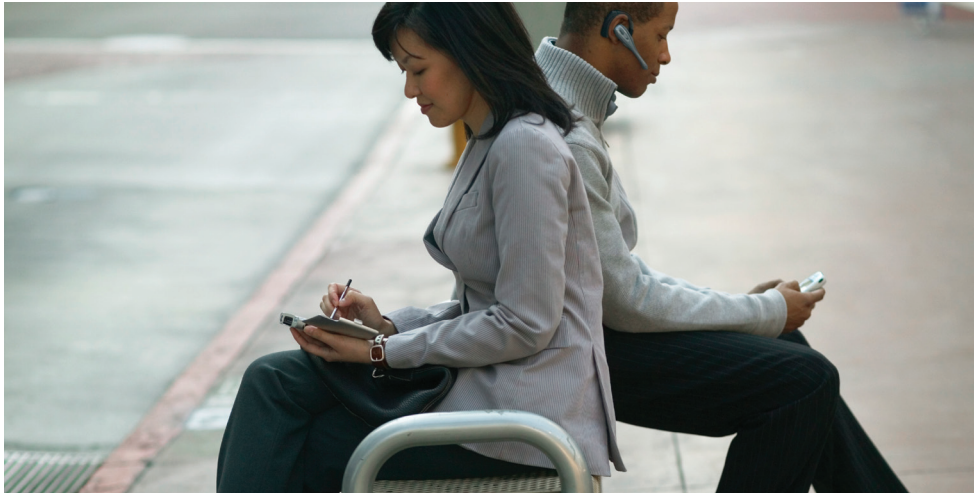


THE NEWSLETTER OF THE BDO TECHNOLOGY PRACTICE

BDO TECH



▶ THE BIG PICTURE



SAAS IS DIFFERENT – AN ACCOUNTING PRIMER FOR SAAS COMPANIES

By Jay Howell of BDO

▶ OVERVIEW

The accounting rules in the United States for software-as-a-service or “SaaS” companies are fundamentally different from the rules more traditional software licensing companies are required to follow. In addition, the revenue accounting rules applicable to SaaS companies have recently changed. Because investors and other stakeholders often evaluate SaaS company performance using revenue and gross margin metrics, application of accounting rules to SaaS companies can be significant to the perception of a company’s value. This article helps to explain the key differences between accounting for SaaS versus traditional software licensing, and how the recent rule changes will affect SaaS companies.

The SaaS business model is rapidly gaining broad acceptance. Existing companies that historically sold software products are increasingly rolling out SaaS offerings, and numerous new SaaS companies are springing up. The software-as-a-service model has been around for a long time, and has been referred to as an application service provider (“ASP”) or hosted service model. However there are a number of recent trends that are converging to make this a much more common and frequently preferred software delivery model including:

Availability of world-class platform-as-a-service (“PaaS”) or cloud computing resources.

Companies like Google, Amazon and Microsoft allow start-up SaaS companies to release service

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DID YOU KNOW...

More than 95 percent of organizations plan to increase their use of SaaS, according to **Gartner**...

A majority (56%) of CFOs at leading U.S. technology businesses are currently using cloud computing in some capacity according to the **BDO 2010 Technology Outlook Survey**...

In an interview with **InformationWeek**, Microsoft CEO Steve Ballmer says that every CIO he talks to is at least considering the move to cloud computing...

A **Network Instruments** survey found that 41% of network managers and IT Pros have some form of public cloud resources available on their corporate systems...

Ninety percent of CFOs report their use of cloud computing will remain the same or increase this year according to the **BDO 2010 Technology Outlook Survey**...

According to an **InformationWeek** survey of 131 business technology professionals at companies using SaaS, Salesforce.com is the most popular vendor (41%), followed by Google (28%), Microsoft (26%) and Oracle (26%)...

CFOs cite cost flexibility (32%), increased scalability (32%) and improved business ability (29%) as the driving reasons for embracing cloud computing according to the **BDO 2010 Technology Outlook Survey**...

