WHITE PAPER

A PATH FOR PROFESSIONAL SERVICES FIRMS TO TACKLE CHALLENGES IN REVENUE RECOGNITION

Abstract

The revenue recognition requirements at professional services firms are evolving with the advent of innovative pricing constructs, engagements driven by fixed pricing approaches, new subscription-based models, and outcome-based contracts. This paper explains how technology can be harnessed to transition to real-time and granular revenue recognition solutions. Specifically, the paper discusses Infosys cloud solutions and offerings from its SAP S/4HANA practice and how they can help professional services firms transform into intelligent enterprises.

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Introduction

The professional services industry comprises many players that offer advisory services in accounting, business, legal, financial or technology. Like others, this highly segmented industry has had to make substantial changes to cope with the rapidly evolving market environment. For example, digitization has changed the flavor of client demands significantly. In addition, the onset of the COVID-19 pandemic has introduced more uncertainties leaving this industry at crossroads. Therefore, they must re-examine their existing strategy to align with the new scenario. In essence, they must become more agile, digitally savvy and value-driven. These trends will have a definite bearing on how engagement contracts will be structured and charged.

Professional services firms must take this opportunity to set right the problems they have historically faced with revenue recognition.

Challenges in revenue recognition

Increasing demands from customers for faster delivery and higher quality of professional services are triggering changes in the way services contracts are structured. However, these changes also introduce challenges on the operational, accounting and reporting fronts.

How do these challenges impede revenue recognition?

On the operational challenges front, consider the case of fixed price engagements. For a fixed engagement price, the professional services firm must determine the number of consultants across different locations, the time of these consultants and the resources such as server space to use. In addition, all inputs to the engagement must factor in revenue recognition which becomes challenging in a fixed price situation.

On the accounting front, challenges such as overruns are common. For example, at the start of an engagement, a firm may budget for a certain number of resources and with the progress of project the actual efforts to deliver increases midway. Overruns can be in the form of an increase in the number of consultants or time required to complete the work. Another classic example is when work begins at a client, but a formal contract is yet to be signed. Here, consultants have started generating revenues, but accounting practices prevent it from being realized.

The practice of offering discounts poses issues for reporting. Just like how revenues must be apportioned to all consultants working on an engagement, discounts must be similarly distributed. In addition, profitability at an employee level based on realization and utilization is also difficult to track. For example, it is not easy to determine how much percentage of a consultant's time is billable.

Table 1 gives a detailed view of the different types of challenges.

Operational Challenges

- Dynamic construct of engagements
- Impact of adaptive billing schedule
- Excessive demand of fixed price engagements
- Higher prevalence of outcome driven engagements

Accounting Challenges

- Appropriate accounting of resources and time overruns during an engagement
- Need to retract revenues on unsigned contracts
- Correct valuation of revenue and WIP for foreign currency contracts

Reporting Challenges

- Correctly allocate price discounts
- Absence of real-time traceability of employee level profitability
- Correct calculation of realization and utilization efficiency

Table 1: Different types of challenges troubling professional services firms

Eight steps to overcome barriers to seamless revenue recognition

Here are some recommendations on how to recognize revenues effectively. These are based on the SAP S/4 HANA system and Infosys' experience in the Professional Services industry.

Create a holistic engagement structure

Typically, professional services firms charge clients using the time and material method. Other methods commonly used are fixed price or those based on periodic services or subscriptions. Consider these crucial aspects when setting up engagements -

- Holistic engagement structure - Start with a clear definition of revenue recognition requirements for each engagement type. No single approach will work for revenue recognition across engagement types. For example, some engagements can follow the percentage of completion method or while for some revenues are by billing or for some revenues are based on bill rates of consultants. What's important is to determine the method to follow right at the start.
- Separate the engagement structure to capture billable and non-billable aspects - The time or expenses recorded by consultants may be chargeable or non-chargeable. Making this distinction will ensure revenue is recognized for the billable work only. For example, suppose the total time of consultants includes both time worked on the engagement and travel time. In that case, only the work time will be considered billable to recognize revenues. The travel time will be non-chargeable and be absorbed as costs.

