Deloitte.

Capitalising Your Cloud

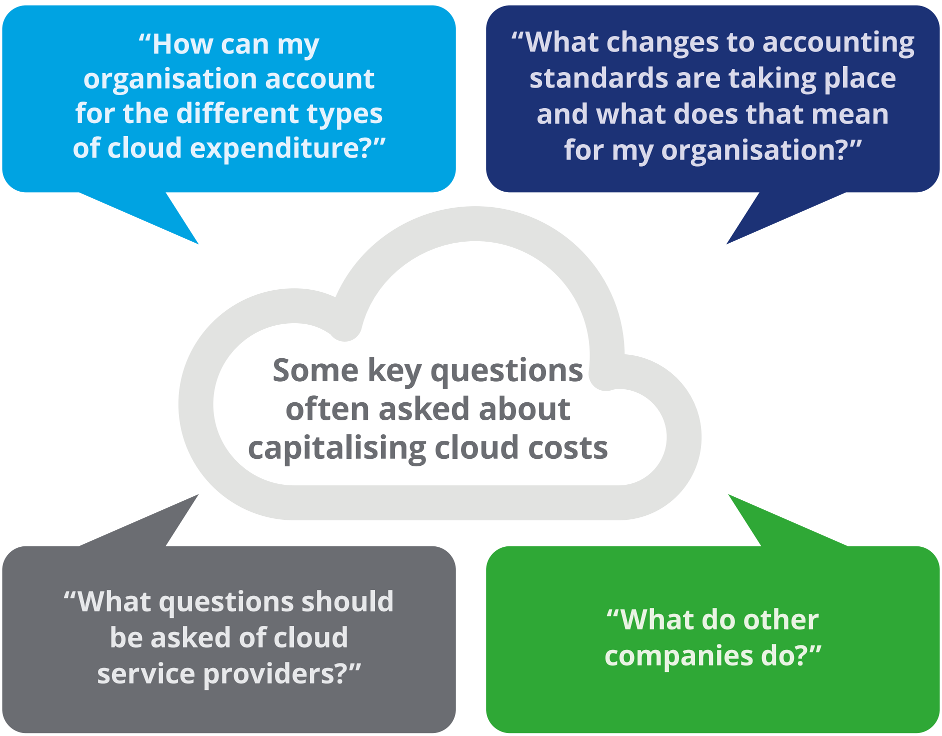
January 2017

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.



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 cost capitalisation landscape

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.

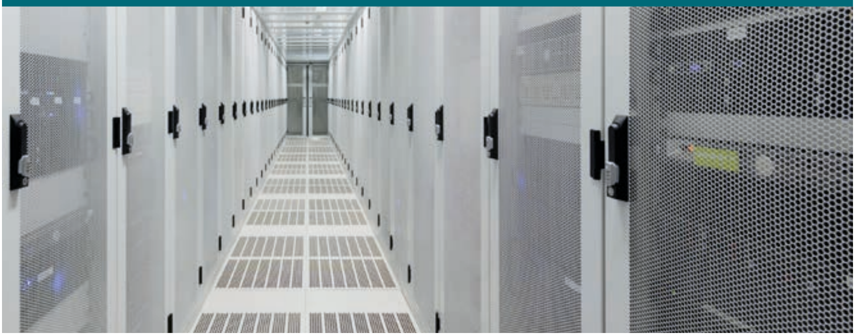
	On-premise		Cloud
Software	Purchase of license can be capitalised as intangible asset and amortised over its useful economic life (license period)	vs	Committing to a usage period or a recurring rolling contract requires the costs to be recorded as operating expense over the service period
Software Implementation	Implementation costs can usually be capitalised if they are development activities	vs	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	vs	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.

What causes the difference?

The key accounting differences shown on the previous page are a result of several factors:

- The delivery model of on-premise (a "right to use IP") versus cloud (a service);
- Common differences in cash flows (such as up-front with on-premise but over the subscription period with cloud); and
- The apparent flexibility of cloud contracts versus on-premise and the potential uncertainty this brings to the planned life of technology solutions.



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.

	On-premise	Cloud
Duration	Multi-year perpetual or time-based licences, commonly 3-5 years	Limited fixed term, then rolling
Upgrades	User to implement	Automatically applied
Maintenance services	Separate monthly fee, can sometimes be cancelled while retaining licence rights	Generally included in subscription fee, often cannot be cancelled while access to software still required
Risks and reward of ownership	With user	With suppliers or vendors

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.

Revenue

Cost of sales

Gross profit

Other operating expenses — **Cloud software costs recorded here***

EBITDA

Depreciation and amortisation — **On-premise software licence costs recorded here**

Operating profit

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:

	IFRS
Preliminary project activities (e.g. research)	Expense
Application development stage costs (internal or external)	Capitalise
Data conversion software costs (develop or obtain)	Capitalise
Data conversion costs	Expense
Training costs	Expense
Post-implementation maintenance costs	Expense

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.

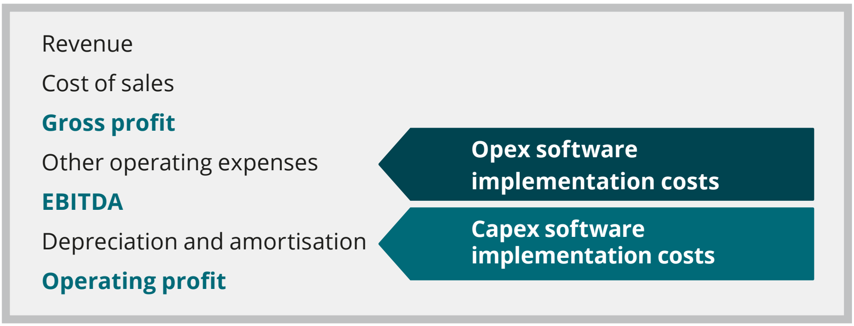
In practice, we have observed some organisations capitalising less for cloud software implementation projects than they would for on-premise software.

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 body[1] and by the UK accounting body for public finance[2] both highlighted the desire to seek comments from a broad range of stakeholders, to determine if additional guidance is required.

1. See Board Meeting Minutes on Agenda Prioritization for 16 November 2016 available on www.fasb.org.
2. See Chartered Institute of Public Finance & Accountancy ("CIPFA") paper "Accounting for the Cloud" available from www.cipfa.org/cloudconsultation.

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.

Revenue	
Cost of sales	
Gross profit	
Other operating expenses	**Opex hardware costs***
EBITDA	
Depreciation and amortisation	**Capex hardware costs**
Operating profit	

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:

Test 1		Test 2
There is a clear identified asset	**and**	The supplier does not have a practical ability to substitute the asset **or** The supplier would not benefit economically from substituting the asset

* 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.

Key Contacts

Mike Barber
Risk Advisory Partner
mbarber@deloitte.co.uk

Chris Overd
Risk Advisory Director
coverd@deloitte.co.uk

John Winstanley
Technology Consulting Partner
jwinstanley@deloitte.co.uk

Jez Back
Technology Consulting Senior Manager
jeback@deloitte.co.uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. J10345