Accounting for Software as a Service (SaaS)

Key factors for a successful go to market strategy

Introduction

Innovation is still the key to growth in the high tech business, but it has broader implications than in the past. Today some of the most important innovations are about the business model—how technology is being sold and delivered. Offering software as a service (SaaS) via subscription or utility models is reshaping key customer relationships for high tech companies. This white paper discusses the advantages of the SaaS model and the implications for managing brand new revenue streams.

Customers Demand SaaS

Customers are looking for an easier way to acquire technology. Instead of large payments up front and on delivery customers increasingly want to mortgage the cost of the technology over a series of monthly payments or simply rent capacity. This takes a huge burden off capital budgets. It also provides a much more flexible and more appropriate financial arrangement for customers.

Fees can be determined not only by the technology itself but by how it is used, which is what really matters to the customer. The base monthly payment can be adjusted by usage levels so the relationship is much easier to scale up and down according to business requirements. Budgeting, paying bills, and controlling the technology are all substantially easier for the customer. In addition, because of the more attractive financing, ROI can often be achieved more quickly.

Even though we're primarily talking about B to B relationships, the economic gap between SaaS and traditional models makes it a very powerful market force. For a good lesson on what is happening in software industry today, look no further than the telecom industry. Innovation and market share are a matter of how services are sold. Rollover minutes, off peak pricing, free weekends, family and friends plans, these offerings are all simple for customers to understand because they are based on how the service is used. Companies that make the transitions first get the biggest market share advantages.

The Path to Market Goes Through Finance

In the long run these new models also smooth out the revenue curve for vendors, but the transition can be tough. There are a lot of things that must be in place in order to be successful. Sales, marketing, development and support must all work together to define offerings, but some of the key management issues occur in the

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finance department. Billing, renewals, cash flow, and revenue management practices must change dramatically from the traditional product licensing days.

When you sell software as a service you are essentially bundling a whole set of products and services with support and other customer entitlements into a single financial arrangement. Contracts become more intricate with tiered pricing strategies that differ by customer, product and consumption levels. This triggers a number of technical accounting rules that make revenue accounting very complex.

Billing capabilities must also become more sophisticated. Services have to be added to the bill upon completion, support has to be tracked against the commitment level. Usage items must be billed in arrears while subscriptions are billed in advance—on the same invoice. Making sure revenue is being optimized while all this is going on requires the ability to monitor vast amounts of transaction activity and quickly find meaningful insights.

The crux of the issue is integrating contract terms into all the downstream financial workflows from order entry to billing, metering, renewals, revenue and expense accounting, and financial forecasting. Many existing financial systems are not equipped to support these demands and there is a risk of having spreadsheets crop up like weeds around the core system. This is one of the key things CEOs are concerned about today—how many spreadsheets did it take to produce the financial data they are being asked to sign off on? Ideally the answer is none. While regulations like Sarbanes-Oxley have forced the issue, software as a service models also demand more timely and detailed financial data.

How these new demands are met depends on your approach to Sass. There are essentially two choices: subscription and utility models. Each has nuances that require an in-depth understanding of various accounting guidelines. (The following discussion of these models is excerpted from "The Revenue Compliant Enterprise Part 2: Managing Multiple Business Models" also available at www.softrax.com.)

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Subscription

The Subscription model is increasingly being applied to many different types of offerings in the high tech business. A subscription service sold as part of an arrangement will need to be revalued in line with the Security and Exchange Commissions' Staff Accounting Bulletin (SAB) 101, and Vendor Specified Objective Evidence (VSOE) will need to be established where necessary in accordance with the AICPA's Statement of Position (SOP) 97-2. This requires the ability to track the following financial attributes over the lifecycle of the relationship, including:

Product activation: The driver for activation of the product must be identified. Subscription services are often sold as part of an offering. However, the activation for revenue purposes can dependent on many factors. These include:

- Receipt of activation keys
- End-user activation
- Delivery of associated products, services, or rights
- Delivery of training
- End-user signup (if offered as part of a package)
- End of trial period (automatic conversion)
- End of warranty period
- Receipt of activation hardware (i.e. dongle)

Subscription term: The term and value associated with the term will dictate the appropriate spreading of revenue. Any additional optional terms that are included need to be included in the revenue calculations. The situation is often complicated since subscription services may be offered as part of a hardware agreement (e.g. cellular phone companies). Many subscription services also include right to cancel clauses that place a limit on the cancellation penalty or remediation terms. In most cases the revenue is spread over the term. More recently the conservative approach has been encouraged that either recognizes revenue on a pro-rated day basis or defers any revenue until the accounting period that follows booking of the revenue.

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Extension impact: Subscription contracts are often extended at the discretion of customer care as an effective means of retaining customers. This must be captured and evaluated to determine if additional treatment is necessary or a change of policy is required. At a minimum it is required that reporting information is available to the revenue management system to assess the materiality of the amounts.

Utility

Utility arrangements are based on the delivery of product measured in a transaction or usage-based manner. Utility arrangements that bill the customer based on usage or transactions are common in many industries and growing in major sectors. Key financial capabilities for the successful launch and management of a utility model include tracking the following key attributes over the lifecycle of the relationship:

Transaction value: The value of each transaction should be valued taking into account volume pricing, etc. In some cases it is necessary to establish the average value over the contract lifetime. The transaction model can be complicated when the pricing model is also time dependent. In general the information that is captured is:

- Actual price per transaction
- Average price per transaction
- VSOE price per transaction

Transactional Volume: The transactional volume may dictate bucketing of revenue and summarization of revenue amounts. In many cases the high volume of similar transactions is captured into revenue "buckets." Any exceptions to the process or cancellations and adjustments are then made in a detailed manner. The transactions are always captured within the system allowing for audit tracking (i.e. the revenue buckets can be associated with the transactions). This gives the system the ability to handle very large transaction volume, and still maintain a detailed audit trail of exceptions and revenue schedules that get changed.

