



Commercial Software Licensing

CHAPTER 2:

Software Publisher Organization & Operation

Prepared by DoD ESI | January 2013

- Like many corporations, Software Publishers often create organization structures around key functions.
 - *Below the CEO, the functional organization includes product development, sales, professional services, and maintenance & support, etc.*
- Although the basic functional areas are still present, many corporations (*including Software Publishers*) create organizations around other factors such as industry, geography, or customer size.
- Roles, duties, reporting relationships, and Key Performance Indicators (KPIs) for each function are similar to other corporations.
 - *Examples: Revenue and profit, time to market, quality, etc.*

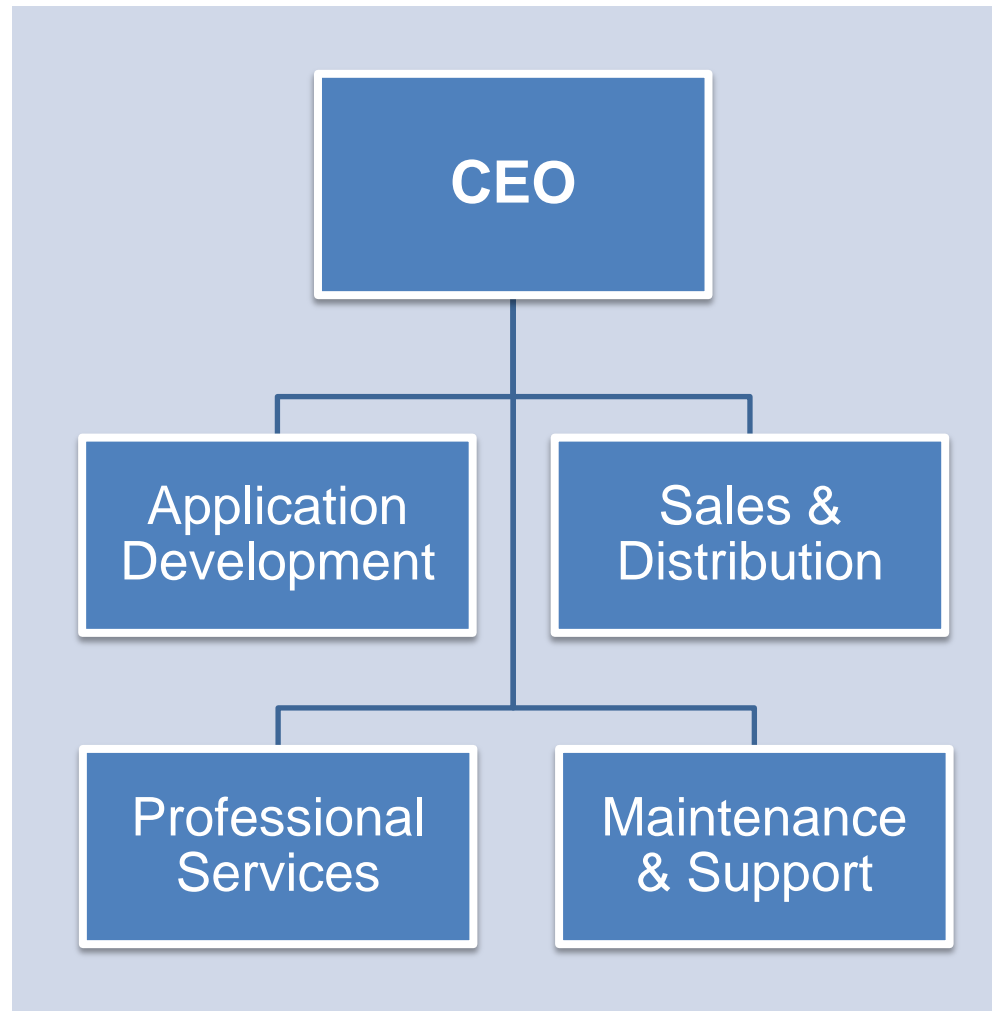


- Emerging Publishers focus on product development/sales licenses.
 - *Most headcount is in product development.*
 - *Most revenue is in licenses with little in support or professional services.*
- Mature Publishers have more balanced head counts/revenue mixes.
 - *Head count and revenue are often equal among licenses (sales), maintenance & support, and professional services.*
- Revenue compliance issues are major factors for Publishers.
 - [Vendor-Specific Objective Evidence](#) (VSOE) was designed to prevent Publishers from recognizing license revenue prematurely.
 - *Public company reporting requirements keep Publishers honest.*
 - [Sarbanes-Oxley](#) (SOX) adds compliance standards.
- Why revenue compliance is important to the government.
 - *Publishers will use VSOE and SOX to decline discounts.*
 - *Smart negotiators will know the facts and the right questions to ask regarding revenue compliance matters affecting Publishers.*

