

avoiding revenue management surprises

You need a good system that lets you keep track of multiple revenue streams at a glance.

BY ROBERT O'CONNOR

In the present economy, and particularly in the more volatile high-tech industries, there's a tangible need to maintain a highly nimble organization that can incorporate rapidly evolving business models in order to meet the challenges of market-entry opportunities and current market conditions. This means companies will be generating revenue from multiple sources and will have an increased need to manage that revenue properly.

Take, for instance, the software, content, and Internet sectors. Whether they are burgeoning, venture capital-backed and pre-IPO start-ups; established, privately held small businesses; or publicly traded, multimillion-dollar enterprises, what these corporations have in common is the dynamic and complex nature of their operations. Untangling and streamlining all of their revenue activities is a mandatory daily task since they must have clear, automated revenue management and reporting procedures that comply with current revenue recognition regulations.

Most companies in the high-tech arena draw revenue from more than one source, and almost all of them use some combination of license, subscription, service, and maintenance billing models. Distilled into their purest form, this equals concurrent, numerous, hard-to-track, and ongoing revenue activities. Billing on time and collecting revenue are daunting tasks. More so is maintaining visibility into past, present, and future revenue activity. Knowing when, how, and how much revenue to recognize can be a major hurdle. If companies mismanage the revenue allocation and recognition process, they can become embroiled in an audit trail nightmare and find themselves needing to restate revenues and repeatedly go back to the whiteboard with attempts to quantify forecasting without information that would support future business projections.

When a company is unable to clearly delineate the revenue streams that sustain its business, it's most likely losing revenue, increasing operating costs, and decreasing vital cash flow. Most operations manage their multiple



revenue streams by using a combination of financial and accounting packages augmented by manually updated spreadsheets, paper files, and custom-built point solutions or workarounds. In a scenario such as this, the core infrastructure of the business is self-limiting, it can't scale with the growth of the enterprise, and it uses many more employee hours than it should. Economies of scale and the efficiencies of automated processes are out of reach for these companies. But the most crucial element in this picture is the high risk for error and negative exposure. Revenue restatements often revolve around an inquiry by the Securities & Exchange Commission (SEC) and can yield damaging results. It can cost billions and sink a business venture in a matter of months.

REVENUE RECOGNITION GUIDELINES

For these organizations, the existence of increasingly more stringent SEC, AICPA, and Financial Accounting Standards Board (FASB) guidelines and regulations that address proper revenue recognition demand extreme vig-

ilance and daily adherence. The AICPA's Statement of Position (SOP) 97-2, "Software Revenue Recognition," and SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions," and the SEC's Staff Accounting Bulletin (SAB) 101, "Revenue Recognition in Financial Statements," are recent regulations that high-tech operations must comply with. If a company's current revenue management processes are incomplete or nonstandardized, there's a good chance the company using them is leaving itself open to significant error, like botched billing opportunities that result in uncollected revenue at the right time or, worse, misstated and misallocated revenue. This complicates the quarter and year-end financial closing process and consumes valuable staff-hours that could be used for something else had the systems and procedures been automated, with sophisticated methods of identifying and eliminating errors, and, more important, those transactions and allocations that violate SOP 97-2 and 98-9 and SAB 101.

SOP 97-2, introduced in 1997, was intended to be

applied to the software industry. It recognized the multi-element nature of most software business contracts with customers and, in simple terms, was meant to ensure that companies booked revenue, not on orders but on shipped and fully received contractual elements. This involved separating license, maintenance, services, and product revenue from each other and accounting for each in detail over phased allocation schedules. It also required that documented evidence of a business arrangement exist, like a signed contract, to support the individual contract management and its related schedules of invoicing and recognizing revenue. In addition, charges associated with the contract need to have fixed or determinable fees. Other stipulations involved allocating revenue using vendor-specific objective evidence (VSOE), like a price book that delineates component pricing when sold separately and prices set by management with appropriate authority. If no VSOE is present, SOP 97-2 requires that the entire contract be deferred, causing immediate impact to a company's bottom line. Without properly applying these methods to bookkeeping, it's almost impossible to understand future revenue bookings and the true financial position of any company.

EARNINGS MANAGEMENT

SOP 98-9, issued in 1998, was an extension of the principles inherent in 97-2. Recognizing the complexity of multi-component contracts even more, it put forth the term "residual method" for situations when VSOE for undelivered contractual elements exists, but VSOE for delivered elements doesn't exist, and all other revenue recognition criteria have been satisfactorily met.

The SEC examined 97-2 with an eye toward making it broadly applicable to all industries, high-tech or otherwise. It issued SAB 101B, which, to summarize, said that as of the fourth fiscal quarter of fiscal years beginning after Dec. 15, 1999, it became mandatory for all U.S. public companies to hold to SOP 97-2-like accounting standards—obviously modified to be appropriate for businesses such as manufacturing operations. Whether or not this exactly fits other business types outside the high-tech sectors is still a debatable question, but the intent is clear. For those high-tech entities that conduct all of their business within the confines of SOP 97-2, SOP 98-9, and SAB 101, the struggle is to apply the regulations' details in perfect form and operate inside the parameters of highly complicated revenue allocation schedules while still maintaining healthy cash flow from contracts it may take years to fulfill. The temptation to

Table 1: Top 10 market-value losses in 2000
Top four market-value losses resulted from revenue recognition issues at technology companies!

