Getting Your Non-Public SaaS Business Prepared for the New Revenue Recognition Standards (ASC 606)

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Sponsors: SaaS Capital, SaaSOptics

September 20, 2017

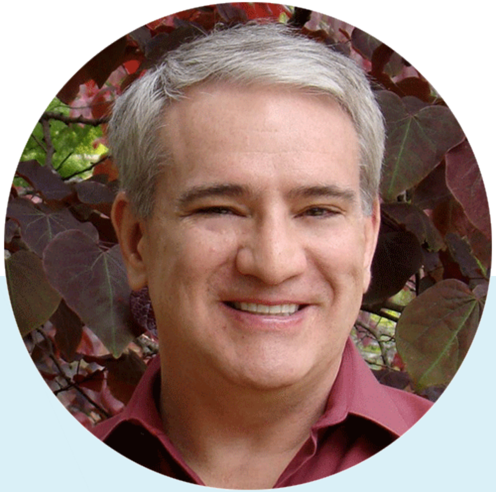
Welcome – About SaaSOptics...

350
Customers

$2.8B+
Managed Revenue

$3B
In Venture Capital and Private Equity Raised

SalesLoft · springbot · Oversight · FLASHPOINT · CrunchBase · greenhouse · DUO · Ingenious Med (IMAGINE THAT. INGENIOUS.) · schoology · OnStrategy


David Ryan
Founder and COO

Welcome – About SaaS Capital…

43	$400M	100%
Companies Funded	of Equity Value Created	Success Rate

Graduway Empowering Alumni Relations
LiquidPlanner
covermymeds
codility
wiredrive
ThinkHR
Reeher
PUSHER
WebLink International
FreeAgent

Todd Gardner
Founder and Managing Director

saas CAPITAL
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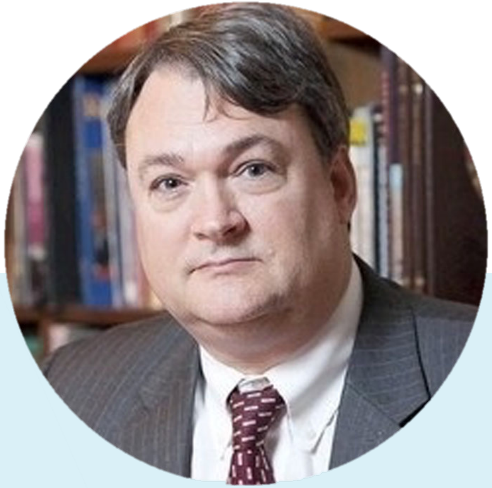
Welcome – About Steve Sehy, CaaS for SaaS

Providing fractional CFO services to SaaS companies

- Preparing for Series A/ Professional financing
- Implementing GAAP (current and new)
- Upgrading accounting processes/systems
- Handling finance for the CEO



Steve Sehy
CaaS for SaaS CFO Services

Bio:

- Started career in Software Development
- Moved to Product Management and Product Development Management
- Auditor/CPA at RSM (previously named McGladrey)
- Recent client: Provided financial leadership for SaaS company Haiku Learning for two years of financial improvements, ending in a corporate acquisition by a Private Equity firm

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To Begin:

Take a Deep Breath…

- Compared to current GAAP, all of the new standards change the timing but not the amount of revenue
- Most non Public SaaS companies will have a +/-5% or less impact on revenue in 2019 based on the changes
- Unfortunately, there may be a lot of underlying work to get the new numbers.

Agenda

- Background and Key Concepts for the new Revenue recognition standards (ASC 606)(also called ASU 2014-09)
- Key SaaS revenue sources and how to treat them
- Changes to Customer acquisition costs
- Allocating the price
- Action items: What to do by 12/31/17
- Additional Resources

Polling Question

Which title best describes your current role? (Select one)

- ❑ Auditor/ Service provider
- ❑ CEO/CFO of a SaaS Company
- ❑ Controller of a SaaS Company
- ❑ Accountant of a SaaS Company
- ❑ Other

New Revenue Recognition - Background

Accounting Name (ASU No. 2014-09, ASC Topic 606) – Revenue from Contracts with Customers:

- Affects all industries
- Attempting to have a single process for determining revenue in all situations/industries
- Principles vs. Rules
- Convergence between U.S. GAAP and International GAAP
- For non-public companies needs to be in place for Calendar year 2019. (For SaaS companies this will include annual and multi-year agreements made in 2018).

