Answers to the Impact of Cloud on Capex/Opex for Midsize Enterprise CIOs

Published 17 May 2021 - ID G00744480 - 7 min read

By Analysts Roger Caleya, Cesar Lozada

Initiatives: Midsize Enterprise IT Leadership; IT Cost Optimization, Finance, Risk and Value

As midsize enterprises continue to evaluate and adopt cloud-based, “as a service” solutions, an accurate depiction of the financial implications is required. This research provides answers to the top questions from midsize enterprise CIOs around the impact both have on their capex and opex budgets.

Overview

Key Questions

- What are the financial implications that most discourage CFOs and CEOs from moving to the cloud?
- How do I justify a shift from on-premises solutions to cloud-based offerings?
- What costs can we capitalize when migrating/deploying workloads to the cloud?

Recommendations

Midsize enterprise CIOs adopting cloud-based solutions must:

- Anticipate potential objections to cloud and operational expenditure (opex) increases by acknowledging that it will be perceived to decrease earnings before interest, taxes, depreciation and amortization (EBITDA), and therefore, the valuation of the company.

- Change the framing of the conversation from a “cost” conversation to a “value” conversation by building a business case that shifts the focus from technology adoption to a business innovation platform that drives business value.

- Support the correct classification of the costs related to cloud-based solutions by showing that the cost of developing or implementing a cloud solution can typically be categorized as a capital expenditure (capex).

Analysis
What Are the Financial Implications That Most Discourage CFOs and CEOs From Moving to the Cloud?

**Bottom Line:** Moving workloads to the cloud will shift some expenses from capex to opex. Without full context, it will be perceived to decrease EBITDA, and therefore, the valuation of the company. This could conflict with the primary responsibility of the CEO and CFO, and risk their incentives aligned with it.

The key differentiator between opex and capex lies in the accounting treatment of these expenditures and the impact in the income statement (see Table 1).

<table>
<thead>
<tr>
<th>Capex</th>
<th>Opex</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recorded on the balance sheet as an asset</td>
<td>Recorded directly in the income statement as an operational expense, because its occurrence produces benefits in one single year</td>
</tr>
<tr>
<td>Its loss of value is recorded in the income statement across the multiple years in which its usefulness is spent, as a depreciation or amortization type of expense</td>
<td></td>
</tr>
</tbody>
</table>

Source: Gartner (May 2021)

Where an expense is recognized in the income statement has an impact in the financial measures of the organization, like the EBITDA. A depreciation and amortization type of expense will not affect EBITDA. If a business expense shifts from capex to opex, it will impact the organization’s EBITDA.

Although it has some limitations, EBITDA is a useful indicator of the gross cash operating profit performance of a business and it is often used as a measure of the value of a business. That is, the way investors value the company may depend to a great measure on the EBITDA evolution. The CEO’s and CFO’s main job is to increase the value of their organization. It is natural that their initial reaction would be against a move that might decrease the EBITDA of the enterprise. This is especially true in capital-intensive industries like manufacturing and private-equity-owned, midsize organizations.
In some countries, like the U.S., businesses can tax deduct their capex spend on computers and software up to a certain amount. A traditional purchase/lease model will benefit from a speedier tax benefit than a cloud model that distributes the spend over the years of usage. For midsize enterprises in these countries, the shift to the cloud may have significant implications in their tax strategy that will also raise concerns with the CFO.

Additionally, the finance practices in the organization are possibly wedded to more traditional capitalization-oriented models. A shift from capex to opex might require them to update their policies, processes and procedures, as well as anticipate and plan for changes in their budgets. The natural resistance to change will add on to your CFO's aversion to the shift.

It is important to address potential capex/opex changes early to avoid cloud investments being dismissed due to an incomplete view of their impact to the enterprise. Moving to a financial model contrary to the direction set by the financial leader can be equally precarious.

How Do I Justify a Shift From On-Premises Solutions to Cloud-Based Offerings?

**Bottom Line: Change the framing of the discussion from a “cost” conversation to a “value” conversation. Shift the focus of the cloud from technology adoption to a business innovation platform that drives business value.**

Build a business case for the cloud that includes both negative and positive aspects. Move the conversation to a healthy collaboration space by supporting the finance function in fully understanding the impacts of cloud technologies and working as partners to assess it.

Start with communicating the financial impact of cloud solutions in shifting capex spend to opex. Show empathy with the CEO’s and CFO’s concerns, and support them in assessing and deciding what will shift to opex and what will remain as capex. The picture must be fair and accurate.

The next step is to change the framing of the conversation from a “cost” conversation to a “value” conversation. If the conversation pivots solely around the spend and how to account for it, leaving current workloads as capex and not impacting the EBITDA will be the preference for your CFO. Proposing to adopt a cloud solution in the context of the business strategy and business value will make the CFO think twice. Avoid technical reasons, make it a business value conversation and bring it down to the specifics of your own organization.

Common benefits, and thus justification, for adopting a cloud solution include:
1. A digital platform that allows businesses the freedom to operate as needed without technology limiting their choices

2. Access to vendors’ latest innovations (as some are making new features only available in their cloud solutions)

3. The global distribution of cloud technology that enables applications to be deployed to other regions quickly and more cost-effectively

4. Additionally for midsize enterprises, the industrialization of cloud services allows smaller businesses to take advantage of hyperscale capabilities and economies of scale

While the cloud has potential to improve business capabilities and outcomes, it also has some negative components, apart from increasing opex concerns, like increased cost, the need to reinforce security and the need for new skills (see Top 3 Drivers of Cloud Adoption in Midsize Enterprises and Top 3 Deterrents of Cloud Adoption in Midsize Enterprises). Make sure that the potential business value overcomes the disadvantages of moving to a cloud solution.

What Costs Can We Capitalize When Migrating/Deploying Workloads to the Cloud?

**Bottom Line:** The cost of developing or implementing a cloud solution can typically be categorized as a capex.

When adopting a cloud-based solution, it is possible to capitalize some of the costs as the rules of capitalization do not change. The costs of developing or implementing a solution that will drive benefits beyond the current year can typically be categorized as a capex.

The following guidance can be considered as a starting point to determine the appropriate accounting treatment of the costs when deploying workloads to the cloud:

- **Preparation Phase**
  - *Preliminary activities* such as research, planning and investigation are typically treated as expenses. These costs include the preparation of the project even before selection of the product/provider.

- **Development Phase**
  - *Application/software development costs,* either internal or external, are typically treated as capital. These include modifications to providers’ set of offerings, developing new modules and interfaces
It is important to note that under any accounting standard there is a degree of judgment and consistency required. Work with your organization’s finance team to assess and decide the appropriate treatment.

---

**Evidence**

1. Challenging the EBITDA Metric, Investopedia.

---

**Recommended by the Authors**

The Impact of Public Cloud on Operating Budgets

Proactively Manage the Impact of SaaS on Opex and Capex Budgets

How Executive Leaders Should Justify Moving to the Cloud
### Table 1: Accounting Treatment of Capex and Opex

<table>
<thead>
<tr>
<th>Capex</th>
<th>Opex</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recorded on the balance sheet as an asset</td>
<td>Recorded directly in the income statement as an operational expense, because its occurrence produces benefits in one single year</td>
</tr>
<tr>
<td>Its loss of value is recorded in the income statement across the multiple years in which its usefulness is spent, as a depreciation or amortization type of expense</td>
<td></td>
</tr>
</tbody>
</table>

Source: Gartner (May 2021)