



BDO Seidman, LLP
Accountants and Consultants

SaaS Revenue Recognition

January 2010

Overview

- Roadmap to re-indexed accounting standards
- SaaS accounting versus software accounting
- Primer on SaaS revenue recognition
- Recent revenue accounting changes that affect SaaS Companies
- Upfront customer costs
- Questions

Roadmap to Re-Indexed Accounting Standards

- Effective in September 2009, the FASB re-indexed all existing US GAAP into a common “**Codification**”
 - Old GAAP references no longer used going forward
 - Potential cause of confusion when discussing accounting issues
- Accounting Standards Codification (ASC)
 - EITF 00-21 / EITF 08-1 → ASC 605-25
 - SOP 97-2 → ASC 985-605
 - EITF 00-3 → ASC 985-605-55-121 to 125
 - SOP 98-1 → ASC 350-40
 -

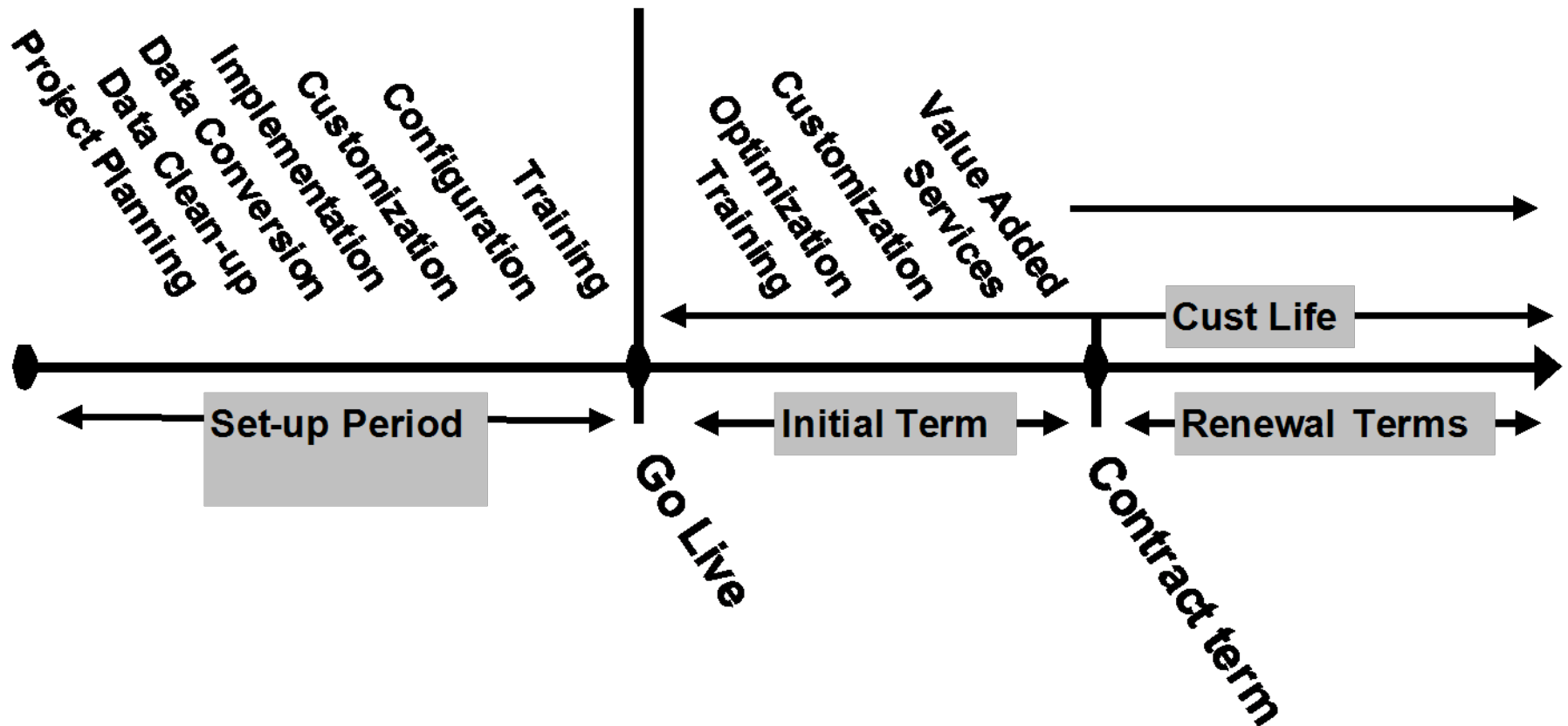
Software Revenue Models

Three common software revenue models:

<u>Licensing</u>		<u>SaaS</u>
Upfront Recognition	Subscription / Ratable	Service Delivery Subscription / Ratable
ASC 985-605 (SOP 97-2)	ASC 985-605 (SOP 97-2)	ASC 605-25 ASC 605-10-S99 EITF 00-21/SAB 104
	(Microsoft)	(Salesforce.com)

4th model – 100% deferral...

SaaS Customer Lifecycle



Multiple Deliverables – Legacy Literature

Two primary criteria to separate multiple deliverables:

Licensing / ASC 985-605

SaaS / ASC 605-25

1. VSOE of FV exists for all **undelivered** elements

VSOE = vendor specific objective evidence

Residual value method allowed

2. Undelivered elements are not essential to functionality of **delivered** elements (p65)

- ORE of FV exists for all **undelivered** elements

ORE = objective and reliable (VSOE or third party) evidence

Residual value method allowed

- Delivered** elements have stand-alone value

Plus other criteria...



BDO Seidman, LLP
Accountants and Consultants

Software as a Service (SaaS) - Issues

1. Do other professional services have standalone value?
 - EITF 00-21 definition of standalone value
 - “sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis”
 - Upfront and follow-on set-up services that do not have standalone value
 - SAB 104 fn 39 – recognize over expected life (# of years??)