Time-based commitments: Commitment to deliver certain levels of transactions must be identified. This allows portions of revenue to be recognized independent of additional transactional volume. These time-based commitments are usually based on the contract. To record this information in the system the following is necessary:

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- Rate of transaction commitment
- Amount of transaction commitment
- Value of transaction commitment
- Actual usage at time of commitment
- Billing/Unbilled issues at time of commitment

Prepayment and scheduled payment options: The payment amounts and the application to the transactions are necessary to correctly account for revenue and backlog. This can be one of the most complex arrears for which to determine correct booking of receivables. This may be an issue if:

- Billing is done from a disparate system
- The invoice detail does not match the service detail
- The invoice amounts are not easily mapped to revenue amounts
- The payment schedules includes partial payments not tied to revenue
- The payments includes amount for other services unrelated by revenue

True-up processing: Payments made in advance for transactional volume need to be reconciled with actual usage. The actual usage must be captured for true-up processing to occur. This is typically the case where a minimum payment is made each month. At the end of each month the actual usage is compared to the minimum. The complication is that the payment at the beginning of the period is continually being apportioned between deferred revenue and revenue at the end of the period. To complicate this further, this true-up may affect the future month billing.

Minimum commitments: These can permit revenue to be recognized ahead of the transactional usage. The minimum commitments may cross product and agreement boundaries. In general, these relationships must be captured within the VSOE pricing mechanism to associate fair value across product boundaries. In many cases this is alleviated since minimum commitments are only booked in arrears. The parameters associated with minimum commitments are:

- Length of commitment
- Date of commitment
- VSOE Values
- Allowed product combinations

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End-of-term processing: Any residual transactional amounts that remain after the contract has expired must be accommodated. The process for this can vary based on the revenue policy; however there are strict accounting guidelines that cover this process (e.g. EITF 01-09). This is often referred to as “salvage” or “Es-cheat” and is common with gift cards, etc. It is important that these amounts are removed from the deferred revenue “buckets” and handled appropriately so that the amount of deferred revenue is not inflated. The following attributes are typically captured:

- Contract identifier
- End of term date
- “Salvage Method”
- “Salvage” Date

Contract Length: The length of the contract and any extensions need to be captured to correctly predict backlog and evaluate run rates where necessary. In the case of a utility contract, the contract may not be for a specified time. However, all contracts are written with some length of the term that it covers. In general the information captured includes:

- Start date of commitment
- End of commitment
- Expected revenue
- Expected monthly commitment

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The New Performance Metric—Revenue

The financial infrastructure has to be adapted to accurately capture, track, and forecast these new revenue streams. Once the initial infrastructure readiness is accomplished, the demands for performance monitoring are also very different. In order to really understand how well the business model is working, we see CEOs asking for more detailed and timely answers to performance metrics by product, region, and customer segment, even down to the account level. Revenue and profit contributions are key issues.

In order to better forecast future performance CEOs are asking for more details on the whole revenue chain from bookings to backlogs, billing, and revenue recognition. Some financial reporting capabilities that will be essential to success include:

- Reporting and comparing bookings and revenue growth
- Tracking renewal rates
- Matching expenses (especially commissions) against revenue
- Understanding how add-on sales to existing customers contribute to bookings and revenue goals
- Having instant insight into revenue growth by new and existing customers
- Improving visibility into how deferred revenue will be recognized over time

Reporting in all of these areas is required to measure the success of your SaaS initiative and to support the ongoing strategic decisions that will need to be made. In particular, analyzing how efficiently revenue goes from deferred accounts onto financial statements is emerging as an effective tool for finding operational problems as well as keeping revenue recognition practices in compliance with complicated accounting rules. Not only will these reporting capabilities help you manage for success, these are the metrics your board and financial analysts will be looking for to evaluate your SaaS business.

The Complexity Tradeoff

The complexity involved in all of this is a zero sum game. Making it all look simple and easy at the front end for the customer requires some very sophisticated capabilities at the back end. This is particularly true when hardware and software components are involved, or when you are required to track consumption or usage – as in some ecommerce businesses – and bill based on a sliding scale. The

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relationship between billing and revenue becomes completely separated. In order to provide meaningful performance information to executives, the system must be as automated as possible. Contract data, metering feeds, and pricing tables must independently drive both billing and revenue recognition. Otherwise revenue will fall through the cracks and the risk of reporting irregularities greatly increases.

This is no small undertaking for most companies, especially if separate systems for contracts, orders, billing, and accounting are entrenched, or if spreadsheets have proliferated. The key thing for CEOs to keep in mind is not to underestimate the operational issues that the addition of a SaaS model is going to demand, particularly in the finance department.

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About Softrax

Softrax Corporation is a leading provider of enterprise revenue management and billing software solutions that fundamentally change the way companies manage, analyze, report, and forecast their revenue. Softrax solutions automate the entire revenue cycle, from revenue recognition, reporting and forecasting, through complex billing and contract renewals. Hundreds of corporations benefit from using Softrax to optimize their revenue, reduce operating expenses, comply with revenue recognition regulations and Sarbanes-Oxley requirements, and gain unprecedented visibility into their business performance. Softrax Corporation, headquartered in Canton, MA, is privately held. More information can be found at www.softrax.com, www.RevenueRecognition.com, or by calling 1.888.4SOFTRAX.

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