Investor perspectives on ASC 606 for software and SaaS

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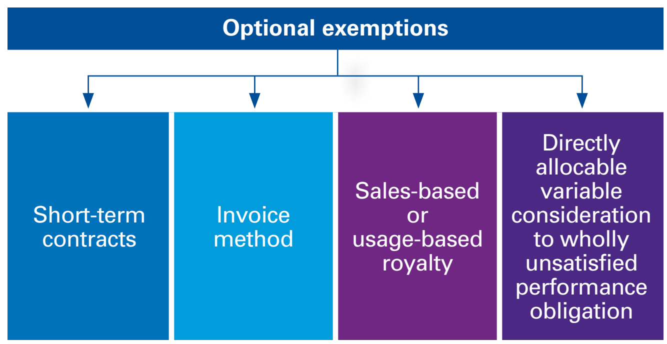
Initial views on how investors will analyze financial statements of software and software-as-a-service (SaaS) companies under the ASC 606 revenue recognition standard.

While it once seemed like a long way off, the 2018 effective date of the new revenue recognition standard (Topic 606) is fast approaching, and some software and SaaS companies are early adopting ASC 606. The new standard provides investors with incremental disclosure such as revenue backlog, and additional transparency is generally welcome. Investors also believe, however, that it is incumbent upon the companies to communicate which metrics they feel are most relevant in evaluating their business.

Investors think that even though ASC 606 changes could impact the short-term optics on financial performance, leadership teams should exercise caution before changing how they manage and operate their business. Some investors even strongly believe that overall, ASC 606 does not change the fundamentals nor should it change how companies manage and operate their business for the long term.

ASC 606 Backlog Disclosure Requirements

The disclosure about the remaining performance obligation is based on ASC 606 determination of the transaction price for unsatisfied (or partially unsatisfied) performance obligations, and therefore it may differ from the disclosure of bookings or backlog, because it does not include orders for which neither party has performed and each party has the unilateral right to terminate a wholly unperformed contract without compensating the other party. The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price (e.g., constrained variable consideration) and therefore is not included in the remaining performance obligations disclosures. The practical expedient allows an entity to exclude from the remaining performance obligations disclosures contracts that have an original expected duration of one year or less. However, an entity is not precluded from including all contracts in the disclosure.



When would an investor consider ASC 606 backlog disclosure to be a primary metric versus a disclosure to comply as per regulatory requirements?

Investors would consider ASC 606 backlog disclosure a primary metric in cases of single revenue model and the company does not generate significant fixed fee professional services revenue. Annual contracts may also play a significant role as to whether ASC backlog disclosure could become a primary metric.

Investors may not consider ASC 606 backlog disclosure a primary metric in cases of a mixed business model (i.e., aggregate disclosure of the backlog versus disaggregation of the backlog disclosure). For example, aggregate disclosure of backlog with mixed SaaS, maintenance, and services revenue streams with no standard contract terms.

Would investors focus more on contractual Annual Contract Value (ACV) or ASC 606 backlog/Annual Recurring Revenue (ARR)?

Investors prefer a standardized ASC 606 definition and would most likely ignore contractual ACV since most companies do not provide contractual ACV (or investors do not have visibility into this metric).

Investors would look at ASC 606 revenue backlog and ASC 606 ARR and ignore unbilled deferred revenue/contractual ACV and look at the quarter-over-quarter change to determine the net new addition to ASC 606 revenue backlog.

If companies try to focus investors on contractual ACV by highlighting unbilled deferred revenue, investors may:

– Look to ASC 606 revenue backlog/ARR disclosures; or

– Compute ASC 606 revenue backlog by reducing unbilled accounts receivable from unbilled deferred revenue and consider average duration of backlog (if time bands are not split between current and long term).

For example, in a price ramp deal at the end of year 1, investors would focus on ASC 606 revenue backlog of $4 million versus $5 million contractual unbilled deferred revenue.

