Roadmap to the Revenue Compliant Enterprise

Part One: Achieving Accurate Revenue Accounting, Reporting, and Forecasting

The Challenge of Revenue Compliance

The importance of a rigorous approach to managing revenue has, in the last few years, risen to lofty heights. Accurate revenue reporting provides a clearer picture of the overall health and well being of the corporation, while inaccurate revenue reporting substantially increases the risk of financial restatements.

However, revenue accounting is simultaneously coming under greater scrutiny and becoming more complex. Guidelines and regulations are under constant review, and many industries are adopting new business models involving wide ranging customer relationships with long-term financial implications.

The introduction by the Securities and Exchange Commission of Staff Accounting Bulletins (SAB) 101 and 104, as well as FASB's Emerging Issues Task Force (EITF) 00-21 and the Sarbanes-Oxley Act have merely underscored the fact that reliable revenue reporting is a demand all companies must meet, and that it is non-negotiable. Accurate, timely, and comprehensive revenue reporting is now a requirement for enterprise infrastructures and an essential component for regulatory compliance. The system required to manage revenue is on a par with a major enterprise application.

Revenue has become a "hot spot" for auditors and investors. As a result, revenue compliance must become a core competency of every finance department to ensure proper reporting, to produce optimal performance, and to mitigate risk. This white paper describes the key success factors for achieving the Revenue Compliant Enterprise.

The Revenue Compliance Environment

The term revenue is often used colloquially in reference many different metrics—sales, bookings, earnings, even the sales pipeline. For the purposes of this white paper we are using a more precise definition of revenue based on how the money represented on sales orders flows through deferred revenue accounts until it is recognized and reported on financial statements.

A revenue compliant enterprise must be able to manage revenue through the complete financial cycle. Managing revenue through this cycle falls into three main phases:

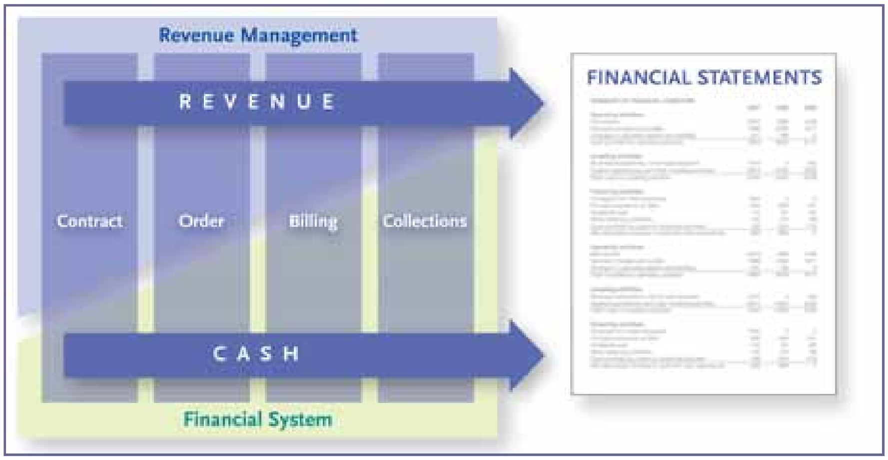
- Managing the order to revenue process
- The analytical reporting of revenue data
- The generation of revenue forecasts

Each phase builds upon the other. The last item is often the holy grail of revenue management as both finance and accounting grapple to make sense of data typically distributed over a multitude of spreadsheets or composed of incomplete reports. However, the order to revenue process is the foundation on which all other revenue related activities will rely, and therefore, it must be systematized first. Only then can a baseline of accurate and consistent revenue data be established for forecasting future revenue and generating a wealth of business performance metrics. In the end, the ability to provide executives and investors with an accurate estimate of future performance becomes a reality.

Managing the Revenue Cycle

The order to revenue process is similar to the order to cash process. In fact, the two processes are inextricably linked, with cash and revenue proceeding through the cycle under different criteria, at different rates and amounts. Therefore, automation should be applied to these parallel processes in a separate but coordinated way.

Figure 1
The Revenue Parallel



It is surprising, however, that while most financial and enterprise systems have developed rigorous mechanisms to manage the order to cash process, the same systems have typically failed to treat the order to revenue process as anything more than an afterthought. While the cash position of a company and the balance sheet are critical indicators of corporate health, it is often the information behind the revenue numbers that provide the granularity needed to understand true corporate performance. The essential question is which offerings, accounts, regions, and contracts are driving revenue growth, and which are creating bottlenecks.

