Roadmap to the Revenue Compliant Enterprise

Part Two: Managing Multiple Business Models

Introduction

Customers are demanding easier ways to acquire, finance, and manage capital investments of all kinds. That means creative ways to enhance customer relationships, including the financial transactions associated with them, will be applied continuously. Companies with inflexible financial infrastructures will find it difficult to bring innovative ideas to market and to keep pace with those that do.

Finance is under pressure to get new business models to market and support them with the same efficiencies and compliance standards that have already been applied to traditional revenue streams. Increasingly, companies are operating two or more business models, frequently within the same customer agreement. As a result, the financial infrastructure—systems, process, and personnel—must manage an increasingly diverse set of challenges. The operational implications should not be underestimated in their scope or complexity.

Business models allow fundamental policies to be established for revenue management. In addition, they provide a mechanism to identify normal business practice versus exceptions. The business models covered in this white paper include:

- Services
- Licensing
- Support
- Subscription
- Utility/Usage

When some or all of these models are sold as part of the same customer relationship, the revenue accounting requirements can be extremely daunting. Allocation issues may stipulate that deliverables made under one model trigger revenue carve outs from items previously delivered under another model. Many factors can directly impact the revenue accounting including currency fluctuations, addendums and additions to original agreements, product upgrades, and tiered pricing schedules, to name a few.

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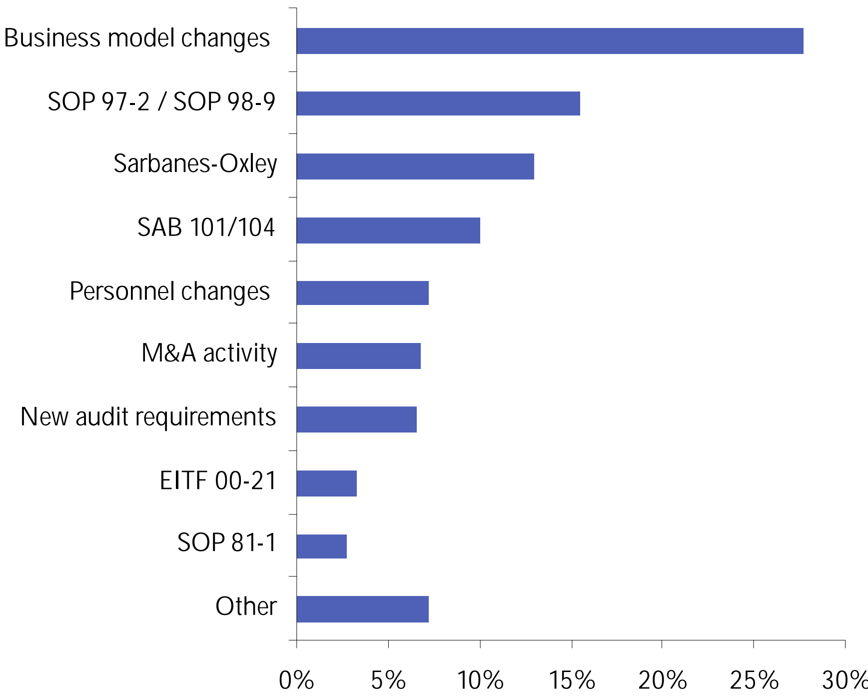
As Figure 1 illustrates, a recent survey of 400 companies by RevenueRecognition.com and IDC showed that business model changes are having by far the greatest impact on revenue recognition practices. The nature of the impact is reflected in the results for the various guidelines and regulations. FASB's Statements of Position (SOP) 97-2 and 98-9 each apply to how revenue is to be recognized from multi-element contracts. These contracts involve multiple business models operating under the same customer agreement, typically over long delivery cycles. When offerings are sold this way, the complexity of the relationship shifts from the front end to the backend—and revenue recognition practices in particular, must be managed with care. The Security and Exchange Commission's Staff Accounting Bulletins 101 and 104 expand the applicability of SOP 97-2 revenue accounting from the software sector to all companies engaged in similarly complex customer relationships.

