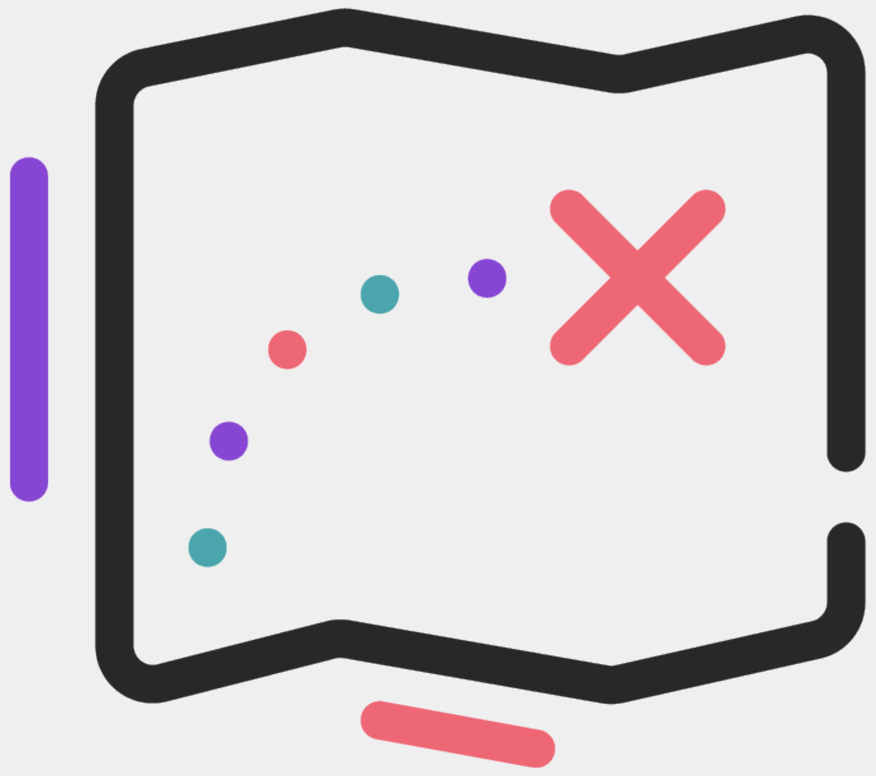
PRECURSIVE REVENUE RECOGNITION FIELD GUIDE



PRECURSIVE

WHAT IS REVENUE RECOGNITION?

Revenue recognition is a feature of accrual accounting that stipulates that revenue can be recognized on a company's income statement during a specific period.

The accounting standards that a company follows will determine specific conditions where revenue can be recognized and how to account for this revenue. Companies must distinguish between sales where they will report on how many sales are made for a given period vs. when revenue is realized and earned but not necessarily equitable to receipt of cash.

The revenue generating activity for SaaS companies is the delivery and usage of your product by the customer - this activity must be complete for that revenue to be included into a respective account period.

STEP ONE

Identify Contract

STEP TWO

Identify Performance Obligations

STEP THREE

Determine Transaction Price

STEP FOUR

Allocate Transaction to Performance Obligations

STEP FIVE

Recognise Revenue as Performance Obligations is Satisfied

ACCOUNTING STANDARDS

Revenue recognition requirements vary depending on the Accounting Standards that your company adopts, and this is often set based on your location.

The two standards that are most commonly adopted are GAAP (Generally Accepted Accounting Principles) and IFRS (International Financial Reporting Standards). GAAP is set by the financial reporting body in each country (so rules can vary from UK GAAP to US GAAP), and as the name suggests IFRS is an international framework that has been introduced to try and create a single approach to accounting policies.

Typically publicly traded companies will adopt IFRS and most private companies will adopt local GAAP. However rules do vary country to country and smaller companies can choose to adopt IFRS but this is not often the case as it is much more complicated.

In order to recognize revenue the conditions that must be met are:

1. Control of the goods or services must be transferred to the customer

2. Payment is reasonably assured

3. The value of the revenue and cost of the revenue can be reasonably measured

When the above conditions are met revenue will either be recognised at a single point in time or over time

BOOKINGS VS. REVENUE

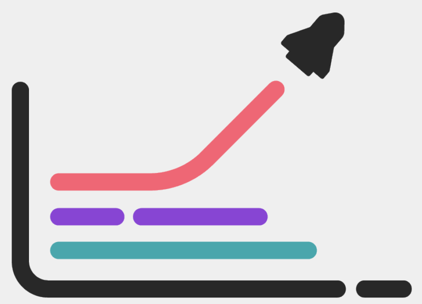
When you sell a product to a customer this is called a **booking**; the customer contractually commits to purchasing products or services from you. **Revenue** is the income you earn as you deliver the products or services that you have previously booked. Revenue recognition is a set of requirements that must be met in order for you to start recognising revenue.