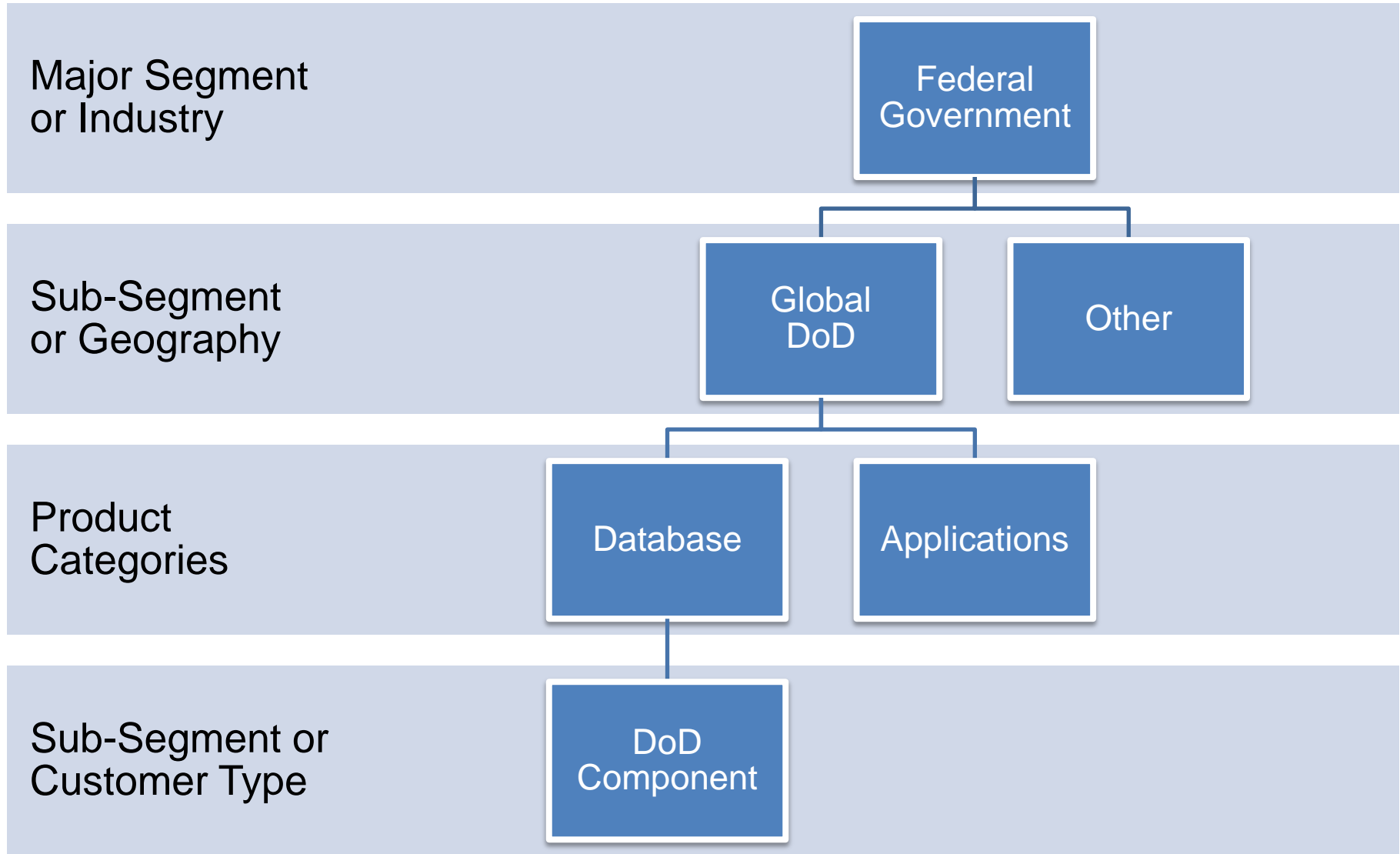


Basic Functional Organization

Commercial Software Enterprise



Alternative Organization Models



Market Segmentation Options

[Review Oracle web site](#) and [SAP web site](#)

Major Segments or Industries

- Commercial-Government.
- Manufacturing, Life Sciences, Hi-Tech, Consumer.

Customer Size

- Global, Regional, Small & Medium Enterprises (SMEs).

Geography

- Theater (*i.e. Americas, EMEA, Asia-Pacific*), Country, Region.

Product Categories

- Enterprise Applications vs. Point Solutions.



Reporting Relationships

- Reports to the Board of Directors.
- Fiduciary duty to shareholders for financial integrity and results.

Primary Duties

- Set the company strategy and ensure execution.
- Lead the company: responsible for overall performance.

Primary KPIs

- Growth in revenue and profit: growth required to stay in business.
- Profit: drives investments and returns to shareholders.
- Share price.

Measuring Company Health (Financial)

- ROA, ROS, ROI.
- Earnings Per Share (EPS) -> stock price and dividends. [Review Financial metric details](#)
- [See top 100 fiscal years and other statistics at http://www.softwaretop100.org/global-software-top-100-edition-2011](http://www.softwaretop100.org/global-software-top-100-edition-2011)



FY 2011 Financial Statement Summary*

Commercial Software Licensing:
