POSSIBLE (RE)DEFINED

Unpacking Revenue Recognition for SaaS Companies

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Certified B Corporation


A Fast- Moving Climate Requires
A New Way of Thinking

Possible (Re)Defined
Go further, faster

Gain confidence and clarity to tackle challenges or plan for tomorrow's aspirations

AREA OF FOCUS

Today, We're Covering

Empowering Operations

QUALIFICATION

Requirements for CPE

RESPOND

Actively Respond to 3 of 5 Polling Questions

STAY ON

Stay on for the duration of the broadcast

- Log in as an individual

FOR QUESTIONS

If you have technical difficulties responding to the polls, please send an email to:

- Elevate@armaninoLLP.com
- Please include the name/date of your session along with your poll response

Learning Objectives

KNOWLEDGE

IDENTIFY:
List the 5 criteria of Revenue Recognition

IMPACT:
Identify the regulations and impact of ASC 606

CONSIDERATIONS:
Review areas to consider for revenue recognition in building your business model

POLICIES:
Describe how to craft policies and accounting processes that set you up for success

CPE INFORMATION

Program Level: BASIC

Recommended CPE: 1

Field of Study: ACCOUNTING

Program Prerequisite: NONE

Advanced Preparation: NONE

WELCOME

Today's Presenters

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EXPLORING NEW AREAS

Agenda

- Key Criteria for Revenue Recognition
- Regulatory Impact of ASC 606 & IRC 451 C
- Performance Obligations
- Business Pricing Models
- Case Studies
- Q & A

BASICS

Revenue Recognition

- Revenue recognition is a generally accepted principle of accounting referring to measurable revenue.
- The principals state that revenue should only be recorded when a revenue generation process has been completed or earned.
- In SaaS, it means the revenue recognized from a contract, including subscriptions paid in advance.
  - What revenue should be recognized?
  - When is it earned and realized?
  - When will payment be received?

BASICS

5 Key Criteria/Steps of Revenue Recognition

Contract

Identify the contract with a customer

Obligations

Identify the performance obligations in the contract

Price

Determine the transaction price

Allocation

Allocate the transaction price to performance obligations

Recognize

Recognize revenue when (or as) the entity satisfies a performance obligation

GAP ASSESSMENT

Common Challenges

Metrics
- Budget
- Forecast

Contracts
- Structure
- Renewals

Pricing Models & Strategies
- Are you correctly recognizing your revenue according to this structure?

Integrated Software
- Disparity or gaps between CRM & ERP

REGULATIONS

Impact of ASC 606

- FASB Accounting Standards Codification (ASC) Topic 606 changed the way SaaS Companies recognize revenue.
- Under ASC 605, recognized as a straight-line basis over the term of the contract.
- Under ASC 606, For SaaS companies, the main impact is from contracts with multiple performance obligations such as implementation services and contracts with usage-based models and variable consideration.
- Rules went into effect:
  - Public Companies: January 1, 2018
  - Private Companies: January 1, 2019

REGULATIONS

IRC §451C

- This section of the tax code refers to the rules that outline the criteria that must be met before a company can recognize the revenue for tax purposes, designed to ensure that it's recognized in the appropriate accounting period and accurately reflects the economic substance of the transaction.
- Criteria Includes:
  - Pervasive evidence that an arrangement exists
  - Delivery has occurred or service has been rendered
  - The price has is fixed or can be determined
  - It's probable that the company will receive payment
- Why is this complex for SaaS companies?
  - Subscription-based and usage-based revenue models add layers of complexity

METHODS

Performance Obligations

- Multiple performance obligations such as professional services and SaaS: Allocate value based on stand-alone selling price (SSP).
- The best method is to use the price when performance obligation is sold by itself.
- If it is not sold by itself, use:
  - **Adjusted Market Assessment Method:** This method involves determining the stand-alone selling price based on market observations, adjusted for factors that are specific to the company and the particular goods or services being sold.
  - **Expected Cost Plus Margin Method:** This method involves estimating the expected costs of producing the good or service, adding a reasonable margin for profit, and arriving at the stand-alone selling price.
  - **Residual Approach Method:** This method involves estimating the stand-alone selling price of each good or service in a bundle, and then subtracting the sum of those prices from the total transaction price of the bundle to arrive at the stand-alone selling price of any remaining goods or services.