Companies that struggle to convert bookings into revenue because of inefficient onboarding of new customers can suffer in multiple ways. For example, if the company is public and analysts see that an efficiency problem exists - then that company may be penalized for this inefficiency by the market through a lower stock price. In one publicly traded communications technology company, they booked $100M in ARR but only recognized $60M in revenue and in the words of the CEO “when we reported this, the analysts had a field day!”

Private companies will also be reporting to their board and shareholders using management accounts that communicate recognized revenues - if that company has delays in delivery that impact revenue recognition, this issue will be seen by shareholders through the company’s reporting.

Booking.

Product sold to a customer



Revenue.

Income earned as products are delivered

RR FOR SAAS VS. PROFESSIONAL SERVICES

SaaS.

For companies that sell annual software subscriptions they have a relatively straightforward task when it comes to revenue recognition. The control of the services is transferred to the customer on a daily basis, payment is often upfront, the value is set in the order form and the cost (likely hosting) will be known. This means that they will be able to recognise revenue over time (on a daily basis) as the customer has continued access to the subscription.

Professional Services.

Many B2B SaaS companies provide a range of professional services offerings and therefore revenue recognition is dependent on the type of service provided.

NB: These are all examples of potential revenue recognition policies that companies can adopt. It is however important that you work closely with your accounting team to understand which accounting standard you follow and how its rules may apply to your contracts.

Implementation Packages

For companies that sell a fixed price implementation package, revenue recognition will typically happen at go-live as this is the point at which the customer has access to the product provided and can start receiving benefits from the implementation. At go-live some SaaS companies will recognize all of the services revenue sold and begin recognizing the software revenue at this point in time. However some SaaS companies begin recognizing software revenue from the start date of the agreement (renewal date).

Consumption based service offerings

Managed services and services credits are two examples of consumption based models where revenue recognition takes place over time as services are consumed. These involve a customer drawing down from a fixed number of hours or pre-purchased credits. It is important to remember that in order to recognize the revenue you will need to know the value and cost associated with the service (this is most likely to be the day rate and cost rate of staff providing the service).

Premium Support

Support services are usually fixed term contracts that offer customers access to support in line with contractual SLAs. Here revenue recognition will take place in the same way as the SaaS example above. The customer is consuming the support access continually over the fixed term of the agreement and therefore revenue can be recognised on a daily basis.

Consultancy

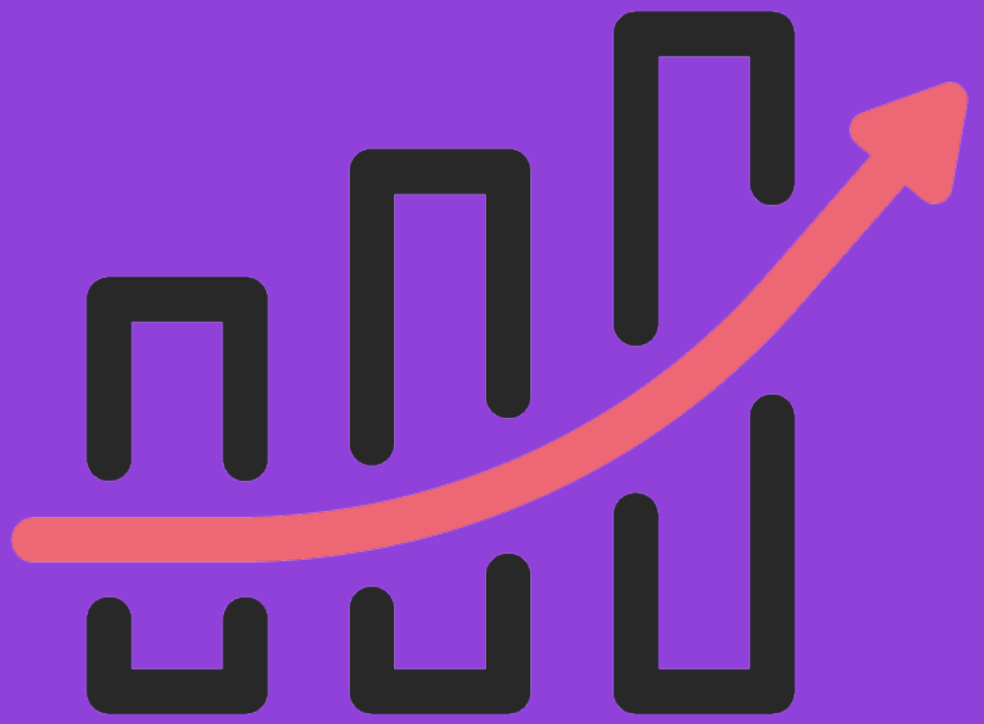
Consultancy or advisory services are value based offerings that are structured around helping customers to achieve certain outcomes. Here revenue recognition can take place in a couple of ways: i) at a point in time based on milestones being achieved. A project can involve multiple outcomes and therefore you must know both the value and cost of each of these individually, ii) based on the time spent by the consultants if a time & materials (T&M) based billing method is being used.

