

WHITE PAPER

Solving for the intersection of revenue recognition and lease accounting in the medical device industry

Margin pressures and compliance mandates pose challenges for **medical device industry**

The medical device industry is poised for steady growth, with global annual sales forecasted to rise by over 5 percent a year and reach nearly US\$800 billion by 2030. Despite the expected growth in the sector, margin pressure and the compliance mandates of revenue recognition and lease accounting continue to challenge the industry.

The industry is particularly impacted by the changes to lessor accounting under ASC 842. The most significant changes align the profit recognition requirements under the lessor model with the new revenue standard and amend the lessor lease classification criteria to make them consistent with those for lessees. In addition, the new standard requires a lessor to classify a lease as a sales-type lease, a direct financing lease, or an operating lease at its commencement.

Like virtually every other sector, medical device CFOs and their teams are turning to technology solutions to enable a digital finance department that can automate compliance and generate real-time accounting, reporting, and analytics for faster decision making.

This white paper looks at some of the complex compliance use cases facing medical device companies and explores how using an integrated revenue management and lease accounting solution can automate compliance and provide increased control, automation, and insights around revenue activity and opportunities.

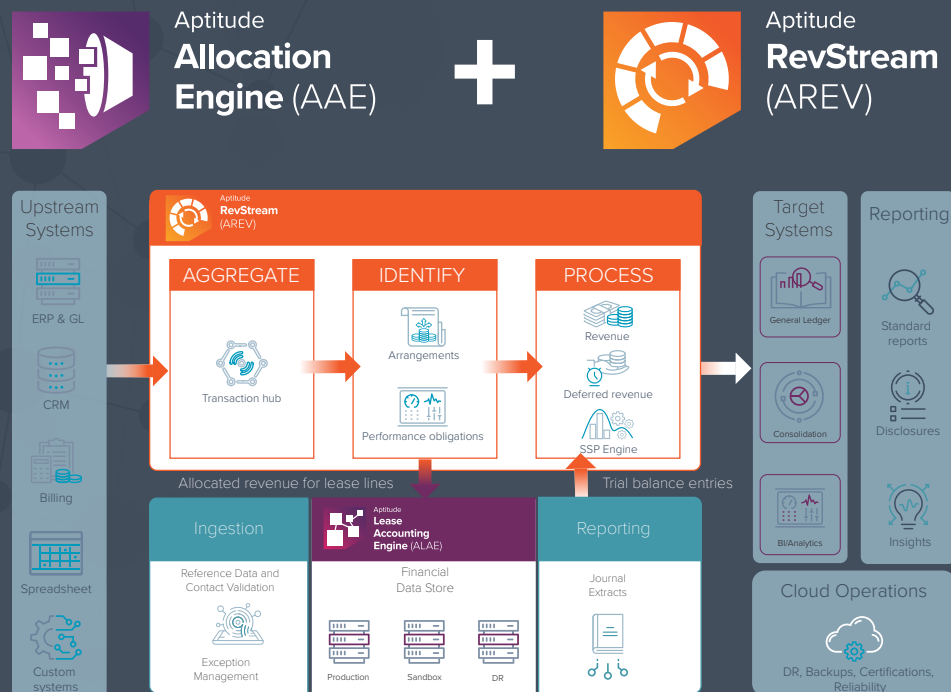
The Financial Accounting Standards Board (FASB), will offer private companies until 2022 to comply with major new lease accounting rule, ASC 842, which was supposed to go into effect in 2021.

The decision to issue a delay came in response to COVID-19.

An integrated solution to solve two regulatory standards

As standalone regulations, revenue recognition (IFRS 15 and ASC 606) and lease accounting (IFRS 16 and ASC 842) are each challenging in their own right. However, medical device manufacturers are in a somewhat unique position of needing to look at how these regulations intertwine and solving for them in parallel and where they intersect.

This graphic illustrates how Aptitude's revenue recognition and revenue management solution, RevStream, (AREV) interacts with the Aptitude Lease Accounting Engine (ALAE) and other surrounding systems.



As an example, say an organization has a 5-year contract with enforceable minimum payments. Lease components include instruments, scanners, computers, and software. Non-lease components include consumables and a servicing agreement.

