POWER OF X

Managing Commissions Under the New Revenue Recognition Standard

Executive Guide to ASC 606 and IFRS 15

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INTRODUCTION

The new Revenue Recognition Standard (ASC 606 and IFRS 15) supports convergence between the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB).

- FASB requirements went into effect for public U.S. companies on December 15, 2017 and begins for private companies December 15, 2018
- IASB requirements became effective January 1, 2018

The vast majority of companies struggled to prepare for one particular piece of the standard: FASB 340-40 (IFRS 15.91-94). Commonly known as the costs of obtaining a contract, this change speaks directly to how companies will manage the treatment of commissions.

The new standard requires the incremental costs of a contract be capitalized at inception and expensed systematically. Although this is just a small portion of the Revenue Recognition Standard, it's of enormous importance for businesses that pay commissions and wish to remain compliant.

Many companies mistakenly believe that this portion of the standard doesn't apply to them, thinking it's limited to software-as-a-service (SaaS) businesses. However, unless you're selling a one-time POS product or service, you most likely have commission costs that need to be accounted for under the new rule. This means that you now have to capitalize commissions at inception and then expense them in a systematic way as you provide goods or services to the customer.

In this report, you will get step-by-step guidance on what your business needs to do to manage commissions under ASC 606 and IFRS 15, including:

- Preparing for Commission Accounting Changes
- Estimating Commission Amortization
- Supporting Audit Requirements

80% organizations that say they must make changes for ASC 606

20% organizations that began preparations before the ASC 606 went into effect

Only 20 percent of companies began preparations before the accounting requirements went into effect

Part 1: Preparing for Commission Accounting Changes

EDUCATING YOUR TEAM

To be effective in accounting for commissions, your team first needs to understand the purpose and intent of sales commissions. However, sales commissions can be applied in dozens of different ways, and commissions also vary from sales role to sales role, as well as by sales performance level.

Since your finance team will be working within a principle-based system under the new standard, this means that they have to make judgments to account for sales commissions – not exactly in the comfort zone for most accountants. To make sure the accounting team is prepared and confident, you need to be sure they're fully educated about the intent of variable pay in sales.

When you consider all of the complexities, it's also clear that the right resources need to be applied to managing this task. Consider assigning someone to manage this problem for the organization. If you do so, make sure the person you assign has enough experience to manage the requirements. This isn't a job for payroll accounting but, rather, revenue accounting.

TIP: Sales incentives motivate desired behaviors that drive higher performance and revenue for the business.

TRACKING DEEPER TRANSACTION DETAILS

To meet the requirements, you now need to account for commissions to a deeper level of detail. You must monitor direct and incremental costs for each revenue contract. If your organization uses spreadsheets to track commissions, you're probably just aggregating payments at the rep level. Now, you must add in the customer level and, potentially, even drill down to the contract level.

You need a system in place that gives you the ability to access and quickly track the right transaction details. Additionally, you still need to go back in time to be compliant due with the two-year look-back period for 2016 and 2017. Companies need to be able to show who got paid, what was paid for, and the commission amounts per customer going back two years before the standard was in effect.

Some companies have gone through spreadsheets to pull all of their commissions from the past two years and transferred their numbers into a compensation management system. This requires loading historical data and making recalculations. Even so, you still may need to pull data from a CRM, such as Salesforce, as most spreadsheets don't have data down to the customer level.

EXPERT ADVICE: "If your company continues to calculate commission in spreadsheets, ASC 606 (IFRS 15) is going to be a problem! ASC 606 (IFRS 15) is the compelling event you've been waiting for to modernize your sales compensation management (SCM) platform."

— Dana Therrien, Sirius Decisions

UNDERSTANDING HOW YOU PAY DIFFERENT PLANS

Before you can even implement a course of action, accounting must understand your company's sales commission strategies in order to back up decision-making.

Your accounting team needs an understanding regarding the rationale behind different variable pay levels. For example, they need to understand why one sales role, i.e. a 'hunter', has a higher variable pay than another, such as a 'farmer.'

In general, the impact the salesperson has on the buying decision influences the percentage of variable versus base pay. Additionally, there are many special commissions, such as bonuses, accelerators or SPIFs. Accounting needs to understand how they're applied and why they matter to the business.

expensed. For example, 50 percent of a sales manager's variable pay might be based on what gets sold and 50 percent on managerial capabilities. So, the variable compensation that relates to managerial capabilities can be expensed immediately while the rest needs to be capitalized.

TIP: Sales reps have have a huge impact on the buying decision, which influences the percent of variable versus base pay.

ESTIMATING YOUR CUSTOMER LIFE

The new standard requires that amortization be "on a systemic basis consistent with the transfer of goods or services to the customer." This requires accounting to expense commission costs over time. To do this, companies need to understand and be able to estimate their average customer lifetime. This requires having insight into typical anticipated recurring revenue, such as upsells and cross sells.

Businesses don't expect to have customers for just one year; they expect to retain customers for a longer period of time. When a company provides a sales rep with variable compensation, they are often paying the rep to bring in a customer for longer than the initial contract term.

Moreover, your customer lifetime isn't static – nor would you want it to be so. In a given year, your customer life might increase (or decrease). Therefore, estimating your customer lifetime is not a one and done process and requires at least an annual reevaluation.

TIP: Your ROI on a commission payment is determined by how long you retain a customer.

