APPLICATION CASE – SOFTWARE REVENUE RECOGNITION

Selectica Contract Performance Management Simplifies Revenue Recognition for Software Companies

With the advent of new regulations, revenue recognition has become a pressing problem for all businesses. Different sales models require different contract milestones, including different points at which you can legitimately claim revenue on the sale. The more complex the customer contract, the more complicated the revenue recognition requirements. Technology companies, especially software companies that offer a combination of hardware and software, can have especially complex revenue recognition concerns, since their deals typically include an initial software license, maintenance fees, and professional service fees. If you are selling hardware and software, like Selectica's customer Sun Microsystems, then revenue recognition becomes even more complex, since you have to outline revenue from the hardware sale, license fees for software, upgrade terms, service, and other factors.

An effective Contract Lifecycle Management (CLM) system, like Selectica's Contract Performance Management (CPM), can help technology companies track revenue recognition in a way that assures they are compliant with the latest SEC regulations. Selectica CPM can track the contractual arrangements of how the parties decide to recognize revenue, such as recognizing revenue from a licensing agreement all at once, while recognizing maintenance fees annually, or recognizing fees for software as service (SaaS) over the life of the contract. It also clarifies revenue recognition when hardware is bundled with supported software, and can scale to accommodate hundreds or thousands of contracts. It's your best defense against costly error that results in misstated revenue.

The Changing Face of Revenue Recognition

New business models have emerged with the explosion of the Internet, and how companies account for their success, and their profits, has changed over time. Especially with technology companies, value and market capitalization became tied to revenues, rather than net profits, and there was a growing temptation to inflate revenues through creative accounting. For example, accounting for revenues for contracts that have been signed for goods and services that had yet to be delivered became commonplace. In fact, a study published in March 1999 revealed that more than half of financial reporting fraud investigated between 1987 and 1997 was due to overstated revenues.

For public high-tech companies improper accounting could result in having to restate earnings, which could be disastrous. Consider the case of Microstrategy, which had to restate its earnings in the spring of 2000 for the last three years. Their stock went from $225 per share to $25 per share in weeks. And they had to settle a stockholder suit in April 2001 for alleged fraud from overstating revenue.

Long-term contracts, such as those required for software licenses, custom development projects, and software installation and service are particularly vulnerable to revenue recognition problems. The terms of such contracts usually span multiple fiscal quarters or even years, so accounting for revenue as it is accrued is crucial for accurate accounting.

The Basics of Revenue Recognition

Organizations such as the Financial Accounting Standards Board and the American Institute of Certified Public Accountants (AICPA) have developed rules and best practices to cover various industries and scenarios, but the rapidly changing business models and new methods for delivering goods and services make best accounting practices a moving target. To deal with the problem, the Security and Exchange Commission (SEC) published Staff Accounting Bulletin No. 101 (SAB 101), "Revenue Recognition in Financial Statements," in December 1999, which summarizes accepted accounting principles for recognizing revenue in financial statements. SAB 101 states that revenue can be recognized and earned when it meets all of the following four criteria:

1. There is persuasive evidence that an arrangement exists;
2. Delivery has occurred or services have been rendered;
3. The seller's price is fixed and determinable; and
4. Collectability of payment is reasonably assured.

Although the criteria seem straightforward, they aren't. Compliance can be challenging, depending on your business model. For example, how do you account for revenue from contracts with multiple elements, e.g. sale of a software license, maintenance agreements, customization fees, and renewals? There are some basic guidelines:

1. Revenue from the sale of a product is recognized at the date of sale, i.e. delivery.
2. Revenue from services is recognized when the service is performed or billable.
3. Revenue from use of an enterprise asset (e.g. rent, royalties, interest, but also a database or SaaS) is recognized as the asset is used.
4. Revenues from disposal of assets (other than products) are recognized at the date of sale.

Most problems with revenue recognition arise because the selling price has not been reasonably assured, or it is difficult to say when the earning process is complete. For example, if you are selling or brokering third-party products and services, do you account for the revenue at the time of the booking (gross) or the time of collection (net)? New Internet companies like Travelocity, Expedia, and Priceline sell third-party services and, according to the SEC, should report their portion of the revenue upon receipt, at net.

The Value of Selectica CPM for Revenue Recognition for Software Companies

Software companies have created different sales models and contract forms, often bundling software with hardware, other agreement, or other products, and selling software with customization and long-term service contracts. As a result, the rules of revenue recognition for software companies have been in a constant state of evolution. The best approach is to ensure that revenue is realized and realizable before recognizing it as earnings.

The AICPA developed its own set of guidelines outlined in the Statement of Position (SOP) 97-2 “Software Revenue Recognition,” (later modified in SOP 98-9). These rules are designed to deal with various sales scenarios that are common in software, such as bundled product offerings, and customer rights with regard to additional software deliverables, services, and post-contract support. Clearly defining the contractual arrangement will also define revenue recognition, which is why CLM software is needed for contract management.

