# Revenue Recognition Accounting for Software as a Service (SaaS)

## An Executive Webcast With Jeffrey Werner



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# Welcome to Today’s Event

- Viewing tips & CPE credit information
- About the webcast sponsor, Tensoft
- Introduction to today’s speaker
- **Presentation: “Revenue Recognition Accounting for Software as a Service (SaaS)”**
- Q & A

# Viewing Tips & CPE Credit

- For "Full Screen," go to "View" on the Control Panel
- Submit questions any time using the "Question and Answer" pane
- CPE certificates will be emailed to everyone who requested them during registration – please allow 1 week
- Recording and slides will be available in the Tensoft Resource Center in 24 hours

TENSOFT®

# End-to-End Business Software Solutions
# For the Technology Industry

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# Who is Tensoft?

Tensoft, Inc.

- Business software solutions provider
- Focus on technology companies
- Software for revenue management (RCM)

Tensoft RCM Product Line

- Complete revenue management suite
- Billing management for contracts
- Business model transaction flow support
- Visibility, Productivity, Compliance

# Tensoft RCM Revenue Management

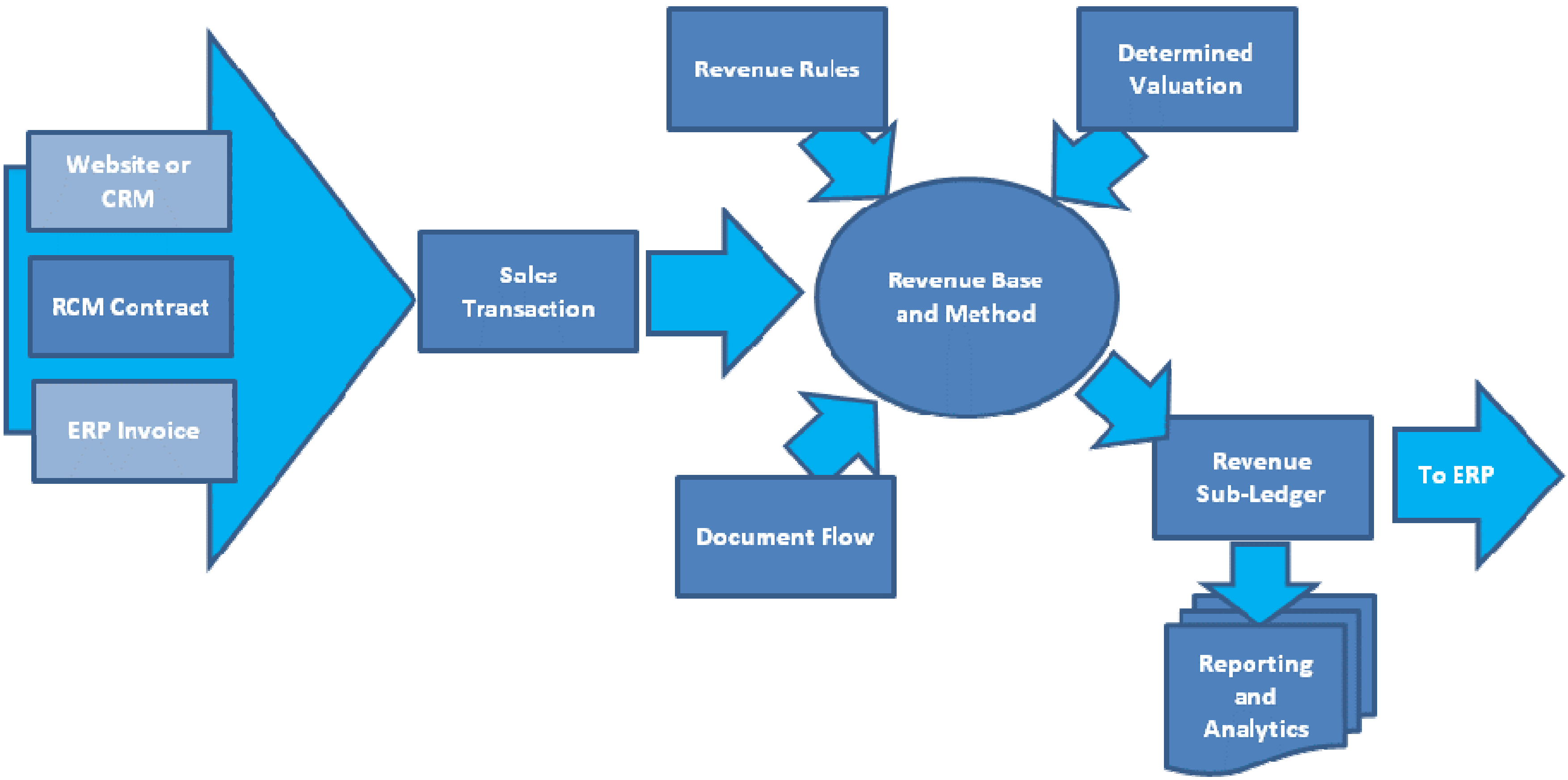
## Sales Transaction

- Generated based on Go-To-Market Model
- Generated from website, ERP, Tensoft RCM Contract

## Revenue Basis

- Determination of policy for document type
- Revenue base determination
  - Sales Transaction Based
  - SOP 97.2 based – residual method
  - EITF 08-01 based – relative value method
- Revenue rules, sub-ledger, and analysis

# Tensoft RCM Revenue Management



# Today's Presenter:

# Jeffrey Werner,

# Werner Consulting Group

# SaaS Presentation Outline

- Introduction
- SaaS Business Model
- Four Revenue Recognition Principles
- SaaS Accounting
  - When SaaS is Software
  - When SaaS is Service
- Set Up Fees and Related Costs
- Consulting and Training Services
- Fees based on Usage

# Introduction to Werner Consulting Group

Revenue Recognition Services Include:

- Pre-Contract Negotiations and Deal Structuring
- Post-Contract Review, Analysis and Accounting
- Best Practices Implementation
- VSOE Studies and Analysis
- Customized Training Classes
- Revenue Recognition Technical Research and Whitepapers
- Revenue Recognition Policy Implementation and Improvement
- Peak Demand Contract Review
- Revenue Management Outsourcing
- Audit Assistance