EVALUATING YOUR COMPENSATION STRATEGY

Look at your products and services being sold.
If your offering is a one-time point of sale transaction, there's no capitalization, so you don't need to amortize any expenses under the new standard. However, many POS transactions still have a financial tail that will require capitalization, i.e. for ongoing maintenance and support. Take car sales for example. An auto company may sell a car, but that sale also includes a multi-year service plan where commission expenses must be amortized.

Take time to understand the fiscal strategy behind your commission policy.
Sales incentive strategy isn't an area of expertise for most accountants, but to comply with the new standard, accounting needs to understand why base and variable pay vary across compensation plans. Recognize the behaviors you're trying to drive with different sales commissions.

Determine which plans have longer-term returns.
Identify the commission plans with payments that you expect will have value beyond the current year. These are your sales commissions that are potentially amortizable, representing your input for the amortization process.

TIP: If your business provides a solution or service that's going to be renewed or supported over a period that's longer than a year, you probably need to amortize commission expense.

Part 2: Estimating Commission Amortization

EVALUATING HOW YOU DETERMINE THE AMORTIZATION PERIOD

The new standard follows a principle-based approach, requiring judgment to determine the amortization period. To come up with a plan for amortization, you must evaluate the long-term benefits of the commission being paid and identify the inputs that provide the basis of that benefit. Then, for each input, organizations must decide the typical amortization period based on contract term and anticipated lifecycle, (i.e. how long do you expect to do business with a customer above and beyond the contract term).

There are obvious inputs and less obvious inputs that can be very complex.
In the SaaS model, some inputs are easily identified, such as the original contract term and anticipated renewals that extend the customer life.

Product turnover is a less obvious input. For example, if customers bought your product two years ago, it may not be what you're offering today. The product itself may be obsolete, as can happen with technology products like computers and smartphones. Therefore, because what you sold two years ago may no longer be what you're offering today, this can be a limiting factor for the amortization period.

TIP: Even though your customer lifetime may be longer, if the technology turnover is shorter, it can affect the input for estimating the amortization period.

Part 2: Estimating Commission Amortization

EVALUATE HOW YOU DETERMINE THE AMORTIZATION METHOD

You don't need to amortize expenses evenly; however, you need to make a case for your amortization methodology. For example, if you determine that the amortization period is 24 months, you could expense 1/24th each month, but it doesn't necessarily have to be that way. Companies may expense 2/3 the first year and 1/3 the second but, whatever path is chosen, they need to be able to justify the rationale behind making that decision.

Portfolio expensing is another possible option. You may be able to group or "bucket" commissions by product type, region, or go-to-market team, and assign an amortization life for each bucket. However, to follow this approach requires a high sales volume. If you only have a few big deals a quarter, it won't work, as there's too much variability in the contracts and the delivery periods.

TIP: You may have different amortization periods based on the your product and service offering life cycles.

Part 3: Supporting Audit Requirements

REVIEWING YOUR INCENTIVE PLAN

Since you're going to need to collect, track, record, and report on cor level of detail, you should look at the current state of your incentive p and evaluate your compensation approach. Are you incenting the rigł commissions? Can you measure the ROI of your incentive compensat

You need a document in place that covers your plan policies and timi trail and audit approach. Different crediting elements will establish the need the system to track for a requisite audit trail.

TIP: The most successful compensation plans incentivize sales rep behaviors that align with company goals and objectives.

Part 3: Supporting Audit Requirements

CAPTURING THE RIGHT DATA

Documenting your methodology for compliance is essential to meet the audit requirements under ASC 606 and IFRS 15. To support audit documentation, be sure that you have a system capable of capturing and reporting all the data required to be compliant. Businesses now need much more detailed and granular commission data – at the customer, contract, product, rep, and manager level.

This means that your audit trail has to extend out to source compensation and commission data. Whether your organization has an ERP system and/or revenue management system, be sure that your incentive compensation management (ICM) solution can support integration for both. Any ICM solution should be flexible and able to work with either scenario.

TIP: An automated system will make it easier to break down commission data at customer, contract, product, rep, and manager level.

Part 3: Supporting Audit Requirements

GET A CLEAR, HISTORICAL AUDIT TRAIL

For auditing purposes, organizations need a clear, historical trail, including when changes were made and by whom. If you're relying on spreadsheets, this is difficult, if not impossible, to achieve. For accounting firms to rely on your internal controls, you must continuously evaluate who has access to those spreadsheets in order to ensure the proper control and security practices are in place and being followed.

With a modernized, cloud-based tool, you inherently have a better (and more secure) model to access information than a spreadsheet. For example, with an ICM solution, you can see what commission changes were made through automated and traceable change management – unlike a spreadsheet where you can't see what it looked like five minutes back.

Moreover, having this auditable system of record should reduce the amount of detail testing required by an auditing firm. This dramatically simplifies your audit evaluation and lowers your costs.

TIP: A system of record that reduces the amount of testing needed by an audit firm saves hours and hours of time – and reduces expenses.

CONCLUSION

The new commission expense accounting requirements bring complexity and judgment to an area of accounting that was previously straightforward.

Additionally, as with any new standard, organizations can expect to be under a higher level of scrutiny with limited industry and accounting guidance. Both public and private companies who want a clean audit opinion will need to the have their systems and processes ready.

To achieve compliance, companies now must track direct and incremental costs for each revenue contract, capitalize these costs as assets, and determine the expected amortization period. In order to meet these requirements, you need a compensation management system able to access all the necessary data and integrate with your existing ERP and/or revenue management system.

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1-866-GO-XACTLY

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Xactly Corporation, 300 Park Avenue, Suite 1700, San Jose, CA 95110