

EFFECTIVE MANAGEMENT OF IT COSTS
COMBINING EFFICIENCY, VOLUME AND OPTIMISATION
PERSPECTIVES IN ORDER TO CONTROL IT COSTS

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Introduction

Many companies are heavily dependent on IT in the execution of business processes and the reinforcement of their competitive position. Besides the possible benefits that IT has to offer, companies are confronted with high and often annually increasing IT costs.

It appears to be complicated to keep IT costs at a competitive level. The main causes are: complex IT environments, differences in semantics between business and IT and the fact that the IT organisation is often solely responsible for keeping IT costs under control.

This fundamental discusses the concept of 'effective management of IT costs' and offers a solution to stay in control of IT costs. The Nolan, Norton & Co. developed EVO model (Efficiency of supply, Volume of demand and Optimised assortment) is presented in this article and is a useful means to realise effective management of IT costs.

The challenge of controlling IT costs

Many companies have complex IT environments. The environments frequently date from the seventies or eighties (legacy), which leads to relatively high maintenance costs. Also, as an effect of mergers and acquisitions the application architecture has become complex with a multitude of information systems, partly overlapping in functionality, with fragmented data storage and limited interoperability. On top of this, companies are currently implementing new technologies in an accelerated pace, which must interact with the legacy environments. This complexity leads to relatively high IT cost levels.

Beside complex IT environments there also appear to be differences in the semantics of the business and the IT organisation. This inhibits a common understanding of the desired and delivered IT services, service conditions, related costs and the way in which these costs can be influenced (control mechanisms). A solid dialogue on IT services and related costs, including a clear form of governance, is often non-existent. Next to this, IT managers are often not able to bridge the gap in semantics between business and IT.

Strangely, most companies (wrongly) decide to make management of IT costs a sole responsibility of the IT organisation (IT supply). The limited focus on the demand side of IT leads to a situation in which realised savings by IT supply (for example: more efficient IT operations) fade away as an effect of the increasing demand for IT (new functionality, more transactions, new projects, etc.). As a result, expected savings are not realised and IT costs seem to grow autonomously.

A new approach is needed: effective management of IT costs

In order to be able to realise transparent and controllable IT services and to manage costs and profit from the potential business benefits of IT, IT costs should be approached in a different way. This new approach is called 'Effective management of IT costs'. The approach is based on the idea that business and IT should work intensively together, but also that roles and responsibilities for effective IT cost control should be separated and clearly defined. Nolan, Norton & Co. developed the EVO model (Efficiency of supply, Volume of demand and Optimised assortment) to make the concept of effective management of IT costs ready for use. The model is explained in figure 1.

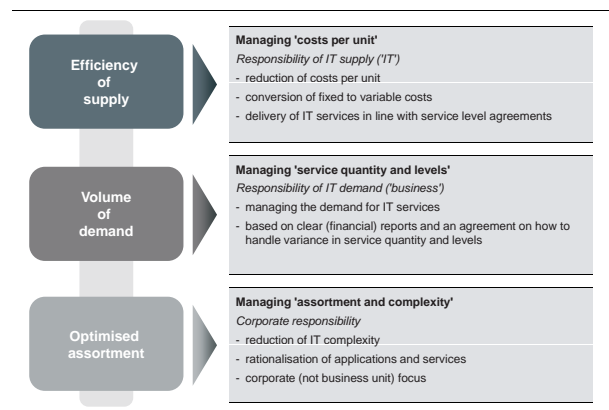


Figure 1: EVO model (Efficiency of supply, Volume of demand, Optimised assortment)

The EVO model distinguishes three types of management responsibilities / perspectives that should be clearly defined: (E) efficiency of supply, (V) volume of demand and (O) optimised assortment. These roles and responsibilities are often not adequately defined and executed, resulting in a limited focus and ineffective IT cost control.

Components of effective management of IT costs

When roles and responsibilities have been clearly defined, one can start the implementation of effective management of IT costs. The most important components of effective management of IT costs (and their hierarchy) are presented in figure 2 and described below in more detail.