Software Publisher Organization & Operation

Income Statement (\$B)

	MSFT	ORCL
Period Ending	30-June-11	31-May-11
Total Revenue	\$69.9	\$35.6
Cost of Revenue	<u>\$15.6</u> 22%	<u>\$8.4</u> 24%
Gross Profit	\$54.3	\$27.2
R&D	\$9.0 13%	\$4.5 13%
SG&A	\$18.2 26%	\$7.6 21%
Other	<u>\$0.0</u>	<u>\$3.1</u>
Total Ops Exp	\$27.2	\$15.2
Operating Inc./Loss	\$27.1	\$12.0
Other	\$0.9	\$0.6
Income Before Tax	\$28.0 40%	\$11.4 32%
Income Tax	\$4.9	\$2.9
Net Income	\$23.1	\$8.5

* - Extracted from Respective 10Ks and Yahoo Finance



Your Preferred Source for
IT Acquisition Across the DoD

Earnings Per Share (EPS)

Used for Publisher Evaluation

Relevance of EPS

- A simple measure of reporting the amount of annual net income per outstanding share of stock.
- Closely monitored by Wall Street.
- An excellent way to gauge performance.

Example:

- Example: $\$1,000,000$ Net Income \div $500,000$ Shares = $\$2.00$ EPS.
- Establishes a base for company actions (dividends per share, etc.).
- Divided into the price of a stock, it establishes Price to Earnings Ratio (P/E).
- Example: Stock price of $\$30.00 \div \2.00 per share = PE of 15.
- Low P/E indicates market expects low growth in future.
- High P/E indicates market expects high growth in future.
- High growth software companies often have P/Es between 20 and 60.
- P/Es as of 11/2011: Microsoft = 9, Oracle = 17, CTXS = 37, and Red Hat = 71.



