Sarbanes-Oxley and Revenue Recognition Practices

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

FINANCIAL EXECUTIVE BENCHMARKING SURVEY

Revenue Recognition Edition

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EXECUTIVE SUMMARY

RevenueRecognition.com in association with International Data Corporation (IDC) recently surveyed 400 business leaders about compliance processes, ongoing risks, and costs. The survey was conducted by email and all responses were on an anonymous basis. More than 75% of respondents are CFOs, Controllers, senior finance executives, and compliance leaders.

Key Findings:

⌐ More than half of all public companies have changed their revenue recognition policies as a result of Sarbanes-Oxley.

⌐ A quarter of these changes were rated "moderate" or "significant".

⌐ Business model changes are having even more impact on revenue recognition than Sarbanes-Oxley.

⌐ Only a small minority of public companies (14%) believe their Sarbox compliance processes are highly efficient and do not require additional improvement.

⌐ The top three ongoing control risks and remediation challenges for public companies are:

  ⌐ Workflow and approval processes

  ⌐ Eliminating spreadsheets

  ⌐ Revenue Recognition

⌐ The majority of companies deploying compliance technology are looking to address two or more key processes

⌐ Contrary to public opinion, perceptions about the costs and benefits of Sarbox do not vary significantly by company size.

SARBOX AND REVENUE RECOGNITION

One of the primary objectives of Sarbanes-Oxley is to ensure that companies are reporting accurate revenue numbers. Therefore, revenue recognition practices have been under particular scrutiny and one might expect to see sweeping changes in this area. As indicated in Figure 1 more than half (55%) of all public companies, responding to our survey indicated that they have changed revenue recognition practices as a result of Sarbox. While the majority of changes have been small, more than 25% were moderate to significant.
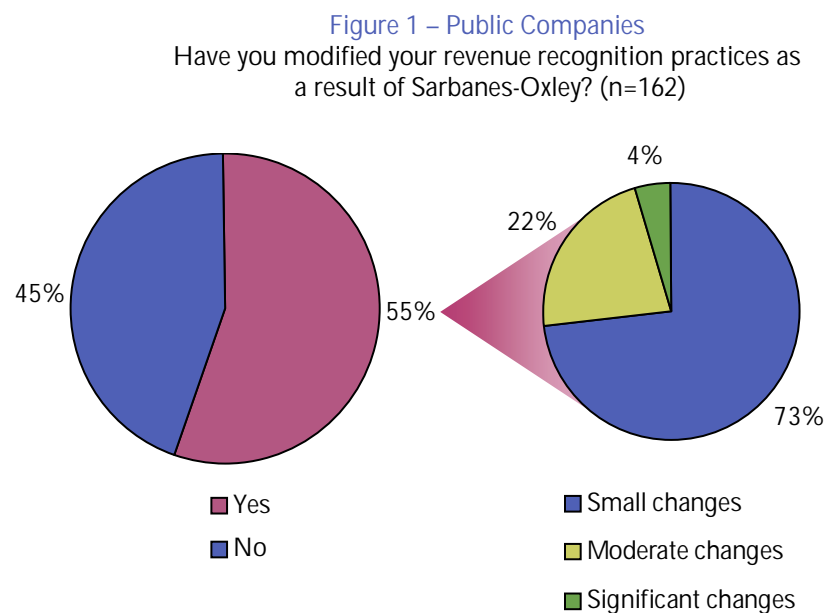
Sarbox is also having a significant impact on private companies as shown in Figure 2. Although fewer companies have changed their revenue recognition practices as a result of Sarbox, a large minority (45%) have. And the nature of the changes is very similar to that reported by public companies.

