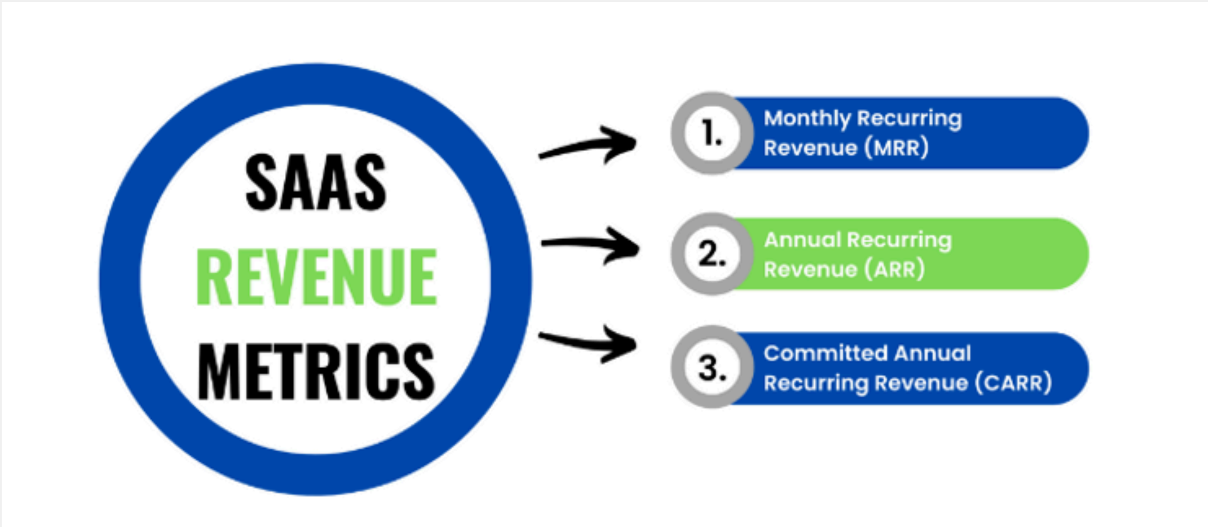
Hal Shelton · Feb 28 · 4 min read

Decoding SaaS Revenue Metrics: A Guide to ARR, CARR & MRR and Their Effect on Financial Performance

Traditional revenue accounting is governed by Generally Accepted Accounting Principles (GAAP). Privately held companies that offer Software as a Service (SaaS) utilize additional metrics to measure and analyze their financial performance. The three most common are Annual Recurring Revenue (ARR), Monthly Recurring Revenue (MRR), and Committed Annual Recurring Revenue (CARR). This paper will define these terms, suggest the significance and optimal use cases, and provide tips to management and board members on what to consider in adopting these measures. This paper is not an accounting treatise on this subject. Companies that use these SaaS metrics should work with their accountants/auditors to establish the ground rules for their calculation and recognition.



LET'S DEFINE THESE REVENUE METRICS

- **Annual Recurring Revenue (ARR):** ARR represents the total revenue a SaaS company expects to generate from its subscription-based customers within a year. It is calculated by multiplying the most current month's revenue by 12. ARR is valuable for assessing the company's long-term revenue stability and growth potential. It provides a picture of the annual revenue stream, aiding in planning and valuation. This is most valuable when customers pay for their recurring subscriptions on an annual basis.

- **Monthly Recurring Revenue (MRR**): MRR is the predictable monthly revenue generated from subscription-based customers. It is calculated by summing the monthly subscription fees from its customers. It is more granular than ARR, providing insights into short-term revenue performance. This is most valuable when customers pay on a recurring monthly basis. It is also an important input to several other SaaS metrics such as CAC payback period.

