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BDO TECH

SEEKING SAAS – WHAT DO SOFTWARE COMPANIES NEED TO KNOW?

By Hank Galligan

In the beginning of 2014, Forrester projected that software would have the fastest revenue growth of any tech category. Software as a service (SaaS) has been a huge driver of that growth, increasing at over 20 percent per year, according to Forrester. Meanwhile, traditional licensed software growth has slowed, leaving many software companies that have not adopted a SaaS model realizing they are behind the curve.

Transitioning to the SaaS model has been, and is likely to continue to be, a strategic move for software companies. Forrester reports that the U.S. accounts for nearly 60 percent of SaaS and analytics spending, and companies are increasingly looking to capitalize on that market. Talkin' Cloud's recent poll on cloud computing, for example, found that 46 percent of participants plan to invest more in SaaS, and 81 percent of respondents reported they offer SaaS to customers.

▶THE CHANGING BUSINESS MODEL

SaaS models are becoming more and more relevant as the business environment changes and the tech industry evolves. Traditionally, organizations purchased enterprise software—bought and installed software on the organization's servers—but on-premise solutions are becoming overpowered by SaaS, especially with the increasing use of mobile devices and related applications. As an increasing number of users look to streamline

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▶DID YOU KNOW...

According to ***Cisco's fourth annual Global Cloud Index***, the cloud will account for 76 percent of total data center traffic by 2018.

Software as a service (SaaS) is expected to be a $45.6 billion global market by 2017, the ***Economic Times*** reports.

Public IT cloud spending will reach $56.6 billion in 2014 and grow to more than $127 billion in 2018, reports ***International Data Corporation (IDC)***.

According to ***Synergy Research Group***, Microsoft has the highest growth rate among the leading cloud infrastructure service operators, growing its revenue by 136 percent on a rolling annualized basis.

There were 244 M&A deals involving software companies in Q2 and 175 transactions in Q3, according to ***BDO's Global TECHtalk report***.

SaaS will continue to dominate public IT cloud services spending, accounting for 70 percent of 2014 cloud services expenditures, according to ***IDC***.

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their work, they are looking for cloud-based services that offer online access.

Recent statistics suggest that the days of selling software entirely on a perpetual license basis, in the manner of on-premise software, are numbered. By transitioning to a SaaS model, companies will be able to provide customers easy administration, automatic updates, compatibility, easy collaboration and global accessibility. As software companies prepare for the changing business model, they will no longer receive a large payment upfront; instead they will receive periodic payments over the period of usage. Overall the periodic payments for the use of their SaaS service exceed the payments under the traditional license model.

WHAT'S DRIVING THE CHANGE

Aside from the obvious factors driving the shift to SaaS, such as easy installation, management, updates and the low initial costs, today's mobile workforce and the need to foster a more collaborative "virtual environment" is driving the change to the cloud even faster than before. As the cloud continues to dominate the industry and more companies adopt a mobile workforce, organizations will need a structure that cultivates a collaborative workplace and offers employees easy and flexible access to their technology. In fact, according to *Inc.,* the number of employees working from home or on the go has increased 60 percent since 2005.

Even long-established enterprise organizations, such as Microsoft, are introducing more cloud-based offerings. In a recent interview at a media event in San Francisco, Microsoft CEO Satya Nadella said the company is in the cloud computing game for the long haul and developed Office 365 and Microsoft Dynamics—both cloud-hosted SaaS applications—to meet increasing consumer demand.

One particular industry that has been significantly impacted by SaaS is healthcare. Technology and healthcare reform have transformed the industry, empowering consumers and providing the opportunity for more access to information and data than ever before. Many software companies see an opportunity to help empower consumers, physicians and healthcare organizations to improve the quality of care, specifically through digital applications. According to the 2014 HIMSS Analytics Cloud Survey, 67 percent of IT healthcare organizations are running SaaS-based applications today, and 92 percent of healthcare providers see the value of cloud services for their organizations.