2. Has VSOE of the hosted service been established?
 - If PS have standalone value but VSOE of hosting does not exist, recognize PS over contractual hosting period
3. How should costs be accounted for?



ASU 2009-13 – “Revenue Arrangements with Multiple Deliverables”

- Issued in October 2009
- Replaces ASC 605-25 (EITF 00-21)
- Eliminates requirement to establish VSOE / ORE of FV
 - **!!! Major change !!!**
 - Still requires use of VSOE or 3rd party evidence if available
 - Otherwise use management’s estimated selling price (ESP)
 - Eliminates the residual method
 - Allocate based on estimated selling prices of all deliverables
 - No change to the “stand-alone value” criteria
 - Does not change SOP 97-2 (ASC 985-605) or apply to software transactions (unless hardware is involved).
- Can be adopted immediately!!!
 - Adoption can be either prospective or retrospective



ASU 2009-13 – Separating Deliverables

- Requires separation when the following criteria have been met:
 - Delivered items have stand-alone value to the customer.
 - Sold separately by any vendor
 - Customer could resell on stand-alone basis
 - ~~– Objective and reliable evidence of fair value (eliminated)~~
 - If there is a general right of return, delivery of undelivered item is probable and substantially in control of vendor
- If deliverables do not qualify for separation, then revenue should be determined for the combined deliverables as a single unit of account

ASU 2009-13 – Allocating Consideration

- Arrangement consideration should be allocated at the inception of an arrangement using relative selling prices
 - Subsequent changes in selling prices do not change initial allocation
- Exceptions and qualifications
 - Only allocate revenue that is fixed and determinable
 - Amount allocated to delivered items is limited to amount that is not contingent on delivery of any undelivered item or meeting specified performance criteria
 - Measurement of revenue per period must assume customer will not cancel arrangement
 - Revenue recognized cannot exceed non-cancelable amounts in the arrangement
 - Other GAAP requires deliverable to be recorded at FV