- **Committed Annual Recurring Revenue (CARR):** CARR considers the contracted, committed revenue for the upcoming year, including existing subscriptions and any upsells or cross-sells agreed upon. This metric provides a forward-looking perspective, offering insights into the company's revenue stability and growth potential. CARR is usually equal to or greater than ARR (until the end of the year) as a contract signed on Feb 1 with product delivery on May 1, will be included in CARR on Feb 1, but ARR will be recognized on May 1.

WHO SHOULD USE THESE REVENUE METRICS

Companies that fully offer SaaS products. Also, companies that have a portion of their business as a SaaS offering. These metrics are not appropriate for service, retail, or hardware companies—where revenue predictability is much more uncertain.

Some companies have a mix. If the SaaS portion is substantial then probably adopt these metrics with side schedules in management reporting detailing the non-SaaS component. And in reverse if the non-SaaS portion is dominant.

REVENUE RECOGNITION GUIDELINES

Typically, ARR is recognized when there is a signed contract and the service is made available to the customer. However, it is essential to adhere to accounting principles such as ASC 606 which details revenue recognition from customer contracts. ARR is recognized over the contract term as the service/product is delivered/used, and the revenue can be reliably measured.

Some confuse the predictability of events with the predictability of revenue. An example given is annual doctor visits. The event is predictable, but until you have an exam the revenue is not predictable.

Also, these matrixes are about revenue recognition, not about cash received. Thus, this applies only to companies that have adopted accrual accounting.

TIPS FOR MANAGEMENT AND BOARD MEMBERS REGARDING THE ADOPTION OF SaaS Revenue METRICS

1. Is the adoption of SaaS metrics to improve business insights or to hype the reported revenue? Typically, SaaS companies sell for higher multiples than hardware or service companies, since it is thought that their revenues are more predictable.
    a. In a growing company, these metrics often show larger revenue amounts than GAAP-reported revenues.
    b. Neither ARR, MRR nor CARR is a GAAP-approved accounting measure, thus there is less regulation/audit on how to consistently define and calculate these. Thus, companies can define these measures to their best advantage.
    c. If a portfolio company thinks it has an ARR-applicable business or a segment of its business is ARR-applicable, then maybe it should be tracking/reporting/goal setting on the full set of SaaS metrics including new ARR, ARR renewals, ARR upsells, ARR churn (customer and dollars), Customer Acquisition Cost (CAC), Long-term Customer Value (LTV), LTV/CAC ratio, CAC payback period, Gross margins in the 75-95% range, etc. and link sales team compensation to these measures.
    d. In determining the applicable definition of ARR, MRR, or CARR, a company should look to what is the common practice in its industry. When it comes to a funding round, venture debt, or exit, and the company has said its ARR is $X million, a potential black mark is when a prospective funder or buyer conducting due diligence, finds that the company is using a non-typical ARR definition especially to enhance its image.
2. Is all revenue, even from a company that offers all software in the cloud products, ARR revenue?
    a. If the product requires an implementation effort by the selling company, these implementation efforts are recorded as service revenue and not ARR.
3. What if products and services are included in one price on the invoice?
    a. While the usage (subscription) and implementation costs might be bundled into a single contract price, often at the request of the customer or required by the seller to have payment upfront for all products/services, for accounting/reporting these should be separated.
    b. This involves identifying the standalone selling prices of each distinct element in the contract; which may involve estimates which need to be substantiated.
4. What to include in financial reporting?
    a. Management should, and board members must require, that financial reports be prepared using GAAP. Additional schedules can be provided that call out the SaaS metrics.
    b. Public companies, even if they sell 100% SaaS products in the cloud, report using GAAP information. In their annual report or other communications, they can show these non-GAAP measures as additional information, but then have to reconcile them to GAAP.

CONCLUSION

Effectively adopting, managing, and reporting on ARR, MRR, and CARR requires a deep understanding of the applicability to the business model, contract terms, and revenue recognition principles. Adhering to industry standards and utilizing these metrics strategically rather than just creating a better image, can enhance investor confidence.

REFERENCE

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