KEY CHALLENGES OF SAAS FOR BUSINESS

Software companies will face numerous challenges as they make the transition to a SaaS model. As many middle market software companies wrestle with the shift to SaaS, they must be aware of how this business shift will impact their reported revenue. Equally important is that they will need to manage

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INNOVATING THE WAY WE MANUFACTURE PHYSICAL OBJECTS:

AN INTERVIEW WITH AVI REICHENTAL, CEO OF 3D SYSTEMS

Last month, **partner and leader of BDO's Global TMT M&A Jakob Sand** interviewed **Avi Reichental, CEO of 3D Systems**, about the latest developments in the dynamic 3D printing market. According to Reichental, major technology companies, such as HP and Autodesk are moving into the 3D printing market, demonstrating this sector's explosion in the last few years. Having spent more than 30 years advancing his company, Reichental has learned that there is no one-size-fits-all approach to 3D printing solutions.

Moreover, Reichental explains that healthcare and manufacturing are two areas benefitting the most from 3D printing technologies. Healthcare is able to benefit through the use of scan data from individual patients to create specific and customizable designs. 3D printing technology is used to create surgical guides, implantable devices, hearing aids, prosthetics and more. Moreover, there are plenty of opportunities for manufacturers as well, particularly as 3D printing offers "free complexity," which means there is no additional cost or penalty for complexity. This translates into improved functionality. As consumers remain fascinated with customization, 3D printing will continue to grow to meet those demands.

Reichental also discusses 3D printing and its place in mainstream industrial use. Almost every company that manufactures a product will use 3D printing at some point in its production process. As this form of printing continues to become readily accessible in various industries, Reichental's goal for 3D Systems is to expand and enhance its technology by integrating and streamlining every step of the workflow.

For more insights on 3D printing trends, read the full Q&A on BDO's Tech and Media Watch Blog.

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SEEKING SAAS

the expectations of the users of their financial statements. Either under existing rules or the new revenue recognition standards, their reported revenue will likely be significantly impacted. Please see the sidebar "Revenue from Contracts with Customers: What Software Companies Need to Know" for more information.

Security concerns have become more prevalent than in years past with the growing popularity of cloud-based applications. Many customers fear unauthorized access to proprietary information and security defects. With an increasing number of mobile employees and having to store sensitive information in the cloud, organizations need to be mindful of the risk of unwanted intrusions to their cloud infrastructure and ensure they have an emergency plan in place. Companies could consider embedding a required periodic independent verification for users to maintain the system's security. Overall, SaaS companies need to have a secure system which their customers can rely on, but building such an environment can be difficult and costly.

Moreover, software companies that offer SaaS models and cloud applications will need to ensure their infrastructure has the capability to provide automatic and frequent updates as well rapid responses to any technical issues.

Aside from the challenges, there are promising opportunities for companies in the SaaS and cloud computing space. According to IDC, public cloud computing services are forecast to grow at six times the rate of the overall information technology market over the next five years. With this surge in cloud spending, software companies may be well positioned for success by offering SaaS products rather than traditional enterprise applications.

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PErspective in Software

PRIVATE EQUITY INTEREST IN TECHNOLOGY COMPANIES, PARTICULARLY SOFTWARE, IS SOARING.

The first three quarters of this year saw $29.03 billion worth of private equity deals in the technology sector, making it the most active sector of the year to date, according to financial data firm Dealogic.

It is not just tech startups that are drawing interest. Older, well-established software companies—especially those that have been around 20 years or more—have recently become targets for private equity firms looking for acquisitions with lots of scope for modernization and optimization. BMC Software, Compuware and Tibco Software, for example, have all been recently acquired in PE-backed deals. Legacy infrastructures provide lots of room for improvement. For instance, Dynatrace—which has just spun off from its parent company Compuware—is the kind of software company that PE firms are going after because its long-standing finance, IT and human resources infrastructure needs to be revamped and modernized, *Computing* magazine reports.

All three of the above-mentioned software firms have multibillion dollar turnovers and are profitable, and yet management was quick to agree to takeovers, according to *Computing* magazine. As public companies, it is difficult to take aggressive action to cut costs and modernize operations. Furthermore, announcing significant tech spends in a quarter where revenues are less than expected is not possible in the spotlight of the public markets. Going private is also attractive as it frees up management to focus on restructuring rather than spending time on the road talking to shareholders and responding to quarterly earnings reports.

