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REVENUE RECOGNITION STANDARD & THE SOFTWARE SECTOR:

Analysis of new revenue standard ASC 606, Contracts With Customers, and its potential effect on deferred revenues in the software sector.

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Introduction

The Financial Accounting Standards Board's new standard for revenue recognition—ASC 606, Contracts with Customers[1]—will go into effect for companies with their next annual report filed on or after Dec. 15 2017. This new standard will be a profound change in how companies recognize revenue. It requires them to define economic transactions as a series of *performance obligations,* **where the company can only recognize revenue from a transaction as each obligation within the transaction is fulfilled.**

One sector likely to be affected heavily by ASC 606 is the software sector. Many companies in this sector have complex, long-term arrangements with their customers, where revenue traditionally has been recognized across the whole term of a contract. Depending on the nature of those contracts and the services the software vendor provides (annual upgrades, for example), the new ASC 606 could lead to material changes in when and how revenue is reported.

Microsoft is an example. It sells its Windows 10 operating system as a service, with automatic upgrades over a period of time. Prior to the new revenue recognition standard, Microsoft recognized Windows 10 revenue *ratably***—that is, in increments, across the lifetime of a contract with corporate customers using Windows 10. Under the new ASC 606, Microsoft will now recognize all Windows 10 revenue** *immediately***, at time of sale and installation on customers' computers.**

Microsoft adopted the new ASC 606 early, on July 1, 2017. Since 2014 the company had told investors that ASC 606 would result in a material change to revenue. In the earnings report it released on Aug. 2, 2017, Microsoft reported what those changes were (in millions):

Year Ended	Original revenue	Adjustment	New revenue
30 June 2017	$89,950	$6,621	$96,571
30 June 2016	$85,320	$5,834	$91,154

Financial analysts will want to pay close attention to how the new revenue standard may affect software companies. Microsoft saw a material change in revenue because of how ASC 606 requires it to recognize sales of Windows 10— but for other Microsoft products, such as Office365 or LinkedIn, the new standard is not expected to have any effect. Some software businesses will find that they face similar material changes; others will have no change at all.

As companies implement the new standard, they are supposed to disclose how those efforts are proceeding[2]. For example, they are supposed to disclose when they will implement the standard;

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[1] See FASB Project Roster, May 15, 2017
[2] See SEC Staff Accounting Bulletin No. 74, Topic 11-M

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what implementation method they will use (companies have two choices); and whether the new standard will have a material effect on the timing or nature of their revenue recognition.

The purpose of this paper is to identify which companies in the software sector have business models similar to Microsoft—that is, they rely on sales where revenue has been recognized ratably over a long contract period—and to see what those companies have disclosed (if anything at all) about the possible impact of ASC 606 to their own financial reporting.

Our Approach

Calcbench began by identifying software firms that are peers of Microsoft, as determined by SIC codes each firm reports to the Securities & Exchange Commission. We found 406 firms.

Future revenues from long-term software contracts are *deferred* revenue, listed as a liability on the balance sheet. So Calcbench analyzed the total deferred revenue and total current liabilities of the 406 firms, as reported in their 2016 Form 10-K filings; and then calculated deferred revenue as a percentage of current assets.

Why this particular analysis? In many instances (such as Microsoft), the new revenue recognition standard will *accelerate* the recognition of deferred revenue, moving that number *off* the liabilities section of the balance sheet. That means firms with a higher ratio of deferred revenue to current liabilities are more likely to experience disruption to the balance sheet.

To put those numbers into context, we first needed to understand the “normal” ratio of deferred to current liabilities in the software sector in recent years. We identified companies classified as software firms by SIC code[3] for 2014, 2015, and 2016; and calculated the industry’s average “DR/CL ratio” for each of those three years.