CONSIDERATIONS

Key Factors in Principal vs. Agent for SaaS:

AWS vs. Resellers (3rd Party Contractors Providing Professional Services)

Control of the goods or services

- One of the main factors to consider is which party has control of the goods or services being provided. If the company has control over the goods or services before they are transferred to the customer, it is likely acting as a principal.

Primary responsibility for fulfilling the contract

- The company that is primarily responsible for fulfilling the contract with the customer is more likely to be considered a principal.

Risks and rewards of ownership

- If the company bears the risks and rewards of ownership, it is more likely to be considered a principal.
- For example, if the company is responsible for any losses or gains related to the sale of the goods or services, it is acting as a principal.

Pricing

- If the company is setting the price for the goods or services, it is more likely to be acting as a principal.

Ability to make decisions about the goods or services

- If the company has the ability to make decisions about the goods or services being provided, it is more likely to be acting as a principal.

Discretion in supplier selection

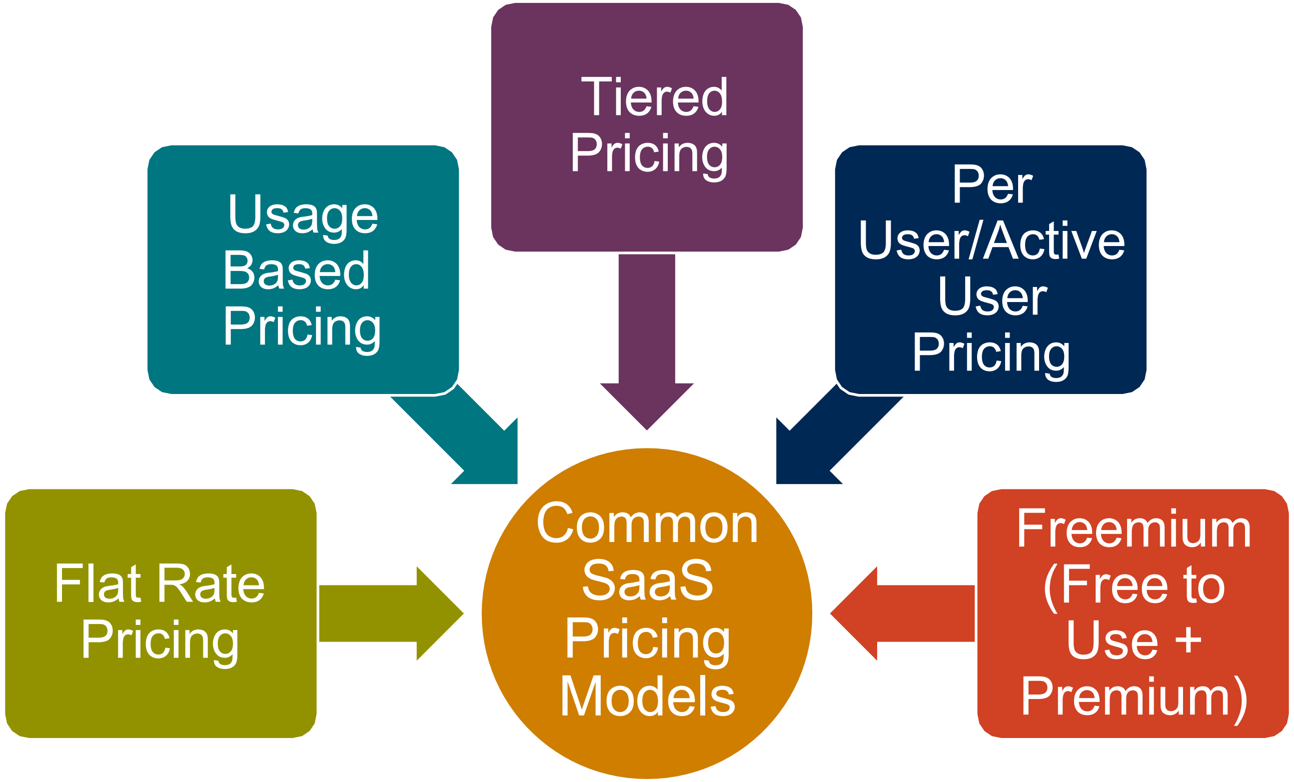
- If the company has discretion in selecting the supplier of the goods or services, it is more likely to be acting as a principal.