Figure 1 – Public Companies
Have you modified your revenue recognition practices as a result of Sarbanes-Oxley? (n=162)

Figure 2 – Private Companies
Have you modified your revenue recognition practices as a result of Sarbanes-Oxley? (n=238)
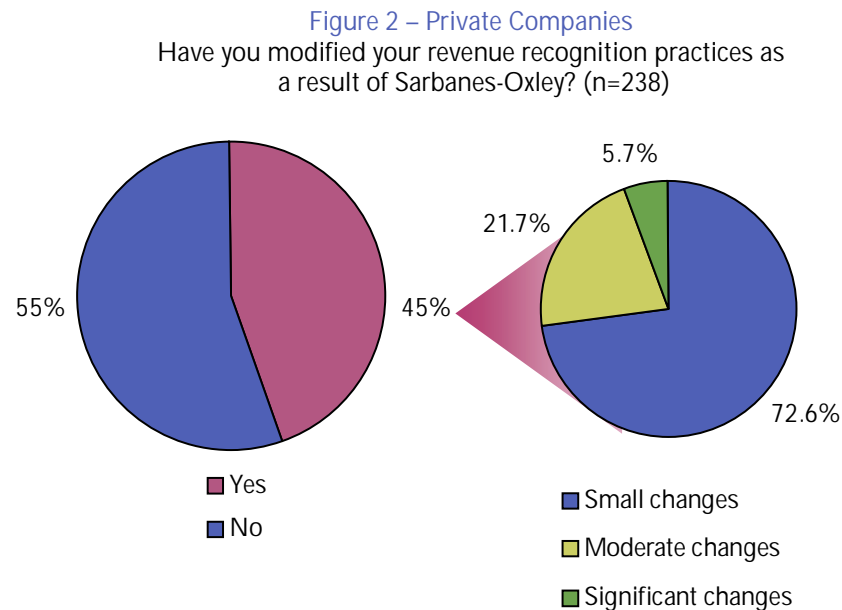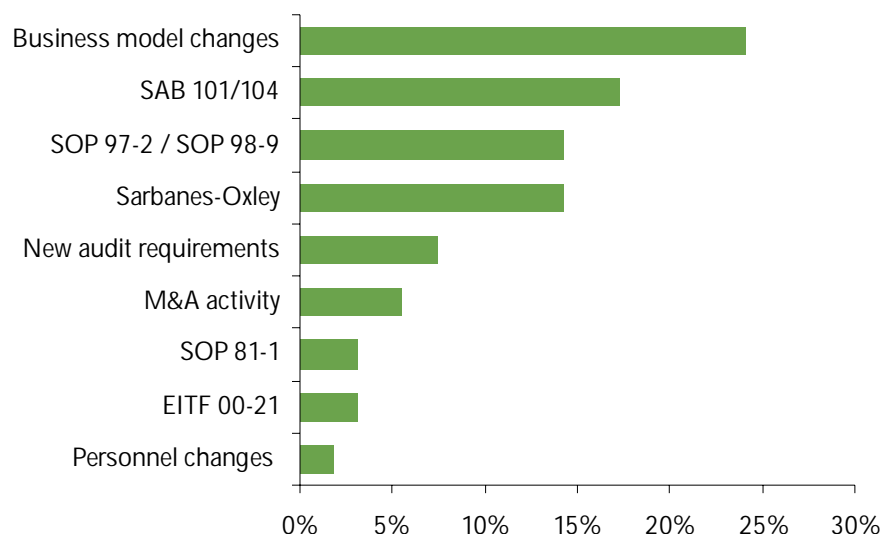
THE IMPACT OF BUSINESS MODELS

Revenue recognition policies at public companies are being impacted to an even greater degree by business model changes, as shown in Figure 3. A key indication of how business models are affecting revenue is also revealed by these results. The AICPA Statements of Position (SOP) 97-2 and 98-9, and the SEC's Staff Accounting Bulletins 101 and 104 all have to do with revenue recognition rules for complex business models—those involving bundled products and services delivered over long term customer relationships.

The results from private companies show an more dramatic difference between the impact of business model changes and all other factors. The key challenge for finance departments is that new business models often require new revenue policies. Interestingly, Sarbox ranks third even though it doesn't directly apply to private companies. An explanation for this may be that standards for auditing, as well as due diligence for raising capital and M&A activity have been elevated for all companies.

