Get more value from standalone selling pricing

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Imagine you run a company that sells bundled solutions, products, or services that are priced using a range of discounts and pricing structures. There are multiple performance obligations, and you recognize revenue in different periods, or when each of those performance obligations is satisfied. The revenue recognition guidance in US generally accepted accounting principles (GAAP) and IFRS® Accounting Standards (IFRS) require determining a standalone selling price (SSP) for each distinct good or service sold in your bundled solution.

It can quickly become an accounting and pricing nightmare, especially if you are launching a new product, going public, or engaging in a merger or acquisition. Even packaging changes can create headaches.

Accounting Standards Codification (ASC) 606, the accounting guidance in US GAAP that governs revenue from contracts with customers, generally requires organizations to allocate revenue to each distinct good or service based on relative SSP. Accounting, faced with audit pressure, may opt for the path of least resistance to meet US GAAP requirements without fully considering how that approach affects sales and marketing. That creates downstream problems and frustration for go-to-market (GTM) teams such as sales or marketing who don't understand how revenue recognition guidance works, leading to missed performance targets.

The risk for companies is greater than underperforming expectations. Failing to determine SSPs correctly might result in misstatements in reporting revenue and restatements of its financial statements.

Solving this challenge requires a cross-functional approach. Accounting, pricing, and GTM personnel, working together, can determine if a particular pricing strategy is conducive to determining appropriate SSPs in accordance with the accounting guidance while being aligned with the company's growth, profitability, and performance targets. A well-crafted and executed SSP process, along with the appropriate technological support, allows for flexibility to accommodate new products and offerings.

Addressing this issue takes a coordinated organization-wide effort. In this report, we explore the ways your company can remain compliant with ASC 606 and win in the market with a strategic GTM strategy.

Overview of the revenue recognition guidance

The goal of the revenue recognition standard, issued jointly by the Financial Accounting Standards Board and the International Accounting Standards Board in 2014, was to provide a more robust framework for addressing revenue recognition issues, improve comparability of revenue recognition practices, simplify the preparation of financial statements by reducing the amount of guidance to which entities must refer, and provide more useful information to users of financial statements through improved disclosure requirements. Simply put, the revenue recognition guidance explains when businesses should recognize revenues in their financial statements—and in what amounts. The revenue recognition guidance provides a five-step model for recognizing revenue:

Five step revenue recognition model

01

Identify the contract

A contract with a customer exists when the agreement is legally enforceable and certain criteria, including collectability, are met.

02

Identify the performance obligations

Generally, performance obligations are distinct goods and/or services that are promised to a customer in a contract.

03

Determine the transaction price

This is the amount that the entity expects to be entitled to in exchange for transferring goods or providing services to its customer.

04

Allocate the transaction price

The transaction price (determined in Step 3) is then allocated to each performance obligation (identified in Step 2) generally based on the SSP of each performance obligation. The SSP is the price that the company would charge the customer for selling the good or service individually (rather than as part of a bundle).