For private equity fund Vista Equity Partners, its $4 billion leveraged buyout of software giant Tibco Software served as a taste of what is to come. Vista, which limits investments to software, data and technology-enabled companies, recently finalized a new $5.8 billion fund—its fifth and largest to date—to focus on acquisitions of high-profile technology companies, according to *The Wall Street Journal.* In October, the fund announced new deals to acquire payments company TransFirst and Navex Global, a maker of compliance software, in deals worth a combined total of $2 billion.

Aside from Tibco, other financial technology firms have been drawing interest from private equity firms. For example, Carlyle Group has acquired financial data provider Dealogic for $700 million. And Blackstone and Goldman Sachs Group's merchant banking division have become majority stakeholders in Ipreo, a market intelligence, data and technology provider to global capital markets firms.

Looking forward, the big space to watch is cloud computing services companies. According to research firm IDC, public IT spending is set to hit $127.5 billion in 2018, up from $56.6 billion this year—a compound annual growth rate of 22.8 percent. Cloud computing is entering an innovation stage and by 2018 will account for more than half of worldwide software, server and storage spending growth, according to IDC. Expect cloud services companies to proliferate and intense competition to drive industry consolidation as firms vie for market share—providing plenty of opportunities for private equity investors.

PErspective in Software is a feature examining the role of private equity in the software industry.

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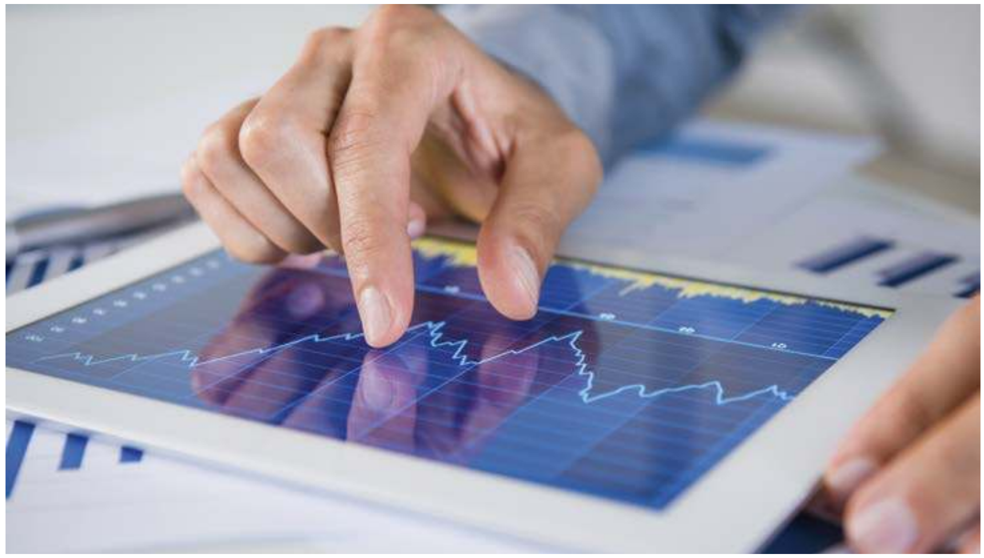
TECH IPOs AND M&A ARE HERE TO STAY

By Demetrios Frangiskatos and Mark Giamo



As consumer demand for innovative products and services continues to grow, the technology industry is making waves in the public market and encouraging interest from investors as well as financial and strategic buyers. With corporate investors and financial services firms, including hedge funds, becoming more active and writing larger checks to technology companies than before, capital has become plentiful for companies.

The overall IPO market in 2014 has been particularly strong and has already outpaced 2013. According to *Forbes*, 249 companies across all industries have gone public through October, and there are another 122 IPOs in the pipeline. This well surpasses last year's total 122 offerings. The technology sector, in particular, has been at the forefront with the Internet software and services subsector seeing the most investment activity than any other subsector. In fact, according to CB Insights, there are currently 320 Internet companies on its Tech IPO Pipeline, an increase of 39 percent from last year's list. Although Alibaba has grabbed headlines with its mega IPO back in September, the middle market for technology IPOs has also flourished. According to *Renaissance Capital*, there have been 48 U.S. technology IPOs to date with total proceeds of $30.7 billion.