Figure 3 – Public Companies
What is the primary factor impacting revenue recognition policy at your company? (n=162)

Figure 4 – Private Companies
What is the primary factor impacting revenue recognition policy at your company? (n=238)
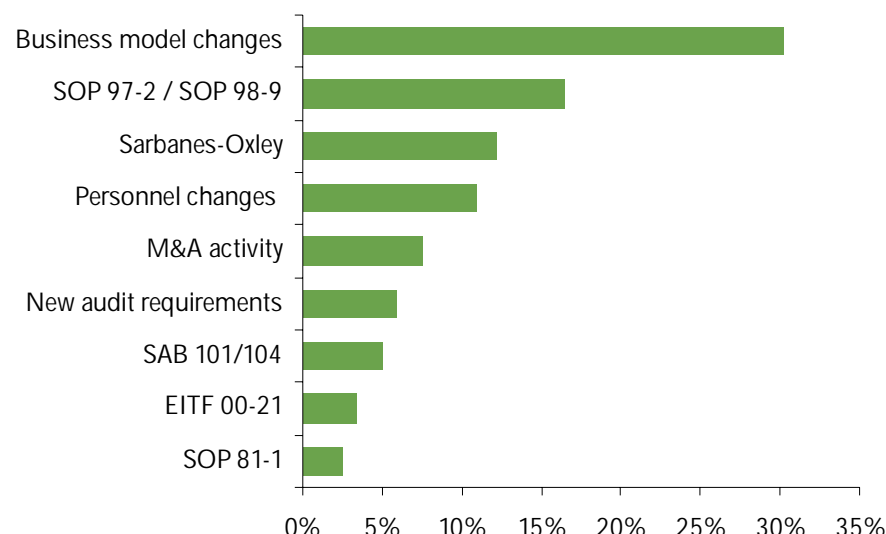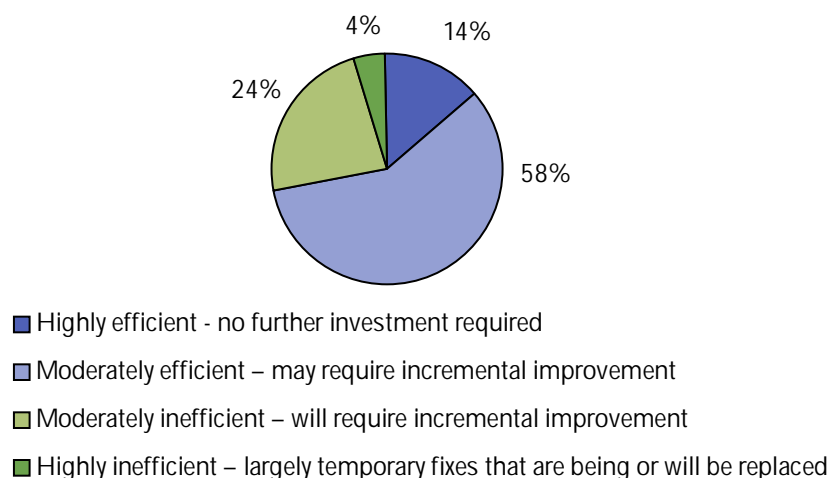
COMPLIANCE PROCESSES – EFFICIENCY AND RISK

