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Your Software Project...Approved!
Discover Agile's CapEx/OpEx Advantage

Software development costs fall into two categories: capital expenses (CapEx) and operational expenses (OpEx). For managers with limited access to OpEx, the ability to capitalize a larger percentage of software development costs can make the difference between starting a project and having it rejected outright for budgetary reasons. This white paper explains how partnering with an Agile firm can give you the flexibility to capitalize more of your software development costs and get your projects done now.

Introduction

If you're a manager who's bending over backwards to fit your software project into the departmental budget and get it approved, you might learn the hard way that all costs are not equal.

Software development costs actually fall into two categories: capital expenses (CapEx) and operational expenses (OpEx).

Capital expenses can be spread out over several years while operational expenses impact the balance sheet of the current year alone. Some costs incurred by your software project will always be OpEx while others can be treated as either CapEx or OpEx.

Why is the CapEx/OpEx distinction important to someone who's trying to get a software project approved?

Because the right mixture of CapEx/OpEx in your project can mean the difference between getting it approved and having it rejected for budgetary reasons. Equally important, your choice of software development process can affect that mixture in a big way.

> An Agile software development process
>
> allows you to capitalize more of your costs.

Many organizations invest heavily in the development of internal software systems that give them a competitive advantage. Some find it advantageous to capitalize costs as much as possible, others expense everything in the current year, and many follow a middle road.

Whatever course they choose, organizations are required to handle each software project the same way, which is why they formulate internal financial policies stipulating how to account for development costs. Organizations with no prior software development experience have an opportunity to draft policies that take full advantage of Agile's CapEx/OpEx flexibility.

If you're planning to seek approval for a software project, you should first understand:

- Accounting guidelines for capitalizing software development costs.

- When it makes sense to capitalize costs.

- Development options that affect how much can be capitalized.

- Internal policies for capitalizing software development costs.

This white paper introduces basic CapEx/OpEx considerations for software projects and explains why an Agile development process gives you the option to capitalize more of your costs. Our intent is to give you a starting point for conversations with your CFO or some other qualified accounting professional about important financial aspects of your software development project.

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Accounting Guidelines for Software Development

As your CFO already knows, public companies in Canada must conform to International Financial Reporting Standards (IFRS) instead of Canadian Generally Accepted Accounting Principles (CGAAP) beginning in January, 2011. Private companies will be required to adopt either IFRS or the new Canadian GAAP for private enterprises.

Under any of these systems, your accountant can treat the finished software that you develop as an *intangible asset.* According to a report[a] by the staff of the Accounting Standards Board (AcSB), both IFRS and CGAAP agree that "expenditure for an intangible item be recognized as expense unless the item meets the definition of an intangible asset and it is probable that there will be future economic benefits from the asset, and the cost of the asset can be reliably measured."

What does this mean to you? It means that the research costs associated with your software project—that is, the cost of all planning and preparation needed to establish the *feasibility* of your software project—must be considered OpEx and cannot be capitalized.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

- IFRS Section IAS 38 Intangible Assets and CGAAP Section 3064 Goodwill & Intangible Assets

Table: Breakdown of Software Project Expenses

Phase	Expense Type	Typical Activities
Research	OpEx	Planning, designing, estimating.
Development	CapEx or OpEx	Programming, testing.
Production	OpEx	Installing, configuring, training.

However, after you have established the feasibility of the software project, you can capitalize the cost of all further *development* activities, provided you can demonstrate that your organization:

- Intends to finish the software.

- Has sufficient resources to finish the software.

- Has the ability to use it or sell it.

- Has the ability to track software development costs.

- Knows how the software will yield future economic benefits.

Production costs like installation, configuration, and training are separate from development. They are OpEx.

To learn more about R&D accounting standards, talk to your CFO or consult IFRS Section IAS 38 Intangible Assets and CGAAP Section 3064 Goodwill and Intangible Assets.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

- IFRS Section IAS 38 Intangible Assets and CGAAP Section 3064 Goodwill & Intangible Assets

a. IFRS/Canadian GAAP Comparison (as of December 31, 2009), item 40211, prepared by the staff of the Accounting Standards Board (AcSB), page 111.

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Capitalize or Expense?

Because every organization is unique, each must balance CapEx/OpEx differently to derive the greatest benefit.

By capitalizing as much as possible, an organization can amortize costs over several years and spread out the impact on earnings. On the other hand, organizations that choose to expense immediately will take the entire hit in the current year, with a greater one-time effect on earnings.

- **Why would an organization choose to capitalize?**
  There are many reasons. For example, in organizations that allocate limited OpEx for software projects, managers must be able to capitalize development costs just to get their projects done.

  Here's another scenario: A private company that's considering an IPO tries to keep earnings statements as consistent as possible by maximizing CapEx and minimizing OpEx on a major software project. Obviously, public companies have similar, ongoing concerns about earnings and investors.

- **Why would an organization choose to expense?**
  Again, there are many reasons. For example, when developing software with a short useful life, an organization might simply expense all costs instead of trying to spread them out over a period that's only nominally longer. Or, if an organization undertakes a relatively small software project, the development costs might be more conveniently handled as OpEx.

  However, if the organization commits to several smaller software projects— perhaps more than originally anticipated—the costs will add up and capitalizing might become more attractive. Therefore, it makes sense to retain as much CapEx/OpEx flexibility as possible, just in case you need it.

The Agile Advantage

Agile software development gives you an advantage that traditional waterfall methods cannot: *flexibility.*

Waterfall developers employ a rigidly structured, sequential process to produce an entire, finished software application in one Big Bang or, possibly, in several linear phases.

A waterfall process starts with extensive requirements gathering, the goal of which is to describe every possible business requirement that the software will need to satisfy. After a detailed business requirements document has been written, comprehensive design plans for the whole application are drawn up based on this document.

These activities require significant effort. Consequently, **the "research" part of a waterfall development project can be quite expensive, representing a substantial percentage of the overall project cost. Remember, research costs are OpEx only.**

Agile, an iterative development process, captures business requirements in much less detail up front, with the understanding that priorities will change

over time and individual requirements will be fleshed out as needed during the "development" phase.

Likewise, initial design effort is minimal—just enough to get started with the first iteration of the software. All other design decisions are deferred until the last responsible moment, when developers have access to the most complete information.

In other words, **Agile developers expend less effort during the "research" phase of a project, which means you need less OpEx to get your project started.**

As you can see, much of the effort that's front-loaded into the waterfall "research" phase—again, OpEx only— has been redistributed (in Agile) to the "development" phase, the cost of which you can treat as CapEx and spread out over several years.

Thus, an Agile process gives you the option of capitalizing a larger percentage of software development costs. With this flexibility, Agile offers a huge advantage over waterfall development methods.

Questions to Ask Your CFO

Before you start shepherding your software project through the approval process, familiarize yourself with all relevant internal accounting policies. Book a meeting with your CFO or a member of the accounting department and find out how your organization handles CapEx/OpEx.

Here are some questions that you might want to ask:

- Do we have an accounting policy for software development projects? If so, what is it?

- Are you aware that we can significantly increase the percentage of CapEx in our software projects by choosing an Agile development firm?

- I want to get this project done now and with Agile I can spread more of the costs over multiple years. My annual budget is *x* dollars but how does that specifically relate to CapEx/OpEx?

- Our company is privately owned now but are there any plans to go public? If so, Agile development will give us the security of greater CapEx/OpEx flexibility in our software projects.

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