Figure 1
What is the primary factor impacting revenue recognition policy at your company? (n=400)



Source: www.RevenueRecognition.com and IDC, 2005

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It becomes acutely obvious that the financial infrastructure must be both flexible enough to accommodate continuous innovation and robust enough to sustain compliance with a wide range of guidelines and regulations. If implemented on an enterprise scale, a revenue compliance infrastructure can lower costs and deliver competitive advantage—better reporting leads to better decisions, which in turn enables more profitable customer relationships.

This white paper discusses some of the key challenges that come with each business model and the capabilities required to systematically control the associated revenue. The following sections present the most important criteria for managing revenue from each of the primary business models in use today.

Services

The Services model generally applies to contracted labor used either to develop solutions or implement solutions. Under these arrangements it is necessary to define:

The term of the contracts: The term of the contract must be established. The length of term will dictate the period over which to recognize revenue. Abnormal contract lengths will typically be flagged for exception processing. Multi-year arrangements require additional scrutiny to determine the relationship between revenue and delivered items. For many complex contracts no single term exists. Each part of the contract may refer to a special provision that covers only those items, and their unique impact on revenue recognition. Therefore the simple capture of single elements relating to start, end, notification, renewal dates, etc. is seldom sufficient. The addition of amendments during the life cycle of the contract may also affect how revenue has been booked historically, calling for adjustments to be made. This is especially relevant when the scope has been poorly defined or the estimate on effort has been misjudged.

The interpretation of SOP 81-1: This AICPA Statement of Position (SOP) defines the rules for applying contract accounting. The exact methodology will depend on the exact nature and terms of the contract. The details of the contract that will dictate the exact method are typically defined in policy documents and as part of the internal audit recommendations. Since many contracts are negotiated on a case-by-case basis the distinction between deliverable phases and items

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delivered with standalone value may require additional notes to be added to each contract to explain why certain methodology is used. An excellent description of this is available at:

http://www.iasb.org/uploaded_files/documents/8_135_200403oba.pdf

Calculation and origin of percent complete: The percent complete calculation can be varied and complicated. Data should be sourced at the project level— for example from a professional services automation (PSA) application— with the appropriate contract terms needed to define revenue associated with the project. While the revenue management system only needs to operate on the final numbers for correct accounting, Sarbanes-Oxley section 404 requirements make the audit trail more important. As such, it may be necessary to carry over certain notes to the revenue management system to provide the basis for revenue recognition. The export of this information into a single repository relieves the effort for testing of both systems and duplicate controls.

Revaluation process: Changes in the contract, including time and scope can cause a revaluation of the revenue to be executed. The changes in items must be pushed into the system and revaluation or rescheduling must be performed.

Assignment of value to milestones: Milestones are usually defined in the contract or at the project level. In many cases these are tied to billing. These milestones must be identified along with the amount of revenue established for each milestone. In many cases the revenue amounts will differ from the billing amounts. The milestones associated with a contract can include:

- Delivery of a work-packet
- Legal sign off of performance
- A reached date
- The passage of cancellation and rights clauses
- The reaching of a pricing milestone
- The reaching of minimum quantities

Milestone and event tracking: Any milestone or significant event that impacts revenue must be tracked. These events will trigger revenue recognition and are critical for reliable backlog forecasting. The process for bringing these milestones into the system and tracking critical events must be identified.

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Unfortunately, milestones and events are typically sourced form a variety of legacy systems. The interplay between each of these milestones requires that the revenue management system have extensive workflow and centralized management functionality.

Application of payments and prepayments: The timing of payments and any prepayments against the project must be identified, and the policy used to assign payment amounts to items must be defined. Payments for services may originate from a variety of disperse billing systems. In some cases, it is easy to tie the payments to specific items within the contract, while in other cases this is less obvious. In both cases it is necessary to bring sufficient invoice detail to perform invoice matching and allocation of billing to revenue.

Licensing

The Licensing model generally applies to software, intellectual property, and technology products. The complexity of licensing generally introduces a number of revenue considerations, including:

Term of license: The length and type of license must be established. There are often tangible and non-tangible changes to the terms made. The changes to the terms must be evaluated against revenue impact. In a similar manner to services, a contract might be subjected to multiple provisions that impact just a phase or certain products within the licensing agreement. For example, licenses may be granted for different distribution rights.