The industry's momentum is forceful, and the Alibaba offering is spurring investor confidence. Investors are seeking investments with higher returns through equity markets, and as a result U.S. IPOs have benefited, outpacing overall market returns. According to the 2014 BDO IPO Halftime Report, the four key drivers of IPO activity are 1) private equity and venture capital firms needing to cash in profits; 2) positive IPO performance encouraging more businesses to move forward with offerings; 3) low interest rates increasing investor demand for higher yielding assets; and 4) increased confidence in the U.S. economy. Another factor impacting the IPO market is the JOBS Act which encourages small and developing companies to go public in the U.S. and are known as "emerging growth companies." As many as 80 percent of new registrants are considered an emerging growth company since the law was passed in 2012, according to the *Wall Street Journal*.

Financial sponsor IPOs continue to drive the market as pricing has been strong. Private equity and venture capital sponsors see this market as an exit opportunity. As dual track exits become a viable option again, many sponsors are using this strategy to explore M&A opportunities as well. This increasing strategy among companies could be a contributing factor to the robust M&A activity in the technology sector. As technology companies respond to rapid changes in consumer and market trends, they are turning to M&A to strategically align themselves for success. In addition, financial sponsors continue to have significant dry powder to keep the M&A momentum going while strategic buyers look for ways to accelerate innovation and improve user experiences among their primary customers. According to *Financial Times*, M&A activity has increased in almost every sector of the economy, and the value of M&A reached $2.66 trillion in the overall global market in the first three quarters of 2014. In addition, BDO's Global TECHtalk report on the global technology market found that the international software market saw a total of 175 M&A transactions.

The gaming space, which flows into software, is setting new records in M&A. According to *VentureBeat*, acquisitions of gaming companies have topped $12.2 billion in the first three quarters of 2014. The two most notable deals from this year are Microsoft's $2.5 billion acquisition of Minecraft maker Mojang and Facebook's $2 billion acquisition of Oculus VR. The rising popularity of mobile, cloud and social may be contributing to the robust M&A activity in gaming and the overall technology market as well. *Digi Capital* reports, for example, that during the past 12 months, mobile Internet M&A has seen over $45 billion in total deal value, and mobile-focused M&A alone is up five times from the previous year.

Given the strong performance of recent IPOs in the technology sector and the wealth of opportunity for M&A deals, middle market technology companies appear to have plenty of options for growth in 2015 as they look to adapt to the needs of diverse technology subsectors and customers. Overall, the industry is poised for growth—consumer demand is strong globally, emerging markets are seeing growth opportunities and commercial needs for innovative services and products are always increasing.

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ARE YOU MISSING OUT ON SECTION 199 DEDUCTIONS?

Many software businesses may be able to take advantage of the Section 199 Deduction for Domestic Production Activities but are not doing so.

By Chai Hoang and Jonathan Forman

SOFTWARE COMPANIES COULD BE MISSING OUT ON A VALUABLE DEDUCTION DUE TO ITS SEEMINGLY INAPPLICABLE NAME.

Section 199, also known as the Domestic Production Activities Deduction (DPAD) or the Domestic Manufacturing Deduction, is centered on production and manufacturing activities. The deduction is, however, also applicable to many other activities, including software development. With the proper knowledge and understanding of its intricacies, determining this deduction can be worthwhile and provide substantial benefits for software companies.

▶BACKGROUND

DPAD provides a tax deduction for production within the United States and was enacted with the intent to reward and enhance job growth and competitiveness. DPAD generally gives a deduction equal to 9 percent of income from qualifying domestic production activities. Businesses that operate in the following industries may be eligible: manufacturing tangible property, computer software, sound recordings, construction, engineering or architectural services, qualified film or the production of electricity, natural gas or potable water.

The deduction is allowed for both regular and the alternative minimum tax for corporations—both C and S corporations—individuals, partnerships and limited liability companies. Under a "safe harbor" rule, companies can claim the deduction even if their production activities are only partially produced in the U.S., as long as its domestic labor and overhead related to production activity account for at least 20 percent of its total cost of goods sold (COGS).

Although the benefit was designed to incentivize U.S. production, its limitations, complex rules and potentially onerous compliance requirements have deterred some taxpayers from claiming the deduction. Still, with its many attractive characteristics, companies should seek to claim these benefits and enlist the help of tax professionals, if necessary.