Customer credit risk

- If the company is responsible for absorbing the credit risk associated with the customer, it is more likely to be acting as a principal.

BUSINESS MODELS

SaaS Pricing Models



REVENUE RECOGNITION

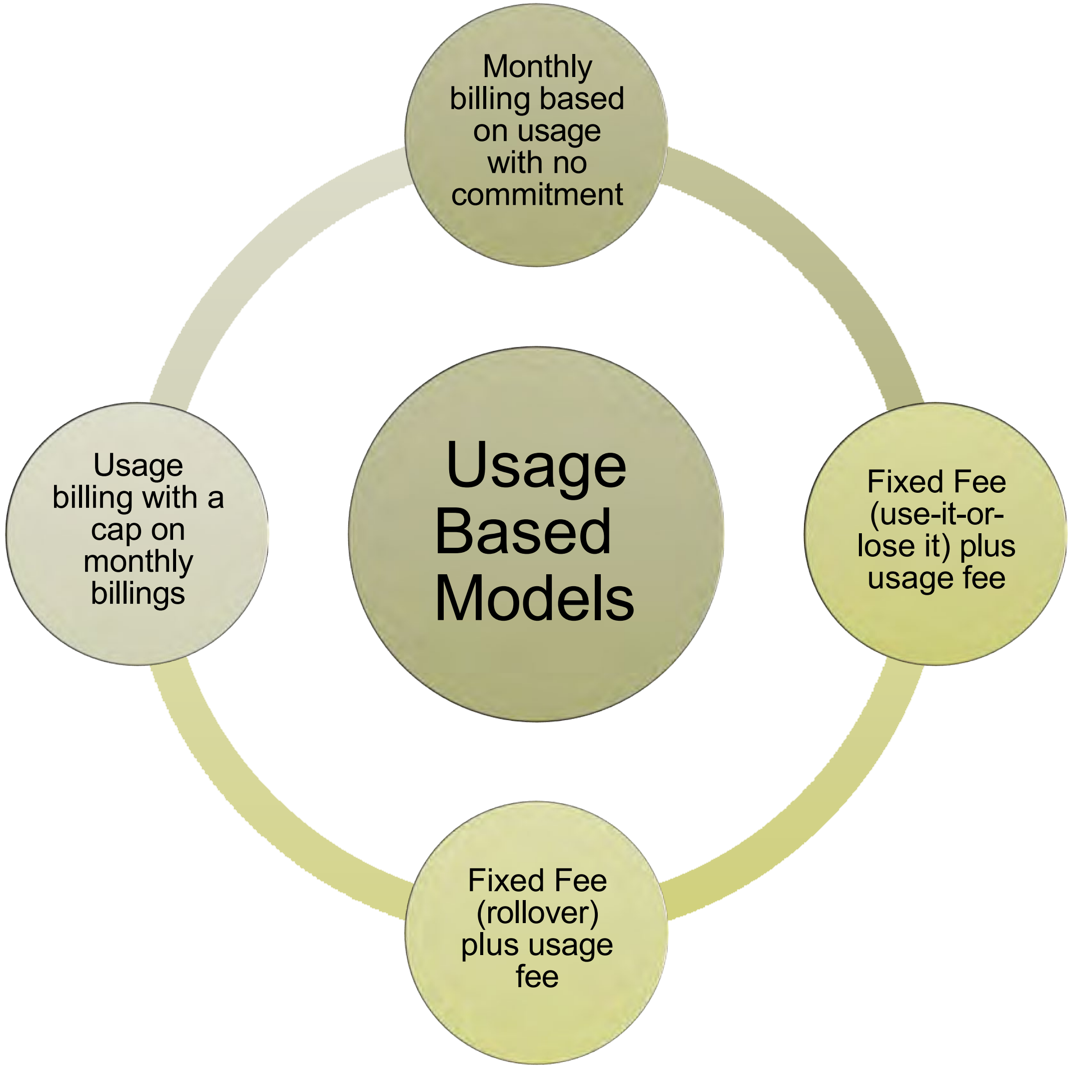
Usage Based Models

- The right to invoice practical expedient permits organizations that recognize revenue from contracts over time to recognize revenue as invoiced if your organization's right to payment is for an amount that corresponds directly with the value to the customer of your organization's performance to-date. For example, a service contract in which an entity bills a fixed amount for each hour of service provided.
- Organizations that use the practical expedient will recognize revenue by multiplying the price assigned to the goods or services delivered by the measure of progress (i.e., the quantities or units transferred). Therefore, you can effectively bypasses the steps of determining the transaction price, allocating that transaction price to the performance obligations, and determining when to recognize revenue (steps 3-5 of the 5-step revenue recognition approach). However, the practical expedient does not permit an entity to bypass the requirements to determine the performance obligations in the contract and evaluate whether the performance obligation is satisfied over time.

REVENUE RECOGNITION

Usage Based Models

- Which model is the best fit for your SaaS company?
- How will the recognition of revenue differ?
- What is the relevant guidance?



USAGE BASED MODELS

Monthly Billing Based on Usage – No Commitment

- **Revenue Recognition:**
  - Under a model with monthly billing and no commitment, the customer is invoiced monthly based on usage with no committed payments other than the usage. The customer can stop using the product at any time and no payments would be due to Teleport for the cancellation.
  - Revenue under this model would be recognized monthly as invoiced for both on premise license and SaaS products. Since there is no commitment, the contract would be an agreement that renews monthly. There would be no deferral any revenue to future periods since there is no obligation for continued service.
  - From a business perspective, there would be no guaranteed cash flow and all payments would be in arrears. The likely business impact is that it would be easier to sign up new customers due to the lack of a commitment and ease of cancellation; however, it could increase customer churn as there would be no barrier to canceling use of the product. This model allows for upside for customers that exceed their expected usage of the product. It works well when customers are dependent on the product and are not able to transition easily.
