

Changing Revenue Recognition Landscape



Executive Summary

Revenue recognition rules are changing and they will impact countless accounting departments and systems. Key concerns include:

- Older financial or ERP software solutions may lack enough functionality to fully support the new requirements leaving customers to use a kludge of spreadsheets and other inelegant and inefficient workarounds.
- New revenue recognition rules will be going into effect in 2018 and 2019. Many firms, especially subscription economy and service firms may be ill-prepared to meet the new requirements.
- Even newer cloud financial accounting solutions may have material differences in how elegantly or efficiently they will accommodate these new accounting rules.
- More than a regulatory change, these rules could impact how deals are made/sold, what gets bundled into deals, how commissions are paid, etc.
- For Finance groups that have outgrown or have outdated accounting software, now maybe the time to replace their solutions. Delays in doing so could require the use of sub-optimal, labor intensive, error prone and expensive alternatives.
- Bolt-on solutions may seem attractive but they may introduce more data latency issues and raise audit costs versus a solution that is part of a larger, fully integrated financial software suite.

Time is of the essence regarding these rules changes. Smart firms must act now so as to:

- Understand new requirements
- Acquire, populate and test new systems
- Model and communicate the financial impact of the changes to key stakeholders
- Prepare for even more rules changes to come

Who is Impacted?

Revenue recognition, like the matching principle, exists to ensure that the recording of a business event accurately reflects the income **and** expenses of a given transaction or contract across all relevant accounting periods. All firms must adhere to these two principles. Of the two methods of accounting, cash and accrual, most mid-to-large firms use the accrual method. But with this method, companies must exercise additional care as to how and when they record income and expenses. The key to this determination is assessing when five key (or critical) events have occurred. Roughly, these criteria identify when:

- risks/rewards are now in the control of the buyer
- the seller has no control over the goods
- the payment is assured
- the amount to be paid is known with certainty, and,
- the costs of goods/sales/etc. are measurable

These rules guide accountants in determining when and what they should book in corresponding accounts during each accounting period. Granted, simple transactions, like retail point of sale purchases, are easy to record as monies and goods are transferred in the moment. There is no argument over the price and the cost of goods sold. But in other situations, guidance is needed. A partial list of transactions that require special consideration include those where:

- payments are tendered over the life of a contract or subscription
- sellers demand advances or deposits prior to the completion of a sale or delivery of the goods/services
- sellers offer a warranty that extends beyond the current accounting period
- the goods are bundled with services that may require several accounting periods to complete
- commissions (and/or other expenses) are earned over the life of a deal's term or earned unevenly
- some or all of the sale is possibly subject to a buyback provision
- goods can be returned for a full or partial refund for some time after the sale
- additional products or services are added to the original contract or the term of a contract is altered

There are also rules that apply when cash is received at a different time than when goods/services are delivered or billed. Likewise, there are rule differentiations based on the kind of asset sold (tangible vs. intangible) or service delivered. Large construction or IT projects (e.g., where percentage completion or other billing methods might be used) present other, specialized accounting requirements.

Many industries will be impacted by these changes. These include financial services firms, firms using grant monies, hospitality firms, technology firms and more. Software-as-a-

CHANGING REVENUE RECOGNITION LANDSCAPE

Service (SaaS) and other software companies will be significantly affected as could construction, service firms (e.g., outsourcers), cellular phone businesses, cable companies and many more. Any company that has products or services delivered across multiple time periods, with billing occurring over multiple time periods or permits adjustments to be made to these customer agreements during the life of the deal may find that its revenue recognition practices will need to be updated.

The New Rules

New accounting rules go into effect in 2018 for public firms and 2019 for private companies. (Note: firms with multi-year contracts may need to implement the changes earlier). Specifically, these new requirements can be found in the Accounting Standards Codification 606 (this supersedes ASC 605). IFRS 15 also addresses these matters and has similar effective dates.