▶SOFTWARE CONSIDERATIONS

A company producing computer software within the U.S. should consider its eligibility for this deduction. Computer software includes code for video games, equipment that is an integral part of other property, typewriters, calculators, adding and accounting machines, copiers, duplicating equipment and similar equipment. This category further includes any incidental and ancillary rights necessary to effect the acquisition of title to or right to use the software.

With this broad definition, software businesses are well-positioned to take advantage of the DPAD. Treasury has, however, somewhat limited the ability of these businesses to claim the deduction by excluding gross receipts derived solely from online software or software as a service (SaaS) delivery models. With companies offering more and more software exclusively online, it may be more difficult for them to claim this deduction.

Thankfully, there are two exceptions to this general rule. The first exception applies if a company generates gross receipts from software provided in a tangible or downloadable form that is nearly identical to the online software in question. The second exception applies when an unrelated party offers software in a tangible or downloadable form that is substantially identical to the online software. Thus, as long as either the company or a third party offers substantially identical software to the online software and offers it in a tangible or downloadable form, then the online software may also be eligible for the deduction.

In 2012, the IRS released a memorandum addressing whether certain third-party

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SECTION 199 DEDUCTIONS

computer software products were equivalent to a taxpayer's online software in order to meet this second exception. The outcome is that a company cannot aggregate multiple software programs in order to meet the exception. Fortunately, components of the online software can be used if a company can identify other businesses that offer substantially identical features offline.

Furthermore, on Nov. 7, 2014, the IRS National Office released in a Technical Advice Memorandum that a taxpayerconducted qualifying activity from licensing customized software to contracting parties that then used their own data in conjunction with the licensed computer software to provide services to end users.

In addition to the pure software development opportunity, there is also an exception for software that is part of a hardware product. If the software development takes place in the U.S. and the cost of the software development is 20 percent or more of the total COGS of the product, the entire product is eligible for the DPAD regardless of the manufacturing location. This is a significant opportunity for companies that write software for hardware products that may be manufactured offshore.

CONCLUSION

The DPAD provides software companies an attractive opportunity to effectively lower their tax rate by approximately three percentage points. The Joint Committee on Taxation estimates that the DPAD will cost $78.2 billion in foregone revenue from 2013 through 2017. With this sizable expected benefit and the chance to lower tax rates, software businesses that are not already claiming this deduction should consider reassessing their activities to determine whether or not they are leaving generous benefits on the table.

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REVENUE FROM CONTRACTS WITH CUSTOMERS: WHAT SOFTWARE COMPANIES NEED TO KNOW

By Hank Galligan

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 establishes comprehensive accounting guidance for revenue recognition and will replace substantially all existing U.S. GAAP on this topic. ASU 2014-09 is converged with IFRS 15, the comparable new standard issued by the IASB.

The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It utilizes the transfer of control between the parties to determine the pattern of revenue recognition based on the consideration to which the vendor is entitled.

To accomplish this objective, the standard requires five basic steps:

1. Identify the contract with the customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Most software entities adopting the new standard will experience a change in the timing and manner of revenue recognition. Some of the more significant potential changes for software companies include:

- The requirement for Vendor Specific Objective Evidence (VeSOE) is eliminated.
- Payments from customer which extend beyond one year will no longer automatically preclude revenue recognition.

For many software companies, the changes could be significant and will require careful planning. Stay tuned to our Revenue Recognition Resource Center, which includes an in-depth publication with examples and practical considerations for your business, and make sure to discuss early and often with your advisor.

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MARK YOUR CALENDAR...

The following is a list of upcoming conferences and seminars from the leading technology associations and business bureaus:

DECEMBER 2014

December 17-19
International Conference on Software Engineering and Digital Technology
Toshi Center Hotel
Tokyo, Japan

JANUARY 2015

January 4-6
International Conference on Software Reuse
University of Miami
Miami, Fla.

January 12-15
Software Engineering Institute's FloCon
Hilton Portland & Executive Tower
Portland, Ore.

FEBRUARY 2015

February 6-12
DeveloperWeek
Pier 27
San Francisco, Calif.

February 7-11
International Symposium on High Performance Computer Architecture
Bay Area, Calif.

February 22-26
Pulse at Interconnect 2015
MGM Grand & Mandalay Bay
Las Vegas, Nev.

** Indicates that BDO is sponsoring and/or speaking at this event.*

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