The business process implications of Sarbox 404 are enormous. With respect to revenue alone, the entire order entry to journal entry process must be reviewed, remediated, and documented across all offerings, divisions, and regions. As a result, many companies have taken a long term approach to compliance in which continuous improvement is a central practice. As Figure 5 shows only
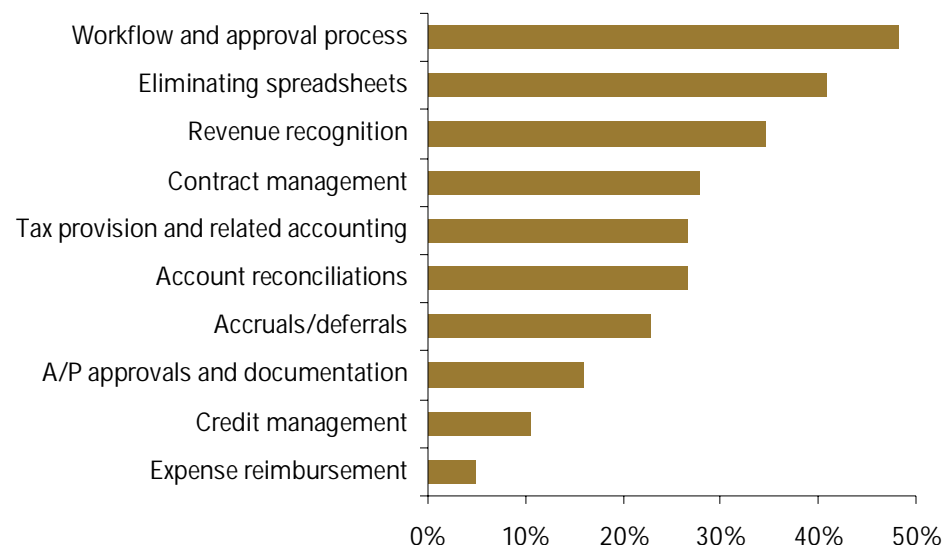
> # 14%
> of public companies said their compliance processes are **"highly efficient"** requiring no further investment.

That begs the question of what processes are companies having the most difficulty addressing. Figure 6 shows that the top three ongoing control risk or remediation challenges are "workflow and approval process," "eliminating spreadsheets," and "revenue recognition." The pervasiveness of spreadsheets and the specialty calculations they perform are making them difficult to replace. But susceptibility to errors and resistance to documentation makes them a major source of risk. Revenue recognition is becoming far more complex as a result of the combined effect of regulation and business model innovation.

Figure 5 – Public Companies
How would you rate the efficiency of your key compliance processes for Sarbanes-Oxley 404? (n=162)

4% 14% 24% 58%

- ■ Highly efficient - no further investment required
- ■ Moderately efficient – may require incremental improvement
- ■ Moderately inefficient – will require incremental improvement
- ■ Highly inefficient – largely temporary fixes that are being or will be replaced

Figure 6 – Public Companies
Which operational processes represent the largest ongoing control risk or remediation challenge?
(Multiple responses accepted. n=162)

Process	
Workflow and approval process	
Eliminating spreadsheets	
Revenue recognition	
Contract management	
Tax provision and related accounting	
Account reconciliations	
Accruals/deferrals	
A/P approvals and documentation	
Credit management	
Expense reimbursement	

0%   10%   20%   30%   40%   50%

COMPLIANCE TECHNOLOGY – MITIGATING RISK

When asked to indicate their plans for evaluating technology to address these operational issues, the results are largely consistent with the previous findings. "Eliminating spreadsheets from the financial reporting process" and "workflow and approval process" are the two key priorities for compliance related technology in 2005. Other key financial processes are also being aggressively automated including contract management and revenue recognition.

Many of the processes listed in Figure 7 are inter-dependent; therefore it is no surprise to find that:

77%
Of companies **evaluating** compliance technology in 2005 are considering solutions for two or more processes.

"As compliance processes evolve, many companies will look to technology to achieve both compliance and business benefits. By automating revenue recognition processes, organizations can more readily achieve revenue compliance as well as improved revenue reporting. This not only reduces risk, but lays the foundation for better business performance by providing more timely and accurate information to executives."