Accountants will need to plan for the transition to the new standards. Of particular concern will be multi-year contracts or contracts that originate pre-2018 (or 2019 for private firms) but whose term goes into the 2018 or beyond timeframe. Those contracts will need to be re-examined under the new requirements once the January 1, 2018 (or January 1, 2019 for private firms) threshold date occurs. Soon, some companies may find they will be:

- doing more frequent reallocation of contract amounts
- see a material difference as to when revenue is now realized
- evaluating contracts under new and old rules for a time

Readers would do well to consider previous accounting standards such as:

- IAS 18 (Revenue Recognition) – Issued in the 1980's and due to be superseded by IFRS 15 in 2018
- AICPA Statement of Position (SOP) No. 97-2 – Guidance as to software revenue recognition
- EITF Issue No. 00-21 – Guidance as to the allocation of contract components

The newest standards/requirements should make financial statement comparisons across companies more comparable. Differences in revenue recognition methods used by companies should be lessened. New regulations will make the accounting more challenging in the short term but hopefully, bring a more consistent set of rules/processes going forward.

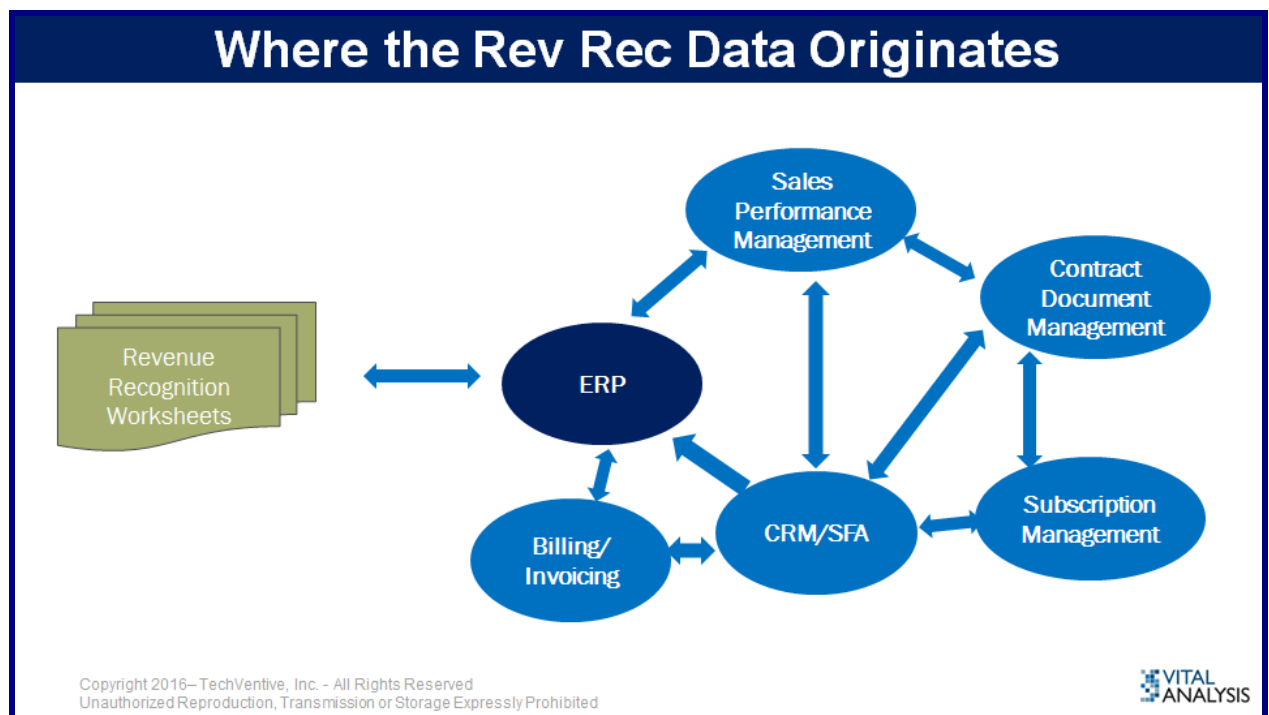
Compliance Challenges

Users will need tools to compare the pre- and post- effect of the accounting rules changes on contracts, contract alterations (e.g., add-on sales), commissions and more. Data for these calculations will come from a variety of sources and may include software systems such as:

- Financial Accounting or Enterprise Resource Planning (ERP)
- Customer Relationship Management (CRM)
- Sales Force Automation (SFA)
- Sales Performance Management (SPM)/Sales Commission Management
- Subscription Management
- Contract or Document Management/Contract Lifecycle Management

Once collected, the needed data must be analyzed with decisions made as to the amounts to be booked to specific accounts within specific accounting periods. The worksheets needed to make these determinations could exist within a financial accounting solution (i.e., the best practice), in a custom system, or, in spreadsheets (i.e., not an optimal, long-term solution).