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offerings to the market very quickly with minimal infrastructure investment and capital outlays.

A shift in perception regarding security.

Historically, SaaS has been regarded as a less secure model, since SaaS applications run outside of a user's firewall; however more recently, the SaaS model is being recognized as having the ability to be more secure, due to the access to state of the art technology and security measures.

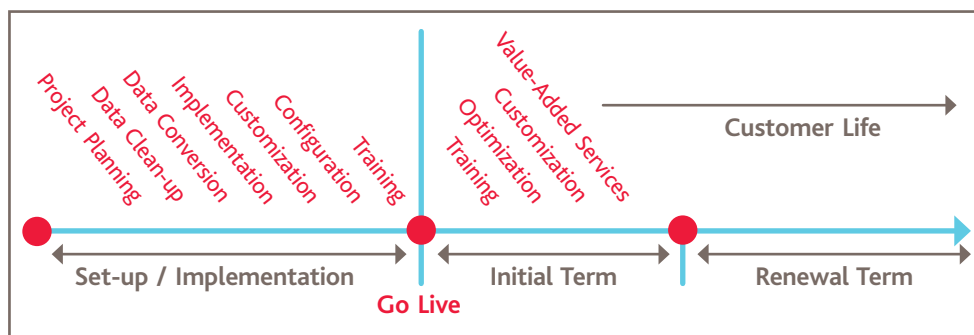
User's demand for scalable solutions.

Companies are looking for software that can be implemented quickly without large up-front costs, and also achieve lower total cost of ownership due to reduced ongoing costs for system maintenance.

Now, more favorable accounting treatment for SaaS companies could also help propel the SaaS model.

▶ SOFTWARE LICENSING VERSUS SAAS

The accounting rules that SaaS companies are required to follow pertaining to revenue and cost recognition are different than the accounting rules that software licensing companies are required to follow because the nature of the underlying transactions with customers is viewed as different. Software licensing is generally treated for accounting purposes as a sale of a product, and SaaS is treated as the sale of a service that is provided over a period of time. As a result, it is important to determine whether software company sales arrangements are considered licensing or SaaS arrangements. Generally, in a licensing arrangement, the customer obtains rights to use the software on its own computers. In a SaaS arrangement, the customer is buying a hosted service based on proprietary software but does not get a copy of the software to use on its own. At times, a SaaS customer will sign a software license agreement, and install interface software on its own computers. However when the primary purpose of this interface software



is to facilitate use of the hosted software services, then this would still be treated as a SaaS arrangement. In other arrangements, the customer receives a copy of the complete underlying software and license rights to use the software on its own computers in addition to using the hosted version of the software. In these situations, if the following two requirements¹ are met, the arrangement would be treated as a licensing arrangement: 1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and 2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. The determination of whether customer arrangements should be treated as licensing or SaaS arrangements is important since it determines which accounting rules apply for both revenue and cost recognition. Generally, for revenue recognition, software licensing companies can recognize a significant portion of the arrangement fee when the software is delivered to the customer, as long as certain criteria are met. SaaS companies are generally required to recognize arrangement fees ratably over the contract term or the estimated life that the customer is expected to use the hosted service.

▶ THE SAAS LIFECYCLE

In order to better understand the revenue recognition issues common to SaaS companies, it is useful to consider the lifecycle of a typical SaaS customer as illustrated in the diagram above.

As illustrated above, SaaS arrangements can include a number of types of services during the set-up and implementation period, and also after commencement of the initial service. Usually there is an initial term, for example one year or one month, and successive renewal periods until the customer ceases to use the service or migrates to a different version of the service. Periodic fees related to the ongoing usage of the hosted service are typically required to be recognized ratably on a straight-line basis over each periodic hosting term. Other services incurred both during and after the set-up period would generally be recognized either when these services are performed or would be deferred and generally recognized ratably on a straight-line basis over the estimated period the customer is expected to benefit from these services through the use of hosted software.