Kathleen Wilhide, Director of Compliance and Business Performance Management research at IDC

Figure 7 – All Companies
Please indicate which technologies you are evaluating in 2005 (n=400)
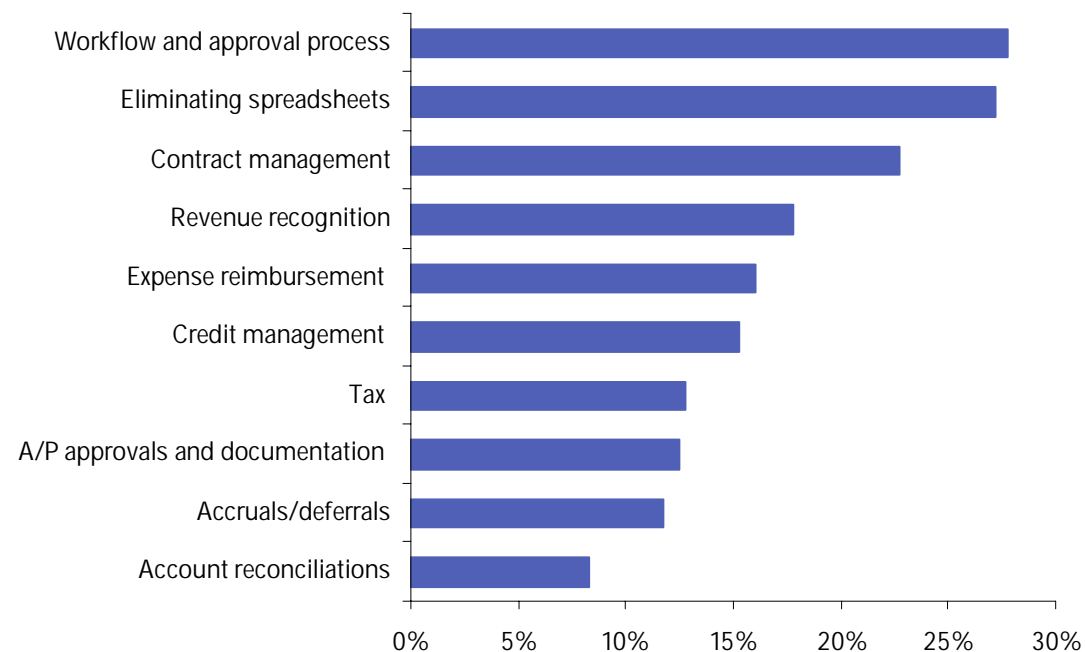
SARBOX COSTS

One area of debate about Sarbox compliance is whether it unfairly penalizes public companies. As shown in Figure 9, there are differences in the cost/benefit perceptions of public and private companies. A little more than 70% of respondents from public companies said the costs of Sarbox "exceeded" or "far exceeded" the benefits, while only approximately 53% of private companies did.

Figure 9 – All Companies
To date how would you compare the costs and benefits of Sarbanes-Oxley compliance at your company? n=400
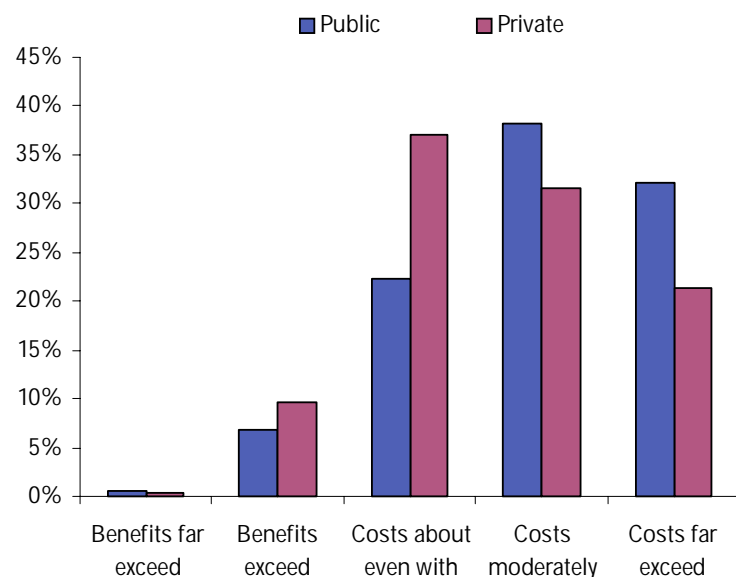
SARBOX COSTS – SMALL PUBLIC COMPANIES

Another aspect of the Sarbox cost debate is whether small public companies (in this case defined as under $200 million in revenue) are unduly burdened by the costs relative to larger companies. The results in Figure 10 show virtually no difference in the responses from public companies with less than $200 million in revenue and those with more than $200 million in revenue.