Develop granular pricing structure

Professional services firms usually have a multi-level structure catering to different skill sets demanded by clients. For example, consultants could specialize in technology, strategic, legal or tax consulting. Therefore, it's essential to clearly define each tier in the organization based on the skills required and attach bill rates to each level. Only by doing so can each employee's revenue be realized accurately. For example, the billing rates of a managing director or partner will be significantly more than that of a director or domain consultant. The consultant's timesheets combined with the tiered bill rates will help recognize revenues and track profitability at an employee level. In addition, if the firm has a global footprint, there is the additional complication of handling different currencies. An intelligent ERP system like SAP S/4HANA can track employee profitability and accommodate these complexities.

Forecast driven thinking

Firms are looking for ways to bill customers with fixed billing arrangements for fixed price engagements. At the same time, they recognize revenues using the time and expenses approach to measure profitability granularly. Therefore, it becomes imperative to forecast revenues accurately for different projects and tie them to the skills, hours and bill rates of consultants required. Project overruns can be tracked cleanly with the forecast setup to identify projects needing a restatement of revenues based on actual efforts. Moreover, forecasts provide a benchmark when overruns occur, help to streamline the process and accurately restate the revenues. Revenue forecasts are thus a critical metric in this industry.

Project Budget (Estimated hours)	5,000 hours
Fixed Price engagement with Project Budget (bill rate of $300 per hour)	$1,500,000
Actual hours spent by consultants till date	3,000 hours
Revenue recorded based on time & materials basis (bill rate $300 per hour)	$900,0000
Revised estimated hours to complete the projects (Actual hours + Projected hours to complete rest of the project)	6,000 hours
Percentage of work completed based on revised estimated hours (Ratio of Actual hours spent till date: Revised estimated hours)	50%
Revenues to be recognized based on a revised estimate	$750,0000
Project overruns to be accounted as revenue reserves	$150,0000

Table: Example illustrating handling of Project Over-runs with Revenue Forecast Approach

In the above example, the firm has contracted into fixed price projects and records revenues using a time & material approach. Then, based on revised estimated hours to complete the project, it has to re-state the revenues to account for project overruns.

Efficient handling of Reserves

Professional services firms start recognizing revenues as consultants record the time when work begins on an engagement despite a formal contract being unsigned. From an accounting standpoint and to be prudent, firms must take Reserves against these revenues. The revenues can be retracted by calculating Reserves integrated with the entire project lifecycle.

SAP S/4HANA provides extensibility options to build applications on cloud that give the ability to record Reserves and measure these against a project manager or all the consultants who work on the project.

Outcome driven engagements

Also known as success fee or contingent fee engagements, a portion of revenues is not guaranteed or at risk. To earn this revenue, service must be delivered per pre-defined criteria. Typically, the success fee revenue is not recognized until the customer confirms the completion of service and/or pays for it. In this model, the professional services firm bears most of the engagement risk.

Such engagements can be tracked through a distinct engagement structure or by setting up a percentage of revenues at risk for service to be delivered. Further, the billing of such engagements must be accounted for specifically and tracked in separate deferral accounts on the balance sheet. This enables the success fee revenues to be allocated across all consultants who worked on the engagement.

Infosys SAP S/4HANA Cloud Solutions built on SAP BTP allow firms to track the entire lifecycle of these revenues, their collection and allocation to appropriate consultants, thereby simplifying the processing of a sophisticated pricing model.

Valuation for foreign currency contracts

With the prevalence of global contracts where engagements are denominated in foreign currency, it is pertinent to evaluate revenues and work in process (WIP) at an appropriate translation date. As a result, firms adopt different valuation approaches such as keeping the valuation constant with a fixed rate as of contract date or evaluating using the month end exchange rate. At the same time, the valuation of WIP is considered from GAAP reporting and the valuation of revenues from a management reporting perspective.