COMPANY	THREE-DAY VALUE LOSS	SEC ENFORCED?	REASON
Microstrategy	\$11.9 Billion	No	Revenue Recognition
Lucent	10.9 Billion	No	Revenue Recognition
Legato Systems	2.0 Billion	No	Revenue Recognition
Raytheon Co.	1.9 Billion	Yes	Revenue Recognition
First Tennessee	701 Million	Yes	Revenue Recognition
The Limited Inc.	672 Million	No	Revenue Recognition
Alpharma Inc.	457 Million	No	Revenue Recognition
Rent-Way Inc.	449 Million	No	Cost/expense
Profit Recovery	438 Million	No	Revenue Recognition
Avon Products	297 Million	Yes	Software Write-off

Source: *Quantitative Measures of the Quality of Financial Reporting*, June 13, 2001.

recognize as much revenue as possible up front is great. Therefore, accurate management reports with hard numbers for revenue projections and forecasts become the lifeblood of any high-tech enterprise. This is the key to side-stepping the revenue management surprises that can unravel a company whose reporting is inaccurate and whose books aren't consistent in methodology.

But the main genesis of SAB 101 was a marked concern on the part of the SEC about earnings management. In the year 2000, there were 156 earnings restatements by public companies; in 1999, 150; and in 1998, 91. The sharp increase was accompanied by shocking market losses, according to a Financial Executives International (FEI) report titled "Quantitative Measures of the Quality of Financial Reporting" (June 13, 2001). From 1995 to 2000, the loss was \$78.3 billion. And in 2000, seven of the top 10 restatements were directly tied to revenue recognition issues. The most celebrated public examples are of Cendant, who restated \$11.4 billion; Microstrategy, \$11.3 billion; and Lucent, \$10.9 billion. Why the trend? And the losses? Revenue mismanagement, obscured revenue facts, incorrect reporting, and use of pro forma statements that provide an incomplete picture of a company's actual status.

Most of these losses are directly associated with revenue recognition errors and the lack of compliance with SOP 97-2 or 98-9 (see Table 1). The SEC reserves the right to become involved and instigate a review and inquiry—an action that raises large red flags for investors and Wall Street. Damage to company image alone can cost untold dollars in investor confidence and ruin credibility with current customers and future sales prospects. For examples of the impact of earnings restatements, see Table 2.

Let's not forget the smaller, privately held companies in

the same situation. The cost to them when they improperly manage their revenue isn't just the obvious impact to the bottom line and the difficulties of knowing exactly where they stand financially but in enormously compromised sale, merger and acquisition, or investor activities. Incorrectly valuing its business when negotiating its sale can cost a company millions, if not billions. Restating revenue or having a significant difference between forecasted returns and actual results can lead a board of VC investors to shut down future funding. A company is never too small or too fledgling to take a serious, comprehensive approach to the way it charges for, allocates, and recognizes revenue.

Most of these issues that affect the successful operation of a viable high-tech business can be addressed by employing a sophisticated revenue management (RM) sys-

Table 2: Impact of restatements is severe

- ◆ Average of 49 restatements per year from 1990-1997, but 132 per year from 1998-2000.
- ◆ Revenue the most frequently cited reason for restatements.
- ◆ Losses are most severe when companies make revenue recognition restatements.
- ◆ From 1998 to 2000, total losses from 397 restatements, excluding IPR&D, equaled \$64.9 billion.
- ◆ "Consistent with other studies, revenue accounting is the largest source of problems."

Source: *Quantitative Measures of the Quality of Financial Reporting*, June 13, 2001.

tem. A revenue management system is fundamentally different from today's widely available financial solutions. A robust, function-rich RM solution will operate around capabilities in managing compliance with SEC and FASB guidelines and automate key processes to provide a consistent, reliable method for recurring billing, deferred revenue scheduling, pricing allocation, and revenue recognition. Inherent in the solution is customization that fits multiple business models and the ability to report data that can be used to forecast revenue in tremendous detail.

For example, in the high-tech industries of the current economy, multi-element contracts are the norm—and in endless variations. Different kinds of product and service bundles, transaction- and subscription-based financial activities, and revenue recognition schedules have to be clearly identified, priced properly, billed on time, and allocated to fit within compliance parameters. Thousands of such contracts can exist inside the systems of a high-tech business, and the business models keep evolving. Contractual adjustments are made, pricing methodolo-

gies shift, and transaction volume increases. By centralizing and standardizing all of this business-critical data in a revenue management system, several immediate benefits are apparent. The biggest is the ability to manage all contract activity from one single system that will talk to other enterprise systems and transfer critical customer/record data, supporting financial information integrity from system to system.

Utilizing a revenue management system to optimize this series of activities begins with entering each contract and then setting up schedules that automatically bill, automatically renew, and automatically record revenue in its proper period; consolidate contract activity for reporting purposes; generate detailed reports; and present a single customer bill regardless of the number of different categories of activity. Such a system streamlines not only the once-manual task of handling the individual characteristics of each contract, but the collection and appropriate allocation of revenue from multiple revenue streams. It can also enable the application of clear pricing methodologies from contract to contract, supporting VSOE.

SOME ADVICE

What's the final lesson in avoiding revenue management surprises in today's fast-moving economy?

- ◆ Correctly interpret SOP 97-2, SOP 98-9, and SAB 101.
- ◆ Construct a scalable, error-proof, standardized financial management infrastructure that can be applied effectively as the business grows.
- ◆ Invest in an automated, flexible revenue management solution that interfaces with other financial and accounting systems and manages the detailed complexity of allocation and recognition schedules, as well as maintenance and subscription billing.
- ◆ Conduct strenuous due diligence on reporting methods and on reporting itself.
- ◆ Understand the crucial competitive advantage of capitalizing on your system to produce accurate forecasting and to deliver visibility into granular levels of revenue activity in the short and long term.

By doing these, you'll have a reliable picture of your business at all times and control your revenue cycle. ■

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