Figure 10 – Public Companies
To date how would you compare the costs and benefits of Sarbanes-Oxley compliance at your company? n=162
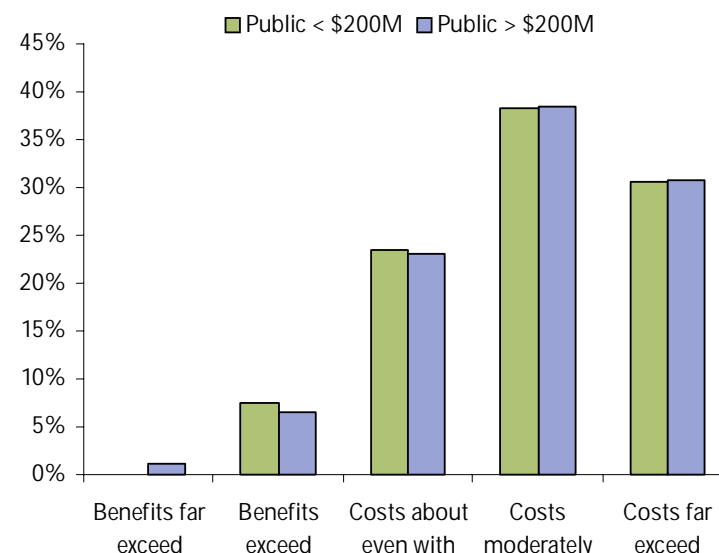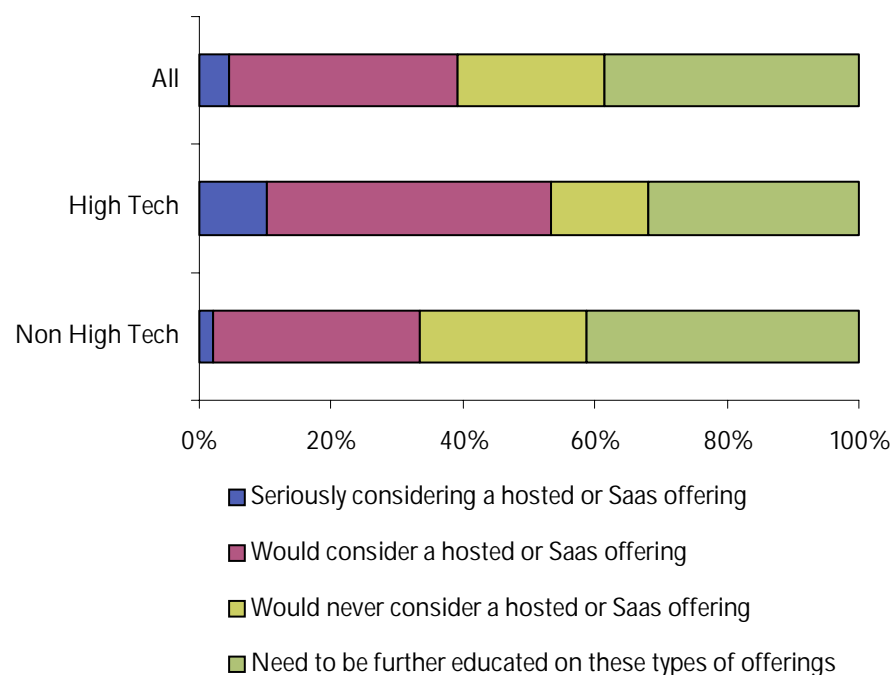
SARBOX COST – OUTSOURCING

The high cost of compliance, particularly with Sarbox section 404 has opened a discussion about the most efficient ways to acquire and manage technology solutions. One emerging alternative is to use a web-based solution that replaces the high up front and ongoing expense with a monthly fee. This is often referred to as "hosting", "on demand", or "Software as a service" (Saas).

