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Software As A Service: Value To Go

SaaS can deliver great long-term value. But comparing the financials is complicated, requiring a new approach to sorting through the options



by Barry Rosenberg and Craig Wright
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Software as a service is one alternative to traditional software-purchasing models that's getting lots of hype. What's important to evaluate in detail, however, are the precise economics and ROI of the SaaS model, and what those details say about the viability of the process for your company. We believe that SaaS is transforming the economics of software for the better. But the unique financial attributes of SaaS aren't easy to model, especially when combined with the economic realities of purchasing and implementing licensed software. The first difficulty, therefore, is making the case. The good news is that when a total-cost-of-ownership (TCO) approach is properly applied and all costs are accurately captured, SaaS in many cases provides great long-term value. Factor in its lower risk and greater speed to market, and SaaS can be a compelling alternative that generates both a high ROI and resulting business benefit. The economics and financial levers used for evaluating SaaS differ from those pertaining to conventional licensed software. Specifically, when evaluating SaaS, CIOs can't estimate, and therefore can't omit, certain costs the way they can with licensed software. In fact, when taken at face value, the SaaS model may appear more expensive than licensed software, since IT budgets often don't take the operating-expense implications of subscription pricing into account. But CIOs who allow their software decisions to be made on this cost comparison alone are setting themselves up for a less-than-optimal decision. Instead, CIOs should develop TCO models that accurately assess the business case for a SaaS approach.

"CIOs should work in tandem with the CFO to make sure there's a clear understanding of the company's business plan," advises David Samuels, CFO at SunRocket, one of the nation's fastest-growing Internet phone-service

providers. "Whether it's a capital-investment or an operating-expense scenario, pay close attention to the options to ensure the terms make sense for the company's financial goals."

Due to the way SaaS costs are accrued, CIOs exploring this option should consider a new way of calculating ROI, too. Once adopted, software-delivery models should yield more savings.

Different Models, Different Results

The SaaS model differs dramatically from traditional software applications in that it eliminates high licensing and development costs, most of the professional-services fees associated with implementation, and both application-maintenance and support costs. By replacing these with a recurring subscription fee, SaaS lets CIOs deliver IT functionality much more quickly and affordably. "Doing more with less—I live that scenario every day," says Rob Kramer, CIO at SunRocket.

But financial challenges loom. Historically, IT spending has been analyzed either in terms of traditional categories—hardware, software, staff, services, and facilities, for example—or by functions such as development, application maintenance, and support infrastructure. While several of these categories are classified as operating expenses, the vast majority are capitalized. But there's an alternate view: recognizing the value, productivity gains, and economic returns realized through investment in IT as an operating expense—consistent with the underlying business case for the SaaS model.

Because licensed software versus SaaS isn't an apples-to-apples comparison, the financial case for the decision can be complex. For CIOs, due diligence means developing a TCO that compares the true cost of the traditional software-application model against that of SaaS. To be effective, this TCO model must include all costs—whether direct or indirect—incurred throughout the life of the service. These costs include acquisition and procurement, operations and support, and end-of-life management.

Also, consider making a shorter-term projection, SaaS implementers say. "We're working on an 18- to 24-month time line," Kramer says. "In some ways, this makes it easier to get our hands around the real cost of the technology investment."

Calculating the true cost of SaaS is vital for CIOs who wish to conduct a TCO comparison of conventional licensed software and SaaS software. These six steps can help CIOs get started.

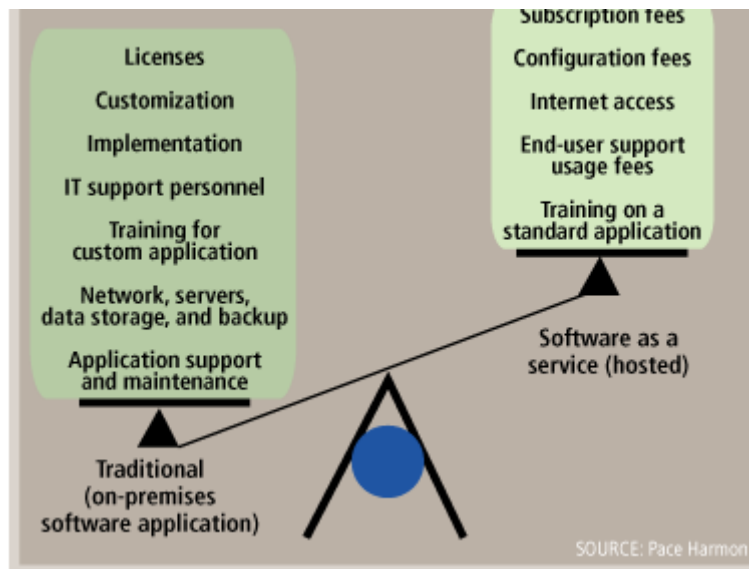
First, define the basis for the TCO model. Include not just cost elements, but also cost drivers. While cost elements for SaaS are relatively simple to

Balanced View

When weighing software as a service against a traditional application, take all costs—direct and indirect—into account

define, the drivers and their overall quantification in the TCO model may be more challenging. Make assumptions that account for "what-if" scenarios and their effect on what is. These assumptions must also be specific enough to remove any ambiguity in their interpretation in the TCO model. Next, CIOs should baseline the cost drivers and cost elements, and record their assumptions, at the earliest opportunity.