- Revenue Management Software Implementation
- EITF 08-1 Implementations

# Upcoming Events

**Software Revenue Recognition Webcast**

**Thursday May 19 Part One**

**9 am – 12:30 pm PDT**

**Wednesday May 25 Part Two**

**9 am – 12:30 pm PDT**

**CPE Credit**

**Pay per attendance**

**Registration and details soon**

# Software Revenue Recognition Class

## Software Revenue Recognition Agenda,

**Day One:**

- General Principles of Revenue Recognition
- Multiple Element Arrangements
- VSOE
- License, Support and Services Issues

## Software Revenue Recognition Agenda, Day Two:

- Introduction and Agenda
- Review - General Principles
- Services Contract Accounting
- Software as a Service (Saas)
- EITF 08-1 and 09-3
- FASB IASB Revenue Project

# Questions / Slides

- Submit questions any time using the "Question and Answer" pane
- Submit questions after the webcast to Jeffrey Werner wernerj@sbcglobal.net
- Questions and responses by email and on Tensoft Blog
- Slides will be available to download after the presentation

# SaaS Business Model

# SaaS Business Model

**History of Software Licensing**

- Time Share Model – the mainframe era
- Perpetual Licensing – mini and PC era
  - License Fees
  - Support Fees
  - Implementation Fees
  - High cost of ownership – up front
  - Long Time to Implement – customization
- Term Licensing – EDA Industry Model
  - Spread Costs over Periods of Use

# SaaS Business Model

## Software as a Service - SaaS

- Evolution of the Internet
- Service vs ownership
- SalesForce.com
  - Industry Leader
  - Made SaaS Acceptable

# SaaS Business Model

**Software as a Service – SaaS**

Customer Advantages

- Easy to implement – ready to go, standard set-up
- Low upfront cost
- Cost over time – pay as you go
- Vendor keeps it running – lower internal IT costs
- Less administration of licenses – how many to buy
- Automatic updates
- Easy access over the internet – browser interface
- Network based rather than PC based

# SaaS Business Model

**Software as a Service – SaaS**

Vendor Advantages

- Easier Sale – Lower Upfront Cost of Ownership
- Predictable Ratable Revenue
- Easy To Upgrade and Change Features
- Customers Locked in to Usage – hard to change to another Vendor

# SaaS Business Model

**Software as a Service – SaaS**

Customer Disadvantages

- Mission Critical Resource in Control of Vendor
- Data in Control of Vendor – Privacy Concerns
- Uptime dependent on Vendor and Internet