▶ OTHER SERVICES

Determining whether the other services should be recognized when performed or over the expected period of benefit depends on the nature of the particular services. Services that have standalone value² to the customer apart from the hosted software services can generally be recognized when performed. If, however, the services do not have standalone value, then they would generally be treated as set-up fees, and recognized over the longer of the initial contract period or the period the customer is expected to benefit from payment of the up-front fees.³ It can be difficult and judgmental to establish that other services provided to SaaS customers have standalone value apart from the hosted

¹ Accounting Standards Codification (ASC) 985-605-55, *Software Revenue Recognition*, paragraphs 121 to 125 (formerly EITF Issue 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware)

² ASC 605-25-25-5, *Multiple Element Arrangements* (formerly EITF Issues 00-21 and 08-1)

³ SEC Staff Accounting Bulletin 104, footnote 39 states: "The revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee (e.g., if subsequent renewals are priced at a bargain to the initial up-front fee)."

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software services. In addition, services that are provided subsequent to the go-live date might also not have standalone value if the customer only benefits from these services from the continued use of the hosted software. The primary criterion to consider when assessing the standalone value of the services is whether there are other third parties that separately sell similar services, however this criterion requires careful judgment to apply. This can involve a careful analysis of the nature of the various services being provided to determine whether any have standalone value. Also, it is important to note that the standalone value criterion is not applicable to software licensing companies. These companies are typically able to recognize revenue from other services when performed. They are not required to defer this revenue over the expected period of benefit, providing different applicable criteria are met.

When other services are viewed as set-up services and recognized over the expected period of benefit, this period must be estimated using all available information. SaaS companies often closely monitor customer attrition or churn rates, and based on historical results, project future expected rates for forecasting purposes. The historic rates and projections would often serve as a starting point for assessing the expected period of customer benefit. Some SaaS companies have a high churn rate or might have technology that is subject to change and obsolescence, in which case the expected period of benefit might be shorter. Other SaaS companies have relatively sticky customers and technology that is not expected to change significantly, in which case the expected period of benefit might be longer.

▶ ALLOCATING THE ARRANGEMENT CONSIDERATION – CHANGING RULES

Historically, SaaS companies have been required to establish the fair value of the hosted software service. This is necessary in order to allocate the appropriate amount of revenue to the ongoing hosted service and recognize the remaining “residual” consideration attributed to the other services when those services are performed.



However this requirement to establish the fair value of hosted services was recently eliminated, making it significantly easier for SaaS companies that provide other services with standalone value to recognize revenue attributable to those services when performed. The new accounting rules⁴ are required for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, and can be adopted earlier. Under the new rules, companies are required to identify the other services that have standalone value and allocate the total arrangement consideration on a pro rata basis between the other services and hosted services. These allocations are based on the company's best estimates of selling prices as if the different services were sold separately. As a result of this change, SaaS companies will have significantly more flexibility when pricing services. Many SaaS companies historically were careful to price their hosted service offerings in a sufficiently narrow range in order to meet the onerous fair value revenue criteria to allow other services with standalone value to be recognized when performed. These companies will now be able to price the hosted services based on market conditions without regard to accounting requirements. It is expected that value-based pricing could become more common as a result of this change.

The new requirement to use estimated selling prices will often require SaaS companies to perform additional analysis of the nature of the other services to assess which services might have standalone value. Additional analysis of the respective estimated selling prices of the hosting and other services will also be required. While the standalone value criterion is not new, it was often not required to be assessed because the fair value criterion

was not met. Now, the standalone value criterion is likely to receive renewed attention. For purposes of estimating selling prices, SaaS companies will often reference data from other transactions where similar services and the hosted service are sold separately. This data can be considered when estimating the separate selling prices of these services.