FY 2011 Financial Statement Summary*

Commercial Software Licensing:
Software Publisher Organization & Operation

Earnings Per Share

	MSFT	ORCL
Period Ending	30-June-11	31-May-11
Net Income	\$23,150,000,000	\$8,547,000,000
# Shares	8,593,000,000	5,128,000,000
EPS	\$2.69	\$1.67

* - Extracted from Respective 10Ks



Your Preferred Source for
IT Acquisition Across the DoD

FY 2011 Financial Statement Summary*

Commercial Software Licensing:
Software Publisher Organization & Operation

Balance Sheet (\$B)

	MSFT	ORCL
Period Ending	30-June-11	31-May-11
Current Assets		
Cash & Equiv	\$9.6	\$16.2
ST Invest.	\$43.2	\$12.7
Receivables	\$17.4	\$7.8
Other	<u>\$4.7</u>	<u>\$2.5</u>
Total Current Assets	\$74.9	\$39.2
LT Investments	\$10.9	\$0.0
Prop, Plant & Equip	\$8.2	\$2.9
Goodwill	\$12.6	\$21.5
Other	<u>\$2.1</u>	<u>\$9.9</u>
Total Assets	\$108.7	\$73.5
Current Liabilities	\$28.8	\$14.2
Long Term Debt	\$11.9	\$14.8
Other Liabilities	<u>\$10.9</u>	<u>\$4.3</u>
Total Liabilities	\$51.6	\$33.3
Shareholder Equity	\$57.1	\$40.2

* - Extracted from Respective 10Ks and Yahoo Finance



Your Preferred Source for
IT Acquisition Across the DoD

FY 2011 Financial Statement Summary*

Commercial Software Licensing:
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Statement of Cash Flows (\$B)

	MSFT	ORCL
Period Ending	30-June-11	31-May-11
Net Income	\$23.2	\$8.5
Depreciation	\$2.8	\$2.8
Other	<u>\$0.9</u>	<u>(\$0.1)</u>
Cash Flow Provided	\$26.9	\$11.2
Capital Expenditures	(\$2.4)	(\$0.4)
Investment	(\$13.2)	(\$3.9)
Dividends	(\$5.2)	(\$1.1)
Net Borrowings	\$6.0	\$1.2
Other	<u>(\$8.0)</u>	<u>(\$0.8)</u>
Total Cash Used	(\$22.8)	(\$5.0)
Net Change in Cash	\$4.1	\$6.2

* - Extracted from Respective 10Ks and Yahoo Finance

[Continue with Org Discussion](#)



Your Preferred Source for
IT Acquisition Across the DoD

- High Growth (High P/E) Companies aggressively seek License Revenue
 - *Immediate revenue recognition – needed to feed growth.*
 - *Services will follow later in company life cycle , “If you build it, they will come”.*
- Small and Growing Companies are hungry for Contract Vehicles
 - *Looking for direct vehicles (GSA Schedule 70, ESI/SmartBuy, etc.).*
 - *Eager to establish Resellers/partners to extend their internal sales force.*
- Mature companies with **Installed Base** in position of power.
 - *Less eager to negotiate discounts on recurring revenue (maintenance, services, etc,)*
 - *Once you reach critical use and critical mass, you are locked in to the Publisher.*
 - *May find that the Reporting and compliance issues of direct contracts are not worth the effort and risk.*
 - *Good approach is to always leverage existing contracts.*



The Four Primary Operating Functions

Product Development

- Responsible for writing the software.
- Quality and End-Adoption are key metrics.

Sales

- Responsible for finding & selling applications to new customers and managing relationships with and selling to existing customers.
- Measured on meeting sales quotas and on customer satisfaction.

Professional Services

- Primary duty is to assist customers with implementation & training.
- Measured on revenue, meeting project time & budget targets.

Maintenance & Support

- Responsible for analyzing & fixing software bugs and delivering new releases.
- Measured on SLAs, maintenance revenue & renewals plus customer satisfaction.



Application Development

- As creators of the software IP, Development can theoretically take credit for all application revenue.
- Since Development is not usually viewed as a P&L organization, it typically is not credited with revenue at all.

Sales

- Sales is tasked with driving company revenue for software—and often for Services and Maintenance & Support.
- In most software companies, the Sales organization carries the P&L for software revenue.
- In some companies, the Sales organization is also responsible for selling services – in those cases, revenue is sometimes included in the Sales organization's P&L.