As shown in Figure 8, more than a third of respondents (35%) said they would consider a hosted or Saas offering. Most indicated they need to be further educated (39%), and only about one in five said they would never consider this approach (22%). Five percent said they are seriously considering a Saas solution for compliance.

These results were consistent between public and private companies and between different size companies. The only differences occurred between high-tech companies which indicated a higher propensity to adopt their own medicine (10% seriously considering, 43% would consider), and non-high tech companies (2% seriously considering, 31% would consider).

Figure 8 – All Companies
Would you consider using a compliance software solution delivered over the Internet for a monthly fee?
(All: n=400, High Tech: n=116, Non-Tech: n=284)

■ Seriously considering a hosted or Saas offering

■ Would consider a hosted or Saas offering

■ Would never consider a hosted or Saas offering

■ Need to be further educated on these types of offerings

SUMMARY

Sarbanes-Oxley has had a great deal of impact on revenue recognition practices. In addition, business model changes are rolling across many industries as customers demand better ways to acquire, manage, and finance capital expenditures of all kinds. The changes can be radical for some industries where cash and revenue have traditionally been equivalent. The advent of subscription business models for complex products and services delivered over long term customer relationships represents a major operational and compliance challenge for finance departments.

Many companies have started looking to enhance their financial infrastructures with better technology. They will also have to optimize key processes and increase staff competencies for managing the accounting and compliance challenges associated with new revenue streams.

There is much more work to be done in terms of maturing the compliance infrastructure, but many companies may find that this is necessary groundwork for supporting more fundamental changes in the way they sell and account for their offerings.

DEMOGRAPHICS

Figure 11
What is your title? (n=400)
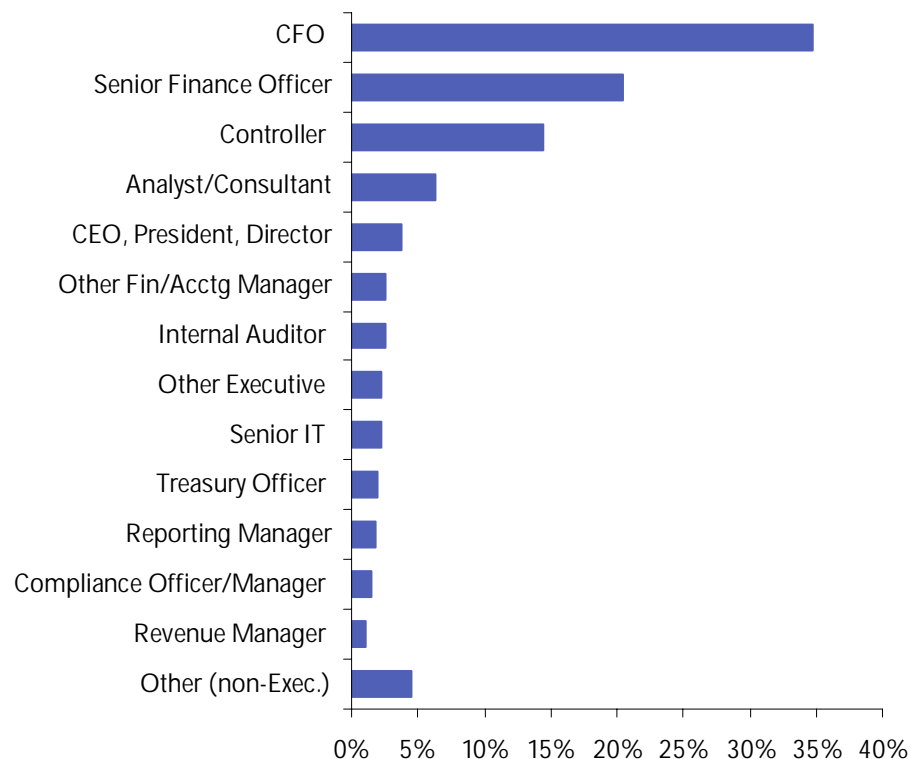
DEMOGRAPHICS CONTINUED
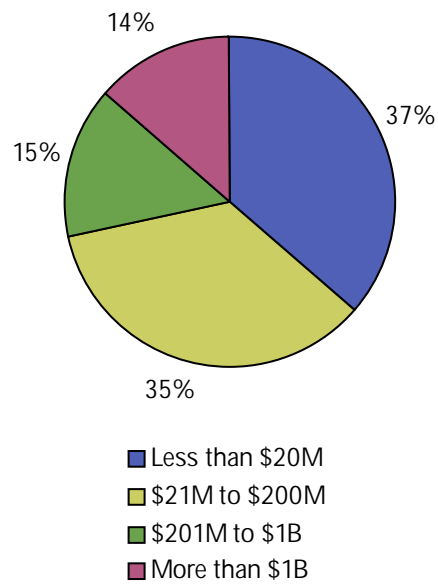
Figure 12
What is your annual revenue? (n=400)

