Deferred Revenue: How an "Easy" Interview Question Makes Real Life Confusing

Real-Life Subscriptions vs. Accounting Textbooks

This Lesson: Deferred Revenue 101

Deferred Revenue is straightforward if you look at accounting textbooks, Investopedia, etc. (and still a common interview question!)

BUT in real life, it's not so easy, especially for SaaS / subscription companies.

This Lesson: Deferred Revenue 101

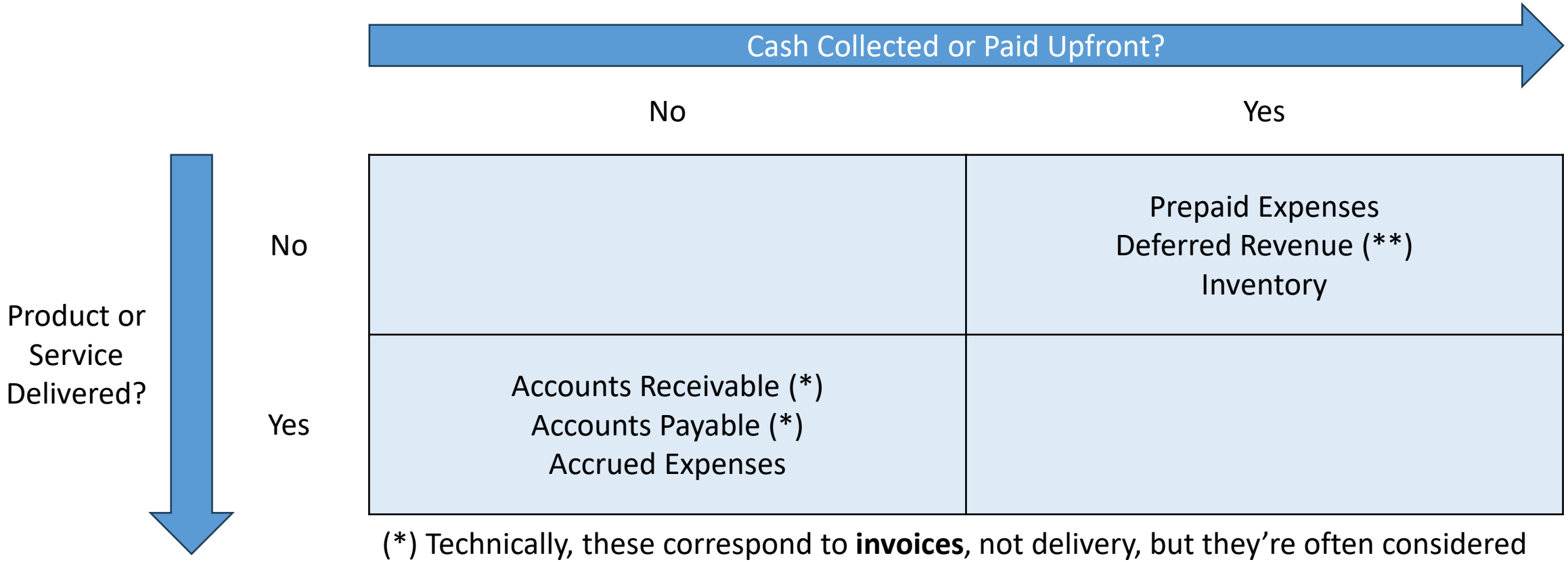
For the files and resources, please go to:

https://breakingintowallstreet.com/kb/accounting/deferred-revenue/

(There's a simplified "3-statement interview question model" there)

The Short Version of Deferred Revenue

- **Deferred Revenue:** Represents **payments** the company has received for products/services it has **not yet delivered**



(*) Technically, these correspond to **invoices**, not delivery, but they're often considered the same in simple scenarios.
(**) Cash treatment varies for subscriptions / multi-pay contracts.