Services

- Provides implementation services to customers.
- Ultimately drives customer adoption and customer references.

Maintenance & Support

- Maintenance revenue is indicative of customer retention and satisfaction.
- Maintenance revenue funds software fixes and development as well as support.



Relative Headcount of the Four Key Organizations

- Most emerging firms focus on Product Development.
- In the early stages, Services and Support demands lag software sales, sometimes causing customer satisfaction issues.

Relative Revenue of the Four Key Organizations

- Product Development does not directly generate revenue.
- Software license fees account for the vast majority of total company revenue—usually 60% or more of total revenue.
- Services and Support revenue run well behind sales until a critical mass of customers is achieved.



Mature Software Company

Relative Headcount & Revenue

Relative Headcount of the Four Key Organizations

- As firms mature, Services organizations grow rapidly to accommodate the implementation demand.
- As more customers go live with software, Support organizations also grow to manage increased customer support calls.

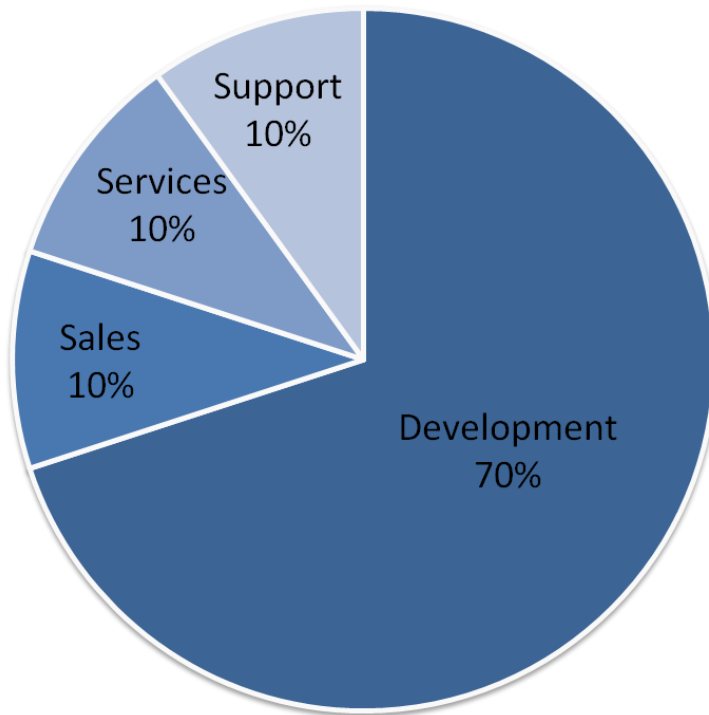
Relative Revenue of the Four Key Organizations

- Over time, revenues tend to balance out.
- Sales should always lead Services and Support.
- Some firms find Services will lead (e.g. IBM, etc.).