Ability to perform alone: A portion or portions of the license may be subject to future deliverables that affect the same or other portions of the license. It may be possible to identify these items in an automated way.

These items are often identified as:

- Future Upgrade deliverables
- Rights to add-on products
- Rights to upgrade items
- Purchase of other future products at a discount
- Upgrade of embedded products

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Although the product may be sold standalone, the additional information may be needed to substantiate that the impact of these other items may or may not be material. Any performance specifications that are included in the contract typically need to be captured to assess if the current product can meet these requirements or if upgrades will be necessary.

Delivery of license: The delivery of the license and what constitutes delivery must be established. Other items that will be processed as part of the same arrangement often impact this. The delivery of a license is often accompanied by a deployment schedule or less frequently, the staged delivery of multiple licenses. For example, an arrangement may provide a restricted license during the pilot phase with conversion to a deployment license. The exact mode that constitutes delivery of a license may also be affected by the end-user agreement such that it requires the user to activate one or more keys for acceptance. Software activation is a particularly sensitive area since the user is typically required to consent to an end-user agreement to complete the arrangement. The dates most commonly used to define delivery are:

- Date of shipment
- Date of delivery to a distributor/reseller
- Date of customer receipt
- Billing date (if billing cannot occur without delivery)
- Date on which support is first provided
- Date when training is complete
- Date when implementation is completed
- Date when minimum commitment is accepted.

Value of bundled licenses: The mechanism for unbundling components within a license must be defined and vendor specified objective evidence (VSOE) must be applied as needed. In many cases this can be automated, however new combinations may need to be identified for exception processing. The unbundling process may involve the following:

- Identification of items based on bill-of-materials
- Identification of items based on pre-defined allocation break-out

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- Identification of related items by virtue of grouping with the sales order
- Identification of items related to information relayed within the contract
- Identification of items linked by delivery or acceptance time frames.

Effective date of license: The effective date of the license may dictate the revenue term as opposed to delivery. In these cases this information may be clearly identified as part of the process. The effective date may be tied to a master agreement. The effective date can only be used if the other requirements for revenue recognition have been met. This requires constant monitoring of these future dates to ensure the effective date of the license is valid for revenue management purposes. The processing requirements for this value are similar to those required for the right to cancel date. These dates include:

- Date of installation
- Date of activation by the vendor
- Date of the contract

Re-mediation clauses: Any clauses, which allow returns, or trials, must be identified. This is particularly frequent with product promotions and bundled arrangements.

The common remediation clauses that are needed include:

- Right to Return (partial or full)
- Right to Cancel (partial or full)
- Cancellation Penalties
- Failure to perform
- Warranty reserve

In many cases a reserve is setup to establish the management of these items. However, depending on the materiality of the items in question this may not be appropriate. For example, a warranty reserve on a completely new product may be difficult when no precedent exists for that type of product within the given marketplace.

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Support

Support is generally provided to customers to facilitate the operation of installed products. In many cases, the support relationship can be leveraged to sell/up-sell offerings from other business models (e.g. increase users, upgrade products, deliver add-on products and services, etc.). It is important, therefore, that support transactions be integrated with the enterprise accounting workflows.

Term of support: The length of term and start of the term are critical. In many cases the start of support is tied to external events and delivery. Support terms can be unique to the customer and the nature of the contract. With the implementation of Sarbanes-Oxley 404, many questions have been raised around latitudes in support agreements that allow support after the stated terms on a "customary" basis. In general, the factors affecting support terms are:

- Date of acceptance
- Date of receipt
- Length of support after warranty

Pre-paid incident support: The commitment for incidents or the prepayment of support incidents will typically require additional treatment. In most cases the timeframe for these incidents to be used must be captured. Pre-paid incident support is becoming increasingly prevalent after the initial support term. However, the incident fee is often waived. This could cause an extension of the original term for revenue purposes, or some other accounting consideration.

