



MEETING STANDARDS FOR REVENUE RECOGNITION

DISCOVER BEST PRACTICES
FOR THE HIGH-TECH INDUSTRY

Different regulations apply to different countries, and different lines of business and services use different revenue standards. There are hundreds of standards and guides on revenue recognition in the generally accepted accounting principles in the United States alone, and these are not always based on consistent concepts.



CONTENT

4 Executive Summary

5 Revenue Recognition Challenges

5 Complex Financial and Regulatory Standards

6 Internal Inefficiencies

6 Multiple-Element Sales Arrangements

7 High-Tech Company Requirements for Revenue Recognition

8 Benefits of an Integrated Revenue Recognition Solution

EXECUTIVE SUMMARY

CALCULATING AND REPORTING REVENUES

Revenue represents the inflow of assets that results from earning activities, such as selling a product or service. Recognition occurs when the revenue is formally recorded in a company's accounts or financial statements. The concept of revenue recognition, then, determines how much and when revenue is recorded in financial statements.

At an ice cream shop, for example, employees take in US\$2 for every scoop of ice cream they serve and recognize revenue at the end of each day. In today's business world, however, revenue recognition is generally much more complex than this. How do you determine the value to be reported and the point in time when revenue is to be recognized? The composition of revenue-generating transactions or sales agreements can vary significantly, and rules for recognizing the revenue can be complex.

Analysts, investors, and regulators intensely scrutinize reported earnings, so it's critical that your company accurately recognizes its revenue. But with the multitude of reporting standards, getting to the right revenue number at the right time isn't easy. In addition, errors in revenue reporting often result in restatements that can trigger dramatic shifts in stock value. Because of the high stakes, your company needs a reliable, flexible, and preferably automated solution for calculating and reporting revenue.

REVENUE RECOGNITION CHALLENGES

MULTIPLE FACTORS IMPACTING ACCURACY

The composition of revenue-generating transactions or sales agreements can vary significantly, and rules for recognizing the revenue can be complex.



A plethora of financial and regulatory standards, many of them subject to interpretation and change, governs revenue recognition. Meanwhile, many companies struggle with internal inefficiencies related to recording and recognizing revenue and with a lack of communication between their sales and finance teams. These concerns hamper their ability to consistently report accurate earnings in a timely manner. The high-tech industry, in particular, faces challenges related to bundled sales agreements in which software, hardware, maintenance, and services are grouped in a single deal.

Complex Financial and Regulatory Standards

Complying with the many revenue recognition standards is a major challenge for high-tech companies operating in the United States. These standards also raise challenges for companies in other countries that use, for example, International Financial Reporting Standards (IFRS). Complicating matters further, different regulations apply to different countries, and different lines of business and services use different revenue standards. In fact, there are hundreds of standards and guides on revenue recognition in

the generally accepted accounting principles in the United States (U.S. GAAP) alone, and these are not always based on consistent concepts.

IFRS and U.S. GAAP outline these basic principles required to recognize revenue:

- There is persuasive evidence of an arrangement.
- Delivery has occurred or services have been rendered.
- The vendor's fee is fixed or determinable.
- There is a reasonable assurance of collectibility.

The right software can provide a high level of automation and increase visibility into the revenue process to ensure compliance with the prescribed revenue recognition standards.

Evolving Revenue Recognition Standards

A joint project between the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) is focused on developing consistent concepts for revenue recognition and a general standard based on those concepts. The new standards would replace the existing standards on revenue recognition in IFRS and U.S. GAAP. The findings are scheduled for preliminary publication in 2008, but the timing for IFRS implementation is uncertain.

Companies use different methods to recognize revenue, such as revenue earned over time using the straight-line basis, which can be used for maintenance and support contracts. For other types of projects and contracts, companies may use percentage of completion, in which revenue is recognized on the basis of progress toward completion of the project, as in a long-term development agreement.

Internal Inefficiencies

Internal inefficiencies, such as reliance on manual processes, can impact a company's ability to accurately recognize revenue. Surveys indicate that the majority of companies still use spreadsheets to process their revenue data

SAP offers a comprehensive sales and revenue recognition functionality that lets you integrate sales orders and contracts with revenue schedules.

manually. These spreadsheets are often labor intensive and error prone. The sales department doesn't always communicate with accounting, so accountants may have limited influence on the structure of sales deals. Complicating matters, many companies attempt to meet period-end sales

targets by creating a flurry of last-minute sales contracts. Global-trading and currency-conversion challenges cause further difficulties. Together, these internal inefficiencies impact a company's revenue forecasts and create timing issues that may result in the need to restate revenue.