Year	Cos.	Total Deferred Rev.	Total Liabs.	DR/CL
2014	296	$81,804,972,454	$194,230,935,85	42.1%
2015	280	$97,491,433,899	$248,782,157,457	39.2%
2016	234	$66,614,813,767	$139,533,437,650	47.7%

After establishing that industry norm, we returned to our list of 406 software companies that list Microsoft as a peer, and asked: which ones have above average DR/CL ratios? That is, which ones have business models that are unusually dependent on future revenues, locked away on the liabilities section of the balance sheet?

[3] SIC codes 7370 (Computer Programming, Data Processing); 7371 (Computer Programming Services); 7372 (Prepackaged Software); and 7374 (Computer Processing and Data Preparation).

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Once we identified those companies with DR/CL ratios well above industry norms, we reviewed their disclosures about ASC 606 as reported in their footnotes, to see how they have assessed the impact of the new revenue standard and what they have disclosed to investors so far.

What We Found

In our study population of 406 companies, 82 had DR/CL ratios above 50 percent. Eleven had ratios above 100 percent:

Company	Current Liabilities	Deferred Revenue	DR/CL Ratio
Web.Com Group	$324,732,000	$426,065,000	131.2%
Vmware	$4,554,000,000	$5,624,000,000	123.5%
Falconstor Software	$20,127,010	$23,666,815	117.6%
Rapid7	$145,609,000	$169,063,000	116.1%
Hortonworks	$166,319,000	$185,390,000	111.5%
Globalscape	$16,367,000	$17,445,000	106.6%
Nuance Communications	$690,899,000	$736,133,000	106.5%
Q2 Holdings	$59,211,000	$61,830,000	104.4%
hopTo Inc.	$3,336,800	$3,453,600	103.5%
CA Inc.	$3,006,000,000	$3,016,000,000	100.3%
Qualys Inc.	$130,332,000	$130,492,000	100.1%

Of those 11 companies, only one said that the new revenue recognition standard will have a material effect on its financial statements (CA), and only one said that the new standard will not have a material effect (Globalscape). One (Falconstor) said nothing about the possible effect, and the remaining eight said they were still evaluating the issue.

These companies used an average of 352 words to discuss the new revenue recognition standard. The discussions ranged from a high of 1,081 words (Hortonworks) to zero (Falconstor, which made no mention of the new standard at all). Stripping out those outliers, the average was 310 words.

We then examined the disclosures of the next 27 companies in the sample list: those with DR/CL ratios from 80 to 100 percent. This group actually said *more* about their implementation efforts, and more of them expected the new standard to have a material effect on their financial reporting. (For a complete list, please see Table 2 at end of this paper.)

This group used an average of 397 words to discuss the new revenue standard, and nine of the 27 said the standard will either probably or definitely have a material effect on their financial reporting. (See chart, Page 4.)