- **Guidance:**
  - Consideration for some service contracts is based entirely on customer usage, and an entity has a stand-ready obligation to perform, regardless of how often the customer uses the service. Therefore, the usage-based fees are variable consideration…
  - If the usage-based fees relate specifically to the entity's efforts to satisfy the performance obligation to provide services (or to a specific outcome from satisfying the performance obligation) and allocating the variable consideration to each distinct day is consistent with the allocation objective, the variable consideration allocation exception is met and the consideration is allocated to the period in which the usage occurred.

USAGE BASED MODELS

Fixed Fee (use-it-or-lose-it) Plus Usage Fee

- **Revenue Recognition:**
  - Under a model with a fixed fee and a usage fee, the customer would pay a fixed rate either upfront or periodically for access to the product and pay an additional fee calculated based on the amount of usage of the product. The arrangement could have a minimum, use-it-or-lose-it amount of usage that is included with the fixed fee and only usage above this amount is invoiced or all usage can be invoiced with no amount of usage included in the fixed fee. The contract would include a commitment to pay the fixed fee for a period of time (contract term).
  - The usage portion of the fee would be considered variable consideration. The proper revenue recognition model would be to estimate the total revenue (fixed fee plus estimated usage) for the contracted period and recognize based on the proper revenue recognition model for the product (license vs. SaaS). The estimate should be hedged as revenue accounting guidance includes that revenue should not be recognized if there is a risk of a significant reversal of revenue. Prior to having history to estimate a customer's usage, it would be recommended to recognize revenue using the fixed fee as the transaction price, and only adjust the transaction price once the company has earned additional fees from the usage fee. Once history has been established, a usage fee should be able to be reasonably estimated.
  - From a business perspective, this model includes guaranteed cash flows and a floor to the monthly revenue recognition. The model also allows for upside to the Company if a customer exceeds their expected usage. This model is less advantageous for customers in that they are not able to cancel the contract as they would be able to with the monthly model without a commitment, so it will not likely assist in bringing in new customers. It also introduces uncertainty in cost for customers.