Vendor Disadvantages

- No One Time Large Sales Revenue
- Must have customer service focus

# Revenue Recognition

# General Principles

# General Principles of Revenue Recognition

- **Persuasive Evidence of an arrangement exists**
- **Delivery has occurred**
- **The fee is fixed and determinable**
- **Collectability is probable**

# General Principles of Revenue Recognition

**Easy Memory Device - Not ABC – CDEF**

- **C – Collection**
- **D – Delivery**
- **E – Evidence**
- **F – Fixed**

# Revenue Recognition Literature

**Revenue Recognition Literature**

- SOP 97-2 and 98-9
- SAB 101 and 104
- TPAs (AICPA Technical Practice Aids)
- EITFs – 00-3, 00-21, 03-5
- EITFs 08-1 and 09-3
- FASB / IFRS Revenue Recognition Project

# SaaS Accounting

# SaaS Accounting

**Is it Software or Service?**

## Software

Take possession – on customer server or right to take possession from vendor without significant costs

- Customer has the ability to use independent of vendor
- Perpetual and Term right of use
- Right and Ability to use without vendor
- License Fees and Support Fees
- Upgrades – part of maintenance or upgrade fees
- Data at customer

# SaaS Accounting

## Is it Software or Service?

## Service

- Hosted by Vendor
- Monthly or Usage Fees
- Data on Vendor Server
- Data Transition or Conversion Rights at End of Use
- Right to Use only
- Significant additional cost to take possession

# SaaS Accounting

**Software**

Use SOP 97-2 Accounting

VSOE for Undelivered elements

Typically Recognize License on delivery

Support Recognized over period

**Service**

Use EITF -8-1 Accounting

Generally ratable over subscription period

# Accounting for Elements of an Arrangement

Two Step Process

1 – Separation

2 – Allocation

# Accounting for Elements of an Arrangement

Separation of the Elements

- Individual elements are independent
  - Functionally – one is not essential to the other
  - Contractually – payments not linked or contingent
  - No related refunds or rights of return
- Individual elements have stand alone value
  - Sold separately by any vendor
  - Have resell value
- If can't be separated, treat as one unit of accounting

# Accounting for Elements of an Arrangement

Allocation of Revenue to the Elements

- Software revenue recognition uses the Residual Method
- Service revenue recognition uses ETIF 08-1 Relative Selling Method

# Accounting for Elements of an Arrangement

Residual Method

- Defer the full value of undelivered elements using Vendor Specific Objective Evidence (VSOE)
- Allocate the remaining value or residual to the delivered elements

# Accounting for Elements of an Arrangement

Relative Selling Price Method

- Allocate to each element based each element percentage of total (relative value)
- Value is based on VSOE, TPE or ESP
- Defer revenue for undelivered elements
- Recognize revenue for delivered elements

# Accounting for Elements of a SaaS Arrangement

SaaS –Multiple Element Arrangements

- Subscription Fees
- Set-up Fees
- Consulting
- Training
- Usage Fees

# Accounting for Elements of a SaaS Arrangement

SaaS – Multiple Element Arrangements

- Is there Stand-Alone Value?
  - Often in SaaS the elements do not have stand alone value
- Stand-alone value includes items sold separately by another vendor

# Up-Front Fees

## SaaS – Up-Front Services (Set-Up Fees)

- Up-front services are a necessary and inseparable part of obtaining the services
- Up-front services have little or no value without the ongoing services
- Customer cannot buy the up-front services from another vendor

# Up-Front Fees

Revenue from up-front services should be accounted for either:

- over the initial contract period for services
- over the expected customer relationship period if greater than the contract period if the customer will benefit from the up-front services after renewal

# Up-Front Fees and Costs

Costs that are incremental and directly related to up-front services should be accounted for either:

- Expensed as incurred, or
- Deferred and charged to expense proportionally over the over the same period as the related revenue

The accounting is an option of the vendor and should be applied consistently

# Accounting for Elements of an Arrangement

Multiple contracts or one arrangement?

