Revenue Recognition Accounting for Cloud Computing (SaaS)

Jeffrey Werner, Werner Consulting Group
Bob Scarborough, Tensoft
October 15 2013

Confidential 1

Welcome to Today's Event

Caprice Murray, Tensoft

Confidential 2

Webcast Briefing

- Submit questions any time using the "Question and Answer" pane.
- CPE certificates will be emailed to everyone who is eligible by Friday.
- Recording and Slides will be available on Tensoft's Resource Center by Friday.
- Submit questions after the webcast to Jeffrey Werner, wernerj@sbcglobal.net, or to Caprice Murray, caprice@tensoft.com.
- Question responses by email and on Tensoft's Blog.

Confidential 3

About 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

Confidential 4

1

Tensoft RCM Revenue Management

- **Sales Transaction**
  - Generated based on Go-To-Market Model

- **Revenue Agreement**
  - Workflow / policy for document type
  - Revenue fair value allocation
  - Revenue Rules

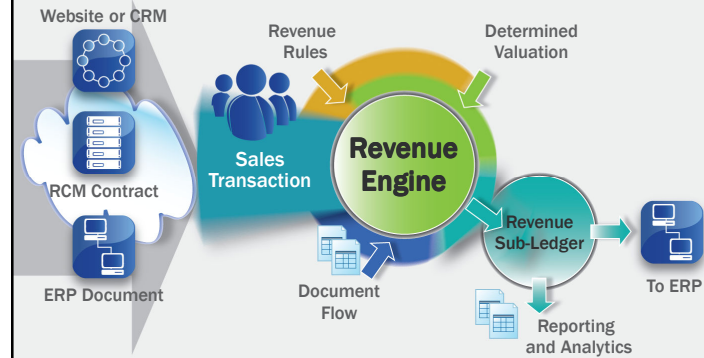- **Revenue Recognition and Analysis Process**

Tensoft RCM Process Flow

Website or CRM

RCM Contract

ERP Document

Sales Transaction

Revenue Rules

Determined Valuation

Revenue Engine

Revenue Sub-Ledger

Document Flow

To ERP

Reporting and Analytics

Today's Presenter: Jeffrey Werner, Werner Consulting Group

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast

Tuesday November 12 Part One

9 am – 12:30 pm PST

Thursday November 14 Part Two

9 am – 12:30 pm PST

CPE Credit

Pay per attendance

Registration and details soon

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast

Agenda Day One

- **General Principles of Revenue Recognition**
- **Multiple Element Arrangements**
- **VSOE**
- **Software Revenue Recognition**
- **Services and Contract Accounting**

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast

Agenda Day Two

- **Review - General Principles**
- **Services Contract Accounting**
- **Relative Selling Price Method (EITF 08-1)**
- **Cloud Computing (Saas)**
- **FASB IASB Revenue Project**
- **Other Rev Rec Issues**

Revenue Recognition
Accounting
for Cloud Computing
(SaaS)

Jeffrey Werner, Werner Consulting Group
Bob Scarborough, Tensoft
October 15 2013

Confidential

TENSOFT 11

Cloud Computing (SaaS) Outline

- Introduction
- Cloud Computing (SaaS) Business Model
- Cloud Computing (SaaS) Accounting
  – When SaaS is Software
  – When SaaS is Service
- Set Up Fees and Related Costs
- Consulting and Training Services
- Fees based on Usage
- Cloud Computing (SaaS) and Software MEA

SaaS Business Model

History of Software as a Service

Application Service Provider (ASP)

Software as a Service (SaaS)

Cloud Computing
- The HOT new business model
- Recurring Revenue Model
- Use instead of owned / installed software

SaaS Business Model

Cloud Services - SaaS

Applications

Platforms

Infrastructure

Other Services

SaaS Business Model

Cloud Computing (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

Cloud Computing (SaaS) Accounting

Is it Software or Service?

Software

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

Right and Ability to use without vendor

Perpetual and Term right of use

License Fees and Support Fees

Upgrades – part of maintenance or upgrade fees

Data at customer

Contract may not be clear

Cloud Computing (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

Contract may not be clear

Cloud Computing (SaaS) Accounting

Four Principles of Revenue Recognition

– **Persuasive Evidence of an arrangement exists**

– **Delivery has occurred**

– **The fee is fixed and determinable**

– **Collectability is probable**

– **Not ABC - CDEF**

Accounting for Elements of an Arrangement

Revenue Recognition Steps

1 – Separation into elements

2 – Allocation of revenue to elements

3 – Recognition of revenue

Accounting for Elements of an Arrangement

Elements or Obligations of an Arrangement

– Named in the contract

– Require distinct action of vendor

– Transaction price would vary if not included

– Lack of performance reduces price / penalty

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 - Software

– 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 (SaaS)

– 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 Cloud Computing (SaaS) Arrangement

SaaS – Multiple Element Arrangements
Subscription Fees
Set-up Fees
Implementation
Data Migration / Content
Consulting
Business Process
Training
Project Management
Usage Fees

Accounting for Elements of a Cloud Computing (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)

– If Up-front services are a necessary and inseparable part of obtaining the services

– If Up-front services have little or no value without the ongoing services

– If Customer cannot buy the up-front services from another vendor

– No stand alone value – account for as one element

Set-up Fees

– Some Companies and Auditors take the position that set up fees are an asset created for the customer that has value after the initial contract period and should be allocated revenue and the revenue recognized over the customer relationship period. **This seems to be the dominate position and SEC approach**