Where the Rev Rec Data Originates



These worksheets also need to serve another function: they may be needed to explain the effect of new Revenue Recognition standards on pre-existing and new contracts. This view could highlight material changes in the financial condition of a firm. Management and shareholders will need to understand how these accounting changes may impact future financial statements. Businesses may need to create an alternate set of books within their current financial accounting system to capture and report these different views of revenue.

CHANGING REVENUE RECOGNITION LANDSCAPE

There will likely be other changes required as well. Organizations may discover that prior sales practices, commission structures, etc. may warrant change. When companies bundle services, warranties and products into a single contract, these amounts must be unbundled to determine their correct revenue recognition impact. Moreover, other factors (e.g., commissions earned in subsequent periods, add-on sales to a pre-existing contract, contract term extensions/contractions) may warrant a re-examination as well. Why? The new accounting rules for some of these actions may become onerous. For example, some contract changes may simply be easier to accommodate via an all-new contract than a re-casting of an existing contract.

So, how will businesses cope with these new requirements? There are roughly three options:

- Develop a custom solution
- Create spreadsheets, spreadsheet templates, etc.
- Upgrade or acquire new financial accounting software

Choosing among these three options, accountants and businesses must determine which option is best short-term and long-term. But, if the wrong option is chosen, businesses will find they have created a time-consuming and costly mess.

The Custom Solution option:

Custom-developed financial applications are rarely a good use of IT resources. The best use of scarce IT budget and personnel should be in the development of "strategic" applications (e.g., Internet of Things data analytics) – not in the development of a "tactical" back office application. Revenue Recognition functionality should be licensed/subscribed not custom-made. Smart firms do just this as it would take too much time for IT to research, design, test and build the accounting software to handle the current and future Revenue Recognition functionality. It's doubtful that there is enough time now to build a custom, well-tested, accurate, highly functional and integrated Revenue Recognition application by January 1, 2018.

The Spreadsheet option:

Accounting departments could develop a number of custom spreadsheets/worksheets to allocate the costs and income for each transaction or contract. This option is fraught with potential problems as there could be substantive issues with version control, unintentional errors, hard to find/resolve errors, different spreadsheets producing different results for the same data, etc. Additionally, the output of these calculations would need to be correctly entered into the financial and other systems. Would spreadsheets also forecast future period revenues? Would spreadsheets show the pre-/post- effect of new Revenue Recognition standards? Would spreadsheets handle mid-contract adjustments/extensions/add-ons? Would there be automated or manual interfaces to/from these numerous spreadsheets to the affected systems (e.g., general ledger)? If the interface is manual, then additional error opportunities could arise.

There exists a real problem for those firms that end up using hundreds or thousands of spreadsheets for Revenue Recognition calculations. When the time comes to upgrade their financial accounting software, how will they convert all of the formulas, implied rules, data

CHANGING REVENUE RECOGNITION LANDSCAPE

values, etc. within these Revenue Recognition worksheets to a new accounting package? The amount of manual labor to do so could be daunting and prone to errors.

While spreadsheets may appear to be short-term option, the long-term costs could be huge. There is an efficiency (and error-risk) concern with all of the spreadsheet data that would need to be moved from these spreadsheets into journal entries. This is a cost and data quality concern. Likewise, external auditors might find the audit trail of such patchwork activity to be a concern. This could drive up audit costs.

Spreadsheets are great tools but it's rare to see one make a great replacement for a fully functioning, tightly integrated accounting solution. Before any company goes this route, they may want to see if their external auditor likes this approach.

The Upgraded/New Financial Accounting solution:

This may be the best, logical and long-term solution of all. The key advantages of a pre-built, pre-tested solution include:

- a consistent approach to Revenue Recognition
- immediate availability to the solution so that users have time to assess current as well as future deals with new and old accounting standards
- a fully tested solution
- a solution that meets accounting standards
- a solution that may be tightly integrated with the customer's financial accounting/ERP software
- calculations and audit trail of same to satisfy internal and external auditors

Moreover, if the solution is from a multi-tenant cloud solution provider, the vendor, not the customer, is on the hook for future accounting standard and functional upgrades.