BOOKING SERVICES REVENUES AS ARR

Companies of all sizes across software, SaaS and professional services are exploring ways to generate additional revenue streams. At the same time, every professional services and customer success organization needs to improve retention rates and enable further expansion revenue opportunities.

REVENUE TYPE	BOOKING CLASSIFICATION
SOFTWARE	Software revenues are booked and classified as ARR
SERVICES PACKAGES	Services packages that are sold on an on-going basis, ideally on an annual subscription basis. These will be booked as recurring services revenues.
BUNDLED SERVICE & SOFTWARE	When services offerings are bundled into the overall subscription fee, the classification will depend on whether the bundled services can be sold separately from the software. If they can then they should be split for reporting purposes with the software element being booked as ARR and the services element as recurring services revenues. If they are not able to be sold separately then the full booking can be treated as ARR.

BOOKING SERVICES REVENUES AS ARR



A common question and challenge is how to book services revenues and whether this revenue can be classified as ARR.

The most common mandate for professional services leaders in the modern SaaS economy is to maximize ARR without losing money. This means that services teams are focused on delivering fast time-to-value during implementations as well as driving further value realization for in-life customers through packaged services offerings. These packaged offerings are also sources of additional revenue for companies that help to cover the cost of services organizations that can be highly costly to run.

There needs to be strong alignment between professional services and finance teams on both revenue recognition, cost allocation and incentives. For example if services revenues are folded into subscription fees then there needs to be agreement on where revenue and cost are recognized because this will impact the profitability of the services organization. If services revenues are recognized as a part of software ARR but the costs of services are going against the professional services P&L, then this can mean lower gross margin for the services organization. This is a common approach because companies want to avoid impacting their software gross margin - however services leaders are often incentivized on services gross margin.

EXAMPLE SAAS P&L

In this example P&L, Services Revenue has been split into recurring (eg: managed services) and one-time (eg: implementations). This enables us to further break down Gross Margin across Software and Services. If however Services revenue is bundled into software fees and not split out there are one of two things that should take place.

For the purpose of internal reporting companies can apportion out either a % of the bundled revenue/cost that is attributable to professional services; therefore enabling a fair appraisal of the profitability of the services organization or you ensure that the professional services targets (Services Gross Margin % in this instance) is reflective of all Professional Services costs going against the PS cost of sale but a portion of services revenue is being booked as software and therefore may lead to a negative services profit margin.

	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	FY22
Revenue													
Software	900	908	921	935	952	977	1,002	1,023	1,052	1,069	1,090	1,115	11,944
Recurring Services	150	151	153	156	159	163	167	170	175	178	182	186	1,991
One-Time Services	70	72	80	82	84	90	90	85	95	84	85	90	1,007
Total Revenue	**1,120**	**1,132**	**1,154**	**1,173**	**1,195**	**1,230**	**1,259**	**1,278**	**1,322**	**1,331**	**1,356**	**1,390**	**14,941**
Cost of Sales													
Hosting	135	136	138	140	143	147	150	153	158	160	163	167	1,792
Professional Services	209	212	222	226	231	240	244	243	257	249	253	262	2,848
Customer Support	90	91	92	94	95	98	100	102	105	107	109	111	1,194
Total Cost of Sale	**434**	**439**	**452**	**460**	**469**	**484**	**495**	**498**	**520**	**516**	**526**	**541**	**5,834**
Gross Profit	**686**	**692**	**702**	**713**	**726**	**745**	**764**	**780**	**803**	**815**	**831**	**850**	**9,108**
Gross Profit Margin	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*	*61%*
Software Profit Margin	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*	*75%*
Services Profit Margin	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*

HOW DELIVERY TIMES IMPACT REVENUE RECOGNITION

Delays to software implementations is a critical challenge because they have a significant impact on revenue recognition. With accounting standards dictating that most companies will begin recognizing revenue at go-live, any delay to launch has financial implications. Companies that can improve the consistency and velocity of service delivery will not only drive better retention rates because customers are getting to value more quickly but they will also drive significant benefits for the overall financial performance of the company.

