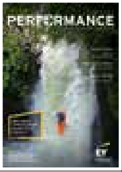

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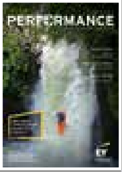
IT cost transparency: reducing external provider spend in IT outsourcing

IT outsourcing decisions are primarily driven by the desire to control and reduce operational costs. But for many companies, outsourcing may actually turn out to cost the same or even more than captive IT services — and with greater pressure than ever on the IT function to deliver innovation, failed attempts at cost savings can mean less funding available for value- and profit-growing activities. But looking in depth at IT cost transparency can help deliver on the IT outsourcing business case.



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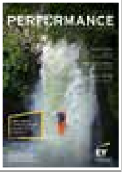
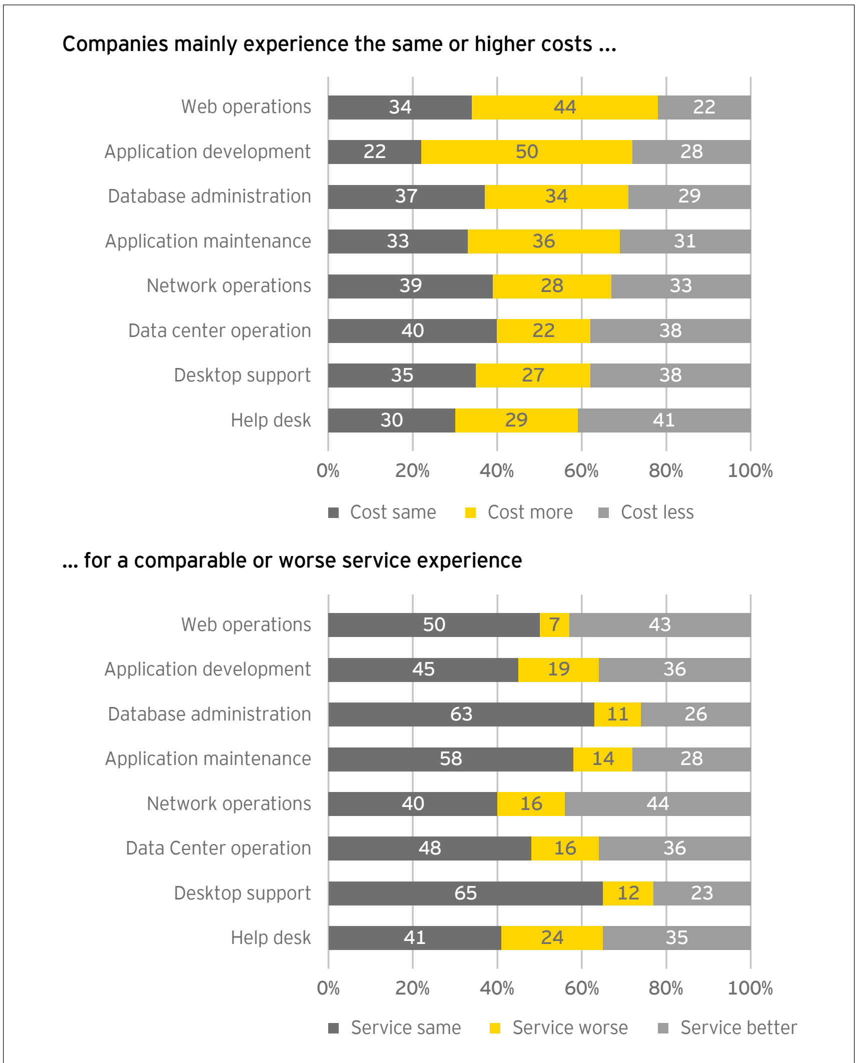


New digital technologies and trends are transforming companies across all sectors. This puts more pressure on IT functions to transform: according to an EY study, transitioning the IT function to a digital world is a key focus for CFOs worldwide – yet only 58% of them make it a high or very high priority.[1] As a result, companies start IT transformation programs such as organizational redesign. They embrace cloud, software as a service (SaaS) and other flexible IT models, and aim to shift to a more agile infrastructure. In this context, many companies outsource IT and need to evaluate, select and manage external service providers more extensively.

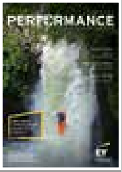
The primary drivers for outsourcing IT services include operational cost reduction and control.[2] But recent studies show that, for the majority of companies, operational costs remain the same or even increase after outsourcing IT services.[3] The same is true of service quality and, coupled with reduced control over IT services, the value of outsourcing is becoming more difficult to demonstrate – and this can damage the credibility and reputation of the IT function.

Figure 1. IT outsourcing – cost experience



Source: Computer Economics, *IT Outsourcing Statistics, 2016/2017*.