The Short Version of Deferred Revenue

- **Sell a Product for $100, Get the Cash, But Don't Deliver It**
  Yet: Cash and DR both increase by $100 on the Balance Sheet

- **Delivery:** Company recognizes $100 in Revenue, and Deferred Revenue falls by $100

- **Statements:** Assuming no expenses, Pre-Tax Income is up by $100, Net Income is up by $75 at a 25% tax rate, and the Deferred Revenue change reverses/cancels out on the CFS

- **So:** Cash at the bottom is up by $75; Equity also up by $75 on the L&E side of the Balance Sheet

The Short Version of Deferred Revenue

- **SaaS / Subscription Context:** More complicated because "delivery" might take place continually or many times

- **So:** Deferred Revenue typically corresponds to **invoices**, and if a customer does *not* pay in cash upfront for the contract, Accounts Receivable and Deferred Revenue both increase

- **Cash Collection:** AR falls as the Cash is collected, and DR falls over time as the Revenue is recognized during the product/service delivery

Deferred Revenue: Lesson Overview

- **Part 1:** Deferred Revenue with Delivery Expenses **5:46**
- **Part 2:** Why is Deferred Revenue a Liability? **7:40**
- **Part 3:** Deferred Revenue in SaaS Accounting **9:28**

Part 1: Deferred Revenue w/ Delivery Expenses

- **Common Objection:** "This is unrealistic! It always costs something to deliver a $100 product/service, even a digital one!"

- **Initial Step:** Nothing changes; DR and Cash both up by $100

- **Step 2:** $100 of Revenue gets recognized, but now there are COGS and/or OpEx (we'll say $20 in COGS)

- **So:** Net Income is only up by $60, and Cash and Equity are both up by $60 → This generates after-tax profits, but they're lower than before

Part 2: Why is Deferred Revenue a Liability?

- **Common Question:** "Deferred Revenue seems **good** because it means we earn more Revenue in the future. Why is it a Liability? Don't Liabilities cost us something?"

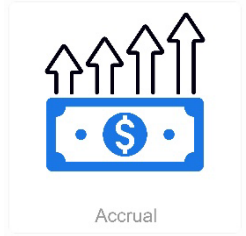
- **ANSWER:** Liabilities represent **future obligations or cash outflows**

- **DR:** It means that the company *will incur future costs since it now has a delivery obligation*

- **OR:** The company has already collected the cash ("the good part"); now, it needs to pay to deliver the product/service (even with no delivery expenses, there are taxes)

Part 2: Why is Deferred Revenue a Liability?

- **Accrued Revenue:** It's the *opposite* of Deferred Revenue and counts as an **Asset** because it means the company has *delivered* a product/service but not yet received the cash



- **AR vs. AR:** Accrued Revenue is similar to Accounts Receivable (both are Assets), but Accounts Receivable typically has a **specific invoice attached** and is based on this invoice, not strictly delivery (hence the * note in the 2x2 matrix)

Part 3: Deferred Revenue in SaaS Accounting

- **EX:** An enterprise software company has contracts for $120 per year, with billing every 6 months and payment due within 90 days for each invoice

- **January 1:** AR and DR both increase by $60


- **January 31:** $10 of Revenue gets recognized for the month, DR falls to $50, and AR is still at $60


- **March 31:** Cash collection takes place, so AR falls from $60 to $0, and DR is at $30 by the end of the month



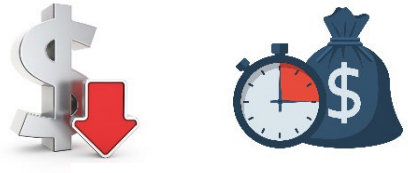
Part 3: Deferred Revenue in SaaS Accounting

- **3-Statement Model:** A company has a 12-month contract for $1,200, with invoices every 4 months and “Net 60” terms

- **January Invoice:** AR and DR both increase by $400

- **Monthly IS:** $100 of Revenue recognized in each month

- **Balance Sheet:** AR stays at $400 and then falls to $0 by the end of Month 2; DR decreases by $100 per month



- **Cash:** *Decreases* when Revenue is recognized, but *increases* when there’s a cash collection

Recap and Summary

- **Part 1:** Deferred Revenue with Delivery Expenses

- **Part 2:** Why is Deferred Revenue a Liability?

- **Part 3:** Deferred Revenue in SaaS Accounting