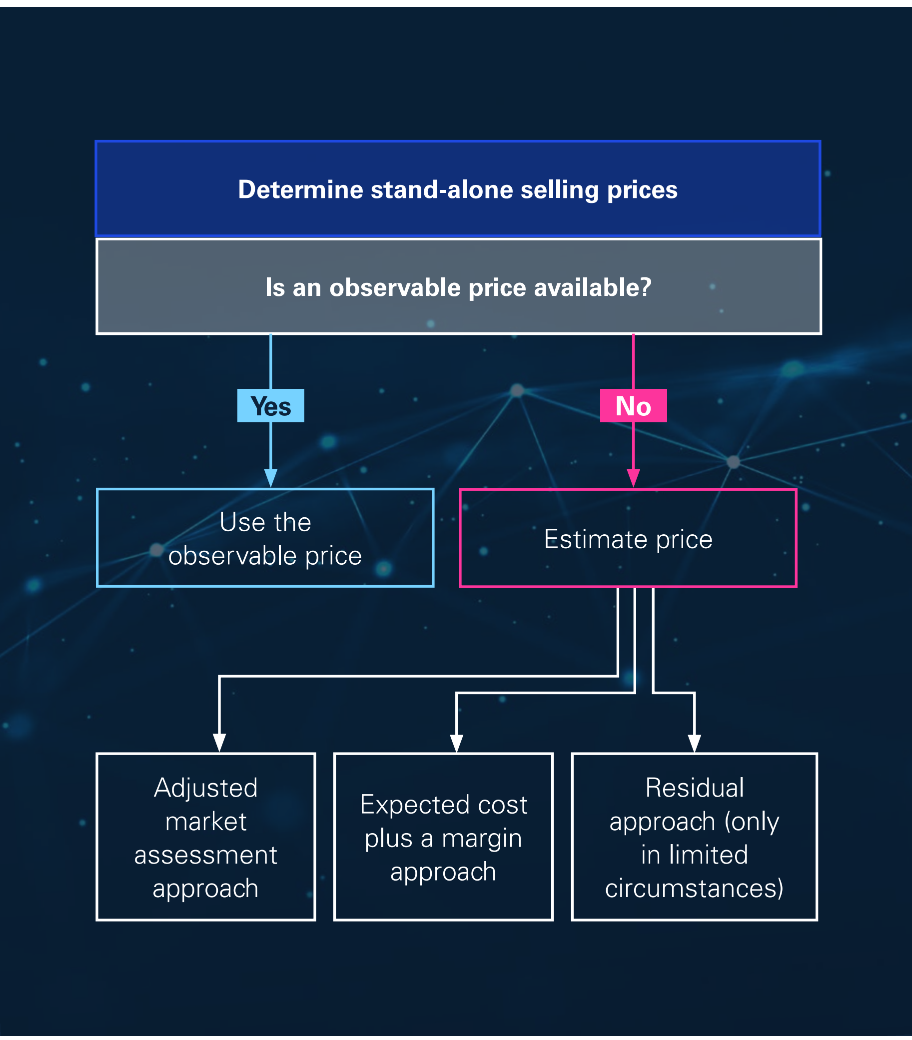
05

Recognize revenue

Revenue is recognized when—or as—a performance obligation is satisfied. This can occur all at once (i.e., at a point in time) or over time, depending on how and when the services are performed or the goods delivered.

There's more to revenue recognition than accounting

Many organizations focus primarily on the accounting aspects of ASC 606, which, of course, is important. However, most overlook the strategic possibilities regarding the development of SSP models. The right SSP model helps your organization recognize the appropriate amount of revenue when you sell goods or services. But when you add strategic planning, development, and benchmarking to the mix, you can align people, processes, and systems to facilitate better decision-making around pricing. If your GTM team collaborates with accounting, then they can learn how the revenue recognition guidance impacts their choices, and how that impacts the bottom line. For example, what are the tax ramifications of reducing the number of product or service packages that your organization offers? What happens if you bundle them differently? Or, what's the financial outcome if you switch from pricing services on a time and materials basis to a fixed fee as a percentage of total costs? A strategic approach allows organizations to avoid back-end accounting problems while enabling GTM teams to drive growth.



Three key implementation steps

01 Create a cross-functional team

To align your GTM strategy with the realities of accounting guidance, you will need key players from accounting, sales, marketing, and finance. Without cross-functional collaboration, GTM initiatives often fail to meet their targeted goal.

GTM and finance teams may set top-line and bottom-line targets based on a strategic repackaging of their goods and services. This strategy may include new sales incentives to drive growth from bundling, cross-selling, and upselling. But these teams typically don't view business decisions through a revenue recognition lens.

It's critical that accounting inform GTM and finance how their incentives and bundles will impact how the costs and revenues will be recognized. GTM and finance can then take the accounting impact of the revenue recognition guidance into consideration early in the process. This, in turn, allows the organization to make timely and appropriate adjustments to its strategy to meet its financial and growth goals.