1. EY, *Partnering for performance, Part 3: the CFO and CIO*, 2015, http://www.ey.com/gl/en/issues/managing-finance/ey-cfo-program-partnering-for-performance-the-cfo-and-cio-a-growing-collaboration, accessed March 2017.
2. EY, *Outsourcing in Europe*, 2013, http://www.ey.com/gl/en/services/advisory/factors-governing-outsourcing-in-europe-2013, accessed March 2017.
3. Computer Economics, *IT Outsourcing Statistics, 2016/2017*.



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This means that IT services outsourcing, by no means, guarantees the realization of cost reductions or service improvements – instead, consistent and systematic management is needed both before and after signing an IT outsourcing contract.

Cost cutting to enable future growth and profitability

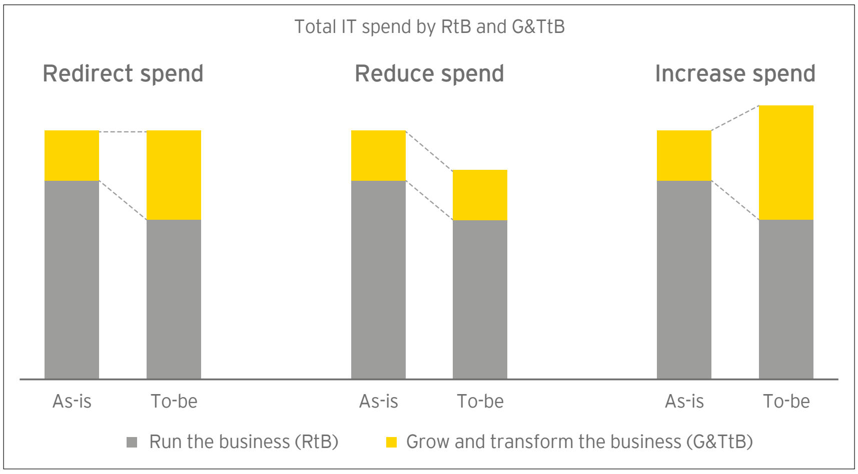
Business expects to fund value-adding projects with realized cost reductions to enable future growth and profitability.

The ability to make fact-based IT outsourcing decisions, manage providers' costs and track the benefits is increasingly translating into competitive advantage.

The split of total IT spend by "run the business" (RtB) and "grow and transform the business" (G&TtB) provides an indication of how IT contributes to business outcomes and performance. IT spend for RtB includes nondiscretionary spend and demonstrates low value for future business growth and profitability, whereas G&TtB includes discretionary spend and demonstrates high business value.

The value of outsourcing is becoming more difficult to demonstrate – and this can damage the credibility and reputation of the IT function.

Figure 2. Overview of IT cost optimization options



From a cost and value point of view, IT outsourcing can help achieve three potential outcomes:

1. **Redirect** RtB spend to value-adding IT projects to G&TtB, so that total IT spend remains flat. An increased share of G&TtB spend will enable future growth and profitability through digital innovation. The IT function's contribution is to increase future top-line and decrease future bottom-line (not only sales, general and administrative expenses (SG&A) but also cost of good sold (COGS).
2. **Reduce** spend to RtB but maintain G&TtB spend so that the total IT spend decreases. IT contributes to reducing bottom line, such as SG&A costs, in the short term.
3. **Increase** IT spend to G&TtB and additionally redirect and reduce RtB IT spend. This will enable future growth and profitability through digital innovation. IT contributes significantly to increasing future top line and decreasing future bottom line (not only SG&A but also COGS).

Empower CIO and CFO to manage IT like a business

Because of the increasing strategic importance of IT, there is a growing relationship between CFOs and CIOs to drive digital innovation. An EY study shows that 71% of CFOs have already increased their involvement in the IT agenda.[4] Although the relationship has grown closer, there are two threats. First, CFOs continue to struggle with balancing their responsibility to maintain cost discipline with more strategic ambitions. Second, effective communication and

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understanding between these two C-suite peers is an all-too-common problem.[5] The challenge, therefore, is how to empower both the CFO and the CIO, enabling them to manage IT like a business, sharing common terminology and understanding.

As illustrated in Figure 3, there are strong interdependencies between the IT value proposition and supply and demand that need to be understood, managed and steered by CIOs. The value provided by IT needs to be demonstrated and communicated to CFOs and business leaders in a common business terminology.

Large IT outsourcing deals typically have a direct impact on RtB — but because this is a nondiscretionary spend, and the total budget is limited, it also has an indirect impact on discretionary spend to G&TtB. As a consequence, failing to derive the expected benefits from an IT outsourcing deal will impact organizations' bottom line in the short term and the top line in the long term. It is crucial, therefore, to prepare fully for an IT outsourcing deal and manage the vendor throughout the contract period — and it is the joint responsibility of the CFO and CIO to provide end-to-end IT cost transparency and management capabilities to support fact-based decisions.

