CAPEX OR OPEX?

Which is better when recording your IT investments?

When considering the acquisition of IT assets, not only do you have to determine whether to purchase or lease the equipment, you also need to decide how to record it on your balance sheet. The way your IT investment is recorded can make a difference in how the company's performance is represented on paper. This decision involves classifying your investment as a capital expenditure (CapEx) or an operational expenditure (OpEx) to properly manage your earnings statements. However, before we examine how the two scenarios play out, let's start with a brief overview of CapEx and OpEx as they relate to acquiring IT equipment.

CapEx

Capital expenditures are business purchases that have a future benefit and usually take the form of fixed assets, such as PCs and servers. A capital expenditure is recorded as an asset. It's also recorded as a liability in addition to an asset, if you include it as a lease on the balance sheet. The initial value of the asset is depreciated over its useful life and the depreciation expense is recorded on the income statement.

OpEx

Operational expenses are costs associated with operating the business that are incurred immediately, such as office supplies and advertising costs. With these expenses there is no asset or liability recorded on the balance sheet. If the products and services are leased, the payments are expensed as they are paid and future lease payments are noted in the audited financial statements.

How is leased IT equipment recorded?

If the IT equipment is purchased outright, it's CapEx. If it's leased, it could be either CapEx or OpEx. The Financial Accounting Standards Board (FASB) developed a four-criteria system that makes it easy to determine which class applies to your particular IT investment. It is mandated that the lease be recorded as CapEx if one (or more) of the following criteria apply:

(1) Payments represent substantially all of the fair value of the asset

(2) The lease term is for a major portion of the asset's economic life

(3) Purchase of the asset is considered a bargain

(4) Title transfer to the lessee is automatic at the end of the lease

If one or more of the four criteria applies, it's a determined to be a CapEx lease and recorded as an asset with payments recorded as liabilities. If none of the four criteria apply, it's determined to be an OpEx lease and not recorded as an asset or a liability. In this case, each month the payments are represented as rental expenses and recorded as an off-balance sheet item.

The significance of how the lease is recorded is related to the impact it has on the return on assets (ROA), which is a key performance indicator for a company. It's an indicator of a company's profitability relative to its number of assets that demonstrates how well (or not) the company used its assets to generate revenue. Typically, the higher the ROA, the stronger the financial health of the company. If the returns are greater than the assets, there is a higher ROA. Conversely, if the assets are greater than the returns, there is a lower ROA. Therefore, because an OpEx lease does not count toward the company's assets, it helps boost ROA.

Which classification is better?

With regard to the classification of CapEx or OpEx, one is not necessarily more desirable than the other. It all depends on your business and financial objectives, and how the FASB criteria apply. Generally, a company makes the determination based on how the classification affects EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). EBITDA is an indicator of a company's operational efficiency and indicates whether certain line item costs are subtracted before gross profit, or after gross profit. This is referred to as the EBITDA line. If the goal is to show higher gross profits, structuring your lease as CapEx will put the line item cost below the EBITDA line so the gross profit is greater. If the goal is to minimize assets and liabilities, structuring the lease as OpEx will put the line item cost above the EBITDA line showing a lower gross profit but also lower operating expenses.

What's the right classification for your business?

The Veristor Capital team has in-depth expertise on IT equipment leasing and the complexities involved with recording them properly. We share all of the possible scenarios and outcomes with our customers so they can make the most informed decisions. We work with you to determine which options are available to you based on the nature of your lease, and then guide you through the process of structuring the lease so it supports your objectives and the overall financial position of the company.

Contact Veristor today and let us walk you through the process of recording your IT lease the right way from start to finish. With our expertise, you'll be on your way to meeting your strategic goals and structuring a healthy business. Visit **veristor.com/capital** for more information.