Many companies attempt to grow their annual recurring revenue by bundling and giving away or discounting their hardware to preserve the transaction price of their software or services. But the SSP-based allocation requirements in ASC 606 can cause a reallocation of revenue from the software or services back to the hardware and dilute intended gains.

At the same time, your GTM strategy shouldn't be determined by the revenue recognition guidance alone. For example, while "good-better-best" bundles offer a simpler approach from an ASC 606 perspective, they may not provide the financial upside that more flexible upselling and cross-selling opportunities can.

The bottom line for organizations is to create a go-forward framework that takes the revenue recognition guidance into account but is also easily repeatable and creates value for the business. Think: Can this pricing model be built with flexibility in mind, and will I be able to adapt this revenue recognition process for future models?

Strategies for determining the SSP

If an observable price is not available, ASC 606 provides three possible approaches to estimate SSP:

Adjusted market assessment approach: The seller evaluates the market in which the performance obligation is sold and estimates the price that customers in the market would be willing to pay.

Expected cost plus a margin approach: The seller forecasts the expected costs of satisfying a performance obligation and then adds in an appropriate margin for that good or service.

Residual approach (permitted in limited circumstances): The seller subtracts the sum of the observable SSPs of other performance obligations in the contract from the total transaction price.

Note that significant judgment is often necessary when estimating SSPs. As a result, it's essential for organizations to have appropriate internal processes and controls in place for estimating the SSPs of goods or services that aren't typically sold separately

Here are some factors on which to base estimates of SSPs:

Reasonably available data points. This may include costs incurred to manufacture the goods or render the services that are identified as the performance obligations, profit margins, supporting documentation to establish price lists, third-party or industry pricing, and contractually stated prices.

Market conditions. This may include market demand, level of competition, market constraints, product awareness, and market trends.

Entity-specific factors. This may include pricing strategies and objectives, market share, and pricing practices for bundled arrangements.

Information about the customer or class of customer. This may include type of customer, geographic location, and distribution channels.

02 Design a flexible product taxonomy

To enable agility, create a simple product taxonomy that can flex as market conditions change. Accounting can help you understand how to best group products and services by cost basis and then segment them into the right product or service categories.

Also, consider that the more complex your selling strategy is, the more complicated your revenue recognition process will be (which also adds net new work for accounting). Either way, it's helpful to establish a narrow range in terms of the pricing of products and services since the value of your products and services may vary by market and class of customer, and an appropriate SSP estimation approach uses observable data inputs that are within a narrow range. The goal is to come up with a repeatable, transparent, and supportable process.

But your job doesn't end once you decide upon a process. Business is perpetually in flux, and your company will need to adapt and modify its GTM strategy accordingly. This will drive the need for SSPs to be refreshed and redone numerous times over the course of your company's lifetime.

Accounting typically is responsible for determining a "narrow range" for the product taxonomy or hierarchy that aligns and groups products. However, the accounting policy doesn't define narrow range, and how you interpret it will help inform the number of SSP estimates you will need.

Maintaining a separate product taxonomy designed around accounting allows you to align some of the lower level products and services with your revenue recognition policies. However, accounting alone should not drive the taxonomy needs for financial reporting or GTM analytics. So, having these separate taxonomies allows for all business needs to be met efficiently and effectively.

Ensuring this process is established, and the definition of "narrow range" is understood and tested within each group and aligned to accounting needs, will save significant costs and improve the bottom line.

Global IT services company develops flexible SSP generation playbook

A global information technology services and consulting entity was looking to generate SSPs for its two software portfolio brands as well as for a third-party software package that the entity resold and installed.

The software was sold alongside maintenance and hosting services. Since the company frequently added new products to its portfolio, it also wanted to create a "go-forward SSP generation" playbook for future releases.