The contract would move through the solution as outlined below:

- Contract data is ingested into AREV from upstream systems
- The transaction prices are allocated to lease and non-lease items based on ASC 606 policy
- After SSP allocation, the lease component lines, including all data around lease contract code, contract item, and payment profile are pushed to ALAE. Non lease components are accounted for appropriately in AREV under ASC 606
- In ALAE, lease lines are classified as a sales type lease and accounted for appropriately under ASC 842
- Accounting entries and trial balances are fed back into AREV and include contract reference IDs, line types, GL dates, debit/credit amounts, account codes and other additional attributes
- AREV consolidates lease and non-lease components to generate the final outputs and reports which are fed to the appropriate target systems



Case Study:

Global medical device company automates complex revenue recognition & lease accounting

COMPANY OVERVIEW

With over \$3B in revenue this global, publicly held, medical device company leases high-tech equipment generating a lessor requirement under IFRS 16 and ASC 842.

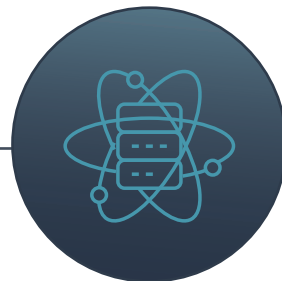
Lease agreements with customers are complex and need to consider compliance requirements under the revenue recognition standards IFRS 15 and ASC 606 as well.



PREVIOUS SOLUTION

Prior to selecting Aptitude Software, the organization was addressing both revenue recognition and leasing compliance requirements using spreadsheets and point solutions.

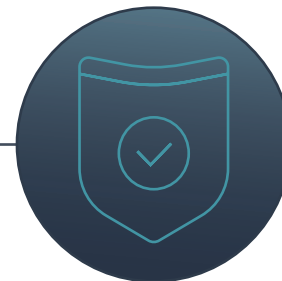
This introduced significant risk and lacked the finance and accounting controls required for audit processes. It also prevented the organization from accessing insights from revenue and leasing data.



SOLUTION SELECTED

In 2020, the company selected Aptitude solutions AREV and ALAE to automate revenue recognition and lease compliance.

Having a single, holistic solution that provides robust lessor capabilities was critical.

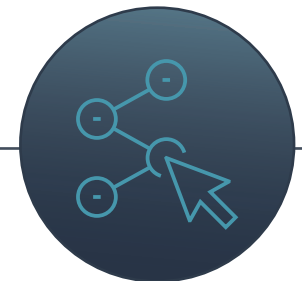


PATH FORWARD

The organization now has an integrated, automated solution for revenue recognition and lease accounting compliance.

Benefits include:

- Ability to automate SSP calculations
- Automated classification of lease and non-lease line items
- Ability for end users to easily navigate and generate standard and ad-hoc reporting



Case Study:

US-based medical technology company automates compliance to support growth

COMPANY OVERVIEW

A high-growth, global medical technology company recently completed an acquisition and had a new product achieve FDA approval. They planned to quickly scale their business with new offerings that would place instruments with customers for free with a committed volume of consumables purchased over the period of the contract.

The company was excited to grow but had no desire to add to their accounting team and needed to automate revenue recognition and lease accounting.



PREVIOUS SOLUTION

All lease accounting and revenue recognition was done using Excel spreadsheets and reported under US GAAP.

This spreadsheet approach was not sustainable given their expected growth plans and existing finance team structure.

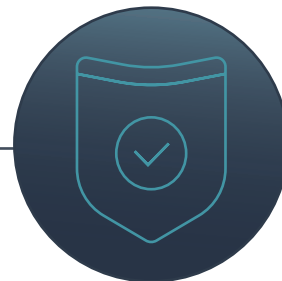
A cloud ERP migration was also in plan, presenting a good time to rethink all finance processes and technology.



SOLUTION SELECTED

In 2021, the company selected Aptitude solutions AREV and ALAE to automate revenue recognition and lease compliance.

The solution will reduce the amount of manual work required by the finance team and met their tight implementation timeline of three months.

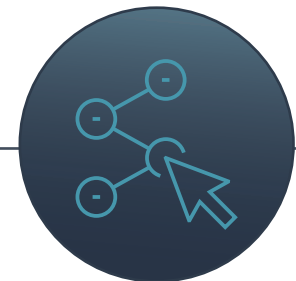


PATH FORWARD

The integrated, out-of-the-box solution will allow them to achieve their high-growth plans.