The situation is exacerbated by the sales pipeline. The pipeline to cash process is the subject of continuous planning as assumptions are made about when contracts under negotiation may lead to cash. The same level of analysis is required for revenue but is often missing from systems developed around simple financial models in which there is little or no separation between cash and revenue. With the advent of more sophisticated long-term financial relationships with customers, more and more companies are looking for a solution to provide the revenue counterpart to the cash analysis.

The Order to Revenue Process

To support a rigorous approach to revenue, there are five core business processes that should be addressed by the implementation of a revenue compliance system:

Revenue Allocation

The critical first step is properly allocating revenue across a complex set of products and services with different pricing schemes. Both GAAP (e.g. based on EITF 00-21) and non-GAAP (e.g. driven by internal reporting needs) allocation rules should be able to be applied to the appropriate revenue streams. This process must be automated as much as possible and robust transaction tracking must be built in to limit audit exposure. Inaccurate allocation and has been the cause of many financial restatements.

Revenue Scheduling

Best business practices call for revenue scheduling to be applied at the transaction level. This simplifies managing the changes that inevitably occur after the original contract has been initiated and represents a point of detailed audit control. The major challenge faced by most companies is the sheer volume of data that needs to be created and managed. This typically exceeds the capability of general financial applications.

Revenue Recognition

Revenue recognition covers a wide range of processing. It can be triggered from a recognition date or can require intense manual scrutiny by the financial staff to ensure the four pillars of recognition have been satisfied. Ultimately, most corporations are forced to establish controls for recognition so that each transaction is appropriately treated. The major problem is providing visibility into the critical events that impact revenue recognition.

Four Pillars of Revenue Recognition

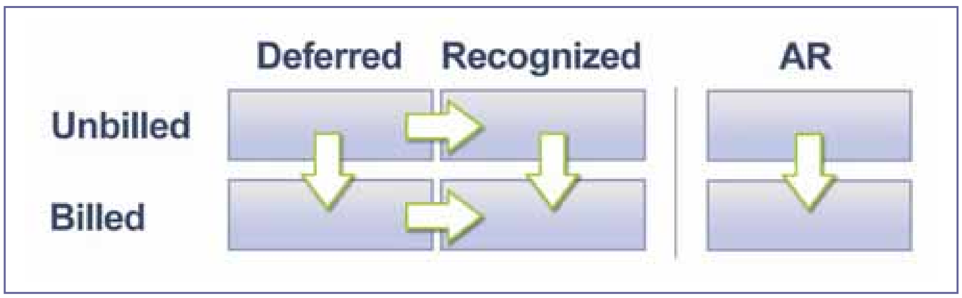
According to GAAP, revenue is realizable and earned when all of the following criteria are met:

1. Persuasive evidence of an arrangement exists
2. Delivery has occurred or services have been rendered
3. The seller's price to the buyer is fixed or determinable
4. It is reasonably assured that payment will be collected

Revenue Accounting

Revenue accounting is the bridge between the subsidiary ledger and the general ledger. There are effectively two major hurdles that must be addressed. The first is the ability to record accurate billing/receivables against the revenue schedules so that the correct amount can be booked into unbilled and billed revenue. This is known as the six-account problem where revenue moves from being unbilled and unearned to billed and earned over the transaction lifetime. Unfortunately, most companies fail to control the unbilled revenue even though it typically represents a significant amount of future revenue booking.

Figure 2
The Six Account Problem



Six Account Problem: Money can flow from Unbilled/Deferred to either Billed/Deferred or Recognized/Unbilled depending on contract terms for delivery and payment. Then the billing and recognition processes must be reconciled before it becomes Billed and Recognized. This flow must be coordinated with Accounts Receivable entries.

The second problem relates to multi-currency transactions as defined by FASB 52. A revenue schedule may need to be revalued to provide accurate revenue bookings due to fluctuations in the exchange rate over length of the recognition period.

Revenue Compliance

The last key component is to control the compliance of the revenue recognition process and ensure the appropriate steps and re-mediation is applied. Compliance is a holistic effort that must be consistently rigorous throughout the revenue cycle. Revenue transactions must be supported with a robust audit trail in order to provide the records necessary to fully document internal controls. User identities, access privileges, and authorization rights must be centrally controlled.

Most companies reach a point where 80% to 90% of the transactions can be booked through a standard business process. However, there are always exceptions that fall outside the normal business practice that need to be addressed uniquely. These transactions are often materially significant since they stem from a new business or entry in a new market. These risks put the revenue from such ventures under increased scrutiny. It is critical therefore, that the underlying infrastructure be flexible enough to quickly and easily systematize new revenue streams and apply the same compliance standards.