▶ FUTURE RELEASE ROADMAPS

It is not uncommon for customers of SaaS and software licensing companies to request access to roadmaps of upcoming future upgrade and product releases, including rights to receive specified future upgrades and new products when released. Historically, when rights to specified upgrades and new products were provided to customers, this commonly required deferral of all revenue until the specified upgrades or products were delivered, since it was typically difficult to establish fair value of these future upgrade or product rights. Under the recently revised revenue accounting rules, this is no longer an issue for SaaS companies, since they will now be able to use their best estimate of selling prices of the upgrades or new products to allocate revenue between the existing hosted service and future upgrade rights or new products. They can then start recognizing the portion of revenue related to the existing hosted service as soon as the customer begins using that service. However, since the rules for software licensing companies have not been changed, and still require establishment of fair value of the upgrades or new products, those companies would generally still be precluded from recognizing any revenue until delivery of the specified upgrades or new products. This ability to offer specified future upgrades and new service offerings can provide SaaS companies that are competing against software licensing companies with a significant competitive advantage.

▶ COSTS

There are two different types of costs incurred by SaaS companies that are relevant to consider from an accounting perspective: 1) costs to develop and maintain the underlying software used to provide the service; and

⁴ The Financial Accounting Standards Board (FASB) approved Accounting Standards Update 2009-13 in October 2009. This Update amends the criteria in ASC 605-25 for separating consideration in multiple-deliverable arrangements.

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SAAS IS DIFFERENT

2) direct customer costs related to specific customers.

Some development costs can be capitalized and amortized over the expected life of the software and other development costs and all maintenance costs are required to be expensed as incurred. Exactly which costs can be capitalized depends on whether the underlying software being developed is expected to be licensed for use on a customer's own computers, or solely used internally to provide hosted services to customers. As a result, software licensing companies are required to follow one set of accounting rules⁵ when determining whether to capitalize software development costs, and SaaS companies are often subject to different accounting rules⁶ if they do not have plans to separately license the software.

Direct customer costs incurred at the beginning of an arrangement, such as set-up costs or sales commissions, can either be expensed as incurred, or deferred and recognized as the related revenue is recognized based on accounting policy election.⁷ Once this policy is established, it should be consistently followed. Many SaaS companies elect to defer these costs and recognize them over the period that the revenue is being recognized, however this can result in an increased recordkeeping burden. For example, when providing other services during the set-up period, costs that relate to services with standalone value should be recognized as those services are performed, and costs related to set-up services that don't have standalone value can be deferred and recognized ratably over the expected period of customer use of the hosted service.

▶ CONCLUSION

SaaS companies often struggle with assessing how to price their products and services because of their unique nature and the complex competitive landscape. Understanding the accounting implications of arrangement pricing is an important aspect, and SaaS companies now have much greater flexibility to price competitively under the new accounting rules. In addition, the ability of SaaS companies to offer rights to

FAIR VALUE AND ESTIMATED SELLING PRICES

Software licensing arrangements can include future services such as maintenance and support, and other future deliverables, such as rights to specified future upgrades. In order to recognize revenue pertaining to the software products delivered to the customer, it is necessary to establish the fair value of all products and services that will be delivered in the future to ensure that the appropriate amount of revenue attributable to the undelivered products and services is deferred. A residual value method is then typically used whereby the full fair value of the future products and services is deferred, and the remaining (residual) contract value is allocated to the delivered software and recognized as revenue.

Fair value is determined based on vendor specific objective evidence or "VSOE" which is defined as the prices that the company separately sells the products or services for. The separate sales prices must be within a sufficiently narrow and consistent price range in order to establish VSOE, and software licensing companies are required to track their separate sales prices for purposes of assessing whether VSOE has been established. If VSOE cannot be established for all future products or services in an arrangement, then all revenue is either deferred until the future products and services have been delivered, or recognized ratably over the term of the agreement. Detailed accounting guidance for software companies regarding the above rules is provided in ASC 985-605 (previously SOP 97-2 and related interpretive literature).