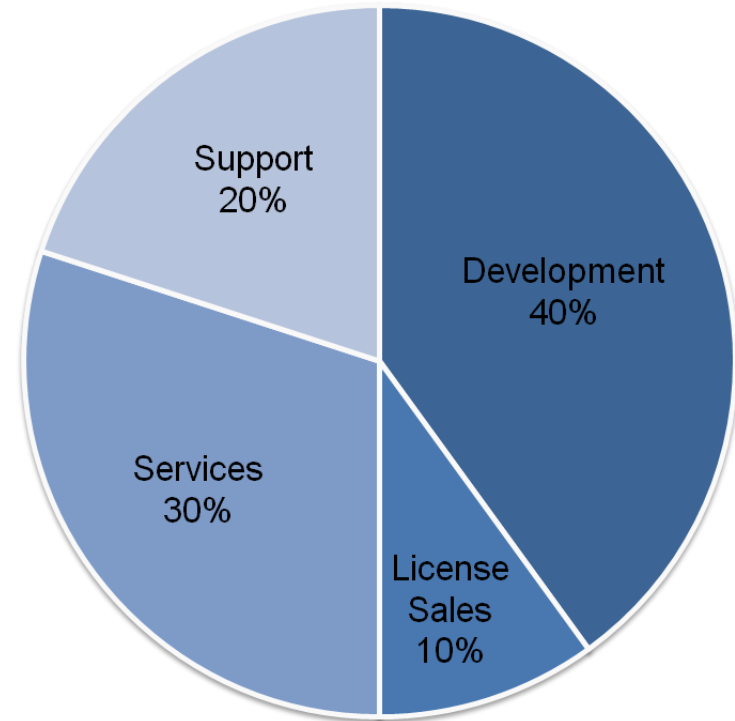


Relative Headcount of Key Organizations

Emerging Software Company

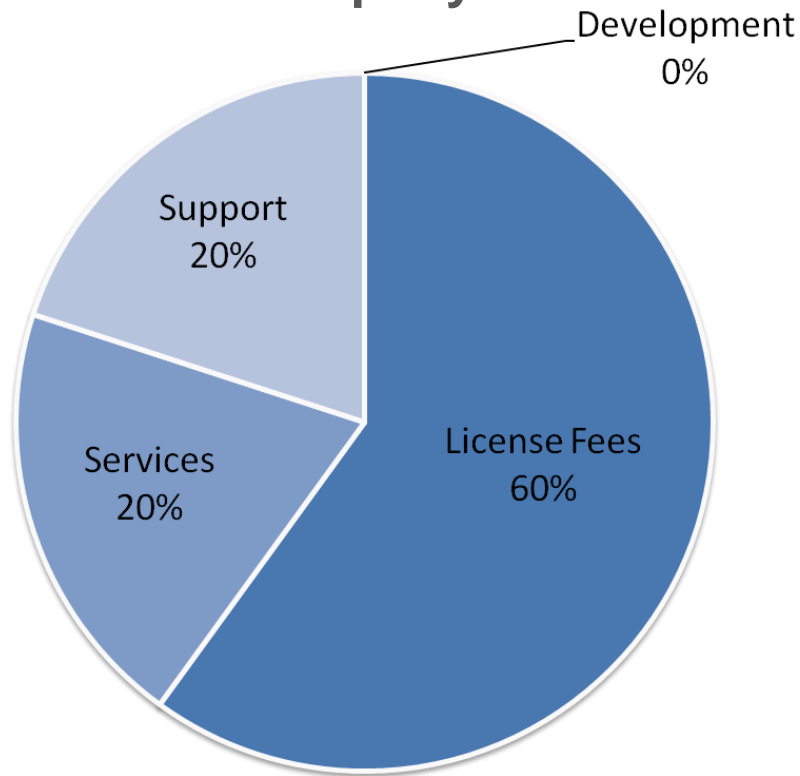


Mature Software Company

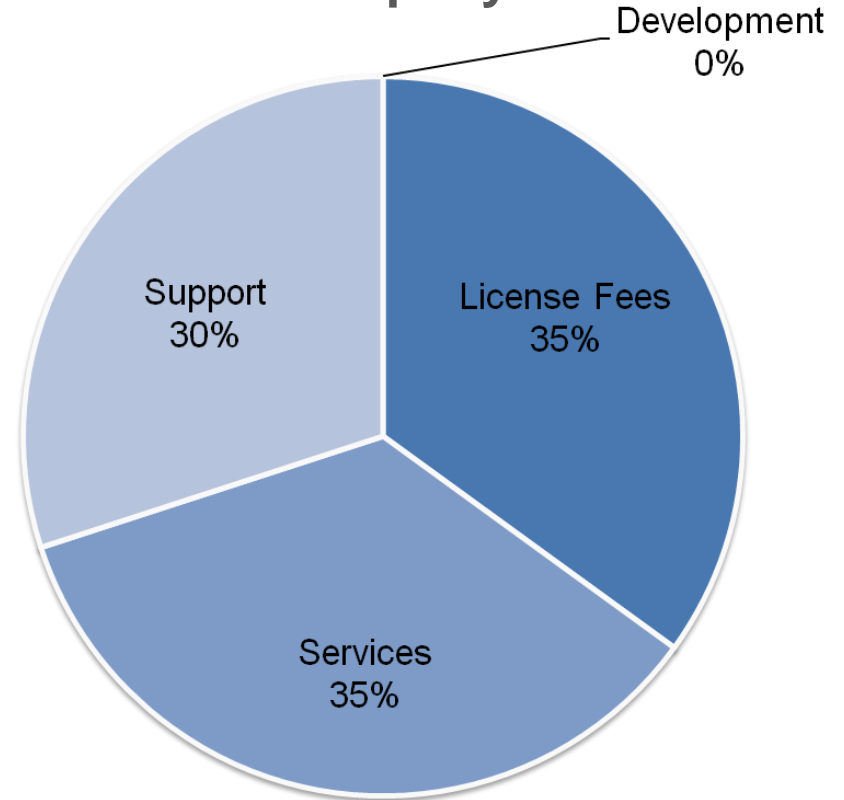


Relative Revenue of Key Organizations

Emerging Software Company



Mature Software Company



Relative Revenue & Headcount

Why They Matter to KOs

Emerging Software Firms

- Emphasis is on license sales—it has the highest margin to obtain customers as fast as possible.
- Easier to negotiate license discounting.

Mature Software Firms

- Although license revenue is now lower as a percentage of total revenue, it is much higher in real dollars.
- It is difficult to maintain revenue growth.
- Higher multiples for stock valuation based on software sales than for services or support.
- Discounts will be harder to obtain.
- By this time the services and support organizations are much larger and will push hard for the business—discounts available.



Vendor-Specific Objective Evidence (VSOE)

- A mechanism introduced to ensure proper revenue recognition of software in multi-item deals (*e.g. software, maintenance, training, etc.*).

Public Company Reporting

- Audited financial statements are required for publicly traded companies.
- Investors and others rely on the accuracy of these statements.

Sarbanes-Oxley

- A broad set of corporate governance laws passed in 2002 in response to the collapse of Enron and other publicly traded companies.
- One of the most discussed provisions requires CEOs and CFOs to sign a statement verifying the accuracy of financial statements with civil and criminal penalties for noncompliance.



How Revenue is Recognized Affects Perception of Sale

- Companies must follow accounting rules on how and when to count sales as revenue.
