



# DEFERRED REVENUE

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## Introduction to Deferred Revenue

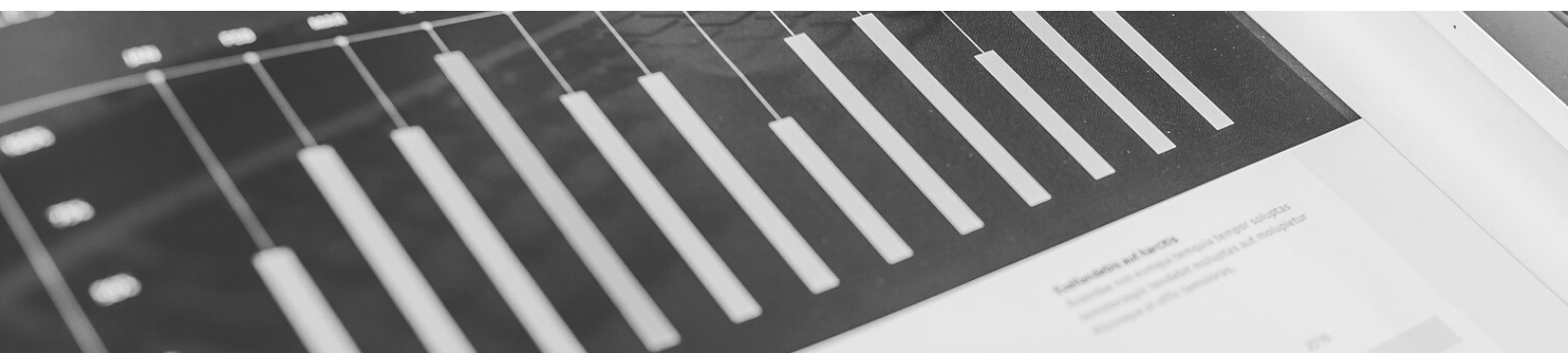
Deferred Revenue is a financial metric that traditionally has not received much attention in Corporate Finance. Balance Sheet-related concepts such as Days, Sales Outstanding (Accounts Receivable), Inventory Days, and Days Payable Outstanding (Accounts Payable) are very familiar to Corporate Finance professionals, as are obviously the amount of Debt and Shareholders' Equity on a company's Balance Sheet. Even though it is not as well known, looking for Deferred Revenue on the Balance Sheet can indeed reveal a lot about a company.

First, it is important to explain exactly what Deferred Revenue is. Deferred Revenue appears as a liability on a company's Balance Sheet. It usually appears in the Current Liabilities section, which therefore means it is part of a company's Working Capital balance.

Deferred Revenue is created when a company receives a payment from a customer (cash) before the company has delivered the product or service to the customer. This represents a very different scenario from the typical cycle in which a company delivers a product or service to the customer, issues an invoice, and eventually receives payment from the customer 30-60 days after the invoice date. In this "typical" scenario, a company recognizes revenue with an offsetting Accounts Receivable entry. When the customer eventually pays their invoice, the cash received offsets Accounts Receivable.

For a company that receives payments from customers in advance, there is no Accounts Receivable to offset against the cash payment received from a customer – because revenue has not yet been recognized. Therefore, a liability is created which represents the obligation the company has to deliver the product or service to the customer at some point in the future. This liability is called Deferred Revenue. The Deferred Revenue account will decrease, eventually to zero, as the company delivers the product or service; the offsetting accounting entry is to recognize revenue.