Regardless of the solution chosen, finance executives must assess whether:

- their existing financial accounting system is past its prime and should be replaced
- it is cost effective or technically relevant to put more capital into an old-technology based solution
- new functionality for Revenue Recognition will be available and installed on their existing solution in a timeframe that permits testing now and a go-live for January 1, 2018
- their current system will also support additional accounting standards and regulatory changes to come

Key Components of a Great Revenue Recognition Solution

- **Full-suite of accounting software not just a single revenue management application** – To do revenue recognition activities easily, efficiently and with few errors, the revenue management solution should be tightly integrated with as many of the feeding systems (e.g., CRM, billing, etc.) and accounting systems (e.g., general ledger) as possible.
- **What-if or other revenue recognition scenarios should be kept in the same accounting book** – If different books are required for these scenarios, then the production of comparative financial results is more difficult and costly. These multiple sets of books could also introduce errors.
- **Unlimited scenarios** – If your firm has a rich legacy of writing all kinds of one-off deals, bundled deals and/or granting mid-term contract changes, then you will want extensive scenario modelling capabilities to understand the effect of new rules on these transactions.
- **One or many contracts within a single scenario** – When defining different scenarios, users may want to lump numerous, similar contracts/deals into a single scenario for allocation processing.
- **Functionality for expense recognition** – Revenue recognition technically covers both revenue and associated expenses (e.g., sales commissions) for a given transaction. However, not all solutions are ready yet for modelling rules changes for both revenue and expenses. Vendors have been working on the revenue side first and may deliver new expense functionality in a future release. Make sure you have both capabilities in time for your firm's needs.
- **Large pool of potential allocation rules/bases** – Some amounts will need to be spread out evenly across the life of a deal. Some will have lumpy distributions. Some will be one-time and others may occur as a result of some other basis (e.g., percentage of completion or milestone).
- **Flexible date options** – Make sure you can recognize revenue during any accounting period, accounting year, quarter, etc.
- **Transition tools, data conversion tools, etc. for new software** – Software buyers should look for tools to help load data from prior contracts and accounting systems. Given how many data elements must be converted and how these were used for prior revenue recognition rules calculations, any help with this is great to have.
- **Transition tools, data conversion tools, etc. for existing software** – If you currently have a revenue management software solution, will the vendor provide you with tools to painlessly convert data from one set of revenue recognition rules to the new rules?
- **Substantial notes retention functionality** – Users should be able to annotate any allocation or other decision. These notes should stay with the transactions and be available to auditors and other authorized users

Implementation Timing for New Revenue Recognition Requirements

So, when should firms start acting on new revenue recognition requirements? The short answer is NOW!

For some companies, the impact of these new requirements may be minimal to non-existent as their firm or industry does not have many bundled, long-term or other affected transactions. As a result, they may not need new or updated financial software. They do, however, need to test their knowledge and assumptions re: new Revenue Recognition requirements internally and with their auditors to verify their understanding and compliance needs.

For those firms modestly or materially impacted by these new requirements, they must act quickly to determine how they will meet these requirements and what potential impact these changes will have on current and future earnings.

Impacted firms must decide the technical approach they will use to meet the new requirements. They must assess the impact on their firm should they delay the implementation of new or upgraded financial software. This decision requires an assessment of the:

- availability of new software, software upgrade or custom functionality
- cost to implement new/upgraded software
- cost to support/maintain the new solution
- ability to apply new/future rules/standards
- potential risk if the rules are incorrectly applied
- reputation damage if the company misstates its financials

If businesses need any further encouragement to get acting on new Revenue Recognition requirements, they should know that more changes are coming. Specifically, new rules governing lease accounting are coming. Software vendors will likely address these requirements in short order. Businesses will likely incur years of Revenue Recognition accounting changes. As a result, the debate for firms won't be "*Should we replace our financial accounting software?*" but rather "*When should we replace our financial accounting software?*"

Conversion Issues

As organizations prepare to meet new Revenue Recognition requirements, there are several conversion and implementation issues to consider. Specifically:

- Any worksheets, contracts, etc. used in calculating the appropriate Revenue Recognition journal entries for previous deals may need to be re-examined and possibly re-worked given the new requirements especially if the term of the deal crosses the January 1, 2018 timeframe.
- If the customer was using Revenue Recognition functionality in their current financial accounting software, they may still face a material upgrade and conversion process of their old system and data. This is due to the material changes in the requirements.
- Some vendors may charge extra for the new/upgraded functionality.
- New lease accounting functionality may follow later.
- Any company considering new financial accounting software should ensure that the software already supports new revenue recognition rules now. Delays in receiving this software could result in substantive problems.
- More data elements are needed to support new Revenue Recognition requirements. As such, some prior deals will need re-examination to collect these new data elements.