Revenue Analysis and Reporting

Once the revenue data is placed into a controlled environment, the next challenge is transforming revenue data into meaningful information. The benefit of optimizing the process for managing the mechanics of revenue is that the data is now organized to support detailed analysis. However, the problem many organizations typically face is that the analysis needed to address this issue is not present and therefore needs to be developed. This problem can be addressed effectively by a business intelligence solution designed specifically for analyzing revenue data.

While this capability produces the typical list of desired reports, the real advantage is that it can provide new ways of looking at the data. This is often the first time an organization can provide the executive team with the key revenue metrics they need to truly understand performance trends across offerings, regions, and customers both historically and into the future.

The dimensions for revenue analysis

The basis for revenue forecasting is more than just the data. Descriptive attributes such as sales territory, marketing segment, and contract type are often required for any meaningful analysis of revenue performance. However, these attributes may only be captured at the sales order or contract level. Similarly, the revenue and deferred revenue journal entries that record a transaction are often entered with minimal description, creating a major obstacle for analysis.

The reporting level for revenue

The amount of information on a transaction is usually diluted during the sales process until it is recorded at the general ledger. As a result, for many types of analysis it is necessary to report on revenue further upstream than the GL account number. Different organizations often require that revenue information is reported at different levels. For example, project managers may have a significant interest in the percentage of completion of a project independent of the billing against that project. This information should be present within in the same environment used at the corporate level.

Revenue Forecasting

Forecasting revenue requires that data be created within the system based on active contracts and future transactions. This necessitates an inherent link between the revenue accounting system and data from many other systems to incorporate the terms of multi-year contracts, sales pipeline data, the status of service projects, consumption of support and maintenance resources, etc.

Forecasting revenue can typically be broken onto four main areas:

- The revenue that will be recognized based on the deferred revenue schedules maintained within the system. These typical have a high degree of confidence associated with them.
- The revenue related to future commitments, such as services. This revenue typically has a high degree of certainty associated with it, although the timing of recognition may not be well understood and may depend on critical milestones being reached.
- The revenue associated with the contract renewals. Forecasting this revenue must take into account historical trends and exceptions.
- The revenue associated with new business contracts. This is the least certain revenue in the forecast and must often be based on global assumptions from historical trend analysis.

To produce a forecast that will closely match revenue if the transaction is booked, the following must be satisfied.

- The rules that are used to schedule and recognize revenue in the forecast are closely related to the same accounting standards that will be used when the order is booked.
- The forecast data must be merged with the analytics model, so that the same analytical procedures can be performed on the various forecasts.

Using this methodology, a large number of forecasts can be quickly generated based on a variety of assumptions. This leads to a much better understanding of the elasticity of the forecast and the risk associated with each model.

Closing Thoughts

The benefits of achieving the revenue compliant enterprise are wide ranging. The availability, reliability, and usability of key business performance information improve tremendously. Compliance processes are easier to manage. Tedious mandatory tasks such as closing the books and supporting audit processes become far more efficient allowing more time for proactive analysis. Executives are better informed about key revenue drivers, enabling issues to be identified and acted upon with greater immediacy.

Our experience at Softrax has led us to believe that achieving the revenue compliant enterprise is an opportunity. With an optimistic approach to the implementation of such a system, it can and will turn into a competitive advantage for your organization.

Get Part Two: *Managing Multiple Business Models*

The second part of "Roadmap to the Revenue Compliant Enterprise" outlines some of the key operational elements that can impact the implementation of a revenue compliant enterprise. It provides an overview of the most common enterprise issues, business models, accounting complexities and other components that need to be considered for such a solution.

Go to: www.softrax.com/revenuepart2

About Softrax

Softrax Corporation is a leading provider of enterprise revenue management and billing software solutions that fundamentally change the way companies manage, analyze, report, and forecast their revenue. Softrax solutions automate the entire revenue cycle, from revenue recognition, reporting and forecasting, through complex billing and contract renewals. Hundreds of corporations benefit from using Softrax to optimize their revenue, reduce operating expenses, comply with revenue recognition regulations and Sarbanes-Oxley requirements, and gain unprecedented visibility into their business performance. Softrax Corporation, headquartered in Canton, MA, is privately held. More information can be found at www.softrax.com, www.RevenueRecognition.com, or by calling 1.888.4SOFTRAX.

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