Historically, SaaS companies have also been required to establish VSOE of the hosted services that are delivered over the term of the arrangement in order to recognize revenue from other services that have standalone value when those services are performed, however the rules applicable to SaaS companies came from the more general accounting literature located in ASC 605-25 (previously EITF 00-21). Last year, however, the FASB eliminated the requirement in ASC 605-25 to establish VSOE of fair value for purposes of unbundling revenue arrangements. Under the new guidance, SaaS companies should use VSOE of estimated selling prices of all deliverables in an arrangement to allocate the total consideration, however if VSOE of estimated selling prices is not available, then SaaS companies can use their best estimate of the separate selling prices of each deliverable to allocate revenue. The best estimate of separate selling prices should take into account all available information, and would likely change over time. Also, under this methodology, revenue should only be separately allocated to deliverables that have standalone value. Other services that have been determined not to have standalone value would not be considered for arrangement allocation purposes, and fees related to these services would be treated as set-up fees under SAB 104. The literature also allows use of third party data to determine selling prices, however SaaS companies rarely have access to third party selling price data for products and services that are sufficiently similar to their own products and services.

specified future products and upgrades in sales arrangements should provide the SaaS model with a significant competitive advantage over the traditional software licensing model. Obtaining a strong understanding of the application of accounting rules to SaaS companies will help to optimize customer arrangements for maximum value and ensure

the reliability of financial information reported to outside investors and other stakeholders.

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⁵ ASC 985-20, *Costs of Software to be Sold, Leased or Marketed* (formerly SFAS 86)

⁶ ASC 350-40, *Internal Use Software* (formerly SOP 98-1)

⁷ SEC Staff Speech by Russell Hodge (<http://www.sec.gov/news/speech/spch120604rph.htm>)

THIRD-PARTY ASSURANCE OPTIONS FOR SAAS PROVIDERS



By Ray Cheung of BDO

SAAS PROVIDERS OFTEN FIND IT NECESSARY OR USEFUL TO PROVIDE CUSTOMERS WITH SOME FORM OF INDEPENDENT THIRD-PARTY ASSURANCES REGARDING THE SECURITY AND RELIABILITY OF THEIR SOFTWARE SYSTEMS AND SERVICES.

Audit and compliance functions have always played an important role in traditional outsourcing relationships. However, these functions take on increased importance in the SaaS industry given the dynamic nature of the software as a service ("SaaS") environments. SaaS providers are challenged to establish, monitor, and demonstrate ongoing compliance with a set of controls that meets their customers' business and regulatory requirements. This article provides an overview of the types of third-party assurance services that are available to SaaS providers.

There are four primary third-party assurance options available to SaaS companies. Each provides a differing type and level of assurance regarding security and reliability of the software systems and services. These are summarized as follows:

1. **SAS 70 (<http://www.aicpa.org/>)**
 - a. Audit of financial reporting controls based on control objectives and control activities (defined by the service provider).
 - b. Auditor opinion on the design, operational status, and operating effectiveness of financial reporting controls.
 - c. Intended to cover services that are relevant for purposes of customers' financial statement audits.
 - d. Often required by customers when the SaaS offering is financial in nature.
2. **SysTrust (<http://infotech.aicpa.org/>)**
 - a. Audit of controls based on defined principles and criteria for security, availability, confidentiality, and processing integrity.

- b. Intended to apply to the reliability of any system.

3. WebTrust (<http://infotech.aicpa.org/>)

- a. Audit of controls based on defined principles and criteria for security, availability, confidentiality, processing integrity and privacy.
- b. Intended to apply to online/e-commerce systems.

4. ISO 27001 (<http://www.iso27001.com/>)

- a. Audit of an organization's Information Security Management System (ISMS), as defined in a document ISMS.