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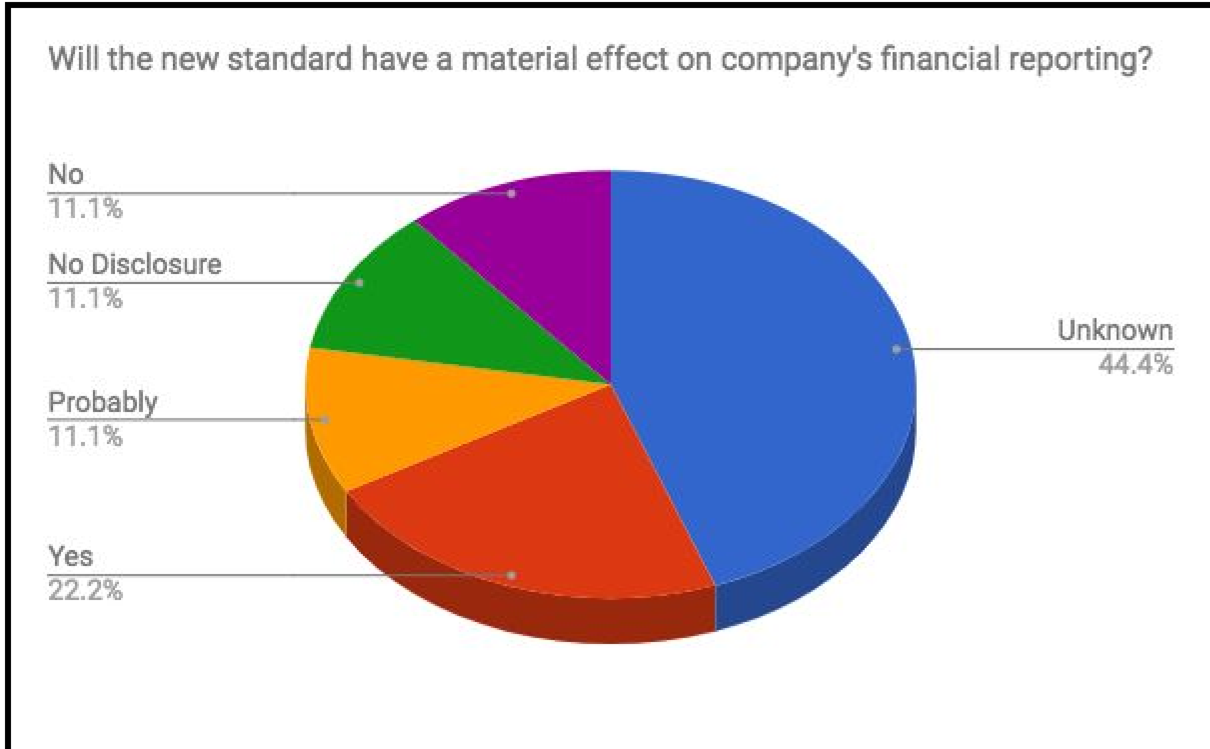

For comparison purposes: Calcbench recently looked at the 30 companies in the Dow Jones Industrial Average, to see what they have disclosed about implementing the new standard. In that group, only three of the 30 (including Microsoft) expected the new standard to have a material effect on financial reporting, and the average number of words used to discuss the new standard was only 326. (That said, many companies in the DJIA are not in the software sector, and have very different revenue streams that don't rely on deferred revenues to the extent that software firms do.)

Key Points in Disclosures

Several themes emerged in the disclosures of the software companies we studied.

First, numerous firms expect the new standard to accelerate revenue recognition for some long-term software contracts, where previously the revenue would have been recognized in increments across the life of the contract. This is because the new standard eliminates the need for "vendor-specific objective evidence" (VSOE). VSOE is evidence showing that some elements of a contract are still undelivered, and therefore the revenue from those undelivered elements cannot be recognized. With the VSOE requirement gone, the new standard will allow firms to recognize more (or even all) of the revenue from a long-term contract immediately.

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This has both good and bad points. Yes, firms can recognize more revenue from a contract, more quickly— but as several companies warn (Avid Technologies, for example), this will also *make their earnings more volatile from one quarter to the next,* **depending on which large-dollar contracts are closed in any given quarter.**

That is, if corporate customers tend to buy multi-year software contracts that begin on Jan. 1, under the new revenue standard, more software companies will report stellar Q1 results every few years… and then doldrums, until the next big contract is signed. The steady pattern of revenue moving *off* **the balance sheet (where it is locked away as deferred revenue) and** *on* **to the income statement will disappear.**

And as firms recognize more revenue immediately, the amount of deferred revenues on the liabilities side of the balance sheet will decline. For companies such as those we have highlighted here, with significant deferred revenue, the decline could be substantial and swift. That could have follow-on consequences as management recalibrates the assets stockholder equity to account for the shift.

Second, numerous firms said the new standard will change how they account for sales commissions, which qualify as costs of obtaining contracts. Under the new standard, sales commissions can be capitalized over the term of a contract, rather than expensed immediately. That means deferred commissions will increase as an *asset* **on the balance sheet, and the amortization costs will be expensed over the term of the contract.**

Finally, the data does raise questions about how well-prepared some software firms are for the new standard. The effective date is now less than four months away. Numerous firms say they plan to implement the standard by Jan. 1, 2018— but still report that they are uncertain about its possible effect, or even what adoption method they will use. (Companies can choose from two methods: a "full retrospective" approach, where they restate all prior periods under the new standard; and the "modified retrospective" approach where they make a one-time adjustment in their first reporting period under the new standard.)