New Revenue Recognition

This standard is a moving target because:

- Principles vs. Rules – “judgement” used to determine methods
- SEC rules may “interpret” the standards
- Precedents may be set by “first implementations”
- U.S. Legal Environment – lawsuits may impact standards
- Audit Firm positions – may “interpret” the standards.

New Revenue Recognition

Revenue Recognition Changes We are NOT covering:

- Collectibility
- Software licenses (old school software)
- Hardware
- Usage fees (e.g. # of transactions, # of Gigs)
- Contract modifications*
- Disclosures/Footnotes for non-public companies*

*Everyone should probably learn this, we just don’t have time.

Key Concepts

Core Principle Steps

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) each performance obligation is satisfied.

Key Concepts

Performance obligation timing

- Point in time (after training is provided & invoiced– recognize revenue then)
- Satisfied over time (recognize revenue on a single basis over time)

Over Time: Output-based Methods
- Appraisals of results achieved (e.g. % complete)
- Milestones reached
- Time elapsed

Over Time: Input-based Methods
- Resources consumed
- Costs incurred
- Time-based
- Labor hours expended.

Key Concepts

Common Performance obligations for SaaS

(This is not based on how you bill your customers. It is based on the services you provide.)

1. Subscription (Access to the hosted software)
2. Installation (vs. Setup/initiation fees)
3. Training
4. Ongoing Support
5. Ongoing Upgrades to the software
6. Custom Development/ “Promised Features”

Revenue by type

Examples of Common Performance obligations for SaaS

- Key Changes from current GAAP will be highlighted
- Note: The new standards may result in revenue being treated the same as current GAAP.

SaaS Revenue Recognition - Subscriptions

Usually satisfied over time

Calculated using the Time Elapsed - Output method

In general, the GAAP treatment is similar:

- Spread the revenue over the period, but the period may change
- Options to renew may impact current revenue
- Pay close attention to major customers!.

Polling Question

What type of Subscriptions do you provide at your company? (Select all that apply)

- ☐ Monthly
- ☐ Single year
- ☐ Single year with option to renew
- ☐ Multi-year
- ☐ None of the above/ Or not a SaaS Company

SaaS Revenue Recognition - Subscriptions

Single Year:

Customer is provided with a one year agreement with an option to renew for a second year at the same terms.

- *Revenue is recognized as a one year contract.*

Multi-Year

Major Customer is provided a one year agreement with an option to renew for a second year at a 15% discount.

- *Revenue is recognized as a two year contract. (because customer is incentivized to renew) (Change from current GAAP).*

SaaS Revenue Recognition - Subscriptions

Examples of the Impact of Delivery

Customer is provided with a one year agreement starting on January 1. Customer pays $1,200 up front.

- *Revenue is recognized as $100 per month starting on January 1*

Customer is provided with a one year agreement starting on January 1 and going to December 31. Customer pays $1,200 up front. Installation took three months so customer starts using the software on April 1

- *Revenue is recognized as $1200/9 per month starting in April since customer did not receive the product until then. (Change from current GAAP.)*
- *Customer doesn't have to "sign for acceptance", but you need some verification that they have "access"*

Moral – contract and actual delivery terms impact revenue recognition.

SaaS Revenue Recognition - Installation

Usually satisfied over time or at completion
Depending on your contract, this could be calculated using the:

- Time Elapsed - Output method: (e.g. Install done in first 30 days)
- Appraisals of Results Achieved – Output method (e.g. % complete)
- Labor hours expended – Input Method (e.g. x hours out of 20)
- Point in Time method (e.g. finished in the 3rd month)

If this is a material component of your service and you do not charge separately, but now need to separate the performance obligation, this could impact your MRR (install fees are not recurring).

SaaS Revenue Recognition - Training

Satisfied over time or at a point in time

Depending on your contract, this could be calculated using the:

- Time Elapsed - Output Method
- Labor hours expended – Input Method
- Point in Time Method.

SaaS Revenue Recognition - Training

Example – Revenue recognized over time:
Customer is provided with 3 training webinars per week for the first three months. Customer pays $1,200 up front.

- *Revenue is recognized as $400 per month for 3 months*

Example – Revenue recognized as hours are expended:
Customer is promised 24 training hours of training. Customer pays $1,200 up front. At the end of the first month of the project 8 training hours have been delivered.

- *Revenue is recognized as $400 (8 * $50) for the first month*

Example – Revenue recognized at time of completion:
Customer is charged $1,000 for each on-site day of training. At the end of the first month, two days of training have been provided.