► SAS 70

Statement on Auditing Standards No. 70 (SAS 70) was developed by the American Institute of Certified Public Accountants (AICPA) to provide a mechanism for service organizations to complete an audit of their controls resulting in a report that could be provided to their customers and their customers' auditors. This audit framework was designed to facilitate completion of the service organization's customers' financial statement audits while reducing the need for multiple audits of the service organization's controls.

The service organization may choose to align its controls with a standard such as ISO 27001 and reflect this in the SAS 70 report, but this is not required. Given the importance of outsourced control activities, the concept of SAS 70 audit has broad international acceptance. Thus, the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board (ASB) in the United States have recently issued, in March 2010, new audit standards that replace the existing SAS 70 standards. While the new standards have been improved in many regards, from a service organization's standpoint, the new standards achieve the same objectives and will appear similar in nature to the prior standards.

► SYSTRUST

SysTrust is an audit framework that was developed by the AICPA and Canadian

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THIRD-PARTY ASSURANCE OPTIONS

Institute of Chartered Accountants (CICA) to provide a mechanism for service providers to complete an audit based on a predefined set of criteria for security, availability, processing integrity, and confidentiality. Whereas SAS 70 was intended to focus on financial transaction processing, SysTrust was designed to apply to the reliability of any system – focusing on the principles of security, availability, confidentiality, and processing integrity. As a result, it is particularly well suited to SaaS providers serving enterprise customers. SysTrust reports focus on the operating effectiveness of controls over a period of time.

▶ WEBTRUST

WebTrust is another AICPA/CICA audit framework, very similar to SysTrust, but is intended to focus on e-commerce services – often where there is direct interaction with individual end users. WebTrust uses the same criteria as SysTrust. It can also include privacy criteria (based on Generally Accepted Privacy Principles) where the service provider is interacting with and collecting personal information from individual end users in accordance with a Privacy Policy.

▶ ISO 27001 CERTIFICATION

ISO 27001 certification is another available audit approach. With this approach, the auditor assesses whether the organization has a formal ISMS in place – including documentation of the ISMS, completion of risk assessment, development of a risk remediation plan, and implementation of processes for responding to identified issues. Typically, the certification is valid for three years and involves an initial audit with smaller update audits performed approximately annually during the remainder of the three-year period. The ISO 27001 certification is more focused on the overall security program rather than the effectiveness of specific control activities.

▶ WHAT SHOULD SAAS PROVIDERS DO?

SaaS providers should understand the aforementioned assurance tools and consider their applicability to their own services offerings. The matrix in the table above was developed to summarize how selected existing SaaS providers are currently using these assurance tools.

SaaS Market Segment	SaaS Providers	SAS 70	Web or SysTrust	ISO 27001
Content, Communications and Collaboration	Cisco WebEx	Yes		
	SumTotal	Yes		
Customer Relationship Management	Salesforce.com	Yes	Yes	Yes
	Oracle's AppsHosting	Yes		
Enterprise Resource Management	SAP	Yes		Yes
	NetSuite	Yes		
	Venture Soft	Yes	Yes	
	Hyland Software	Yes	Yes	
Supply Chain Management	Ariba	Yes	Yes	
	Log-Net	Yes		
Office Suites	Google Apps/Postini	Yes	Yes	
	Zoho			
Security	Identrus	Yes	Yes	
	Qualys	Yes	Yes	Yes
	Verisign	Yes	Yes	

Data based on publicly reported information. BDO assumes no responsibility for accuracy.

▶ CONCLUSION

Obtaining third-party assurance with respect to SaaS systems and services can be beneficial in two ways:

1. To help establish initial credibility with customers and/or to respond to customers' requirements; and
2. To help protect ongoing brand credibility in the marketplace.

One of the more significant risks that SaaS companies face is data security and reliability of their services, and if there is an issue in this regard, a company's reputation could be severely damaged. The control assessment frameworks described in this article are all different from a traditional financial statement audit, which generally does not specifically address the security and reliability of the hosted service. Selecting the appropriate assurance tools that align with the SaaS provider's security and reliability objectives is an important consideration for SaaS providers.

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