How to Use This Data

Financial analysts can use the conclusions in this report, plus company-specific data available on Calcbench.com, to help focus conversations you might have with corporate CFOs about the new revenue standard. Our databases can help analysts research quantitative data about deferred revenue for specific companies and industry sectors; plus qualitative discussion disclosed in footnotes.

Our Interactive Disclosures database indexes disclosures as they are filed with the SEC. Subscribers can easily search for accounting policies, including implementation plans for the new

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revenue standard; and compare the current period's disclosure to what was reported in prior years, or compare multiple companies' disclosures on the same subject.

Calcbench also allows subscribers to craft their own peer groups, so one can quickly create peer groups with similar traits, and then compare disclosures about the new standard within that smaller, more like-minded group. Disclosures can also be exported as Word, PDF, or Excel files.

Table 2. Software companies with DR/CL ratio of 80 to 100 percent.

Company	Current Liabilities	Deferred Revenue	DR/CL Ratio
Workiva Inc.	$99,887,000	$97,501,000	97.6%
Mobileiron Inc.	$90,528,000	$88,076,000	97.3%
Commvault Systems	$285,595,000	$277,580,000	97.2%
Avid Technology	$237,936,000	$225,684,000	94.9%
Imperva Inc.	$138,094,000	$130,471,000	94.5%
CyberArk Software	$78,156,000	$73,506,000	94.1%
Splunk Inc.	$667,373,000	$625,459,000	93.7%
Apigee Corp.	$57,766,000	$53,889,000	93.3%
Check Point Software Technologies	$1,165,858,000	$1,065,584,000	91.4%
Rosetta Stone	$158,749,000	$141,457,000	89.1%
Connecture Inc.	$46,466,000	$40,916,000	88.1%
Veeva Systems Inc.	$246,784,000	$213,562,000	86.5%
CommerceHub Inc.	$14,726,000	$12,730,000	86.4%
Mimecast Ltd.	$110,388,000	$95,348,000	86.4%
Apptio Inc.	$116,374,000	$100,139,000	86.0%
Endurance International Group	$516,785,000	$444,390,000	86.0%
Instructure Inc.	$89,799,000	$75,891,000	84.5%
Coupa Software Inc.	$108,537,000	$90,840,000	83.7%
ServiceNow Inc.	$1,071,498,000	$895,101,000	83.5%
Broadsoft Inc.	$130,891,000	$109,189,000	83.4%
Tyler Technologies	$361,501,000	$300,357,000	83.1%
Everbridge Inc.	$63,783,000	$52,634,000	82.5%
Benefitfocus Inc.	$92,073,000	$75,838,000	82.4%
Autodesk	$2,185,400,000	$1,788,000,000	81.8%
Cornerstone OnDemand Inc.	$346,311,000	$282,332,000	81.5%
New Relic Inc.	$155,333,000	$126,404,000	81.4%
Box Inc.	$297,941,000	$241,984,000	81.2%

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About Calcbench

Calcbench databases and research tools provide a new experience in researching financial and accounting data. Calcbench tracks all types of corporate disclosures—10-Q, 10-K, 8-K, earnings releases, proxy statements; more to come in the future—whether they are displayed prominently or buried in the footnotes. We have that level of detail for more than 9,000 U.S.-listed businesses. Above all, we let you connect the dots among all that data, from a numerical disclosure on one financial statement to the narrative behind the number elsewhere.

Financial analysts, investors, academics, auditors, and economists can instantly access, research, and share data, both online and through our Excel add-in. Our accessible and intuitive platform can help you better understanding competitor financials, identify potential risk areas, find trends across industry sectors, or conduct more effective due diligence. Calcbench is the tool you need to make better decisions.

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