There may be some people issues to consider as well. These include:

- Does your systems integrator (or vendor or vendor channel partner) possess personnel who are skilled in both IT and Revenue Recognition requirements? These subject matter experts (SME's) must possess deep accounting knowledge.
- Does the company's accounting group have the appropriate knowledge re: new Revenue Recognition requirements? If not, who will provide this training?
- Does the company's accounting group have enough time to implement new Revenue Recognition (or possibly an entirely new Financial Accounting) solution? Are current accounting activities already taxing employees? Does the firm need to acquire some short-term accounting talent so that it can free up its best accounting resources to work on this initiative?

And, of course, there will likely need to be policy, pricing and other conversations within the company as executives begin to understand the effect the new requirements will have on the firm's financials, accounting workload, etc. More specifically, the company may want to change the way it bundles some products, services and/or warranties together. Simplifying deals might simplify the accounting for same and, possibly, change the timing of when some monies are booked. Likewise, the timing of when commissions are earned and paid may need adjusting to better align with new accounting requirements. Will Sales agree with these? And, should the firm adjust the way or terms for making a mid-term contract adjustment? Companies will need to balance the ease with which sales people and customers want to do business with the company versus the accounting workload these 'conveniences' place on Accounting. Who will arbitrate these discussions and how they will get resolved in a timely manner will be a test of a great executive team.

Future Concerns

This wave of accounting rules changes will not be the only one to impact firms in the near term. Additional changes can be expected with expense recognition and lease accounting.

The implication of this is that meeting the requirements for this latest set of changes may not be all that companies must address. Selecting a technology approach for the current requirements must be done in a way that maximizes short and long-term business requirements.

The Cloud and Revenue Recognition

Software buyers have many choices when it comes to new financial accounting software. They can deploy solutions: on-premises, private cloud, hosted single-tenant cloud, and, multi-tenant cloud. One of the advantages of the multi-tenant solutions is that the vendor, not the customer, is on the hook to upgrade the software for the customer.

Why is this important? For many non-multi-tenant solution users, their IT department will have to acquire the new revenue recognition software, schedule the upgrade project(s), load the software, convert data, configure all interfaces, test the software, etc. This effort(s) must occur within the backlog of other, possibly more strategic, IT projects. A delay in getting the new solution in place could create problems for the accounting organization in meeting the new requirements in a timely and cost-effective manner.

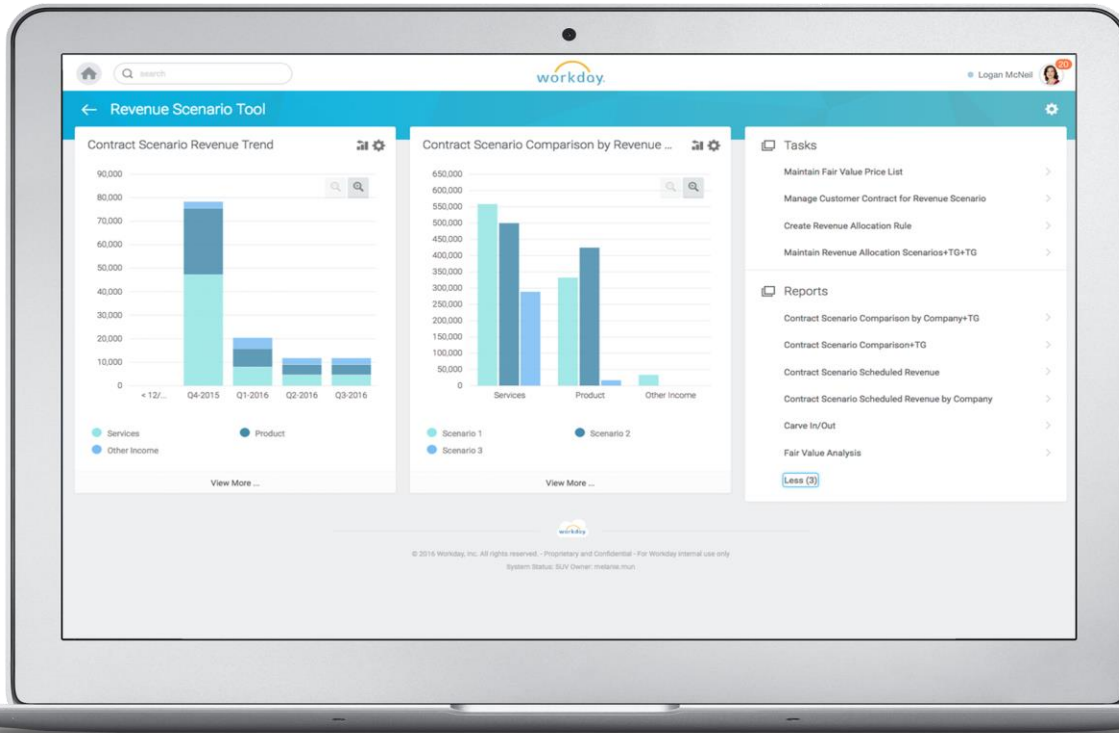
Regardless of deployment method, all financial software vendors will likely release several updates to their products as newer revenue recognition rules are required and supported. The question for software users is can their IT department have the just-in-time resources to implement these upgrades?