Second, build a SaaS-specific TCO model to highlight the key drivers. Different TCO models focus on different drivers and emphasize different cost elements. Simply reusing a traditional on-premises model is unlikely to yield meaningful TCO results for an on-demand SaaS solution.



Next, weigh the impact of full lifetime cost. Look beyond initial entry prices; instead, quantify the organization's total cost of use, cost of service, and cost of terminating services. Don't assume you can simply walk away from using a SaaS solution. Because vendors incur sizable startup costs to provide their service to an organization, most agreements include both minimum-term commitments and penalties for early termination.

In addition, keep it simple—and highly visible. Start with only the most important cost elements and drivers. Add details only where they aid understanding or improve the quality of the result.

Also, perform sensibility checks on the TCO data to improve accuracy and confidence. Identify and pull data points from as many sources as possible. Look into the TCO models that many SaaS vendors publish to support their value propositions. While these may be biased and could have variations on the application footprint, they're still useful in performing comparisons and checking that the data is within range.

Last, include corporate growth projections. If your organization is growing, research the volume-tiered pricing models that many SaaS vendors offer. This is particularly important if the cost is being compared with that of an on-premises solution. The latter often features user-block pricing, which lowers the price per user as the overall number of users rises.

What To Watch Out For

The TCO model must account for the glitches and other costs typically omitted in software price comparisons. When a company compares licensed software from several vendors, it can typically disregard, omit, or understate certain costs with few implications, since the omissions are the same across all providers. But when comparing licensed software with SaaS, there's less room for error.

One common glitch found in conventional licensed software is the cost of being late. This includes both delayed introductions of new products and the inability of the software to deliver the desired customer experience. Another common problem: first-generation implementations of application software that fail to optimize the surrounding business processes. Costly manual workarounds may be required to compensate.

TCO comparisons should also incorporate the following:

- **Upgrades.** For licensed software, users usually pay for both major and minor releases. For SaaS, upgrades are embedded in the subscription cost.
- **Conversion to new applications.** With SaaS, this is simplified through utility programs and open, published APIs. Getting the data in and out is relatively easy and doesn't require much cooperation from the vendor. By contrast, for traditional point integration and middleware models, there are extra costs, and the vendor's cooperation is needed.
- **Vendor management.** Maintaining the vendor relationship for licensed software requires time from procurement, contracts, and enterprise leadership. With SaaS, the complexity of vendor management is greatly reduced.
- **Miscellaneous expenses.** Other costs are associated with administration, dormant licenses, and staying current. The latter includes the cost of attending industry conferences, working with market analysts, and generally keeping up.

A number of costs, while included more frequently, are understated in a way that can weaken a comparison of SaaS and licensed software. For example, there's the cost of acquiring and maintaining knowledge of the licensed application to optimize its footprint within the organization's technology infrastructure. Additional understated costs include those of testing, business continuity, and compliance.

All this isn't to say that SaaS is always appropriate. Choosing between licensed software and SaaS is similar to deciding whether to buy or lease a motor vehicle. For a driver who travels 50,000 miles annually, buying a vehicle outright will probably be less expensive in the long run than leasing.

Why Software As A Service? The benefits of SaaS at a glance:

Similarly, an organization that has heavy customization requirements may find SaaS less than ideal. While a SaaS solution may be configurable, the provider can achieve economies of scale only by hosting it as a standard enterprise application for all its customers. Customization, though not necessarily a bad thing, increases the TCO. It also creates a maintenance headache and erects potential barriers to the adoption of future upgrades.

For an organization with transaction-intensive processes or large storage requirements, for example, SaaS may not be suitable. Another no-go zone for SaaS may be companies in highly competitive markets. Because it's available to all, the use of a standard offering could be a concern for any organization looking to differentiate itself. "There's a lot to be said for not operating every piece of your infrastructure on SaaS," Kramer says. "It allows us to focus on operating our core products and differentiators."

Finally, companies with highly mobile workforces will need to think through the connectivity issues before moving to a SaaS solution. That's because a hosting model depends on broadband Internet to deliver its application functionality on demand.

But despite these limitations, most CIOs should at least examine the economic benefits of SaaS. The successful CIO is the one who can creatively manage a fixed or shrinking budget while meeting the increasing demands of the business. To that end, SaaS can be a useful tool—but only when correctly evaluated.

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Source: Pace Harmon