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Opex vs. Capex: CIOs Should Partner With CFOs

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Often, enterprise IT spending decisions are made on whether spending can be capitalized or not. With changes in delivery models, CIOs need to have a firm understanding of capitalization and partner with CFOs to ensure the right IT investments are made.

Impacts

- CIOs' lack of understanding of capitalization and how it impacts corporate financials will hinder the development of a combined IT and finance approach to properly capitalizing IT assets.
- CIOs' decisions to utilize delivery methods such as cloud continue to be disproportionately driven by how these purchases impact operating expenditure (opex) and capital expenditure (capex).
- Improper classification of opex or capex of IT costs can limit CIOs' abilities to invest in the right technologies.

Recommendations

- CIOs and IT leaders must understand the financial implications of opex and capex in order to ensure the right investment decision is made for the enterprise.
- CIOs should become evangelists for doing what is best for the enterprise by encouraging that both a "cash" view and a "profit and loss" ("P&L") view are included in the decision-making process.
- IT leaders should not be responsible for accounting policy. However, their expertise can be invaluable in assisting accounting to make the right decision on capitalization of technology assets.

Analysis

CIOs and IT leaders are often constrained due to limited funding for technology projects and services. This is often understandable, as there is always tension between supply and demand. However, there should be a healthy tension driven by the strategic goals of the enterprise and IT's ability to enable these goals. However, there is often unhealthy or unneeded tension due to the focus on opex versus capex.

Understanding the impacts of technology purchases on opex and capex is essential for CIOs and IT leaders so that they can ensure that technologies that cost the least and provide the most value are leveraged.

Figure 1. Impacts and Top Recommendations for CIOs Weighing In on Opex and Capex

Impacts	Top Recommendations
CIOs' lack of understanding of capitalization will hinder the development of a combined IT and finance approach to properly capitalizing IT assets.	• CIOs and IT leaders must understand the financial implications of opex and capex in order to ensure the right investment decision is made for the enterprise.
CIOs' decisions to utilize delivery methods such as cloud will continue to be disproportionately driven by how these purchases impact opex and capex.	• CIOs should do what is best for the enterprise by encouraging that both a "cash" view and a "P&L" view are part of decision making.
Improper classification of opex or capex of IT costs can limit CIOs' abilities to invest in the right technologies.	IT leaders should not be responsible for accounting policy, but they can be invaluable in assisting accounting to make the right decision on capitalization of technology assets.

Source: Gartner (May 2015)

Impacts and Recommendations

CIOs' lack of understanding of capitalization and how it impacts corporate financials will hinder the development of a combined IT and finance approach to properly capitalizing IT assets

Gartner fields hundreds of calls each year related to capitalization issues. A few things are clear from these calls. First, CIOs and IT leaders often lack a clear understanding of the effects of capitalization versus expensing IT assets. Second, IT is not getting clear guidance from their finance organizations on this issue.

Generally, companies can capitalize assets if those assets have a useful life of more than one fiscal year. Once they are capitalized, these costs represent assets of the company, and, are recorded on the balance sheet. Capitalization decisions also impact the income statement and cash flow statement. Specifically, decisions concerning whether to capitalize assets will have an impact on:

- **Net income —** Capitalizing assets generally results in a smoother pattern of reported income. From a profitability standpoint, in the early years, a company that capitalizes costs will have a higher profitability than it would have had if it expensed them. In later years, the company that expenses costs will have a higher profitability than it would have had if it capitalized them.
- **Stockholders' equity —** In the long run, capitalizing assets will have little effect on shareholders' total equity. That said, expensing firms will have a lower stockholders' equity at first (less profit, leading to smaller retained earnings).
- **Cash flow from operations —** A company that capitalizes its costs will display higher net profits in the first years and will have to pay higher taxes than it would've had to pay if it expensed all of its costs. That said, over a long period of time, the tax implications would be the same.
- **Assets reported on the balance sheet —** A company that capitalizes its costs will display higher total assets.
- **Financial ratios —** A company that capitalizes its costs will display higher profitability ratios at the onset and lower ratios in later years. So-called solvency ratios are better for firms that capitalize their costs because they have higher assets, earnings before interest and taxes (EBIT), and stockholders' equity.

