ACCOUNTANCY

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Solving the SaaS enigma and accounting for it

Understanding the nature of SaaS is crucial to getting finances right | Photo Credit: Getty Images

With renewed R&D focus and large talent pool, India is poised to become the software capital of the world

The pandemic has hastened the shift toward cloud computing — some with the notion of anytime-anywhere access and others due to budget constraints. There has been a mammoth demand for cloud-based software models such as SaaS (Software as a Service), IaaS (Infrastructure as a Service) and PaaS (Platform as a Service).

SaaS system gives a convenient means to access software. The user is not required to buy and install the software, spend on maintenance and security costs, or purchase upgrades, especially given the fast pace of change and obsolescence. It can be accessed from anywhere using the internet, offers various subscription plans to suit specific user needs, and provides regular updates and customisation, if required.

As per a 2019 McKinsey & Company report, the SaaS market will be valued at $200 billion by 2024.

The industry has had such an exponential growth that it is currently at $300 billion market.

A major chunk of SaaS companies are based in the US, the UK, and Canada, currently. India is ranked sixth position in the list of leading SaaS-producing countries. However, India also has the third largest start-up ecosystem in the world and 18 out of the 107 unicorn start-ups belong to the SaaS category.

The Indian companies are expected to capture 8-9 per cent of the global SaaS market share by 2025, according to a Bain & Company report. With renewed R&D focus and a large talent pool, India has the potential to become the SaaS capital of the world in a few years.

Costs and budgeting

There are multiple steps involved in developing and rolling out SaaS products in the market and various costs are incurred at every step of the process.

Starting with the first step for any business — the planning and research phase, which involves analysing viable resources to develop the product, market demand, and competitor analysis. The costs incurred at this juncture are expensed as it is the preliminary stage of production. All costs incurred before product development are to be treated as expenses as the asset is not in existence.

The next and most crucial step is the application development phase. The major costs that are incurred at this stage are direct costs involved in the software development — software design, licenses and fees, third-party developer fees, software testing; payroll costs of employees developing the software; and borrowing costs.

All costs incurred in respect of development are capitalised if the entity considers the product to be "technically feasible" and it will subsequently be available for sale in the market.

Effective practices

The technical feasibility of the product is subjective and hence, the accounting approach differs from entity to entity. These costs are capitalised and treated as intangible assets as they add value to the software being developed. Then, they are amortised or expensed over the estimated useful life of the software, which varies from three to five years. After the software is developed, there are certain inevitable recurring expenses incurred for efficiency fixes and R&D updates for newer versions. These costs should be recognised as expenses and taken to the profit and loss statement as they are incurred after the product is available for sale.

Post-development costs spent on user training, sales and marketing are expensed when they are incurred. According to the 2021 annual survey by SaaS Capital, a growth debt provider for SaaS entities, R&D and administrative costs constitute the major expenses.

Given that SaaS is a service agreement for a limited period, the subscription costs are treated as expenses when the contract commences. Similarly, configuration and customisation are also recognised as expenses.

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