- *Revenue is recognized as $2,000 (2 * $1,000) for the first month.*

SaaS Revenue Recognition - Support

Satisfied over time or at a point in time

Depending on your contract, this could be calculated using the:

- Time Elapsed - Output Method,
- Labor hours expended – Input Method
- Point in Time Method.

SaaS Revenue Recognition - Support

Example – Revenue recognized over time:
Customer is provided with ongoing phone and other support during a one year agreement. Customer pays $1,200 up front.

- *Revenue is recognized as $100 per month*

Example – Revenue recognized as hours are expended:
Customer is promised 24 hours of support. Customer pays $1,200 up front. At the end of the first month of the project 8 support hours have been delivered.

- *Revenue is recognized as $400 for the first month*

Example – Revenue recognized at completion:
Customer is invoiced $100 for each hour of support provided. At the end of the first month, 6 hours of support have been provided.

- *Revenue is recognized as $600 for the first month.*

SaaS Revenue Recognition - Upgrades

Satisfied over time

This could be calculated using the ***Time Elapsed - Output method***

SaaS Revenue Recognition - Upgrades

Example – Standard agreement with ongoing updates

Customer is provided with ongoing upgrades during a one year agreement. Customer pays $2,400 up front.

- *Revenue is recognized as $200 per month*

Example – Standard agreement with significant updates

Customer is provided with ongoing upgrades during a one year agreement. Customer also was promised a significant upgrade would be delivered after 6 months based on a road map on the web site. Customer pays $2,400 up front

- *Revenue is recognized as $100 per month for the first six months and $300 per month for the second six months. (The upgrade was determined to be worth $1,200 and is recognized over the rest of the contract.) (Change from current GAAP).*

SaaS Revenue Recognition – Custom Development

Custom Development Fees (or “promised features”)

Satisfied over time

This could be calculated using the ***Time Elapsed - Output method***

SaaS Revenue Recognition – Custom Development

Example - Modification is critical to the overall deal

Major Customer is provided with one year's access starting January 1. Customer is provided with a critical custom modification on March 1. The customer could cancel the agreement if the modifications were not done properly. Customer pays $2,400 up front for the modification

- *Revenue is recognized as $2,400/10 per month starting on March 1. The standard subscription revenue would also not start until March 1. (Change from current GAAP)*

Example - Modification is NOT critical to the overall deal

Major Customer is provided with one year's access starting January 1. Customer is provided with a non-critical custom modification on March 1. The customer would just receive their custom development fee back if the modifications were not done properly. Customer pays $2,400 up front for the modification

- *Revenue is recognized as $2,400/10 per month starting on March 1. The standard subscription revenue would start on January 1. (Change from current GAAP).*

SaaS Revenue Recognition – Costs

Customer Acquisition and Setup Costs

(Huh? I thought this was a Revenue recognition change…)

- This was an option in current GAAP. It is now required and applies to all incremental costs, not just direct costs.

- In general: The standard indicates that these costs should be consistent with the revenue recognition which generally means capitalizing and amortizing
- Creates an Asset: Deferred costs (or Deferred commissions)
- Practical expedient – If the agreement is for one year or less, you can just expense.
- Costs incremental to acquiring this customer (not general marketing or pre-sales)

SaaS Revenue Recognition – Costs

Customer Acquisition Costs

- Incremental
- Commissions (could include salesperson, manager, regional manager)
- Bonus (if totally based on sales, if based on other factors would probably not qualify)

SaaS Revenue Recognition – Costs

Customer Setup Costs and Cost Amortization

- Setup Costs: Capitalize if directly related to a contract, it creates a company resource, costs are expected to be recoverable
- Setup Costs: Could include the salaries of an implementation team

- Amortization of Costs: Could be based on a contract, a specific performance obligation or anticipated renewals. Management determines the amortization period.
- Amortization would not include anticipated renewals if costs are the same for each agreement (e.g. 2% commission on first year and each renewal)
- Amortization will include anticipated renewals if costs are different (e.g. 8% commission on sale and 2% commission for renewals) (Amortize over management estimate of customer life) (Either the total 8% or the amount over the renewal amount 6%).

SaaS Revenue Recognition – Costs

Customer Acquisition and Setup Costs (Balance sheet - Deferred costs)

Example - Commissions:
Customer is provided with two year's access to the system starting January 1. Sales commission for the two year agreement is $2,400

- *Sales commission is capitalized as an asset. Cost is recorded as $100 per month starting on Jan 1*

Example – Setup Costs:
Customer is provided with one year's access to the system starting January 1. Incremental cost of customer setup is $3,600. Management determines that customer is expected to renew for at least two more years

- *Customer cost is capitalized as an asset. Cost is recorded as $100 per month starting on January 1. Spread over the three year expected life of the asset.*

Allocating the Price

The transaction is allocated based on Stand-alone selling price or Estimated Stand-alone selling price. (See Additional Resources for more info)

Stand-alone selling price can be established if items are sold separately.
Example: Annual phone support is sold separately for $1,200 per year.