For example, consider a vendor who sells off-the-shelf software and deployment services. The software and service revenue have to be accounted for separately; the software license fee is due in 30 days, where the implementation or service fee may be over 90 days or more. Since the software can be implemented without service (i.e. the implementation doesn’t alter functionality), and there is sufficient company-specific objective evidence to establish separate pricing, the software license is recognized at delivery and the implementation revenue is recognized as the service progresses.

This example uses a concept outlined in SOP 97-2 called “vendor-specific objective evidence of fair value” (VSOE). The key here is that the fair value has to be determined in advance of the contract. If fair value can’t be determined, e.g. because the company never offered the elements separately, then the revenue for the entire contract needs to be deferred until fair value is established or the contract is completed, whichever comes first. Here is where CLM software such as Selectica’s CPM can be invaluable. Using a central contract data repository makes it easy to create a library of standard contract terms that establish precedent for pricing and fair value and set terms for each revenue element.

Similarly, if a software company produces customized software for customers, revenue recognition needs to be handled in much the same way as any long-term contract. The contract is treated as a whole and revenue is realized over the life of the contract, as milestones are met. There are basically two revenue recognition models: the percentage-of-completion method or completed-contract method. Most long-term contract providers use percentage-of-completion as the preferred accounting method, assuming a contract has been executed that defines the obligations of the buyer and the seller along the way.

Contract terms have a direct relationship on revenue reporting, and while contract terms cannot supersede accounting rules, they go a long way toward providing necessary information on revenue recognition, such as identifying specific deliverables, milestones, revisions, etc. Ill-defined contract terms make it impossible to produce dependable estimates of service and implementation progress. And, of course, there have to be terms to deal with changing circumstances, such as modified specifications, missed delivery dates, change orders, etc. Again, Selectica CPM can be a lifesaver when it comes to tracking all the contract terms, including performance variables, to clarify revenue recognition.

Applying Selectica CPM for Revenue Recognition

Considering the dire consequences that can come with having to restate corporate earnings, the safeguards offered by contract management software are an inexpensive investment. Selectica CPM automates the manual processes of contract administration, including standardizing terms for obligation, compliance, performance, and payment. And as the contract terms become more complex, say to account for software service agreements or bundled packaging, the contract terms can be easily tracked, including price, incentives, and warranties.

What's more important for revenue recognition, Selectica CPM can implement accounting rules and guidelines, tracking revenues and expenses and translating them according to established guidelines. CPM also can standardize contract terms, translate contract terms into specific revenue elements, help manage non-standard contracts and their potential impact on revenue recognition, and provide analyses and reports so incremental revenue is transparent accountable. In terms of SAB 101 compliance, Selectica CPM can help you:

- Provide persuasive evidence of an arrangement;
- Demonstrate when delivery has occurred or services are completed;
- Show that the sellers price to the buyer is fixed and determinable; and
- Prove that collectability should be reasonably assured.

Using contract controls and a central data repository also eliminates errors from manually entering data from order management, billing, and shipping systems. Using links from contract terms and changes to revenue recognition policies saves times, eliminates errors, and avoids regulatory problems. It also provides:

- The means to translate contract deliverables into revenue from independent but interrelated revenue streams. This makes it easy to manage multiple schedules against a single contract, including tracking percentage of the overall contract value and degree of completion.
- A library of standard terms and associated revenue-recognition business rules, making it easy to establish and enforce best practices for revenue recognition. This makes it easy to provide a single source for information about the contract, users, licenses, maintenance, etc. It also updates all accounting processes, tracking by accounting changes or by software upgrades, versions, etc.
- Standardized approval processes for non-standard contracts to avoid mistakes in revenue recognition, especially in complex billing. With contract management software you can manage the most complex billing schedules, including the ability to audit and report on all activities.
- Contract analysis and reporting to make sure that incremental revenue is transparent and can be accounted for properly, including generating an audit trail in the event of an audit.

As new software sales models continue to evolve, new guidelines for revenue recognition will evolve as well, but at a much slower pace. To be prepared for changes in reporting regulations, it's best to stay ahead of the game with a revenue reporting approach that gives you visibility and accountability to meet new guidelines. Revenue reporting should always reflect economic reality, and a solid contract management system like Selectica CPM can provide the control and transparency you need over any deal to keep you safe from the auditors.

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Selectica Contract Performance Management Helps Manage Revenue Recognition

Selectica's Contract Performance Management (CPM) platform can help you meet the criteria and provide protection in the event of an audit by tracking terms and conditions that specify price, performance, delivery, performance, and payments – all the information you need to clearly demonstrate that you are recognizing revenue appropriately.

- Tracks terms and tiers for each contract, including payment schedules and revenue recognition.
- Manages multiple payment schedules and complex billing against a single contract.
- Allocate percentage of revenue based on vendor-specific object evidence (VSOE).
- Automate renewal processes and allocate percentages against completion.
- Create a central data pool for contracts so information about users, licenses, maintenance contracts, terms, serial numbers, platforms, etc. are all available from a single repository.
- Automate updating of all contract changes and accounting processes.
- Transparency into all contracts including detailed audit tracking of all activity.
- Generate reports and audit trail to support any audit and demonstrate compliance with revenue recognition rules (SOP 97-2, SOP 98-9, VSOE, SAB 101, and more).