ASU 2009-13– Estimating Selling Prices

- ESP is not the same as fair value
- Three-tiered hierarchy
 - VSOE
 - 3rd party evidence
 - Estimated selling prices
- Now required for delivered and undelivered elements
 - Allocate arrangement consideration on pro rata basis
- Level of support for estimated selling prices
 - Consider available evidence
 - Develop a methodology and consistently apply
 - Monitor for changes – changes could occur mid-period
 - No requirement for ability to reasonably estimate



ASU 2009-13 – Estimating Selling Prices

- Some estimates likely to be quite subjective in nature
 - Products that are never sold separately
 - Products with a wide range of selling prices
 - Future products
 - Software and other intellectual property
- Inconsequential and perfunctory deliverables
 - Not entirely clear how this guidance would continue to be applicable under ASU 2009-13
 - Instead evaluate under ASC 605-25 and taking materiality into consideration
 - If considering use of the SAB 104 guidance prospectively – suggest proceeding with caution and consulting with SEC.



ASU 2009-13– Estimating Selling Prices

Use of a range to define VSOE or estimated selling prices:

- No specific authoritative guidance on approach
- Range should be reasonably narrow - for example
 - Within + / - 15% of a median price
 - From list price to list minus 30%
- As long as prices are within the range, the item is deemed to be priced at the VSOE or ESP rate and no allocation of discounts are necessary.
- If one or more items are priced outside of the range then prices must be allocated based on a specific VSOE or ESP point estimate.
 - Generally the midpoint of the range



ASU 2009-13- Estimating Selling Prices – Example

- SaaS Co. provides a hosted solution, and also provides related consulting services.
- Both the hosted solution and consulting services have standalone value.
- Hosted solution: List = \$5,000/year/user
ESP = \$3,000-\$4000/year/user
(+ / - 15% range)
- Consulting services: List = \$1000 per day
VSOE = \$700- \$1000 / day
- Customer A purchases a 10 user package for \$25,000 and agrees to a \$20,000 consulting project that is estimated to take 25 man-days.



ASU 2009-13- Estimating Selling Prices – Example

- Since the hosted solution was sold for less than the ESP range of \$30,000 - \$40,000 (for ten users), the total sales price of \$45,000 must be allocated between hosting and consulting services.
- SaaS Co. uses the midpoint of the VSOE or ESP ranges for purposes of allocations as follows:
 - Hosting midpoint = \$35k ($\$3,500 * 10$ users)
 - Consulting midpoint = \$21k ($\$850 * 25$ hours)
 - Hosting rev = $\$35k / \$56k * \$45K = \underline{\$28K}$
 - Consulting = $\$21k / \$56k * \$45K = \underline{\$17K}$
- If the hosting sales price had been \$30,000, then it would have been within the ESP range, and no allocation would be necessary.



ASU 2009-13 – Stand-alone Value to the Customer

- EITF decided not to revisit or change guidance:
 - Sold separately by any vendor or
 - Customer could resell the delivered item(s) on a standalone basis
- Elimination of FV requirement could place added scrutiny on stand-alone value criteria
- SaaS considerations
 - Structure contract to separately define and price upfront services that are deemed to have stand-alone value
 - Consider whether subsequent post-implementation sales of additional services have stand-alone value



ASU 2009-13 – Manner of Adoption

- Flexible approach allows:
 - Prospective adoption – required for fiscal years beginning on or after June 15, 2010.
 - Retrospective adoption – for all periods presented
 - Will probably not be used very often in practice?
 - Could be attractive to pre-IPO companies
- ➔ – Early adoption - either prospectively or retrospectively
 - Can be prospectively adopted early in any quarter, as long as adoption is reflected back to 1st fiscal quarter of the year
 - Private companies likely to consider early adoption in 2009



ASU 2009-13 – Prospective Adoption

- Only apply to new revenue arrangements or materially modified arrangements in periods subsequent to adoption
 - Legacy transactions still follow legacy accounting rules
 - Will often result in revenues being recognized under both the legacy and new rules in the initial period(s) of adoption