Recommendations:

- CIOs and IT leaders should take the lead in understanding opex/capex of technology spending in order to ensure the right investment decision is made for the enterprise.
- When it comes to capitalization of assets, firms have some choices. When it comes to IT assets, those choices should be made jointly by IT and finance, based on the enterprise's goals.

CIOs decisions to utilize delivery methods such as cloud will continue to be disproportionately driven by how these purchases impact opex and capex

While capitalization has short-term appeal, a shift from technology budgets made up largely of capitalized IT assets to ones made up largely of operating expenses sounds appealing, because it would afford greater flexibility when budget cuts loom.

However, shifting IT costs from capital budgets to operating budgets has balance sheet implications that CIOs must explore with CFOs. Today, most companies capitalize IT assets and most IT development labor. Though cloud computing acquisition models are still taking shape, we expect that a significant amount of IT costs that are currently being capitalized will eventually wind up in the operating budget.

The "IT as a service" model also raises issues with regard to budgeting. Today's asset-based IT budgets are relatively predictable. Predictability would not be a given with cloud computing, because actual IT spending will be largely driven by end-user behavior (usage). Budgeting challenges will be compounded by the fact that business users are expected to buy cloud offerings directly.

Recommendations:

- CIOs should become evangelists for doing what is best for the enterprise by encouraging that both a "cash" view and a "P&L" view are included in the decision-making process.
- CIOs should ask themselves whether their enterprise is really prepared to shift a good portion of today's capex to opex. We suspect many CFOs would not support this, and that wholesale moves to cloud computing will be disrupted by the unwillingness of CFOs to surrender the short-term financial benefits of capex. In short, "IT as a service" strategies must consider financial implications, and must be made with the knowledge and support of the CFO.
- Be prepared for budgeting challenges triggered by moving to cloud-type services by being able to explain the value and risk to the enterprise, not just the impact on opex and capex.

Improper classification of opex or capex of IT costs can limit CIOs' abilities to invest in the right technologies

Gartner is not an accountancy, and we do not offer clients advice on tax or accounting issues (such advice should be obtained from audit firms and attorneys). However, we do review hundreds of IT budgets annually, and spot many inconsistencies in how organizations classify IT assets in terms of opex and capex.

The risks here are not obvious. To our knowledge, no publicly traded entity has been fined for accounting irregularities involving IT assets. However, the risks of "overcapitalizing" really exist, saddling the IT organization with such a high percentage of depreciation that it becomes difficult to invest in growth and innovation.

In a typical IT budget, depreciation and amortization — the cost associated with assets already in use — is typically around 20%. However, we routinely encounter companies where depreciation represents 35% or more of the operating budget. These firms struggle on two levels. First, they tend to look more expensive than peers when they conduct IT cost benchmarking. Second, it is often difficult for them to find the money to keep the environment current and add appropriate staff when saddled with such a large depreciation expense.

Recommendations:

- IT leaders should not be responsible for accounting policy. However, their expertise can be invaluable in assisting accounting to make the right decision on capitalization of technology assets.
- With increased focus on using IT for growth and digital business enablement, CIOs must work with CFOs to strike a good balance between exploiting the short-term financial advantages of capitalization, but not limiting the IT organization from growing and investing in the systems of the future.

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Conclusion

IT leaders should not be the ones to set accounting policy, but they should not blindly follow capitalization policies. Today, capitalization decisions of IT assets are often based on outdated capitalization policies, or "this is how we have always done it," or policies that focus on the short-term financial advantages of capitalization. However, the shift to IT-as-a-service models of delivery that are opex-oriented will require executives to rethink the issue of IT capitalization.

CIOs should ensure that both they and their leadership team have a firm understanding of what IT spending should be capitalized. That way they can partner with CFOs to understand enterprise financial strategy and ensure that IT investments are aligned with both the financial objectives of the firm and the strategy of the IT function.

Gartner Recommended Reading

Some documents may not be available as part of your current Gartner subscription.

"Be Aware of Financial Roadblocks When Moving to the Cloud"

"The Financial Case for Moving to the Cloud"

"FAQ on Cloud Financials"

"Understand Software Capitalization to Improve Budget Planning"

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