The Benefits of Subscription

Perspective

ServiceXRG

The Subscription Economy

The subscription economy is here. From consumers to global enterprises, people are taking advantage of subscription services. Consumers can subscribe to meal services, entertainment and transportation and so much more. Airlines and trucking companies can use a subscription model to equip their fleets with tires, and global enterprises are running mission critical operations on infrastructure they subscribe to.

Subscription Creates New Opportunities For Businesses

Subscription services provide access to innovative products and services uniquely available through a service model. Subscriptions also provide flexibility, predictability and scalability. You can buy only what you require, scale it as your needs change, and forecast what you will pay for.

> The newest, most innovative software applications are likely to be available through a subscription model.

Subscriptions also offer financial benefits. The method by which subscriptions are acquired means that you can access more innovation and capability for a lower initial up-front cost and spread payments over time.

Subscription Momentum Builds by 2020

Gartner predicts that within a year, new entrants to the software market and 80% of established vendors will offer subscription-based business models. The implications of this predication are that the newest, most innovative software applications are likely to be available through a subscription model.

Get Ready for Subscription

Subscription may not be appropriate for every customer and every situation, but the reality is that the subscription economy is here and is permeating every corner of the global marketplace. Every industry sector and nearly all business processes will be enabled by applications available as a subscription.

This guide outlines the primary considerations and implications of subscription licensing to help companies understand and prepare to embrace the subscription economy.

Understanding Software Subscriptions

For many companies, subscribing to software is fundamentally different than purchasing it as an asset. The newness of subscription creates potential uncertainty about how and when subscription is most advantageous. The consideration of software subscription is further complicated by misconceptions and lack of clarity about the most important characteristics of subscription.

Ownership vs. Innovation

With a software subscription, customers are granted a right to use the software; they do not own the license. This point has become unnecessarily contentious. Assumptions about license ownership are misconstrued as a primary consideration when in fact the most important consideration is ongoing access to innovation.

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Software applications are dynamic with continuous improvements in terms of performance, functionality, and security. Software-as-a-Service (SaaS) is predicated on creating a model that assures a steady flow of enhancements influenced by the direct needs of customers.

Conversely, when software is purchased it is quickly out of date. Access to ongoing updates requires an additional purchase of support and maintenance agreements.

The question companies need to ask is – whether they need to own software, or rather if they need ongoing access to innovative software to ensure agility in order to drive their business forward. For companies that want and need the latest innovations, software subscription is the preferred approach.

Pay Now or Pay Over Time

Software subscription differs from the traditional acquisition of perpetual software licenses because it allows customers to spread payments over time. This flexibility provides advantages to customers that want to manage cashflow.

This approach also more closely aligns payments to value and the return from the use of a software application. When you pay for software upfront, you typically must wait for the application to deliver benefit. With subscription, payments are spread out and the return from the investment and associated value begin before the full cost of the software is paid.

Secure and On Premise

Software-as-a-Service (SaaS) is often associated with cloud-based architectures, but subscription does not mean that software must be run in the cloud. A subscription does not necessarily change how or where software is installed and run.

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SaaS is a licensing model used to acquire software but does not determine where it will be run. Software acquired as a service may often be run on customers' own infrastructure and does not necessarily require cloud deployment.

Buy Just What You Need

Subscription models offer customers the ability to acquire just the capabilities they need. As business and operational needs change, the subscription relationship can expand or contract.

Subscription models vary in their approach to provide customers with the capacity they need. Subscriptions offer rights to use software by named users (an individual is assigned a specific right to use software), the number of total concurrent users (anyone can access the software up to the limit of the subscription), credit-based where a fixed number of credits are provided and allocated to enable access to a portfolio of products and capabilities, and capacity-based which is often associated with Platform-as-a-Service (PaaS) models.

With each of these models, customers have the option to buy the amount of software or capacity they need with the ability to modify scale as needs change.

Vendor Commitment to Shared Success

The nature of the subscription relationship provides an added incentive for vendors to assure that customers can use and apply their software successfully. Companies that offer as-a-service models are more likely to include support and customer success services to help customers realize benefits through subscription offers.