- **Guidance:**
  - *Variable consideration:* An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions or bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled.
  - To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard generally requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date. There are limited situations in which estimation of variable consideration may not be required.

USAGE BASED MODELS

Fixed Fee (rollover) Plus Usage Fee

- **Revenue Recognition:**
  - Under a model with a fixed fee (rollover) and a usage fee, the customer would pay a fixed rate either upfront or periodically for access to the product and pay an additional fee calculated based on the amount of usage of the product. The arrangement would have a minimum amount of usage that is included for the fixed fee that can be rolled to future periods if it is not used. Once the minimum amount of usage is exhausted, additional usage is invoiced. These contracts may have an expiration date or cap for rollover usage.
  - The usage portion of the fee would be considered variable consideration, and if the rollover can be extended past the contract period, the period of performance would also be undetermined. The proper revenue recognition model would be to estimate the total revenue (fixed fee plus estimated usage) for the contracted period and recognize based on the proper revenue recognition model for the product (license vs. SaaS); however, the revenue should be recognized at the usage amount if it is below the fixed fee amount since the usage can be used in future periods. For example, for a contract that includes a fixed monthly fee of $100 for usage of 100 units in a month, and unused units can be rolled over to future periods, if the first month usage was less than 100 units, the revenue would be capped at the amount used since the units could be used in future periods. If the usage exceeded the minimum amount, then it would follow the revenue recognition noted in the use-it-or-lose-it model.
  - From a business perspective, this model includes guaranteed cash flows. The model also allows for upside to the Company if a customer exceeds their expected usage. This model is more advantageous for customers than the use-it-or-lose-it model in that they can carry the usage forward. This may make it easier to sign new customers up to the usage model that are uncertain about the level of usage required.

USAGE BASED MODELS

Usage Billing with a Cap on Monthly Billings

- **Revenue Recognition:**
  - Under a model billed based on usage that includes a maximum amount that can be billed in a month, the customer would pay based on monthly usage but would be entitled to unlimited usage once a maximum billing threshold is reached.
  - The revenue would follow the model above that is applicable to the other terms in the contract. If the contract is on a month-to-month basis with no fixed fee, it would be recognized the same as other monthly contracts with no commitment. If there was a committed period, the revenue would follow the use-it-or-lose-it or the rollover models, depending on the circumstances from the order.
  - From a business perspective, this model is more advantageous for customers since it removes the risk of billings above their expected budget.

CASE STUDY

Value-Based Care

CASE STUDY

Donation SaaS Platform

RELATED TOPICS

Additional Considerations

- Capitalized Commissions
- Capitalized Software

Thank you for attending

Additional Questions?

Reach out to us at

Experts@armanino.com

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We're Just What You Need

A Net Promoter® Score (NPS) is used by more than two-thirds of Fortune 1000 companies. **Armanino's NPS (68) is almost two times higher** than the accounting industry average (38), and it places the firm scores closest to household name brands such as Starbucks, Peloton and Zoom.