Additional background of a price ramp deal with the difference in accounting and metrics is noted below:

ABC Corp enters into a cloud-based service contract with the customer for a three-year period and the customer is obligated to pay for Year 1 - $1 million, Year 2 - $2 million and Year 3 - $3 million. The nature and quantity of service provided for all three years is the same and due to cash flow reasons the payment terms are back end loaded (i.e., price ramp deal).

Revenue recognition under current and new revenue guidance is noted below:

	Year 1	Year 2	Year 3
Current GAAP	1	2	3
ASC 606	2	2	2

Metrics as of end of the year

Current GAAP	Year 1	Year 2	Year 3
Unbilled Deferred Revenue	5	3	0

Metrics as of end of the year

ASC 606	Year 1	Year 2	Year 3
Unbilled Accounts Receivable	1	1	0
ASC 606 Revenue Backlog	4	2	0

It is likely for SaaS that this ASC 606 revenue backlog metric becomes relied upon more than the current unbilled metric. For non-SaaS, this metric might be ignored.

How are investors going to analyze ASC 606 revenue backlog disclosure when it is considered to be a primary metric?

ASC 606 revenue backlog disclosure is required only for the most recent period presented in the financial statements.

Investors look at this disclosure as total contract value (TCV) less revenue recognized.

Select metrics:

– **Next twelve months (NTM):** Investors would prefer companies to disclose NTM on a quarterly basis versus the fiscal period view of the time bands.

– **Revenue coverage ratio = ASC 606 backlog NTM/ Annual Revenue Guidance**: Investors also understand that there is seasonality to this coverage ratio, much like if investors calculate this today using deferred revenue.

– **Trend analysis of ASC 606 backlog disclosure** with time bands compared to prior-period comparatives for growth rates. During the transition period, investors may continue to focus on calculated billings metric. For companies that provide deferred revenue growth rates guidance, investors may continue to focus on that metric during the transition period. For companies adopting ASC 606 on a retrospective method, investors might prefer ASC 606 backlog disclosure with prior-period comparatives split between NTM and long-term.

Investors do not believe companies would provide annual backlog/booking guidance. However, some investors would prefer companies to provide annual backlog/booking guidance in certain circumstances.

Some might believe that companies should provide annual booking guidance due to the following:

– Keep investors focused on annual targets versus quarter-over-quarter volatility

– Take away customers being able to use that end-of-quarter leverage to pressure bigger discounts, and remove the temptation for management teams to allow bad deals to make one metric look good

– Company has a limited number of enterprise deals that could slip between quarters

– Reduce volatility on the stock

This view may be applicable only for companies that have software license revenue and generally may not be applicable for SaaS companies.

Company A's sales commission amortization period is 3 to 5 years, and Company B's sales commission amortization period is 5 to 9 years. Both companies have the same customer churn rate per annum. How should we think about the stock valuation of Company A versus Company B?

Factors companies consider in the determination of the sales commission amortization period are: customer life, product technology life, expected renewal of "the contract," and factors considered in determination of customer relationship in valuation of intangible assets in a business combination.

View A (Company A): If churn for both companies is equal, then Company A stock may be more valuable since the customer is potentially paying incremental consideration at the end of year 3 to 5 for an upgraded product. Potential "land and expand" opportunities exist for Company A's portfolio of products with higher margin and stickiness of one-stop-shop for diverse products.

View B (Company B): Company B may look more profitable through the growth period and this could make it GAAP or NG profitable earlier. Most investors look at cash-flow-based valuation for these growth stocks, and as such, is not likely to have significant impact.

Does ASC 606 impact any fundamentals such as cash flow?

Accounting impact to earnings would be offset by changes to working capital in the statement of cash flows. However, we would need to think about any impact to earnings as a result of acceleration of revenue and deferral of expense (which might be the case for software and SaaS companies), which may result in incremental earnings for tax purposes resulting in cash taxes for any incremental income.

Treatment of sales commission for tax purposes could be different for tax purposes as compared to financial reporting. For example, deduction can be recognized when liability is incurred as opposed to recognition of expense in the financial statements.

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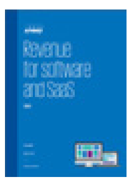

Revenue for software and SaaS

Transforming your SaaS business: A strategic guide for optimizing business performance

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