If the item is never sold by itself, the stand alone selling price needs to be estimated.
Example: Phone support is always included with a subscription.

Allocating the Price

Simple option: If all of the Performance Obligations will be treated the same, then you don't need to allocate the price.

Example – All performance obligations recognized the same way: Annual Subscription, phone support and upgrades are always sold together and will all be allocated over the year. They can be treated as one item for price allocation.

- Subscription, phone support and upgrades are sold for $3,600 for a year. These items would not need to be allocated

Example – Performance obligations recognized differently: Annual Subscription, phone support and upgrades are always sold together, however phone support is based on hours while the other items will all be allocated over the year. *They cannot be treated as one item for price allocation*

- Subscription, phone support and upgrades are sold for $3,600 for a year. These items would need to be allocated between the subscription/upgrades and phone support.

Comprehensive example

Gold product Annual Plan: Includes hosting, support, ongoing software updates, 90 day installation services and 5 hours of training. Salesperson gets 10% commission on new business and 5% on renewals. Client is sent a login/password on the first day of the agreement

<u>Performance obligations:</u>

- Subscription, Support, Upgrades, Installation, Training
- Over time – one year: Subscription, Support, Upgrades
- Over time – 90 days: Installation
- Over time – labor hours: Training

<u>Acquisition costs:</u>

- 5% “extra” commission allocated over 3 year estimated life of asset.

What You Need To Do By 12/31/17

1. Assemble your team
2. Identify how you will treat each of your types of revenue, including how you will group them for price allocation
3. Identify how you will treat customer acquisition costs
4. Determine how you will allocate the price in deals with multiple performance obligations
5. Review your standard contracts and Terms of Service (Based on the above. Should be in place on 1/1/18.).

What You Need To Do By 12/31/17

6. Implement a process of pre-approval or review of any customer specific contract modifications for new and existing deals
7. Contact your auditor or due diligence reviewer (or a consultant) and confirm your documented conclusions for the steps above.
8. Determine how you will transition: You can select either the full retrospective (recast all numbers for prior years) or modified retrospective method. (disclose key prior year changes)
9. Prepare a statement for investors, potential investors, or bankers: Ideally this should be something like… "We have reviewed the impact of the new revenue recognition rules for their impact on our financials. Based on our review, from 1/1/2019 our (type of revenue..) revenue will be affected and the change will accelerate/delay the recognition of this revenue. Currently this revenue is only xx% of our total revenue." They will not want to hear "We don't know" when they ask this question.

Call to Action / To Do List

10. Identify if your current financial systems will support your changes when needed

By 1/1/19 you should able to:

- Record new/renewing contracts under new standards
- Re-cast existing contracts into new standards
- Collect information needed for disclosures.

Polling Question

For SaaS company employees, what revenue recognition change preparation steps have you already completed?
(Select all that apply)

- ❑ Identified Performance Obligations and price allocation
- ❑ Determined acquisition cost policy
- ❑ Reviewed current contracts and Terms of Service
- ❑ Determined implementation plan
- ❑ Attended a Webinar

Additional Resources

Note: Some do not differentiate between the standards for Public vs. Private companies.

- Sehy - 10 Steps To Prepare For The New Revenue Recognition Standards – Software Executive Magazine – October Issue

- pwc New Revenue guidance –Implementation in the software industry – July 2017, 31 pages
  - http://www.pwc.com/us/en/cfodirect/publications/in-depth/revenue-implementation-guidance-technology-industry.html

- RSM Revenue Recognition: A Whole New World – Jan 2017, 43 pages
  - http://rsmus.com/what-we-do/services/assurance/revenue-recognition-a-whole-new-world.html

- RSM Changes to revenue recognition in the technology industry – Jan 2017, 18 pages
  - http://rsmus.com/what-we-do/services/assurance/financial-reporting-resource-center/financial-reporting-resource-center-revenue-recognition/changes-to-revenue-recognition-in-the-technology-industry.html

- KPMG Revenue for Software and SaaS – March 2017, 648 pages
  - https://frv.kpmg.us/reference-library/2017/03/revenue-for-software-and-saas.html

New Revenue Recognition Standards

Questions?

Thank you for joining us!

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