Approach: KPMG helped the firm clean up and transform its data so it could understand the separate performance obligations across its portfolios. Then we helped conduct extensive market research and assess several SSP estimation approaches. These approaches included:

1. The expected costs plus a margin approach

2. The adjusted market assessment approach using external benchmarks for similar products and services and internal benchmarks based on transaction data.

This allowed the entity to develop a value relationship between different pieces of its product/service bundles and assign relative values if observable data inputs were not directly available.

Result: The entity developed an SSP model that could be used for current portfolios as well as future products/offerings. Determining the SSP for in-scope brands was based on cost and market benchmark estimates. The SSP model also included a detailed playbook with "adjustable" assumptions and other criteria for future SSP estimations, if needed.

03 Equip GTM and pricing teams with the right training

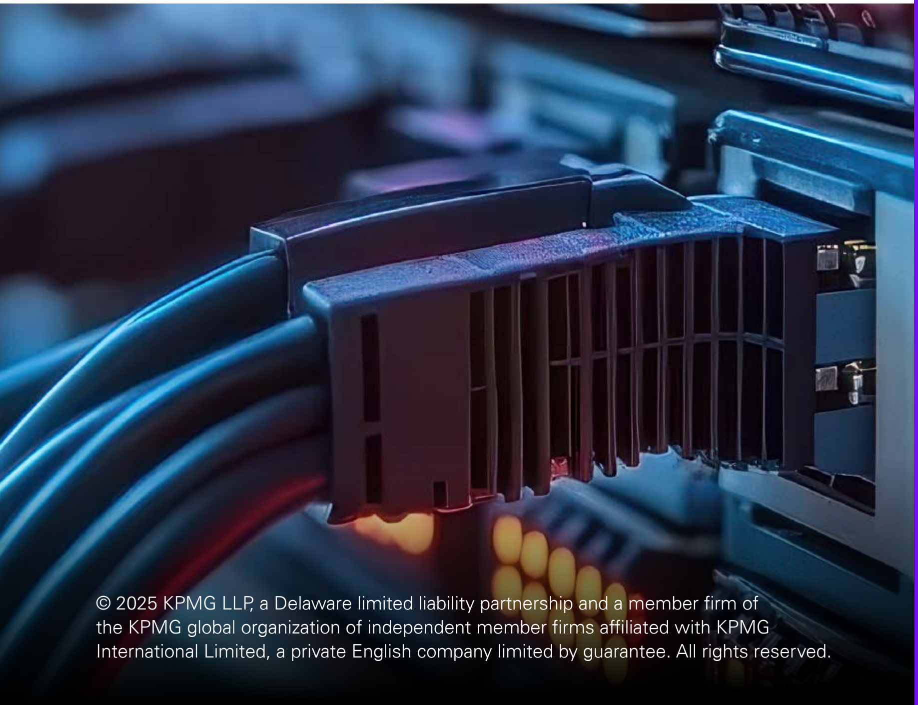
Employees involved in the revenue recognition process, typically those in your accounting department, should be offered training on ASC 606, including practical examples of how it works. But it shouldn't stop there.

Sales and marketing personnel, as well as those involved in pricing, should also be included in annual cross-functional training. These teams should learn about revenue recognition guidelines, how they impact your selling and marketing strategies, and what it means to your company's profits—and their paychecks.

The more they understand the nuances of ASC 606, and the better equipped they are to work together, the more likely it is that optimal decisions will be made about designing and executing the right pricing strategy as well as SSP estimation process for your organization.

Stay on top of ongoing SSP changes as your business grows and evolves

When it comes to the SSP requirements mandated by ASC 606, it's not a matter of if you'll have to deal with them, it's a matter of when. But with collaboration, a simpler taxonomy, and education, you can make more strategic pricing decisions and establish better SSP estimations processes—or spend time and money down the road to fix it.



Mid-size tech company develops SSP generation models

An international original equipment manufacturer (OEM) in the storage technology space provides clients with hardware/software solutions. Its portfolio is extensive and highly complex, with individual products having hundreds of possible configurations with differing components. It had been using the residual approach for estimating SSP, but realized it needed to convert to a process where it could determine SSPs for its various portfolio items.