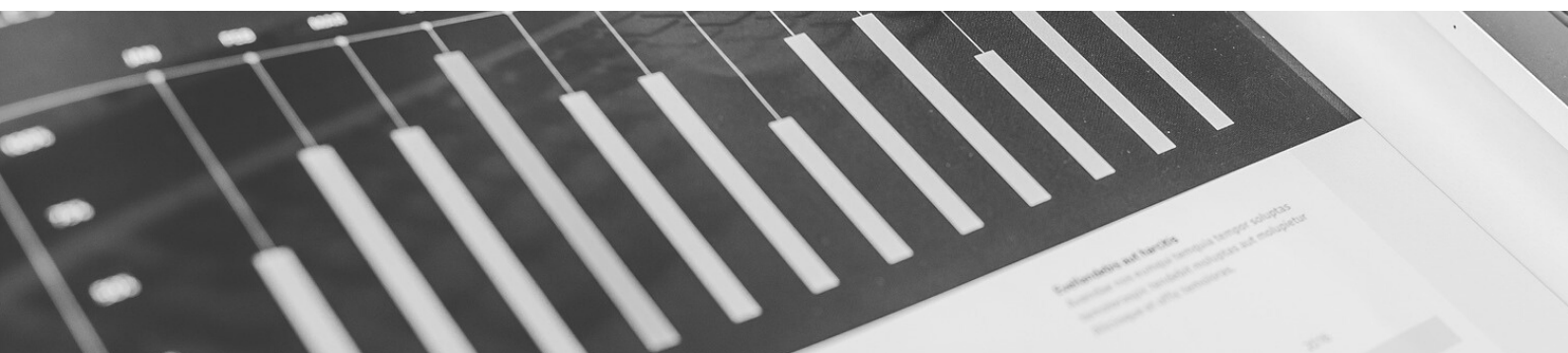
Software-as-a-Service (SaaS) companies often have Deferred Revenue on their Balance Sheets, since many require annual subscription payments upfront. Salesforce.com's Balance Sheet is presented below, in which Deferred Revenue is referred to as Unearned Revenue:



**salesforce.com, inc.**  
**Consolidated Balance Sheets**  
**(in millions)**  
**(Unaudited)**

|                                                                | January 31, 2019 | January 31, 2018<br>(as adjusted)* |
|----------------------------------------------------------------|------------------|------------------------------------|
| <b>Assets</b>                                                  |                  |                                    |
| Current assets:                                                |                  |                                    |
| Cash and cash equivalents                                      | \$ 2,669         | \$ 2,543                           |
| Marketable securities                                          | 1,673            | 1,978                              |
| Accounts receivable, net                                       | 4,924            | 3,921                              |
| Costs capitalized to obtain revenue contracts, net             | 788              | 671                                |
| Prepaid expenses and other current assets                      | 629              | 471                                |
| Total current assets                                           | 10,683           | 9,584                              |
| Property and equipment, net                                    | 2,051            | 1,947                              |
| Costs capitalized to obtain revenue contracts, noncurrent, net | 1,232            | 1,105                              |
| Capitalized software, net                                      | 152              | 146                                |
| Strategic investments                                          | 1,302            | 677                                |
| Goodwill                                                       | 12,851           | 7,314                              |
| Intangible assets acquired through business combinations, net  | 1,923            | 827                                |
| Other assets, net                                              | 543              | 384                                |
| Total assets                                                   | <u>\$ 30,737</u> | <u>\$ 21,984</u>                   |
| <b>Liabilities and stockholders' equity</b>                    |                  |                                    |
| Current liabilities:                                           |                  |                                    |
| Accounts payable                                               | \$ 165           | \$ 76                              |
| Accrued compensation                                           | 1,167            | 1,001                              |
| Accrued expenses and other liabilities                         | 1,356            | 970                                |
| Unearned revenue                                               | 8,564            | 6,995                              |
| Current portion of debt                                        | 3                | 1,025                              |
| Total current liabilities                                      | 11,255           | 10,067                             |
| Noncurrent debt                                                | 3,173            | 695                                |
| Other noncurrent liabilities                                   | 704              | 846                                |
| Total liabilities                                              | <u>15,132</u>    | <u>11,608</u>                      |
| Stockholders' equity:                                          |                  |                                    |
| Common stock                                                   | 1                | 1                                  |
| Additional paid-in capital                                     | 13,927           | 9,752                              |
| Accumulated other comprehensive loss                           | (58)             | (12)                               |
| Retained earnings                                              | 1,735            | 635                                |
| Total stockholders' equity                                     | <u>15,605</u>    | <u>10,376</u>                      |
| Total liabilities and stockholders' equity                     | <u>\$ 30,737</u> | <u>\$ 21,984</u>                   |

Deferred Revenue is indeed a bit of a paradoxical metric. One normally thinks that creating a liability on a company's Balance Sheet is a bad thing. But in the case of a Deferred Revenue liability, it is tough to argue that having a customer pay upfront is anything but a good thing.





