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Attention, Tech Executives: Watch Out for Revenue Recognition Trap

By John Yates and Stephen Combs, Special To LTW

ATLANTA - Revenue recognition is one of the most fundamental concepts in accounting. Unfortunately, technology companies are particularly prone to run afoul of the revenue recognition rules.

The reasons are:

- New technologies and business models have stretched the bounds of accounting literature.

- Barter transactions in the prior dotcom era have resulted in increasing scrutiny on the economics of transactions.

- Pressure from the investment community has led some public tech companies improperly to stretch the accounting rules.

- The revenue recognition rules are complicated and often misunderstood, especially by overly aggressive sales teams.

The repercussions of improper revenue recognition are monumental. Just look at the dozens of SEC investigations of technology companies in the past few years to see allegations of wrongful recognition of revenue – usually where a company has recognized revenue too early. The penalties are severe – civil penalties can result in significant monetary damages and criminal penalties can mean jail for the executives.

There are several lessons to be learned from the court cases and government investigations of tech companies that have been charged with violating the revenue recognition rules:

1. Substance versus Form: The accounting literature focuses on the substance of a transaction. Despite the titles or headings used by a tech company in drafting an agreement, the accountants should look behind this window dressing and focus on the actual substance of the deal.

For example, the accountants may ignore a price list, marketing literature or suggested retail prices. Rather, the actual terms and conditions of an agreement will be carefully analyzed to determine the economic realities of the deal.

2. Vendor Specific Objective Evidence (VSOE): In reviewing the "form" of a transaction, accountants focus on objective evidence of a deal. For example, the actual fees charged for the license, maintenance or services are key, not the published price list. Also, the accountants will review similar technology transactions of the vendor. These transactions will be analyzed for consistency of pricing across products and services. Therefore, a company is prevented from playing games by allocating revenue to one product or service (– defined in accounting terms as an "element.").

3. Documentation for VSOE: VSOE is extremely important in determining the allocation of revenue among the various elements of the transaction. How do you establish VSOE? Suggestions include maintaining a chart of the actual license fees and maintenance charges in your final, signed agreements. Periodically, compare these actual fees with your pricelist for suggested retail fees. If they don't match, consider modifying the future pricing terms in the price list to be consistent with actual practice.

4. Educate the Sales Force: Inconsistent or random pricing among technology products and services will wreak havoc on your accounting treatment. Take steps to educate the Sales Force on the importance of consistent pricing arrangements.

Often, overly aggressive sales execs will alter pricing in improperly creative ways. In the areas of pricing and revenue recognition, such actions are a detriment. Consistency is a much better trait for your sales force to follow in determining fees and charges. Incentives should be established for the sales force to follow strict rules for changing prices, granting discounts or providing any variation from the pre-established prices.

5. Educate the Sales Team: Consider some easy steps to educate the players in the sales process as to the basics of revenue recognition. Although the accounting rules are complex, some straightforward lessons can be taught at all levels of the sales process. These lessons include:

- No side letters or special deals.

- No discounting without signoff of two senior executives.

- No rebates or money back guarantees, either in writing or verbally.

- Include pricing information on the appropriate contract attachment/exhibit – and not buried in the text of an agreement.

In addition, a short educational course on the accounting literature governing revenue recognition may prove helpful to the senior executives involved in the contracting process.

6. Create and Modify a Revenue Recognition Policy: Every technology company should adopt a written revenue recognition policy. The policy should include:

- The company's position on recognizing revenue among its products and services.

- The process for determining license fees, service and maintenance charges.

- The process for amending any of these rules.

- The sanctions for violating the guidelines.

The Revenue Recognition Guidelines should be reviewed at least annually with the Audit Committee and your accountants. Also, a copy of the Guidelines should be provided to the sales team as part of the educational process.

7. Establish a Pricing Committee: A Pricing Committee serves as a decision-making body for addressing many of the pricing issues discussed above. The Committee should be composed of your Chief Financial Officer, General Counsel or Contract Administrator, and a senior representative from the Sales Group. Any changes to pricing should be run through this Committee and require its approval.

The Pricing Committee can serve a valuable function in a technology company, especially if the company is constantly adding new products or changing prices. The Committee should meet, as needed, to perform several functions:

- Review existing prices and price lists.

- Determine any changes that need to be made based on actual licensing and sales transactions.

- Review price list and pricing guidelines for consistency.

- Review revenue recognition policies and proposed modifications with Audit Committee.

- Establish procedures for approving changes to prices, discounts, and any other alternations to pricing or sales terms.

Revenue recognition issues will become more important as a technology company grows. Early in a company's life cycle, these policies should be developed, implemented and rigorously monitored. Otherwise, the consequences may be catastrophic for a tech company's future.

As a final word of caution, review your revenue recognition procedures carefully with your accountant and consult frequently with accounting and legal professionals in developing the processes and guidelines mentioned above.

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