14%
37%
15%
35%

- Less than $20M
- $21M to $200M
- $201M to $1B
- More than $1B

Figure 13
What is the ownership structure of your company? (n=400)

40%
60%

- Private
- Public
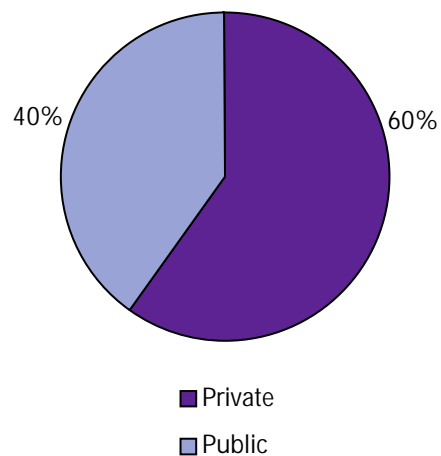
Figure 14
What is your company's main industry? (n=400)

1% 13%
2%
4% 22%
5%
7% 15%
8%
12% 13%

- Computer HW/SW
- Services
- Manufacturing
- Financial services
- Healthcare
- Trade
- Communications
- Non-Profit
- Transportation
- Utilities
- Other
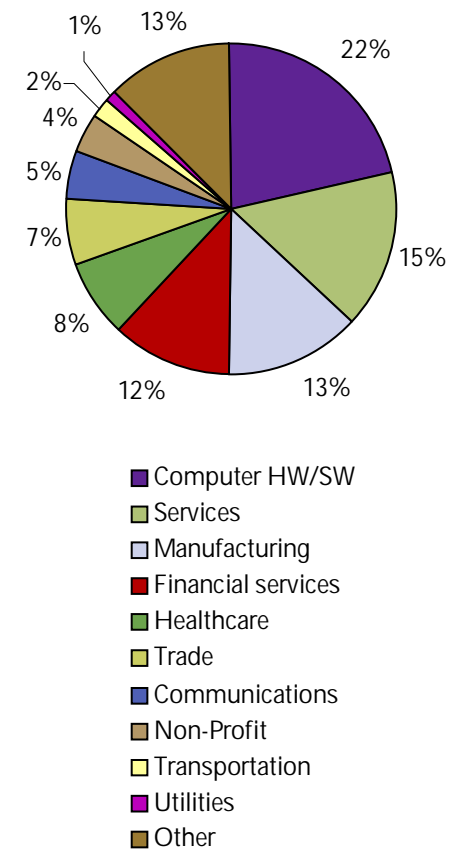
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