- When certain conditions exist, sales must be recognized as revenue over time or when contingencies are met. (*i.e. customization, performance guarantees, etc.*)
- A sale that cannot be immediately recognized is viewed as less important, because it is recognized ratably over time.

Accounting Requirements

- A broad set of corporate governance laws were passed in 2002 in response to the collapse of Enron and other publicly traded companies.
- CEOs and CFOs must sign a document verifying accuracy of financial statements, with civil and criminal penalties for noncompliance.



Software Revenue Recognition

SOP 97-2 *(to be updated soon)*

Conditions for Software Revenue Recognition

- Persuasive evidence of an arrangement exists.
- Delivery (*i.e. usable software*) has occurred.
- The vendor's fee is fixed or determinable.
- Collectability is probable.
- Non-cancellable, non-refundable.
- No significant modifications are required.
- No contingencies exist. (*Standard warranty applies.*)
- No promise of future functionality.



Vendor-Specific Objective Evidence

A Key Element of Revenue Recognition

VSOE of Fair Value

- Each element of a transaction (*license, maintenance, services*) must be sold at fair value.
- Each vendor must establish and maintain specific evidence of each element's fair value (VSOE).
- When VSOE is not established for an element, VSOE of other elements is used to apportion revenue.
- Designed to prevent over-recognizing revenue on one element to the detriment of another element.



Rules on VSOE

- On a multi-element purchase, any discount should be apportioned across each element in the arrangement based on each element's fair value.
- Except for upgrade rights, revenue is also allocated to the elements based on their relative fair values, provided that VSOE of fair value exists for all elements.