Here you can see the financial impact of a 1 month delay for a SaaS company that recognizes revenue at go-live

To calculate the cost of overrun for your organization, use our Overrun Calculator: https://www.precursive.com/professional-services-overrun-calculator

Average order value (ARR)	$75,000
# of customers onboarded	100
Target implementation duration	3 months
Actual implementation duration	4 months
Delayed revenue per implementation	$6,250
Total delayed revenue per year	$625,000
# of additional days worked to complete implementation	5
Av. cost per team member by year	$70,000
Additional labor cost incurred per project	$1,346
Total additional labor cost across all projects	$134,615
Total financial impact per project including cost and revenue delay	$7,596
Total financial impact of 1 month overrun	**$759,615**

IMPLEMENTATION DELAYS (AND WHAT TO DO ABOUT THEM)

Software implementations are inherently complex and can face numerous reasons for delay with some driven by natural causes such as holidays whilst in other cases, delays are considered controllable and are influenced by some typical customer behaviors or the services delivery methodology.

On the next page, we address some of the common challenges faced during delivery and tactics to address these issues. Companies that can incorporate some of these techniques into their delivery methodology and thinking can improve the quality and velocity of implementations to generate more predictable revenue by reducing delays.

Watch & learn how spend management platform, Procurify, tracks the reasons for delay and uses this information to improve professional services delivery.

[watch the webinar here]

Type of delay	What happens	What to do about it
Executive engagement	Senior executive sponsor checks out after sign off or disengages early in the project due to other perceived priorities.	Continue to focus on value by keeping the executive engaged by leveraging the business case during handover and in the kickoff of the project
Poor handovers	A gap emerges between sales and services with a lack of information provided to the delivery team.	Sales and Services must agree how to best forecast demand based on the sales pipeline. Sales must be coached on communicating accurate delivery windows and start times.
Scope creep	Customer requirements expand during the implementation leading to more customization and complexity of the solution.	Create a playbook and coaching for managing creep and discussing change requests. Include a specific talk track during the kickoff on scope and change requests.
UAT Merry-go-round	Time spent testing the solution extends often due to people testing who are unfamiliar with the product.	Share product education materials (videos, documentation) with users early in the implementation - it can be common for testers to not have seen the product until the UAT phase. Better product education will help users to understand how your product works or should work (expected behavior).
Stakeholder readiness	Customer stakeholders who play a role in the deployment of a new solution are unprepared or unaware of key dependencies.	Curate and share a customer launch plan that highlights key dependencies (tasks) that are linked to customer actions, e.g. UAT, data loading, training. This customer plan should help the customer to better understand what they need to do and when and how much effort (time) will be needed through the implementation.
Delivery Process Maturity	There are inconsistent approaches to project management with different teams approaching delivery in different ways.	Packaging services delivery into a repeatable process with clearly defined roles, effort, steps and timeline helps to guide the delivery team on a consistent approach. Build the relevant delivery assets to support your team including SOWs, Project Plans, Cost/Margin Templates for Packaged Services and Customer Facing Documentation.

HOW PRECURSIVE HELPS

Professional services, project management and implementation teams improve delivery times to pull forward revenue and accelerate time-to-value for customers.

Precursive helps to:

Improve Revenue Management

Get more visibility and control over financial performance with better forecasting and recognition of services revenues.

Optimize Services Delivery

Build repeatable delivery playbooks with templated project plans that include tasks, timelines, roles and effort estimations.

Track Project Margins

Understand the costs, profit and margin of implementation packages and managed services offerings based on the time spent to deliver.

Make Better Decisions

With reporting on key operational metrics including delivery times, team utilization, project margins, time recording, and revenue.

Precursive is used by a range of companies including BetterCloud, Dealertrack, Gong, and MX to manage all elements of high-velocity services delivery.