SAP S/4HANA solution provides options both to evaluate with a fixed exchange rate or at month end rate. The granularity will vary with both approaches, providing options to track the valuation differences at an engagement level or an overall department level.

Allocation of price discounts across employees

Price discounts on the standard rates of consultants are an integral part of a services contract. The discounts are allocated to the partner driving the engagement or attributed to all consultants engaged in the project. Allocation of these discounts must be carefully planned to achieve profitability at the employee level. Further, to make matters more complex, there can be other components like success fees that can also be distributed to consultants based on the discounts on their bill rate.

SAP S/4HANA provides the ability to tag discounts to each consultant's timesheet and trace it through accounting. In this way, employee level profitability remains accurate. In addition, building custom cloud apps on S/4HANA using SAP BTP can help achieve some of the unique allocation requirements.

Adopt employee level profitability

The efficiency of operations in professional services is deeply linked to the profitability of employees. Arriving at employee level profitability requires tracking employees on every revenue or expense transaction. This move will compel firms to track employees in setting up the project structure, determining prices, booking timesheets and expenses, invoicing and managing work in progress.

SAP S/4HANA provides granular tracking of employees at every stage and transaction. It also allows firms to derive the employee's department dynamically. Further, custom apps can be built on cloud to achieve additional distribution of revenues to an employee to realize the model of 'revenues follow the employee.'

Reference

Infosys SAP S/4HANA Services Making Businesses Live and Digital

The Infosys value addition

Infosys' comprehensive suite of accelerators can be deployed across migration, conversion and implementation stages of SAP S/4 HANA. Over 40 tools and solutions bolster Infosys' SAP S/4 HANA adoption framework to implement SAP S/4 HANA. These accelerators are part of Infosys Cobalt, a set of services, solutions, and platforms designed to help enterprises speed up their cloud journey. Enterprises that harness the many features and advantages of Infosys accelerators during the SAP S/4 HANA implementation can realize their vision of becoming an intelligent enterprise quickly .

This powerful combination has helped many professional services firms transform their key business functions by automating transactional processing.

An American management consulting firm wanted to enhance its revenue recognition process and improve reporting. Infosys implemented SAP S/4 HANA Professional Services for Cloud for this client and facilitated accurate revenue accounting. In addition, the "revenue follow the employee" method was used to recognize revenues to streamline revenue allocation. As a result, the company was able to gain real-time insights on revenues, work in progress and accounts receivable.

Another global management consulting firm used an outdated, homegrown legacy system for its business operations. It still relied on MS-Excel for its forecasts frustrating many users. To modernize its processes through digitization and operate more agilely and in real-time, the company partnered with Infosys to implement SAP S/4 HANA Enterprise Management with a Professional Services line of business globally. During this exercise, Infosys enabled real-time revenue recognition based on time and expense entry by the consultant using S/4HANA Event based revenue recognition functionality. As a result, several key benefits were delivered, including traceability of operational sources of revenues, resultant financial target driven revenue recognition and revenue forecasting preparation time reduced by 80%. Further, management reporting at a detailed level was possible.

Concluding thoughts

Revenue recognition is a vital process for Professional Services firms. However, the complexities involved make this an error-prone process leading to intensive manual efforts, misrepresentation of accounts or inability to get a true picture of the work done. As a result, business planning is questionable. SAP S/4 HANA Professional Services and Infosys cloud solutions present a powerful way to overcome these challenges and streamline revenue recognition.

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Rupesh focuses on delivering large scale SAP transformation programs for Fortune 500 organizations. His specialties cover SAP S/4HANA Finance, Central Finance, Professional Services and Cloud implementations. He has deep expertise in accounting standards, management reporting, tax regulations and best practice-based business processes. As part of SAP Transformation Center of Excellence at Infosys, he works across industry verticals leading and delivery complex finance transformation programs.