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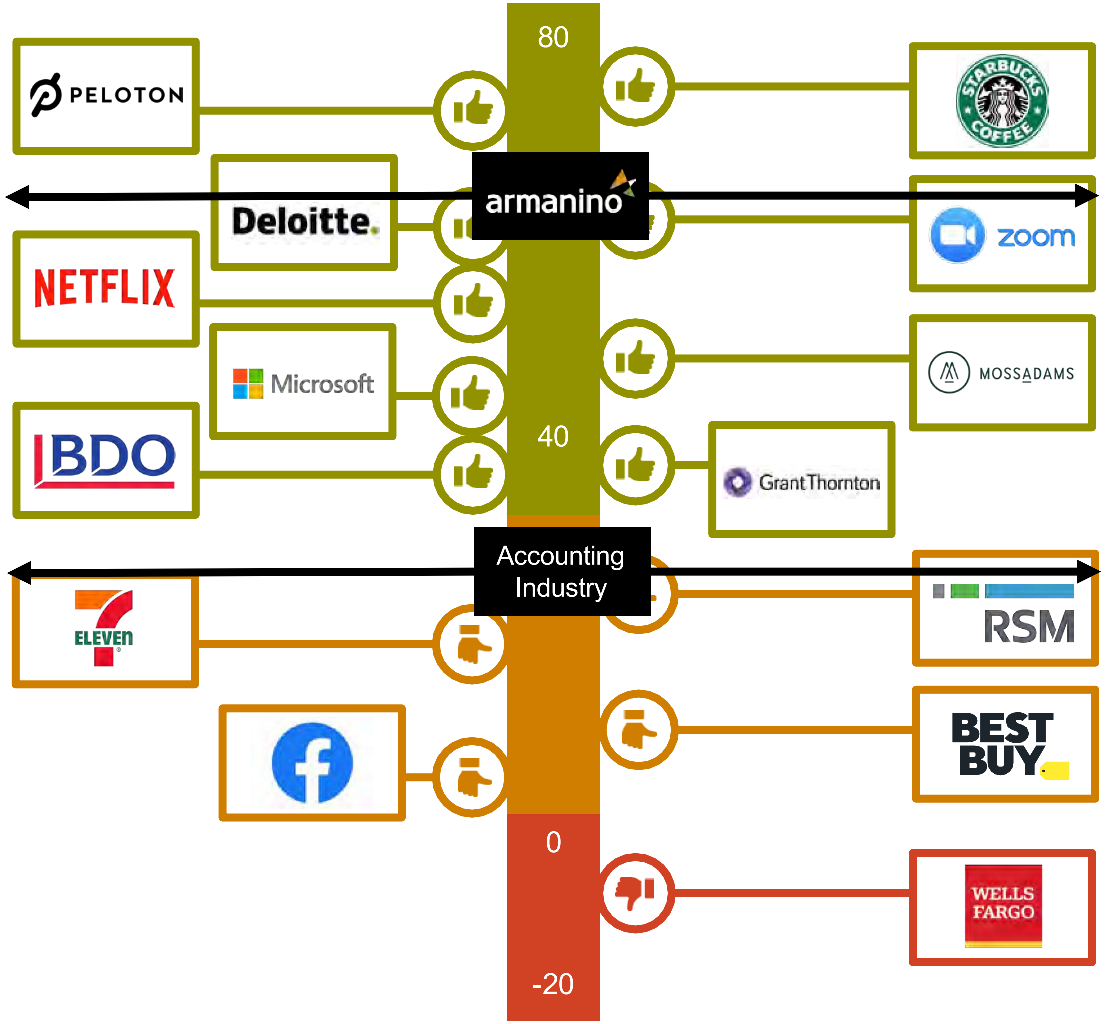

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Unconventional Approach

We're a vested, entrepreneurial partner who sees your organization through a 360 lens and finds opportunity at every stage

Comfort in Change

Our experts provide guidance and support while quickly facilitating transformation that gives you a competitive advantage.

Focused on You

Our integrated teams and solutions deliver tailored insights to bring you more value and clarity throughout your journey.

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Equipping you with the insights and tools needed to redefine what's possible

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- Trust & Estate
- SOX
- Contract

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- Restructuring
- Revenue Recognition

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- Budgeting/Forecasting
- Account Receivable
- Accounts Payable


Possible (Re)Defined™
Delivering impactful, bold solutions that increase clarity
and spark success for today and tomorrow.