# EFFICIENT ALPHA DEFERRED REVENUE INDEX

## Why Deferred Revenue?

Deferred Revenue is an important financial metric for three key reasons. First, receiving cash payments upfront from a customer obviously has a positive cash flow impact. It is not uncommon for companies with Deferred Revenue to operate with a negative Net Working Capital balance, largely due to the favorable timing of customer payments: instead of having Accounts Receivable asset (increases Working Capital needs), these companies have a Deferred Revenue liability (reduces Working Capital needs).

Second, carrying a Deferred Revenue balance can be a positive “signal” of a company’s competitive positioning or uniqueness of their product or service. In other words, only companies that offer their customers something very differentiated can require upfront payments from them. Revisiting the example provided above, it probably should not be surprising that Salesforce.com, which offers the “gold standard” for CRM software, is able to require upfront payments from its customers.

Finally, although this is not universally true, companies with Deferred Revenue more often than not have a relatively low marginal cost associated with incremental revenue. This is particularly true for companies that sell “digital goods” – software, data, etc. – that require very little additional Costs of Goods Sold for an incremental customer. Even old-school examples such as newspaper and magazine publishers can generate very high marginal Gross Profit in delivering a copy of their publication to an incremental customer. Companies with low marginal costs on incremental revenue generally can scale more quickly and achieve higher levels of overall profitability.

Putting the above elements together, all else being equal, companies with Deferred Revenue on their Balance Sheets can definitely represent more compelling investment opportunities compared with those that do not.

## Limitations of the Deferred Revenue Metric

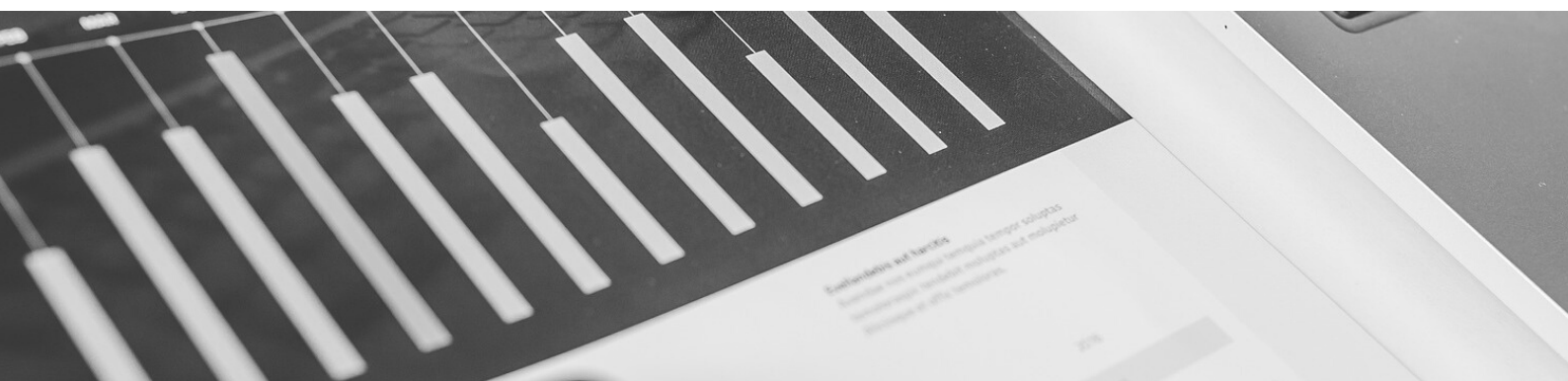
Like any financial metric, Deferred Revenue is certainly a measure that cannot be relied upon in isolation to assess the financial profile of a company and ultimately make investment decisions. As simply a point-in-time Balance Sheet metric, Deferred Revenue must be combined with measures of growth, profitability, and indebtedness to paint a complete financial picture.