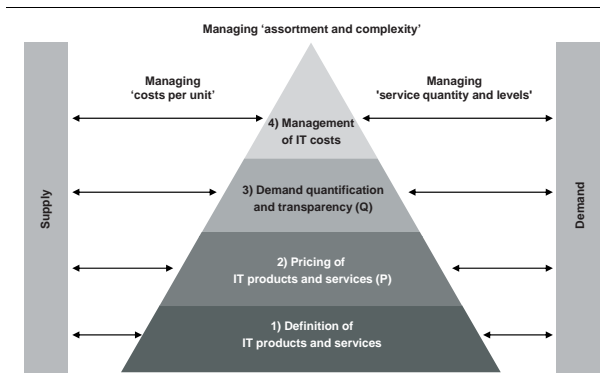


Figure 2: Components of effective management of IT costs

1. Definition of IT products and services

The first component of effective management of IT costs is the definition of a clear set of products and services which are delivered to the business by IT. This so-called 'product and service catalogue' is ideally determined in a joint effort by business and IT, so that the business understands the products and services and recognises the various service levels. Such a catalogue facilitates the business in determining the IT products and services it needs, in which quantity and at what service levels.

When defining IT products and services a lot of companies end up with definitions that are either too technical or too detailed and that are in fact not controllable by the business. To avoid this, it is useful to start with a clear high-level classification (recognizable for both business and IT), for example:

- Office automation (e.g. desktops, laptops, printers, etc.)
- Information systems (e.g. business applications such as SAP, Siebel and tailor made systems)
- Releases (e.g. small adaptive maintenance)
- Projects (e.g. large development initiatives)

Subsequently, this high-level classification needs to be further detailed to products and services in close cooperation between business and IT.

2. Pricing of IT products and services

When there is consensus on the IT products and services delivered to the business, the pricing of products and services must be determined. Agreement is necessary regarding the pricing system (fixed costs, based on volumes, based on FTE, etc.) and actual prices (market-price, cost-price, based on negotiations, etc.) that will be charged per product / service. The nature of the company, the goals of the IT organisation (cost/profit centre) and the requirements of the business determine which choices need to be made with regards to the pricing system and prices to be charged.

In our experience, most methods for charging IT costs to the business often are disproportionately detailed, complex and expensive. This leads to a situation in which the focus is on justifying the charging of costs instead of delivering reliable IT services against competitive costs. Our preference is to use a model that is simple and widely accepted among stakeholders. Such a model is explicitly based on the 'product and services catalogue' and its structure (top-down classification, no technical details). Next to this, the focus of such a model should be on the primary cost components (for example: laptops, in case of office automation) and not on products and services which only lead to marginal costs (for example: mouse devices, in case of office automation). Such a model should also have a pragmatic pricing system. This means that the method for cost allocation should be 'good enough', instead of a comprehensive activity-based costing method. This avoids the potential pitfall of "paralysis by analysis".

3. Demand quantification and transparency

Transparency in the actual demand for IT products and services (quantity and levels as obtained by the business) is required to be able to charge the business for the use of IT. In most companies however, a sufficient administration to provide insight in the use of IT is often not available. The demand quantification and transparency component entails an adequate and integral administration, including related processes and procedures, that:

- give a clear overview of the use of IT by the various business units (in quantity and service levels) and the departments within the IT organisation that are responsible for the delivery of the products and services;

- is up-to-date, especially with regard to discontinuation of demand for certain IT services by business units (mutation processes);
- is tightly linked to the financial administration.

4. *Effective management of IT costs*

Once there is clarity in products, services, pricing and actual demand, the next step is to actively manage the IT costs of the organisation. This has to take place in close cooperation with the finance and control function of the company. Companies can use the three perspectives of the EVO model to bring effective management of IT costs into practice:

Efficiency of supply: managing 'costs per unit', responsibility of IT supply

Reducing costs per unit is a primary responsibility of the IT supply organisation within a company. IT supply should continuously focus on reducing costs per unit of IT services, for example by:

- using new or cheaper technologies;
- reducing stock levels and accelerating the delivery of products and services (for example: laptops, desktops, etc.);
- implementing professional contract management (to manage external suppliers and to make costs more flexible and variable).