– Some Companies and Auditors take the position that there is no stand alone value for set up fees and treat as one unit of accounting over the contract period. May be used if little or no difference in results expected

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

Usage Fees Revenue Recognized When
Usage occurs

Monthly fees with usage fees
like cell phone bills
set number of minutes, overage
no rollover to next period

Accounting for Elements of an Arrangement

Example # 1

Vendor sells online service
$12,000 $1,000 monthly service fee - one year contract
                Renewable in year two for $12,000
$10,000 Consulting – 5 days at $2,000 day VSOE
$22,000 Total Transaction Fee

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

Accounting for Elements of an Arrangement

Example # 1 –
$ 1,000 monthly service fee - VSOE
$10,000 Consulting
Recognize service fee $1,000 monthly
Recognize Consulting when completed (assuming
Consulting has separate stand-alone value)
No allocation issue as both at stand-alone value
If Consulting does not have stand-alone value
recognize entire amount ratably ($1,800 month)

Accounting for Elements of an Arrangement

Example # 2 Relative Selling Price Method

Vendor sells online service
$10,000 $1,000 monthly service fee - one year contract
                Discounted year one VSOE is $12,000
$10,000   Consulting - $2,000 day VSOE discounted
$20,000 Total Transaction Fee

Account for based on relative value

Accounting for Elements of an Arrangement

Example # 2 – Relative Selling Price Method

$12,000 55% Subscription VSOE/ESP Value
$10,000 45% Consulting – VSOE/ESP Value
$22,000 100%

$11,000 55% Subscription Revenue
$ 9,000 45% Consulting Revenue
$20,000 100% Total Revenue
Revenue on subscription limited to amounts not contingent
    performance of consulting

Accounting for Elements of an Arrangement

Example # 3 Relative Selling Price Method

Vendor sells online service
$12,000 $1,000 monthly service fee - one year contract
              Renewable in year two for $12,000
$ 8,000   Consulting - $2,000 day VSOE discounted
$20,000   Total Transaction Fee

Account for based on relative value

Accounting for Elements of an Arrangement

Example # 3 – Relative Selling Price Method

$12,000 55% Subscription VSOE/ESP Value
$10,000 45% Consulting – VSOE/ESP Value
$22,000 100%

$11,000 55% Subscription Revenue
$ 9,000 45% Consulting Revenue
$20,000 100% Total Revenue
Revenue on consulting limited to amounts not contingent
    performance of subscription

Accounting for Elements of an Arrangement

**SaaS – Multiple Element Arrangements
That include SaaS, Products and Software**

Separate and Allocate under EITF 08-1

Then Recognize based on type of element
    Product
    Service
    Software
    SaaS
    Etc

SaaS and Software

- **Example Facts – Software and SaaS**
- A Software Company enters into an arrangement with a customer to delivery software License A, support on License A, one year SaaS service B and other services.
- **Contract Elements and Pricing**
  - $ 100,000 License A
  - $ 20,000 Support on License A
  - $ 50,000 SaaS Service B
  - $ 30,000 Services
  - $ 200,000 Total Contract Price

SaaS and Software

- **Example – Software and SaaS**
- **Element Values**
  - $ 130,000 License A based on ESP
  - $ 20,000 Support on License A based on VSOE
  - $ 60,000 SaaS Service B based on VSOE
  - $ 40,000 Services based on VSOE
  - $ 250,000 Total Element Values
- **Relative Values**
  - $ 130,000   52% License A
  - $ 20,000   8% Support on License A
  - $ 60,000   24% SaaS Service B
  - $ 40,000   16% Services
  - $ 250,000 Total Element Values

SaaS and Software

Example – Software and SaaS
Revenue Allocation
  - $ 104,000 52% License A
  - $ 16,000   8% Support on License A
  - $ 48,000 24% SaaS Service B
  - $ 32,000 16% Services
  - $ 200,000 Total Contract Price

More Examples - Software & SaaS

- **Example – Software and SaaS**

- **Revenue Recognition - software**
  - $100,000 License A on delivery
  - $ 20,000 Support ratably over one year at VSOE
  - $120,000 Total Contract Price revenue

- **Revenue Recognition – non-software**
  - $ 48,000 SaaS Service B ratably over one year
  - $ 32,000 Services as provided on a daily basis
  - $ 80,000 Total non-software revenue

  $200,000 Total revenue

Cloud Computing (SaaS) Recap

- Cloud Computing (SaaS) Accounting
  - When SaaS is Software
  - When SaaS is Service
- Multiple Element Arrangements
- Set Up Fees and Related Costs
- Consulting and Training Services
- Fees based on Usage
- SaaS and Software MEA

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast
Tuesday November 12 Part One
    9 am – 12:30 pm PST
Thursday November 14 Part Two
    9 am – 12:30 pm PST
CPE Credit
Pay per attendance
Registration and details soon

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast
Agenda Day One
- **General Principles of Revenue Recognition**
- **Multiple Element Arrangements**
- **VSOE**
- **Software Revenue Recognition**
- **Services and Contract Accounting**

Revenue Recognition Class

Revenue Recognition for Technology Companies Webcast
Agenda Day Two
- **Review - General Principles**
- **Services Contract Accounting**
- **Relative Selling Price Method (EITF 08-1)**
- **Cloud Computing (Saas)**
- **FASB IASB Revenue Project**
- **Other Rev Rec Issues**

Additional questions or comments?

Please contact:

Jeffrey Werner
Email wernerj@sbcglobal.net
Werner Consulting Group
Revenue Recognition Consultant

TENSOFT   49

Thank You

www.tensoft.com

TENSOFT   50