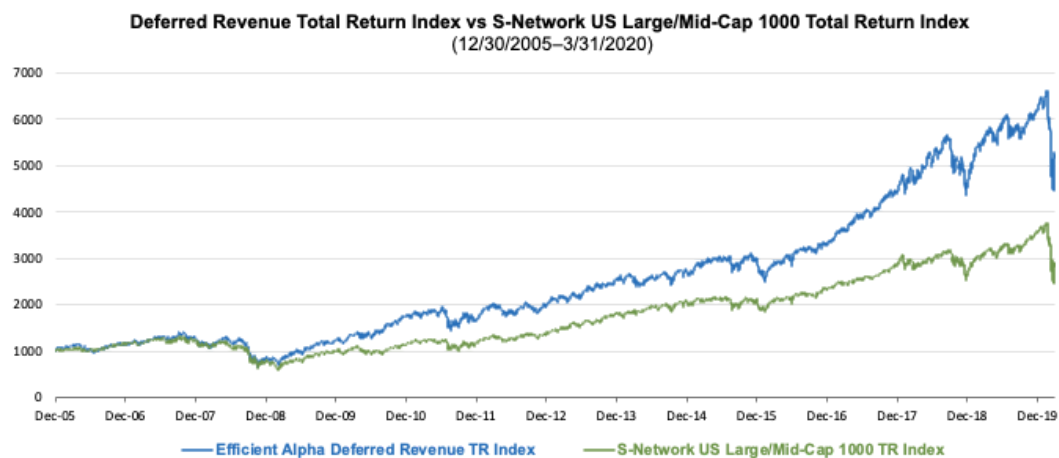
And there are some types of companies with Deferred Revenue that can get themselves in trouble if they do not properly manage the cash they receive via upfront payments. For example, a company that produces events may receive payments from sponsors in advance, but only have to pay the majority of costs associated with the event (personnel, venue, food and beverages) after the event is completed. If such a company failed to “reserve” the upfront cash payments to pay eventually the event’s costs, it could find itself in a liquidity crunch when those bills come due.

## Efficient Alpha Capital Deferred Revenue Index

The Efficient Alpha Capital Deferred Revenue Index (the “EAC Deferred Revenue Index”) applies the insights above to create a stock portfolio whose returns can outperform those of the underlying benchmark index. Companies are included in the EAC Deferred Revenue Index based upon their Deferred Revenue balance as a percentage of annual revenue. The EAC Deferred Revenue Index also includes revenue growth and valuation overlays in an effort to include companies that are growing and not necessarily over-valued. The valuation overlay is particularly important to avoid including wildly over-valued companies, such as SaaS providers, which often have high Deferred Revenue balances, that can trade at double-digit revenue multiples. The result is performance that is summarized below, demonstrating the potential for a positive correlation between Deferred Revenue and investment returns:

| Calendar Year Ending Total Return Appreciation |                                           |                                          |
|------------------------------------------------|-------------------------------------------|------------------------------------------|
|                                                | Efficient Alpha Deferred Revenue TR Index | S-Network US Large/Mid-Cap 1000 TR Index |
| 12/31/2006                                     | 15.00%                                    | 15.44%                                   |
| 12/31/2007                                     | 11.10%                                    | 6.82%                                    |
| 12/31/2008                                     | -34.42%                                   | -36.92%                                  |
| 12/31/2009                                     | 47.46%                                    | 27.61%                                   |
| 12/31/2010                                     | 40.55%                                    | 16.02%                                   |
| 12/31/2011                                     | -4.02%                                    | 1.52%                                    |
| 12/31/2012                                     | 18.87%                                    | 16.21%                                   |
| 12/31/2013                                     | 29.25%                                    | 34.20%                                   |
| 12/31/2014                                     | 6.31%                                     | 12.70%                                   |
| 12/31/2015                                     | 9.28%                                     | 1.00%                                    |
| 12/31/2016                                     | 10.17%                                    | 12.04%                                   |
| 12/31/2017                                     | 34.11%                                    | 22.27%                                   |
| 12/31/2018                                     | 6.66%                                     | -4.86%                                   |
| 12/31/2019                                     | 31.98%                                    | 31.70%                                   |
| YTD 3/31/2020                                  | 10.75%                                    | 5.20%                                    |





For more information on how the lessons of this whitepaper about the power of the Deferred Revenue metric can be applied using the Efficient Alpha Capital Deferred Revenue Index, please visit <https://snetworkglobalindexes.com/indexes/efficient-alpha-indexes>