ASU's 2009-13 and 14 – Ongoing Disclosure Requirements

Requires following disclosures by similar type of arrangement:

- The nature of multiple-deliverable arrangements
- The significant deliverables within the arrangements
- General timing of delivery or performance of service
- Performance, cancellation, termination, and refund-type provisions
- Significant factors, inputs, assumptions, and methods used to determine selling price
- Whether deliverables in the arrangements qualify as separate units of accounting, and the reasons that they do not qualify as separate units of accounting, if applicable
- General timing of revenue recognition for significant units of accounting
- Separately, the effect of changes in selling price or method or assumptions used to determine selling price when significant



ASU's 2009-13 and 14 – Transitional Disclosure Requirements

- Only applies where prospective adoption method is used
 - If following retrospective method, follow FAS 154 disclosure reqs
- Required qualitative disclosures by similar types of arrangements:
 - Description of any change in the units of accounting
 - Description of changes in how arrangement consideration is allocated
 - Description of the changes in the pattern and timing of revenue recognition
 - Whether adoption is expected to have a material effect on future financial statements
- Additional quantitative disclosures required if material...



ASU's 2009-13 and 14 – Transitional Disclosure Requirements

- Required quantitative information if the effect of adoption is material
- Flexible approach - any of the following methods may be used to meet this requirement:
 - The amount of revenue that would have been recognized in the year of adoption based on the prior rules
 - The amount of revenue that would have been recognized in the year prior to adoption based on the new rules
 - Revenue and deferred revenue in the reporting period broken out between legacy contracts still subject to prior rules and new contracts subject to the new rules.



How ASU 2009-13 Affects SaaS Companies

- VSOE of FV of Hosting Service no longer required
 - Allows more flexibility in pricing hosted service
- Where other services with stand-alone value are provided, requires management to estimate separate selling prices of each service for purposes of allocating total consideration.
 - Residual method not allowed
 - Could require significant additional effort
- Does not change accounting for set-up services
 - Consider bundling set-up fee in annual subscription price?

Strategic Considerations for SaaS Companies

- ➔ Expect changes in pricing policies as a result of not having to establish and maintain VSOE, including increased use of **value-based pricing**.
- ➔ Many companies will likely want to early adopt. Now is the time to start assessing.
- ➔ Expect more frequent future product, specified upgrade rights and other hard-to-value future deliverables in agreements.
- ➔ Uneven playing field in some situations, particularly where SaaS companies compete with traditional software licensing companies.



SaaS Companies and Product Roadmaps

- Extensive guidance for software licensing companies
 - Sharing roadmaps can preclude all revenue recognition until roadmap items are delivered
- Minimal guidance for SaaS companies
- How significant are roadmap upgrades to functionality of service?
- Would estimated selling prices be different with or without the roadmap upgrades?
 - If different, allocate total consideration between respective estimated selling prices
- When Competing against traditional software licensing company, use as a competitive advantage?



Upfront Customer Costs

- Examples
 - Installation and set-up costs
 - Sales commissions
- Accounting policy election
 - Recognize as expense as incurred, or
 - Defer over term of contract or estimated life of customer

About BDO

BDO is a national professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. Guided by core values including competence, honesty and integrity, professionalism, dedication, responsibility and accountability, for 100 years BDO has provided quality service and leadership through the active involvement of its most experienced and committed professionals. BDO provides clients superior value by supplying more partner time on engagements, delivering service with a hands-on, collaborative approach, maintaining continuity of engagement team members and offering competitive and transparent rates. BDO has significant expertise and experience serving a large number of public and private software and technology companies.

Contact Information:

Jay Howell, Partner

One Market - Spear Tower, San Francisco, CA 94105
415.490.3270 E-mail: jhowell@bdo.com

Website: www.bdo.com



BDO Seidman, LLP
Accountants and Consultants

