What is cloud accounting?

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In this article

Traditional IT accounting (cost center model)
Central IT accounting (profit center model)
Chargeback
Showback or awareness-back
Impact of cloud accounting models

As described in Creating a financial model for cloud transformation, the cloud changes how IT accounts for costs. Various IT accounting models are much easier to support based on how the cloud allocates costs. As a result, it is important to understand how cloud costs should be accounted for prior to embarking on a cloud transformation journey. This article outlines the most common cloud accounting models for IT.

Traditional IT accounting (cost center model)

Considering IT a cost center is often an accurate viewpoint. In the traditional IT accounting model, IT consolidates purchasing power for all IT assets. As discussed in financial models, that purchasing power consolidation may include software licenses, recurring charges for CRM licensing, purchase of employee desktops, and other large costs.

When IT serves as a cost center, the perceived value of IT is largely viewed through a procurement management lens. This makes it difficult for the board or other executives to understand the true value IT provides. Procurement costs tend to skew the view of IT by outweighing any other value added by the organization. This view is why IT is often lumped into the CFO's or COO's responsibilities. This view of IT is limited and can at times be short-sighted.

Central IT accounting (profit center model)

To overcome the cost center view of IT, some CIOs opted for a Central IT model of accounting. In this type of model, IT is treated like a competing business unit and a peer to revenue producing business units. In some cases, this can be entirely logical. For example, some organizations have a professional IT services division that generates a revenue stream. Frequently, Central IT models don't have generate significant revenue, making it difficult to justify the model.

Regardless of the revenue model, what makes Central IT accounting models unique is how the IT unit accounts for costs. In a traditional IT model, the IT team records costs and draws those costs from shared funds like Operations and Maintenance (O&M) or a dedicated Profit and Loss (P&L).

In a Central IT accounting model, the IT team marks up the services provided to account for overhead, management, and other estimated expenses. It then bills the competing business units for the marked-up services. In this model, the CIO is expected to manage the P&L associated with the sale of those services. This can create inflated IT costs and contention between Central IT and business units, especially when IT needs to cut costs or isn't meeting agreed SLAs. During times of technology or market change, any new technology would cause a disruption to central IT's P&L, making transformation difficult.

Chargeback

One of the common first steps in changing IT's reputation as a cost center is implementing a chargeback model of accounting. This is especially common in smaller enterprises or highly efficient IT organizations. In the chargeback

model, any IT costs that are associated with a specific business unit are treated like an operating expense in that business unit's budget. This reduces the cumulative costs effects on IT, allowing business values to show more clearly.

In a legacy on-premises model, chargeback is difficult to realize because someone still has to carry the large capital expenses and depreciation. The ongoing conversion from capital expenditures to operating expenses associated with usage is a difficult accounting exercise. It's a major reason for the creation of the traditional IT accounting model and central IT accounting model. The operating expenses model of cloud cost accounting is almost required to efficiently deliver a chargeback model.

However, this model should not be entered into lightly. The following are a few consequences that are unique to a chargeback model:

- Chargeback results in a massive reduction to the overall IT budget. For IT organizations that are inherently inefficient, or require a great deal of complex technical skills in operations or maintenance, this model can expose those expenses in an unhealthy way.
- Loss of control is a common consequence. In highly political environments, chargeback can result in loss of control and staff being reallocated to the business. This could create significant inefficiencies and reduce IT's ability to consistently meet SLAs or project requirements.
- Difficulty accounting for shared services is another common consequence. If the organization has grown through acquisition and is carrying technical debt as a result, there is likely a high percentage of shared services that have to be maintained to keep all of the systems working together effectively.

Cloud transformations include solutions to these and other consequences associated with a chargeback model. However, each of those solutions includes implementation and operating expenses. The CIO and CFO should carefully weigh the pros and cons of a chargeback model before considering this model.

Showback or awareness-back

For larger enterprises, a showback or awareness-back model is a safer first step in the transition from cost center to value center. This model doesn't affect financial accounting. In fact, the P&Ls of each organization would be unchanged. The biggest shift is in mindset and awareness. In Show Back or Awareness Back model, IT manages the centralized, consolidated buying power as an agent for the business. In reports back to the business, IT would attribute any direct costs to the relevant business unit, thereby reducing the perceived budget consumed by IT directly. IT would also plan budgets based on the needs of the associated business units, allowing IT to more accurately account for costs associated to purely IT initiatives.

This model provides balance between a true chargeback model and more traditional models of IT accounting.

Impact of cloud accounting models

The choice of accounting models is crucial in system design. The choice of accounting model can affect subscription strategies, naming standards, tagging standards, and policy and blueprint designs.

Once the decisions about a cloud accounting model and global markets have been made with the business, enough information has been aggregated to develop an Azure foundation.

Develop an Azure foundation