The challenge, in executing such measures, is to continuously find an optimum between lower and more variable costs per unit and reliability of the IT services delivered (in line with service level agreements).

Volume of demand: managing 'service quantity and levels', responsibility of IT demand

Managing the volume of the demand for IT products and services is a primary responsibility of the business. The business should actively manage (and limit, in case of cost reduction ambitions) the actual volumes they need, based on clear (financial) reports and an agreement on how to handle variance in service quantity and levels. To effectively manage volumes, a solid understanding of the structure and drivers of IT costs is a prerequisite.

IT cost drivers can be defined in business terminology (for example: number of insurance policies, number of

customers, number of employees, etc.), but can also be defined in IT terminology (for example: number of GB storage, MIPS, etc.). The decision which one is more suitable depends on the type of company. It makes sense to jointly (business and IT) define cost drivers, so that there is a common understanding on the mechanisms that influence IT costs.

When the IT cost drivers have been determined, it is useful to elaborate them in a financial model in order to be able to simulate the financial effects of cost measures. It facilitates decision-making, implementation and monitoring of the cost measures taken by the company.

Optimised assortment: managing 'assortment and complexity', corporate responsibility

Managing the assortment and complexity of IT products and services is a corporate responsibility. Business and IT should jointly reduce the complexity of the IT environment and rationalise the application and service portfolios. In this process, long term and short term considerations for multiple business units need to be taken into account.

There are various possible measures to reduce complexity and rationalise the service portfolio of a company. Examples of such measures are phasing-out of legacy environments, reducing the number of applications or reducing the number of interfaces between applications. To achieve results, it is important to define an architectural framework and to determine clear targets (overall and per organisation unit). These targets will be the basis for progress evaluation. It also helps to allocate a specific corporate budget for the reduction of complexity.

I mplementing effective management of IT costs

Effective management of IT costs needs an integral and gradual approach. In a number of steps organisations can work towards a situation in which IT costs are mainly variable, there is agreement on variance in service quantity and levels, the IT landscape is rationalised and demand volumes have been brought to appropriate levels. The initiation phase of such an initiative takes about six to

eight weeks (see figure 3) and delivers:

- the high level design ('to-be') based on the EVO model and principles;
- short term improvements of the current mechanisms for IT cost control;
- a plan and program design for the implementation of effective management of IT costs.

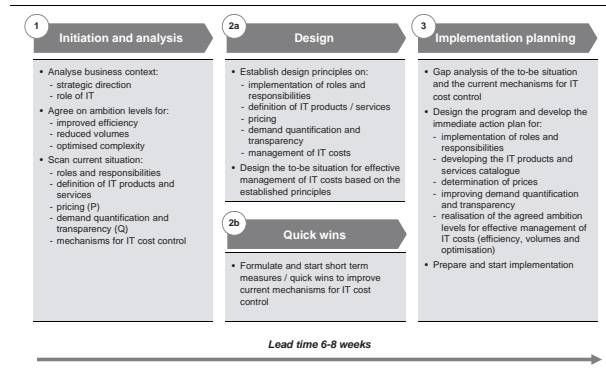


Figure 3: Initiating effective management of IT costs

To bring effective management of IT costs into practice, organisations should make sure that the defined roles, responsibilities, processes and procedures in the organisation are implemented in an effective and sustainable manner, for example by:

- adopting specific governance structures to address IT cost control based on EVO principles;
- setting ambitious targets for IT cost control;
- making effective management of IT costs an integral part of the planning and control cycle.

These points need to be addressed in the initiation phase and need to be further elaborated in the subsequent phases.

Conclusion

Nolan, Norton & Co. sees that more and more companies have taken up initiatives to improve IT cost transparency and control. However, these initiatives often have a limited scope regarding the components of effective management of IT costs as described here. Most of the time, the focus of these initiatives is on transparency and charging costs and not on controlling costs. With this article and the described EVO model, we aim to offer a 'helping hand' to those companies that would like to realise the business benefits of IT and jointly (business

and IT) keep IT costs at a competitive level. This will not be an easy assignment. A strong sense of urgency, in combination with decisive line / project management, clear IT governance mechanisms and an adequate (time and financial) budget are key to get the job done.

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