For multi-tenant solution users, the vendor should automatically update the software and much of the data. Many multi-tenant solution providers already have released updated solutions.

But not all multi-tenant solutions are the same. One solution provider requires users to implement an all-new revenue management module as the number of new data elements and functional requirements with the new regulations made their prior solution obsolete. This solution requires, essentially, a re-installation of revenue management.

Workday's Revenue Recognition Solution

Enterprise cloud application software firm Workday offers full contract-to-cash revenue management functionality as part of its core financial capabilities. These revenue recognition capabilities enable customers to: record revenue events, complete fair value analysis, link contracts, and, allocate and recognize revenue for simple and multi-element arrangements. Customers looking to assess the impact of the new standards on their revenue strategies might benefit from modeling different revenue scenarios using Workday's What-if scenario modeling capabilities (see graphic below) and create alternate contracts for dual reporting.



Workday's solution was developed in concert with market experts and companies evaluating the new standards. The software supports customers looking to transition to and adopt the new accounting rules scheduled to go into effect in 2018 and later.

Going beyond Revenue Recognition: While the new standards relate to revenue recognition, there are broader implications that may affect a firm's commission processing, sales operations, expenses, forecasting, policy decisions and more. We recommend Finance leaders work with other company leaders to assess these impacts early on and seek a solution that can accommodate more than just the financial accounting requirements. Workday's single financial management solution includes contract management, payments and collections, planning, and a general ledger. This solution addresses the most critical elements related to the new standards and allows customers a minimally disruptive mechanism to easily assess and adjust to the downstream effects of the new requirements on their broader organization.

Workday's Revenue Recognition Solution

Workday recommends that users follow a three-phase approach to transition to the new requirements and functionality:

Assess: Review and assess the impact of the new standards on all aspects of the organization. A key part of this review involves a detailed review of active contracts potentially impacted by the new requirements. Workday users can define contract sets – a capability that groups contracts with common characteristics and how those contracts will be impacted re: transaction pricing and revenue allocation. By defining the contract sets, users can quickly identify which contracts will be impacted.

Model Policy Changes: Workday possesses flexibility to configure revenue rules based on the new standards, create alternate contracts for those with potential impact, and run what-if scenarios to assess the total impact of the new standards on historical data. As such, users can understand the broader implications of the new accounting requirements on their P&L statement and more.