Multiple-Element Sales Arrangements

Within the high-tech industry, sales agreements that bundle software, hardware, maintenance, and professional services are increasingly the norm. These multiple-element sales create unique revenue recognition challenges. The foundation of accurate revenue recognition is a complete understanding and application of all terms and conditions of each element of the contract. In multiple-element arrangements, revenue is allocated to each element on the basis of vendor-specific objective evidence (VSOE) and can be recognized only when the revenue recognition criteria for each element are met. Even elements such as cancellation rights, upgrades, and maintenance contracts – whether offered free or at a discount – must be allocated revenue on the basis of VSOE. If VSOE is not available for an element, the timing for recognizing the entire bundle is impacted. Since VSOE does not always equate to list price, your company must have historical evidence to substantiate the fair market value of each deliverable. You must also reassess these values over time.

HIGH-TECH COMPANY REQUIREMENTS FOR REVENUE RECOGNITION

ENSURING ACCURACY AND COMPLIANCE

Given the importance and complexity of revenue recognition, your high-tech company needs a software system that ensures both accuracy and compliance with the prescribed revenue recognition standards. As revenue recognition is subject to judgment and interpretation, it would be rare to automate the process 100%. However, the right software can provide a high level of automation and increase visibility into the revenue process to ensure compliance.

An ideal solution supports multiple methods for revenue recognition, including time-, event-, and project-based recognition. Time-based revenue recognition makes a clear distinction between the recognition of revenue and the invoicing process. For example, your company might invoice a customer for a service agreement in total at the time of delivery. The revenue from this sales transaction will then be recognized on a pro rata basis at periodic intervals, as specified in the contract agreement. The solution should systematically account for time-based revenue in accordance with the contract term. It should also support revenue recognition triggered by



events or milestones (for example, proof of delivery or customer acceptance of an order). In addition, it should be able to calculate project-based revenue recognition using a percentage-of-completion, time-and-materials, or cost- or revenue-based method. Lastly, the solution should be able to manage calculations on contracts with bundled products where revenue amounts are derived on the basis of VSOE of each element.

You need to be able to integrate the solution from contract to execution of terms with workflow functionalities, reducing the number of documents, streamlining the approval process, and eliminating the need for manual postings. The solution should provide reporting functionalities that give you improved visibility into contracts, highlight multiple-element arrangements, track any changes made to contract terms, and provide visibility into customer collection status. The software should also let you track and report on contract authorizations and associated workflows, delivery dates, and historical contract pricing information to support VSOE calculation.

The high-tech industry faces unique revenue recognition challenges related to bundled sales agreement in which software, hardware, maintenance, and professional services are grouped in a single deal.

BENEFITS OF AN INTEGRATED REVENUE RECOGNITION SOLUTION

A FLEXIBLE SOLUTION FROM SAP

Benefits of an SAP® Solution

- Increase the accuracy and transparency of revenue numbers
- Improve revenue reporting and forecasting capabilities
- Ensure compliance with international accounting standards and local GAAP
- Reduce manual accounting processes

As part of its SAP® ERP application, SAP offers comprehensive sales and revenue recognition functionality that lets you integrate sales orders and contracts with revenue schedules. You can configure the application to specific company standards, and it can flexibly accommodate various methods of revenue recognition, including time-, event-, and project-based recognition. The application not only automates the calculation and recognition of revenue on the basis of each method but also reflects changes in time periods or values within the revenue schedule without manual manipulation or lag. It can translate and handle multicurrency transactions, with built-in support for multiple countries and consolidated reporting. The application is flexible enough to recognize revenue before,

during, or after invoicing and can track and audit delivery and collectibility. It includes flexible pricing options to support VSOE and streamlines preparation of financial reporting in accordance with international accounting principles.

Companies need a reliable process for recognizing revenue and complying with local and international accounting standards. High-tech companies, in particular, need help addressing the revenue recognition challenges arising from the bundling of products and services. SAP provides a solution that addresses many of these challenges and is planning ongoing development. To learn more, contact SAP at www.sap.com/usa/industries/hightech/large/businessprocesses/software/softwarequotetocash.epx.

The application can accommodate various methods of revenue recognition, including time-, event-, and project-based recognition. Not only does it automate the calculation and recognition of revenue on the basis of each method, but it also reflects changes in time periods or values within the revenue schedule without manual manipulation.

50 090 724 (08/08)

©2008 by SAP AG.

All rights reserved. SAP, R/3, xApps, xApp, SAP NetWeaver, Duet, PartnerEdge, ByDesign, SAP Business ByDesign, and other SAP products and services mentioned herein as well as their respective logos are trademarks or registered trademarks of SAP AG in Germany and in several other countries all over the world. All other product and service names mentioned are the trademarks of their respective companies. Data contained in this document serves informational purposes only. National product specifications may vary.

These materials are subject to change without notice. These materials are provided by SAP AG and its affiliated companies ("SAP Group") for informational purposes only, without representation or warranty of any kind, and SAP Group shall not be liable for errors or omissions with respect to the materials. The only warranties for SAP Group products and services are those that are set forth in the express warranty statements accompanying such products and services, if any. Nothing herein should be construed as constituting an additional warranty.

www.sap.com/contactsap

THE BEST-RUN BUSINESSES RUN SAP™