Subscription models create a shared commitment to assuring customer success.

If a customer determines that they are not able to get the return on their software investment, it is likely that the subscription will not be renewed. For this reason, subscription models create a shared commitment to assuring business and customer success.

Understanding Subscription Financials

The primary differences between software subscriptions and perpetually licensed software relates to how companies budget and pay for the rights to use software applications. Perpetually licensed software is as a physical asset purchased as a Capital Expense (CapEx) from a capital budget. Software subscriptions are services purchased as an Operating Expense (OpEx).

CapEx vs. OpEx – Complexity to Simplicity

Capital expenditures (CapEx) are used to acquire physical assets such as property, plant, and equipment. This includes perpetual licensed software and the fees associated with its installation and configuration. Once an asset is purchased it is depreciated over the period of its useful life.

Operating expenses (OpEx) are used to acquire items and services necessary for day to day business operations. This includes the rights to use software through a subscription model. An expensed item requires an immediate outlay of cash and will have a direct effect on availability of cash and earnings.

The capital budget process can be long and complex. Sizing and capacity planning must be accurate to assure that the correct type and amount of software is acquired. The advantages of a subscription approach removes many of the complexities associated with capital planning.

Lower Initial Costs

Through subscription licensing, the cost to use software in the first year is significantly less when compared to an outright purchase. When software is purchased it requires an outlay cash for the full amount of the purchase. When the software is subscribed to, you pay a fraction of the total cost in the first year.

When software acquisition is shifted from the capital budget (CapEx) to an operating expense (OpEx), capital spending can be reallocated to other capital expenditures. This means that you can potentially fund other high priority capital projects.

Create a Leaner Balance Sheet

A lean balance sheet indicates that a company has financial flexibility to fund operations and meet financial obligations as well as weathering unexpected expenses. Companies that take on too much debt or own too many unproductive assets are not considered to be lean.

The ability to leverage subscription for the acquisition of software creates an opportunity for companies to spread the cost of software over time, thus reducing the need to borrow funds to pay for the cost of assets. Subscription also means that there are fewer fixed assets recorded on the balance sheet.

Improve Cash Flow

The fundamental premise of subscription is that it creates an opportunity to spread the cost of software acquisition over time. Companies that purchase software outright must pay for the software when it is acquired. This requires an outlay of cash. When companies subscribe to SaaS models they are only required to pay a fraction of the total subscription cost in the first year. The impact is that companies will outlay significantly less cash in the first year.

Impact on Taxes

A subscription expense is reported as an operating expense and deducted from income. This subscription expense will persist throughout the term of the subscription. The result of higher expenses is lower reported income, thus potentially lowering tax liability[1]. The full impact of subscription licensing on taxes will depend on customer specific situations and is subject to regulatory and taxing authorities.

Is Subscription Right for You?

Subscription offers the simplicity and flexibility to acquire the rights to use and continually receive updates to software innovations. For many customers subscription licensing will make good business sense, but not solely based on financial considerations. The unique characteristics of subscription licensing provides significant benefits to customers that transcend financial considerations. Consider how your organization will benefit from the following:

- Ongoing access to software innovation.
- Support and maintenance included.
- Flexibility to pay for only the software you need.
- Simplified planning process.
- Lower initial cost of software acquisition.
- Opportunity to reallocate capital funds to new projects.
- Option to shift spending from CapEx to OpEx.

Disclaimer

The information provided is intended to educate readers about subscription financials. The information contained within is subject to customer specific circumstances. This information can help guide you in your evaluation of subscription licensing. You should seek definite answers about the financial implications of subscription licensing through consultation with your legal, audit or financial advisors.

[1] The depreciation expense of capitalized software is also an operating expense, but EBITDA and tax considerations vary by customer

About the Author

Thomas J. Sweeny is CEO of Service Excellence Research Group a company that helps retain customers, grow revenue, and achieve cost efficiencies through service excellence. Founded in 2004, ServiceXRG works with the world's leading technology companies to transform and optimize service outcomes.