In dealing with pre-paid support the following will be considered:

- The term of the incident support (i.e. pre-paid incidents must be used within a timeframe)
- Value per incident (specifically if tiering is applied)
- Actual Usage
- Projected Usage
- VSOE value (if part of a multi-element arrangement)

Support bundling: The value of support and how it is bundled with the other items must be identified. Overriding support contracts may require additional treatment. Additional complications are caused by support co-termination

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arrangements. Although the support term is often specified, it is necessary to maintain detailed records to substantiate the support offering. In general the support attributes include:

- VSOE value for support (for multiple years)
- Revaluation for future concessions
- Revenue allocation latitude (i.e. sales price variance versus VSOE)
- Number of agreed incidents
- Actual term vs. specified term
- Actual incidents vs. paid incidents

Renewal terms: The renewal terms and any commitments to future pricing must often be considered in the initial valuation of the support. As discussed above, the commitment to future discounted revenue, even if the support agreement is renewable, will affect the initial revenue recognition. On the anniversary date, the revenue will need to be adjusted (typically upwards) if the maintenance is not renewed. Since the renewal term may vary product to product or product group to product group this information must be maintained on a detailed basis. The situation is further complicated when multi-year deals are renegotiated with respect to co-termination rights. The information that is typically needed to track this efficiently includes:

- Renewal term
- Length of agreements follow-on pricing
- Plan variation

Subscription

The Subscription model is increasingly being applied to many different types of offerings and is prevalent in a great and increasing number of industries. Implied with a subscription is future delivery of and payment for the offerings on a periodic basis. In a similar manner to support, a subscription service sold as part of an arrangement will need to be revalued in line with the Security and Exchange Commissions' Staff Accounting Bulletin (SAB) 101, and VSOE will need to be established where necessary.

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It has been interesting to see the growth of bundling of subscription services with many different types of products. For example, it is now commonplace for membership subscriptions to health clubs to now be bundled with free personal services. "Smart services" are being applied to a wide spectrum of offerings from household products that notify the manufacturer of a potential malfunction to transportation satellite information and security systems such as OnStar.

Product activation: The driver for activation of the product must be identified. Subscription services are often sold as part of an offering. However, the activation for revenue purposes can depend on many factors.

These include:

- Receipt of activation keys
- End-user activation
- Delivery of associated products, services, or rights
- Delivery of training
- End-user signup (if offered as part of a package)
- End of trial period (automatic conversion)
- End of warranty period
- Receipt of activation hardware (i.e. dongle)

Subscription term: The term and value associated with the term will dictate the appropriate spreading of revenue. Any additional optional terms that are included need to be included in the revenue calculations. The situation is often complicated since subscription services may be offered as part of a hardware agreement (e.g. cellular phone companies). Many subscription services also include right to cancel clauses that place a limit on the cancellation penalty or remediation terms. In most cases the revenue is spread over the term. More recently the conservative approach has been encouraged that either recognizes revenue on a pro-rated day basis or defers any revenue until the accounting period that follows booking of the revenue.

Extension impact: Subscription contracts are often extended at the discretion of customer care as an effective means of retaining customers. This must be captured and evaluated to determine if additional treatment is necessary or a

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change of policy is required. At a minimum it is required that reporting information is available to assess the materiality of the amounts.

Utility/Usage

Utility/usage arrangements are based on the delivery of product measured in a transaction or usage-based manner. Utility/usage arrangements that bill the customer based on usage or transactions are common in many industries and growing in major sectors.

Transaction value: The value of each transaction should take into account volume pricing. In some cases it is necessary to establish the average value over the contract lifetime. The transaction model can be complicated when the pricing model is also time dependent. In general the information that is captured is:

- Actual price per transaction
- Average price per transaction
- VSOE price per transaction

Transactional Volume: Very high volumes of small dollar transactions may necessitate bucketing revenue and the summarization of revenue amounts, e.g. gift cards in the retail industry. In many cases it is more efficient to capture similar transactions in revenue "buckets." Any exceptions to the process or cancellations and adjustments are then made in a detailed manner. The transactions are always captured within the system allowing for audit tracking (i.e. the revenue buckets can be associated with the transactions). This gives the system the ability to handle very large transaction volume, and still maintain a detailed audit trail of exceptions and revenue schedules that get changed.