In addition to automation and lessor functionality, the finance team is also interested in the ability to generate a trial balance for a potential quote.

This will allow them to see the profitability of the lease over time before signature.



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Complex compliance use cases for medical device companies

USE CASE 1: **Reagent rentals**

Reagent agreements are common among medical device companies and their customers. The medical device company provides equipment or other instruments at 'no cost' to customers who agree to purchase a certain number of consumables over the course of the lease agreement. Under ASC 842 and IFRS 16, this type of arrangement contains an embedded lease and must be accounted for appropriately by the lessor, the medical device company.

Why this is complex:

- The lease must be correctly identified as an embedded lease
- The lease must be analyzed for lease/non-lease components
- The lessor must decide whether they are eligible or wish to use the practical expedient or if they are required to separate the non-lease components from the associated lease components
- The lessor must calculate the standalone selling price (SSP) for the lease and non-lease components at the commencement of the lease according to ASC 606 / IFRS 15



USE CASE 2: **Usage-based leases**

In some cases, medical device manufacturers may charge a customer based on the utilization of a specific piece of machinery. Usage may be measured in number of treatments provided, length of time used, or another trackable measurement. This ‘as a service’ leasing model can be beneficial to manufacturers and customers alike but may introduce accounting challenges. While the company may have an idea of expected usage and may establish a minimum monthly payment, actual amounts may vary.

Why this is complex:

- There is no expected payment profile at the start of the lease
- The lease must be analyzed for lease and non-lease components, including service or maintenance costs that may fluctuate with usage as well
- The lessor must facilitate the integration of usage metrics into finance systems at scale
- The lessor may need to understand the profitability of usage-based contracts based on a large number of scenarios

USE CASE 3: **Bundled offerings**

Bundled offerings can mean many things. This particular use case example highlights the complexity that arises when multiple SKUs are bundled and invoiced to a customer as one line item in a contract. This means the contract line item is not reflective of the fair market values of the individual items that make up the bundle. The invoiced amount must be reallocated to the multiple SKUs and the correct stand alone selling price (SSP) of each SKU must be generated. Lease line items must also be pulled out of the bundle or the larger contract and accounted for appropriately.

Why this is complex:

- The invoice-based amounts must be appropriately reallocated across the individual items in the bundle
- SSP pricing must be established for each SKU
- The lease must be analyzed for lease/non-lease components
- Requires generation of standard reports which use the standardized pricing for performance tracking

A unique **proposition**

Aptitude has the only integrated, globally mature solution for leasing and revenue recognition compliance requirements

Fit for Purpose Revenue Management Solution



Aptitude provides a fit for purpose, mature Revenue subledger with an excellent track record. Aptitude RevStream has been in production for over 10 years. The insights reporting module can transform the role of Finance.

Fit for Purpose Lease Accounting Solution



ALAE is a standard product which includes ASC 842 and IFRS 16 compliance out of the box. It includes accounting templates, events, data models and regulatory disclosure reports.

Configuration not Customization



All customers benefit from the experience built up over multiple projects. This reduces delivery risk, lowers delivery and ongoing support costs and supports future business change.

Bespoke Client Partnership



Clients have access to our Product and Delivery teams and chances to engage with senior leadership. Unlike the large ERP vendors, Aptitude can provide a more personal relationship.

Learn more about this **solution**

To learn more about our integrated lease accounting and revenue management solution, arrange a demo or a call with one of our experts. Or simply visit us at www.aptitudesoftware.com/products

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LEARN MORE ABOUT ALAE

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Aptitude
**Lease
Accounting
Engine (ALAE)**

Aptitude Software provides software solutions that enable finance professionals to run their global businesses, forecast decision outcomes, and comply with complex regulations. Uniquely combining deep finance expertise and IP rich technology, Aptitude gives finance leaders the tools they need to transform their business and achieve their ambitions.

Aptitude is proud to have served the offices of finance for over 20 years, delivering financial control and insight to create a world of financial confidence for our global clients.

Aptitude Software supports businesses with combined revenues approaching \$1 trillion and over 500 million end customers. Headquartered in London, Aptitude Software is an operating company of Aptitude Software Group plc.

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