A Publisher's Approach to VSOE

- Each software Publisher has specific defined methods of determining VSOE.
- Impossible to know internal policies of each Publisher/Accounting Firm.
- Example:
 - Software List Price = \$1,000,000 → Discounted to \$900,000.
 - Maintenance List Price = \$220,000 → Discounted to \$50,000.
 - License revenue used to subsidize maintenance.
 - Accounting might allocate that \$950,000 deal (*approximately*) as \$800,000 for License and \$150,000 for Maintenance.
 - Obtain FFP quote (5 years if possible) for out-year maintenance.



Publisher Compliance Issues

Why They Matter to KOs & SPMs

Vendor-Specific Objective Evidence (VSOE)

- Publishers will often cite revenue recognition or VSOE as an excuse for declining to extend further discounts.
- Although it is a complicated topic, Contracting Officers (KOs) and Software Program Managers (SPMs) should have at least a basic understanding of VSOE to detect when the Publisher is improperly using VSOE to avoid discounts.

Public Company Reporting

- Public company reporting may also be raised as a reason for declining discounts.
- Software companies receive a higher valuation for software revenue than for revenue from other products or services.

Sarbanes-Oxley (SOX)

- KOs and SPMs should have a basic understanding of SOX—often cited as a reason to decline discounts.
- SOX is focused mostly on corporate governance, accurate financial reporting, and independence of outside auditors.



Organizational & Compliance Issues

Leverage for KOs and SPMs

Organization and Compliance Dynamics

- Emerging Publishers are hungry for new license business in order to become established players.
- Mature Publishers need new license revenue to maintain growth, overall revenue, and favorable multiples for stock price.
- Many Publishers will deflect discount conversation through VSOE and other compliance requirements.

Global Account/Strategic Account Leverage

- Beyond organization and compliance dynamics, KOs and SPMs should know about Publisher Global Account or Strategic Account programs.
- Global or Strategic Account programs usually include special discounts or added services to recognize the strategic value of the customer.
- DoD should be in that category.

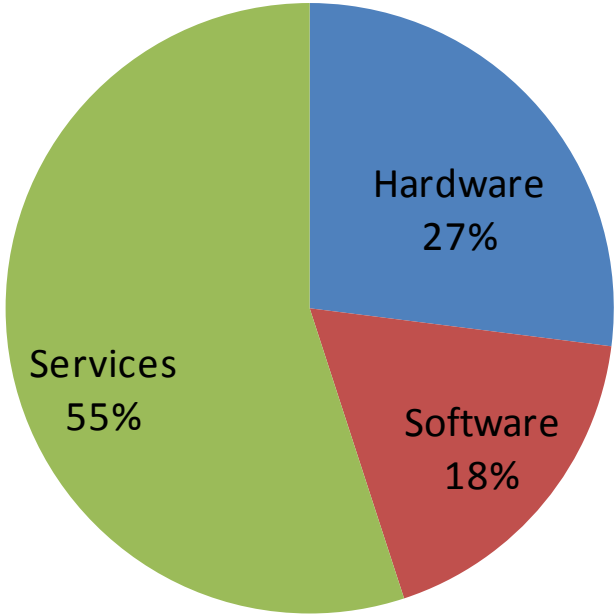


Gartner Global IT Spending Outlook (\$B)				US Federal*
	2011	2012		
Hardware	\$404	\$421	27.0%	\$22
Software	\$267	\$280	18.0%	\$14
Services	<u>\$845</u>	<u>\$856</u>	55.0%	<u>\$44</u>
	\$1,516	\$1,557		\$80

* - Category %s Imputed from Gartner Global Data



IT Spending by Category



Describe the functional organization structure of a Software Publisher and the roles for each function.

Identify common KPIs used to measure performance of business and how those KPIs apply to Publishers.

Discuss alternative organization models and the rationale Publishers may use for choosing alternatives.

Explain why government purchasing professionals need to know about Publisher organization models, the various roles in those organizations, and the KPIs used to measure performance.

Identify KPIs that might impact government negotiations with Software Publishers for software licenses.

Compare emerging vs. mature Software Publishers in terms of head count and revenue.

List and discuss three primary revenue compliance issues facing Software Publishers.

Discuss why revenue compliance is important to government purchasing professionals.