Contract	Contract Line	Customer	Contract Line Type	Revenue Category	Original Contract	Alternate Contract	Original Revenue	Scenario 1		Scenario 2		Scenario 3	
								Revenue	Variance	Revenue	Variance	Revenue	Variance
4054 Big Data Software Company	4054 Sales Item 1 (Line 1)	Big Data Software Company	Fixed Amount	Product	Product		8,000.00	6,211.45	(1,211.40)	1,527.78	3,472.22	3,548.39	1,451.61
4054 Big Data Software Company	4054 Service Item 1 (Line 2)	Big Data Software Company	Fixed Amount	Services	Services		15,000.00	23,958.43	(8,958.43)	22,916.66	(7,916.66)	17,741.94	(2,741.94)
4054 Big Data Software Company	4054 Subscription (Line 3)	Big Data Software Company	Fixed Amount	Product	Product		24,000.00	13,830.12	10,169.88	19,555.56	4,444.44	22,709.67	1,290.33
4057 E-Technology Inc.	4057 Sales Item 1 (Line 1)	E-Technology Inc.	Fixed Amount	Product	Product		5,000.00	5,105.99	(105.99)	1,332.36	3,667.64	7,250.19	(2,250.19)
4057 E-Technology Inc.	4057 Service Item 1 (Line 2)	E-Technology Inc.	Fixed Amount	Services	Services		15,000.00	19,694.54	(4,694.54)	19,985.46	(4,985.46)	36,250.94	(21,250.94)
4057 E-Technology Inc.	4057 Service Item 3 (Line 3)	E-Technology Inc.	Fixed Amount	Services	Services		175.00	229.77	(54.77)	233.16	(58.16)	422.93	(247.93)
4057 E-Technology Inc.	4057 Warranty (Line 4)	E-Technology Inc.	Fixed Amount	Warranty	Warranty		60,000.00	55,144.70	4,855.30	58,624.02	1,375.98	36,250.94	23,749.06
4058 E-Technology Inc.	4058 Service Item 4 (Line 1)	E-Technology Inc.	Fixed Amount	Product	Product		8,000.00	7,351.84	648.16	2,204.72	5,795.28	7,368.42	631.58
4058 E-Technology Inc.	4058 Service Item 1 (Line 2)	E-Technology Inc.	Fixed Amount	Services	Services		15,000.00	17,723.18	(2,723.18)	20,669.30	(5,669.30)	23,026.32	(8,026.32)
4058 E-Technology Inc.	4058 Warranty	E-Technology Inc.	Fixed	Warranty	Warranty		12,000.00	9,824.88	2,175.12	12,115.68	(175.68)	7,426.34	7,164.34

Dual Reporting: Once you have assessed the impact using the scenario functionality you can determine the appropriate allocations to put into effect and automatically generate revenue adjustment accounting entries based on alternate contracts. These adjustments are reflected in real-time across financial statements and disclosures to meet these reporting requirements. Workday allows you to create and maintain alternate contracts in a separate set of books, and run this retroactively during the dual reporting transition period so that you can meet dual reporting and disclosure requirements.

Summary

New Revenue Recognition requirements will create a significant amount of work for accountants and accounting staff for the foreseeable future. The time required for organizations to comply with the new rules is acutely short. Action is required NOW!

Solutions exist to help accounting teams better comply with the new rules but not all solutions are the same. Based on the deployment method, functionality and degree of conversion difficulty, one can expect to see some variations in new solutions. Buyers should be careful in assessing different options.

Simultaneous with any software evaluation effort, accounting teams should already be consulting with their external auditors and other subject matter experts about the new requirements. Becoming more cosmopolitan (i.e., to be more aware of one's environment) is essential with regards to the new rules and solutions.

Accounting teams should also start engaging with other operational entities and executives within their firm. Early conversations about the new rules and the consequences to commissions, deal bundling, etc. should occur as early as possible. Potential process changes could simplify matters for accounting personnel or sales professionals. How these decisions get made could become a top Executive Committee matter. Move now on this issue.

About Vital Analysis



Vital Analysis is a very different kind of technology research organization. We are the intersection set where exceptional technology market knowledge meets the executive suite. Where other 'analysts' replay vendor press releases, we give you the:

- Impact new technologies will have on your business.
- Reasons why you should care about specific emerging solutions.
- Business justifications why you may want specific solutions.

Vital Analysis was carved out of TechVentive, Inc. in 2007 as a new, but related, business. As designed, Vital Analysis is the publishing, research and analytical arm of that company. Our reach, like our blog readership, is truly global. We've consulted with top technology executives across the globe and have been briefed by technology providers from virtually every corner of the planet.

About the Author

Brian Sommer is the CEO of TechVentive, Inc. - a market-strategy and content firm. Brian closely follows what C-level executives think, feel and need. Brian has won several ERP Writers Awards and many of his pieces can be found at www.diginomica.com and <http://blogs.zdnet.com/sommer/>). He welcomes your thoughts and invites you to contact him at brian@vitalanalysis.com.

Reproduction of any part of this publication in any form without prior written approval is forbidden. The information in this report has been obtained from sources believed to be reliable. TechVentive, Inc. disclaims all warranties as to the accuracy, completeness, or adequacy of such information and shall have no liability for errors, omissions, or inadequacies in the information contained herein or for interpretations thereof. The reader assumes sole responsibility for the selection of these materials to achieve its intended result. The opinions expressed herein are subject to change without notice. To purchase reprints of this document or to quote passages within, please email: contact@techventive.net