Capitalising Your Cloud

January 2017
Achieving the right balance of Operational and Capital Costs

**Introduction**

Every IT organisation is under pressure to deliver services as efficiently as possible, utilising infrastructure and services that may have a significant impact on the financial position and results of the organisation. As a result, IT leadership must speak the language of finance to secure investment and support from the board, especially from the CFO.

Historically, cloud technology has made reference to the potential benefits of transferring costs from the balance sheet (capex) to the income statement (opex). However, an unintended consequence has been the perception that few, if any, cloud related costs can be capitalised. This may not be the desired outcome for every organisation and the capitalisation of certain aspects of cloud technology may be preferred, or even required by accounting standards.

Some key questions often asked about capitalising cloud costs:

- "How can my organisation account for the different types of cloud expenditure?"
- "What changes to accounting standards are taking place and what does that mean for my organisation?"
- "What questions should be asked of cloud service providers?"
- "What do other companies do?"
Key findings

In this short paper we outline four key takeaways for CIOs and CFOs:

01. Traditional cloud sales models market opex as a key driver for adoption, but this is not necessarily desirable for organisations;

02. We think companies could be capitalising too few of their cloud software implementation costs;

03. Organisations may have opportunities to start capitalising cloud hardware costs under IFRS in the next few years; and

04. Optimising financial factors during procurement decision making for cloud-centric business cases can be achieved by understanding the different P&L impacts of on-premise vs cloud solutions and the balance sheet impacts (intangible assets vs prepayments).
The key drivers behind on-premise and cloud

The table below presents a simplified view of on-premise and cloud expenditure as well as the key operational and accounting considerations under International Financial Reporting Standards ("IFRS"). IT leadership should work with finance leadership to achieve the financial balance that is most appropriate for the organisation.

<table>
<thead>
<tr>
<th>On-premise</th>
<th>Cloud</th>
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</table>
| **Software**
  - Purchase of license can be capitalised as intangible asset and amortised over its useful economic life (license period)
| Committing to a usage period or a recurring rolling contract requires the costs to be recorded as operating expense over the service period |
| **Software Implementation**
  - Implementation costs can usually be capitalised if they are development activities
| Implementation costs can usually be capitalised if they are development activities however fewer costs may be capitalised in practice |
| **Hardware**
  - Purchased hardware can be capitalised as a tangible fixed asset and depreciated over its useful economic life
| An on-demand or multi-year usage contract (reserved instance or dedicated host), means that the costs must be recorded as operating expense over the service period, if contract is not a finance lease |

We explore each of these three expenditure areas on the following pages.
Why does this matter to the CIO?

While there is in theory more flexibility with a cloud solution, in practice this may not always be the case. Companies using cloud solutions are able to readily scale these applications, however, they may not be able to switch from one provider to another for business critical systems without significant transition or transformational planning activities.

In practical terms the complexities of developing business-critical solutions such as CRM and ERP mean that the implementation costs may still be considerable.
Opex may not be desirable for your organisation’s cloud costs

**Capitalising software**

It is generally considered that cloud software license agreements may only be capitalised if:

- The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and
- 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.

In other cases, cloud software is generally considered to be purchased hosting arrangements which are accounted for as service contracts (opex). The table below summarises how these are typically distinguished from on-premise software licenses, which are capitalised.

<table>
<thead>
<tr>
<th></th>
<th>On-premise</th>
<th>Cloud</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Duration</strong></td>
<td>Multi-year perpetual or time-based licences, commonly 3-5 years</td>
<td>Limited fixed term, then rolling</td>
</tr>
<tr>
<td><strong>Upgrades</strong></td>
<td>User to implement</td>
<td>Automatically applied</td>
</tr>
<tr>
<td><strong>Maintenance services</strong></td>
<td>Separate monthly fee, can sometimes be cancelled while retaining licence rights</td>
<td>Generally included in subscription fee, often cannot be cancelled while access to software still required</td>
</tr>
<tr>
<td><strong>Risks and reward of ownership</strong></td>
<td>With user</td>
<td>With suppliers or vendors</td>
</tr>
</tbody>
</table>
In determining what software to purchase, organisations typically consider qualitative factors such as the functionality of the software, the brand name of the vendor, the level of post-implementation maintenance support and the compatibility with existing data and IT systems. While cost is a key quantitative factor, there are consequential qualitative impacts which depend on the type of arrangement entered into (on-premise or cloud). These qualitative impacts become apparent when the costs for software arrangements are recorded in the income statement.