Time-based commitments: Commitment to deliver certain levels of transactions must be identified. This allows portions of revenue to be recognized independent of additional transactional volume. These time-based commitments are usually based on the contract. To record this information in the system the following is necessary:

- Rate of transaction commitment
- Amount of transaction commitment
- Value of transaction commitment

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- Actual usage at time of commitment
- Billing/Unbilled issues at time of commitment

Prepayment and scheduled payment options: The payment amounts and the application to the transactions are necessary to correctly account for revenue and backlog. This can be one of the most complex areas for which to determine correct booking of receivables. This may be an issue if:

- Billing is done from a disparate system
- The invoice detail does not match the service detail
- The invoice amounts are not easily mapped to revenue amounts
- The payment schedules includes partial payments not tied to revenue
- The payments include amounts for other services unrelated by revenue

True-up processing: Payments made in advance for transactional volume need to be reconciled with actual usage. The actual usage must be captured for true-up processing to occur. This is typically the case where a minimum payment is made each month. At the end of each month the actual usage is compared to the minimum. The complication is that the payment at the beginning of the period is continually being apportioned between deferred revenue and revenue at the end of the period. To complicate this further, this true-up may affect the future month billing.

Minimum commitments: These can permit revenue to be recognized ahead of the transactional usage. The minimum commitments may cross product and agreement boundaries. In general, these relationships must be captured within the VSOE pricing mechanism to associate fair value across product boundaries. In many cases this is alleviated since minimum commitments are only booked in arrears. The parameters associated with minimum commitments are:

- Length of commitment
- Date of commitment
- VSOE Values
- Allowed product combinations

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End-of-term processing: Any residual transactional amounts that remain after the contract has expired must be accommodated. The process for this can vary based on the revenue policy; however there are strict accounting guidelines that cover this process (e.g. EITF 01-09). This is often referred to as "salvage" or "Es-cheat" and is common with gift cards, etc. It is important that these amounts are removed from the deferred revenue "buckets" and handled appropriately so that the amount of deferred revenue is not inflated. The following attributes are typically captured:

- Contract identifier
- End of term date
- "Salvage Method"
- "Salvage" Date

Contract Length: The length of the contract and any extensions need to be captured to correctly predict backlog and evaluate run rates where necessary. In the case of a utility contract, the contract may not be for a specified time. However, all contracts are written with some length of the term that it covers. In general the information captured includes:

- Start date of commitment
- End of commitment
- Expected revenue
- Expected monthly commitment

Accounting for Multiple Models

For most companies the path to growth has been less than straightforward. Initially, companies adopt one or two discrete business models, and can handle the revenue from a minimum number of customers. However, as more sophisticated customer relationships develop, managing revenue becomes far more complex. Some of the common issues include:

1. A wide range of variation in customer contracts and lack of standardization create inconsistent revenue policies.
2. Acquisitions, partnerships, and distribution channels produce different business processes, and interpretation of revenue management rules.

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3. New business units and cross selling opportunities increase the accounting transactions that need to be executed.
4. International expansion leads to the need to account for ongoing fluctuations in the value of billing and revenue recognition amounts.
5. Planning for future financing requires *squeaky-clean* financial reports and disclosures.
6. Increased executive interest in non-GAAP information and pro-forma financial statements.

These issues occur as part of the normal growth of any business, and few businesses can afford to start, staff and implement a scalable solution. Growth companies invest over time in infrastructure and ERP systems, and compensate for functional deficiencies with a myriad of spreadsheets and disparate databases. It is hardly surprising that closer examinations have revealed weakness in revenue accounting, which has led to numerous financial restatements and delays in reporting.

Closing Thoughts

Operating a Revenue Compliant Enterprise is a regulatory and market mandate. Good revenue management practices must be systematically controlled throughout the entire order to reporting process. Traditional financial and ERP systems are designed to manage revenue and cash as similar elements. Companies that move beyond this require specialized revenue management capabilities. The most effective solution is to implement an enterprise system that can manage the revenue streams generated by multiple business models.

Our experience at Softrax demonstrates that it is possible to increase both operational flexibility and internal control over business models at the same time. Establishing core competencies in revenue management will enable the finance department to facilitate business innovation, effectively control how revenue is reported, and help optimize the performance of different business models. Furthermore, a holistic approach to automating revenue compliance and the business processes that feed it can improve productivity, reduce risk, and drive more informed strategic thinking for managers at all levels of the organization.

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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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