Approach: It was unable to break down revenue and cost data to easily calculate the SSPs of its portfolio items. So, it engaged KPMG to help it assess the benefits, drawbacks, and implications of several SSP estimation approaches. This included (1) the expected costs plus a margin approach and (2) the adjusted market assessment approach using external benchmarks for substitute and competitive products and services as well as internal benchmarks ascertained from transaction data.

KPMG helped gather research on over 20 competitors, generated over 2,500 benchmark data points, and developed a roll-up cost allocation process that enabled the company to determine SSPs for its products. We also created a dynamic, flexible process that allowed the company to generate SSP estimates for its various services.

Result: The company now has an auditable, repeatable, and flexible SSP estimation model that can be used to evaluate different assumptions. It also can model the financial impact of SSP estimates for current products and services as well as those it may implement in the future.

How KPMG can help

KPMG takes a two-pronged approach to estimating SSPs.

We have longstanding experience and knowledge of accounting applications with ASC 606. This helps ensure that our methodology for estimating SSPs is both leading and in compliance with the guidance.

Our pricing and commercial strategy background, together with our deep experience in price and cost benchmarking, supports the development of SSP estimation models for your organization, regardless of industry.

KPMG provides a thorough approach to SSP determination, enabled by a cross functional team with specialized SSP and cross-industry pricing experience.

Holistic approach incorporating all offering types: Our approach considers all offering types (hardware, software, services, installation, etc.) along with market lenses in order to adhere to ASC 606 guidance and calculate SSPs.

Deep experience spanning various client settings: Our extensive work in SSP allows us to understand nuances across different industries and have a breadth of experience to provide established leading methodologies to define and generate SSPs.

Integrated cross-functional team of support: We bring a holistic perspective and approach to SSP development through a team of professionals across pricing strategy, accounting, and finance transformation.

Extensive data and analytics capabilities: Our tried and tested data insight processes and tools unlock insights from deep within client transactional data to generate incremental value throughout projects.

Business strategy informed impact modeling: We apply a “test and learn” approach through impact modeling to identify an SSP estimation process that best aligns with your business objectives and reporting needs. We come in, review your GTM strategy, look at how you’re selling, and offer recommendations on your GTM approach. Our recommendations go well beyond just making sure you’re compliant; our goal is to help improve your bottom line.

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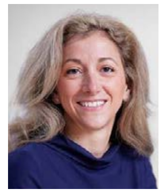
Sudipto (Sudi) is a Partner and leader of the Pricing practice for KPMG. He brings over 25 years of experience working with clients across industries, including industrial goods, automotive, life sciences, technology, and consumer goods. He specializes in commercial transformation, including pricing (strategy, execution, and enablement), sales growth (demand drivers, sales force effectiveness, channel management), and marketing effectiveness (ROMI, and promo effectiveness).



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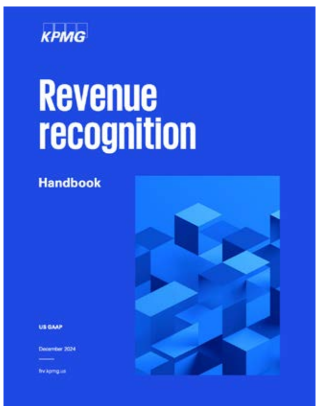
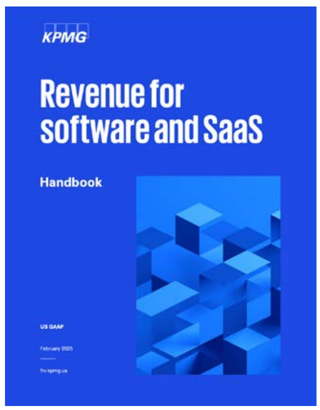


Handbook: Revenue recognition



Handbook: Revenue for software and SaaS

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