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Cost of sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross profit</strong></td>
<td>Other operating expenses</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Depreciation and amortisation</td>
</tr>
<tr>
<td>Operating profit</td>
<td></td>
</tr>
</tbody>
</table>

When choosing to purchase cloud software, careful financial consideration is needed beyond just the potential for immediate cost and cash flow benefits:

- It can result in an immediate reduction in EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation), which is often used by external analysts and investors. It may also impact other Alternative Performance Measures (“APMs”) such as “adjusted” or “normalised” profit metrics, which may exclude software amortisation costs; and

- Management remuneration schemes using these key performance indicators can be adversely impacted and so could drive inappropriate purchasing behaviour, if not carefully considered.

* Or in certain circumstances above Gross Profit in Cost of Sales.
Are you capitalising too few cloud software implementation costs?

**Capitalising software implementation expenditure**

Irrespective of whether an on-premise or cloud software arrangement is being entered into, there are some standard setup and implementation costs which are typically incurred by the organisation. Based on the requirements of IFRS, we would generally consider the treatment for these costs to be as follows:

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary project activities (e.g. research)</td>
<td>Expense</td>
</tr>
<tr>
<td>Application development stage costs (internal or external)</td>
<td>Capitalise</td>
</tr>
<tr>
<td>Data conversion software costs (develop or obtain)</td>
<td>Capitalise</td>
</tr>
<tr>
<td>Data conversion costs</td>
<td>Expense</td>
</tr>
<tr>
<td>Training costs</td>
<td>Expense</td>
</tr>
<tr>
<td>Post-implementation maintenance costs</td>
<td>Expense</td>
</tr>
</tbody>
</table>

Our view is that irrespective of whether these costs are incurred in relation to on-premise software or cloud software consumed as a service, we would expect similar amounts of costs to be capitalised. Particular care will be needed when determining the appropriate treatment of costs associated with the design and implementation of business processes.

In practice, we have observed some organisations capitalising less for cloud software implementation projects than they would for on-premise software.

This could be attributed to several factors:

- An awareness of the different software delivery model behind the implementation costs (right to use IP versus provision of a service);
- A desire for organisations to avoid significant impairments if commercial decisions result in a switch from one cloud software provider to another; or
- A preference to record significant implementation and transformation project costs up-front in order to show profit growth and cost reductions in future years.
In these cases we believe that there is a risk that the accounting will impact business procurement decisions. We recommend that organisations implement greater transparency and monitoring of these cloud software costs in the income statement, to avoid unconscious bias and to provide a clearer basis for decision making in strategic investments by executives.

Our findings
We have analysed the costs incurred in a typical cloud development project which included multiple stages and work-streams. We identified that an organisation could potentially capitalise up to 80% of the total project spend.

Looking ahead
There is growing focus on the treatment of cloud software implementation costs and so this is an area to watch carefully in 2017. Recent announcements by the US accounting standards setting body¹ and by the UK accounting body for public finance² both highlighted the desire to seek comments from a broad range of stakeholders, to determine if additional guidance is required.

Achieving the right balance of Operational and Capital Costs

**Capitalising hardware**

As we have highlighted, under the traditional view of cloud services, hardware or infrastructure costs ("IaaS") are commonly expensed. The emergence of a new IFRS lease accounting standard (IFRS 16) and enhancements in contracting models have meant that some service providers have been considering the impact that the changes could mean for companies. Specifically, could it be possible to capitalise IaaS expenditure?

It is too early to know how the requirements of IFRS 16 will be applied across the range of cloud services available as conclusions will depend on the particular circumstances of each individual cloud delivery model. In each case, careful consideration will be needed to ensure compliance. However, similar to the capitalisation of cloud software costs, there could be a potential P&L benefit from capitalising these costs.

<table>
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<th>Cost of sales</th>
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<tbody>
<tr>
<td><strong>Gross profit</strong></td>
<td></td>
</tr>
<tr>
<td>Other operating expenses</td>
<td><strong>Opex hardware costs</strong>*</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td><strong>Capex hardware costs</strong></td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>Operating profit</td>
</tr>
</tbody>
</table>

**The three key tests**

In order to potentially treat the IaaS costs as capex rather than opex, we think there are two key tests outlined in IFRS 16 which need to be met:

<table>
<thead>
<tr>
<th>Test 1</th>
<th>Test 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>There is a clear identified asset</strong></td>
<td>The supplier does not have a practical ability to substitute the asset</td>
</tr>
</tbody>
</table>

* Or in certain circumstances above Gross Profit in Cost of Sales.
Meeting these tests will require careful consideration of the contractual and practical nature of the IaaS arrangements held and, in our view, will be more suited to long-term IaaS contracts than short-term “on-demand” usage.

With IFRS 16 being effective from 1 January 2019, we believe that there is sufficient time for organisations to review their existing IaaS agreements and discuss the accounting consequences of them with their Cloud Service Providers.

“How can my organisation optimise capitalisation for the use of cloud services?”

“What do the changes to lease accounting mean for my organisation’s planned IT spend?”

“What should I be talking to my cloud service provider about now?”

“How can I better work with finance to make the right business procurement decisions?”
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