the revenue reporting process is that the ERP systems don't have the functionality to manage it. So it's illogical (and expensive) to implement a new one. Best of breed solutions for revenue process automation are fairly new to the market and respondents may not have the same level of awareness about them as they do ERP solutions.

Figure 14
How could you best improve internal controls over financial processes? n=230, 219



SUMMARY

Companies can mitigate operational risk, and the resulting financial reporting challenges, by addressing key business processes. Revenue accounting is one of those processes. Its importance is obvious. But the management challenges it presents stem from sometimes subtle details about exactly how an offering is delivered to customers. As our survey shows, companies using multi-element agreements, licensing and royalty arrangements, or subscription/usage based sales models are at high risk for material error and must be especially vigilant about the impact these approaches have on revenue accounting.

We found that the companies operating these models are more likely to use spreadsheets for more revenue related activities than companies with simpler, low risk models. While spreadsheets compensate for a lack of support and functionality in enterprise accounting systems, they represent weak links that are under scrutiny by auditors. As organizations assess the risk and magnitude of information being managed by spreadsheets, they must do so with the intention of reducing their reliance on them. Spreadsheet-based processes do not scale, nor do they meet the operational and compliance requirements for accurate and timely reporting.

A key issue is that companies are not aware of specialized applications that are available to automate key revenue accounting processes currently being driven by spreadsheets. By automating revenue reporting processes across the enterprise, companies can mitigate risk and error and simultaneously enhance their ability to manage innovative business models and optimize top line performance.

DEMOGRAPHICS

Figure 15
What is your title? (n=586)

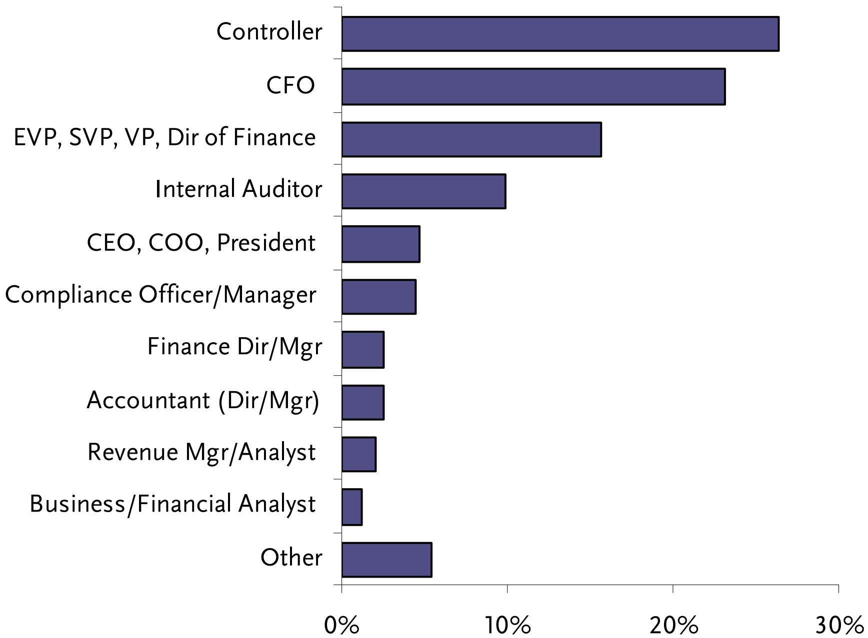


Figure 16
What is your company's main industry? (n=586)

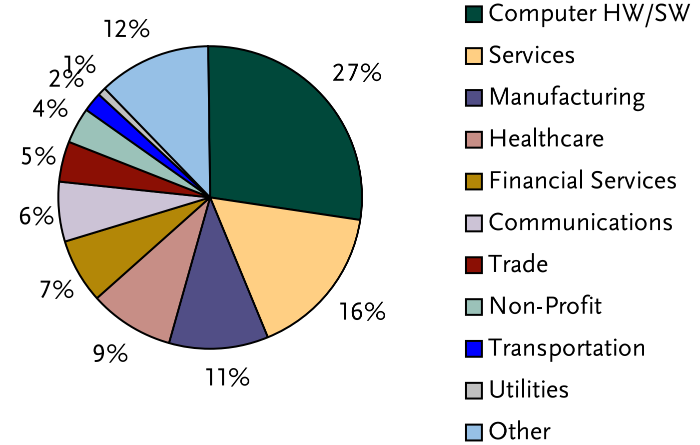


Figure 17
What was your company's approximate revenue in 2007? (n=586)

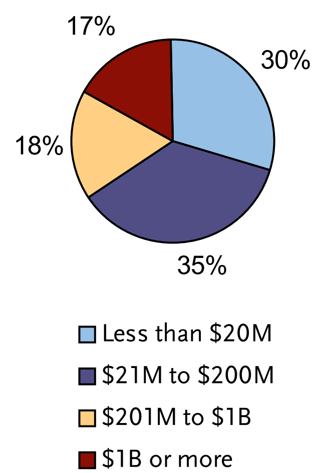
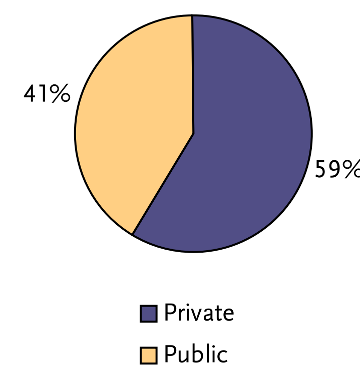


Figure 18
What is the ownership structure of your company? (n=586)



ABOUT REVENUERECOGNITION.COM

RevenueRecognition.com is dedicated to educating finance professionals on revenue management and related issues. The site focuses on revenue accounting; revenue recognition; revenue reporting and forecasting; internal controls; Sarbanes-Oxley compliance; SEC, FASB, and international accounting guidelines; contract management; and industry specific revenue challenges. Contact us at: info@revenuerecognition.com.

RevenueRecognition.com is sponsored by Softrax Corporation, a leading provider of revenue management software solutions. To learn more about Softrax solutions, customers and partners, please visit www.softrax.com.

RevenueRecognition.com
Revenue Management Resources for Today's Financial Executive

ABOUT INTERNATIONAL DATA CORPORATION

IDC is the premier global market intelligence and advisory firm in the information technology and telecommunications industries. We analyze and predict technology trends so that our clients can make strategic, fact-based decisions on IT purchases and business strategy. Over 700 IDC analysts in 50 countries provide local expertise and insights on technology markets. Business executives and IT managers have relied for 40 years on our advice to make decisions that contribute to the success of their organizations. IDC is a subsidiary of IDG, the world's leading technology media, research, and events company. Additional information can be found at www.idc.com.

IDC
Analyze the Future