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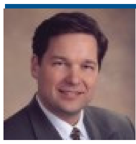

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Agile and Capital Cost Depreciation

As agile method are being adopted more and more at the enterprise level, finance departments are asking questions that agile practitioners have not had to address before. One such question is whether there are tax differenes between agile and waterfall approaches. This whitepaper examines the impact to capital cost depreciation between the two approaches.

A client contacted me recently with an interesting question. The client heads the PMO in a national branch of a multi-national corporation. His group was starting the deployment of agile project delivery methods within the organization and received an interesting query from his finance department. In analyzing the business case justification for incorporating an agile option within their project lifecycle model, the finance team asked the question "Does the switch to agile change how (or if) we can depreciate our project capital costs?"

At first, the answer seemed simple but, upon further analysis, the situation is a bit more complicated. After contacting my own accountant and then both the United States' Internal Revenue Agency and the Canada Revenue Agency, I was able to respond to my client's question.

Basic Principles

Before I share the results of my research, let me provide a few basic taxation principles for those who need a refresher. When a business incurs expenses in order to earn income, tax laws generally allow the business to deduct those expenses from any income earned, reducing the amount of income that is subject to taxation. The categories of expenses that are eligible for deduction and the portion of the expenses that can be deducted vary from country to country but the principal generally holds true. (Yes, I know there are a few countries with NO taxation. If your company is situated in one of these, then this article is not aimed at you.)

There are several ways in which eligible expenses can be deducted as well. Generally, small eligible expenses can be deducted 100% in the year the expenses are earned. Larger eligible expenses may be fully deductible in the first year or may have the deduction spread out over time using a variety of techniques. When the deduction of large expenses is spread out over time, we say the expenses have been "capitalized" and then we use the technique of depreciation (for tangible assets like computers, network infrastructure, buildings, furniture, etc.) or amortization (for intangible assets such as patents, licenses, trademarks, etc.). [Note that in some countries (such as Canada), the two terms are often used interchangeably.] Finally, the allowable rates of depreciation or amortization are often set out in laws and regulations, and differ from country to country.

As my father used to say, "a bird in the hand is worth two in the bush" or, in other words, it is better to take advantage of an opportunity now rather than to wait for a better moment in the future. In accounting, it is best usually to take your deductions as quickly as possible to immediately minimize taxes in the present. Often, excess deductions (causing "tax losses") can be rolled over to future (and sometimes past) tax years.

How Agile Affects the Accounting

On longer projects, expenses get capitalized and generally cannot be deducted/amortized until the project is "done" or when it starts earning its intended business benefits. Waterfall projects are "done" at the end, and it is easy to determine when benefits realization begins; however, on agile projects, deliverables are produced in a phased approach, and benefits realization may begin at many points along the project lifecycle. Which brings us to the question at hand: for agile projects, when can we start deducting/amortizing capital expenses?

The answer, as indicated earlier, depends upon when business benefits start being realized. If you use an agile approach to produce your deliverables in a phased approach but don't start really using them until the end, then the deductions will start at the end, once the deliverables are put into use to earn the intended business benefits – which is how the deductions are structured in waterfall projects. However, if you can put a portion of the deliverables into use early, where they start to earn incremental business benefits, then you can immediately start deducting the portion of the capital costs associated with those deliverables.

The difference can be significant. Let's take a look at an example.

A company is starting a $10 million project to build a custom IT solution integrating multiple back-end systems to create a new customer self-service portal. The project is expected to take 1.5 years to complete. The Canadian Income Tax Act allows an annual deduction of this cumulative eligible capital at a rate not exceeding 7%, which must be pro-rated if the solution is delivered mid-year. This would mean a deduction of $350,000 starting at the end of year two for a waterfall project.

Table 1: Waterfall Approach

Release	Year 1 Deduction	Year 2 Deduction
18-month Release	$0	($10,000,000 x .07) /2 = $350,000
TOTALS	**$0**	**$350,000**

Let's assume that the same project delivered in an agile fashion deploys a functional (and value-earning) increment of the solution every six months, or three 'releases' during the 1.5 year project. Assuming costs are evenly distributed across the 1.5 years, and using the declining balance calculation method, the deduction would look quite different:

Table 2: Agile Approach

Release	Year 1 Deduction	Year 2 Deduction
6-month Release	($3,333,333 x .07) /2 = $116,667	$3,321,667 x .07 = $232,517
12-month Release	$0	$3,333,333 x .07 = $233,333
18-month Release	$0	($3,333,333 x .07)/2 = $116,667
TOTALS	**$116,667**	**$582,517**

For the agile project, the cumulative total deducted by the end of year two is $699,184 compared with a total of only $350,000 for the waterfall project. This shows that by switching to an agile approach, the organization's business case would improve, showing an additional reduction of taxable income of $349,184. At a combined federal and provincial business tax rate of 26.5% (in Ontario), this could mean a $92,534 net reduction in taxes over two years by switching to the agile approach. If the releases were more frequent, then the tax benefits would be even greater.

Of course, the specific depreciation rates, calculation techniques, and tax rates will change over time and will differ between jurisdictions; however, the general premise should still remain the same: agile projects allow earlier deduction of capital expenses which leads to tax savings over and above what would be allowed for a waterfall project. And these benefits may make a meaningful difference when trying to get your project business case approved.

Disclaimer

Our lawyer informs me that I must include the following statement.

I am not a lawyer, an accountant, or a tax law expert. The information contained in this article is based on my own (possibly flawed) understanding of the relevant tax laws and regulations and should not be taken as legal or tax advice. Readers should consult their own advisors for details of how the principles discussed in this article may affect them in their own jurisdiction.

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