TPA 39 Attributes than indicate contracts are independent or related

# Issues to Consider – Multiple Contracts

- “TPA 39” Contracts - Multiple transactions with a Customer in a short time period
  - Can be considered one contract for accounting
  - An element without VSOE in one contract can effect other contracts with same customer
  - All related contracts must be complete and signed for any revenue to be recognized
  - Services SOW referenced or negotiated or being negotiated within the similar timeframe as the license could be considered a related contract
  - All related contracts must be executed for any to be valid

# Issues to Consider – Multiple Contracts

- Indicators That Contracts Are Related:
  - *The contracts or agreements are negotiated or executed within a short timeframe of each other.*
  - *Contracts are executed by the same person.*
  - *The different elements are closely interrelated or interdependent in terms of design, technology, or function.*
  - *The fee for one or more contracts or agreements is subject to refund or forfeiture or other concession if another contract is not completed satisfactorily.*
  - *One or more elements in one contract or agreement are essential to the functionality of an element in another contract.*
  - *Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.*
  - *The negotiations are conducted jointly with two or more parts of the customer's organization (for example, from different divisions of the same company) to do what in essence is a single project.*

# Accounting for Elements of an Arrangement

Usage Fees Revenue Recognized When Usage occurs

Service Meter approach – like the electric bill

# Accounting for Elements of an Arrangement

## Example # 1 – Old Accounting under 00-21

Vendor sells online service

$12,000 one year contract

$1,000 monthly service fee - one year contract

Renewable in year two for $1,000

$5,000 set-up fees – expected life 3 years

# Accounting for Elements of an Arrangement

**Example # 1 – EITF 00-21 Accounting**

**Residual Method based on VSOE**

**NO LONGER USED**

$1,000 monthly service fee - VSOE

$5,000 set-up fees – delivered

Defer monthly fee at VSOE

Recognize service fee $1,000 monthly

Recognize set-up fees $139 monthly ($5,000 / 36)

# Accounting for Elements of an Arrangement

**Example # 2 – EITF 08-1 Accounting**

**Relative Selling Price Method**

$12,000 ($1,000 monthly service fee – VSOE)

<u>$  5,000</u> set-up fees – delivered

$17,000 Total Transaction fee

Allocate using relative selling price

VSOE for monthly service

BESP for set-up fees

Calculate relative selling prices

# Accounting for Elements of an Arrangement

**Example # 2 –**

**Relative Selling Price Method**

$12,000 service fees – VSOE – 60%

$  8,000 set-up fees – BESP – 40%

$20,000

$10,200 service fees at 60% - $850 month

$  6,800 set-up fees at 40% - $189 month ($6,800 / 36)

$17,000 total arrangement fee

# Accounting for Elements of an Arrangement

**Comparison**

**Example # 1 Residual Method - No Longer Used**

Year one

$12,000 Monthly Fee

$ 1,667 1/3 set up fee ($5,000 / 3)

$13,667

**Example # 2 Relative Selling Price Method**

Year one

$10,200 Monthly Fee

$ 2,267 1/3 set up fee ($6,800 / 3)

$12,467

# Accounting for Elements of an Arrangement

## Example # 3

Vendor sells online service

$12,000  $1,000 monthly service fee - one year contract

Renewable in year two for $12,000

$10,000  Training - $2,000 day VSOE

$22,000  Total Transaction Fee

Does the Training have a separate value from the monthly service?

# Accounting for Elements of an Arrangement

**Example # 3 – EITF 00-21 & 08-1 Accounting**

$ 1,000 monthly service fee - VSOE

$10,000 Consulting / Training

Defer monthly fee at VSOE

Recognize service fee $1,000 monthly

Recognize Training when completed (assuming Training has separate stand-alone value)

# Accounting for Elements of an Arrangement

**Example # 4 –**

**Customization Services**

$100,000 Annual Subscription Fee

renewable for year 2 $100,000 (VSOE)

$ 50,000 Customization Services

Do the customization services have stand-alone value?

# Accounting for Elements of an Arrangement

## SaaS – Example # 4 – Customization Services

The customization services have no stand-alone value because the customer only obtains value from the services through the use of the subscription services

Therefore the hosted services and the customization services should be treated as a single unit of accounting

Recognize revenue $150,000 revenue ratably over one year subscription period ($12,500 month)

Capitalize and expense customization costs or expense as incurred depending on company policy election

# Conclusion

## Revenue Recognition Resources

- Big Four Revenue Recognition Guides
- Big Four Revenue Recognition Whitepapers
- AICPA
- FASB / EITF
- SEC Filings
- Webcasts
- Web Searches

# Q & A

**To submit a question now, please click on "Question and Answer."**

**Then just type your question in the space under "Enter a Question"**

# Additional questions or comments?

**Please contact:**

**Jeffrey Werner**

**Email wernerj@sbcglobal.net**

**Werner Consulting Group**

**Revenue Recognition Consultant**

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Revenue Recognition Accounting for Software as a Service (SaaS)

Webcast

March 9, 2011

Thanks for Joining Us Today