4. EY, *Partnering for performance, Part 3: the CFO and CIO*, 2015, http://www.ey.com/gl/en/issues/managing-finance/ey-cfo-program-partnering-for-performance-the-cfo-and-cio-a-growing-collaboration, accessed March 2017.
5. EY, *Partnering for performance, Part 3: the CFO* and CIO, 2015, http://www.ey.com/gl/en/issues/managing-finance/ey-cfo-program-partnering-for-performance-the-cfo-and-cio-a-growing-collaboration, accessed March 2017.

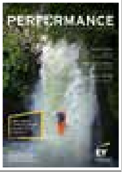
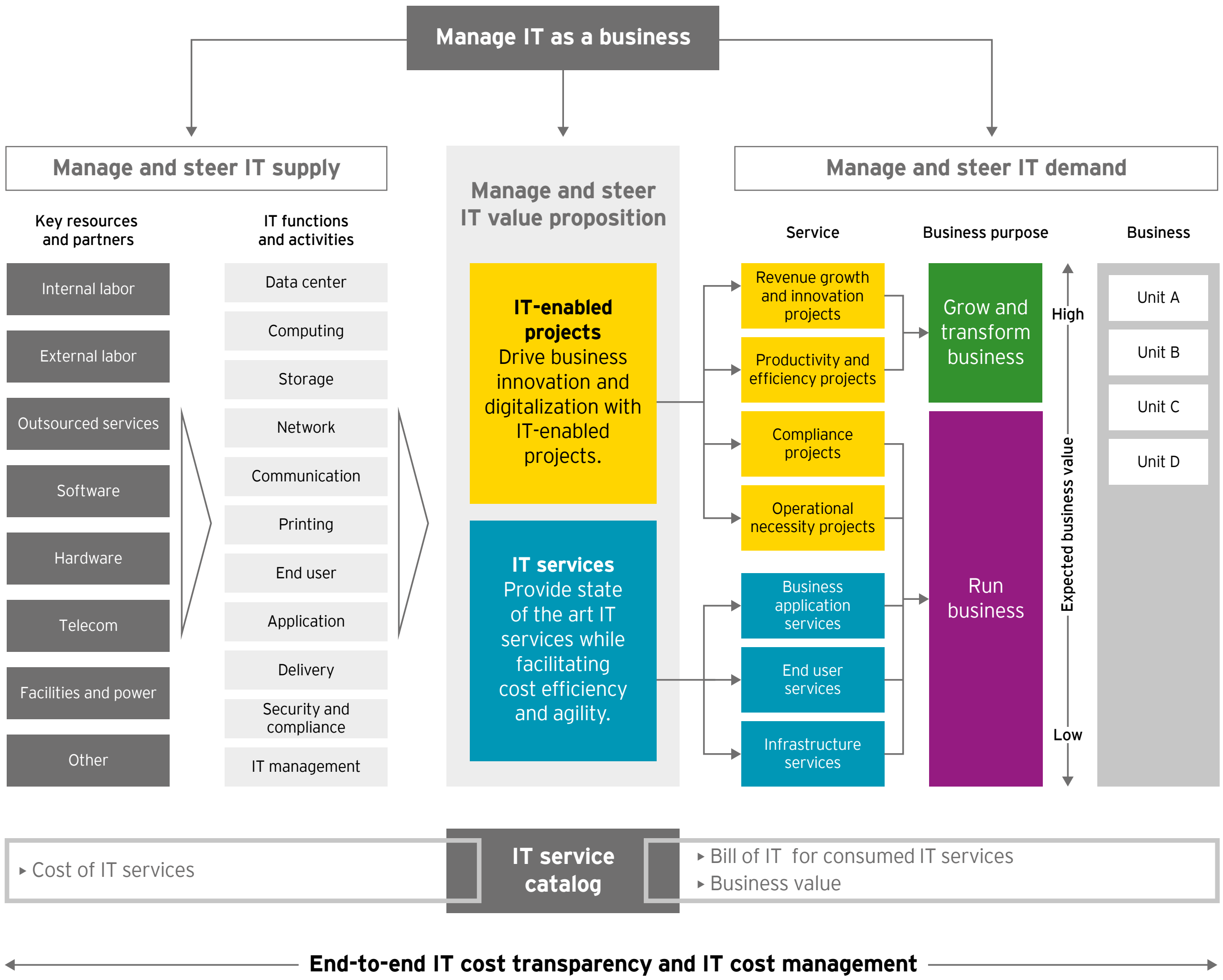


Figure 3. Managing IT as a business — end-to-end IT cost transparency as a basis for demonstrating business value



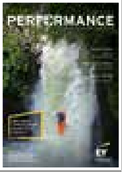


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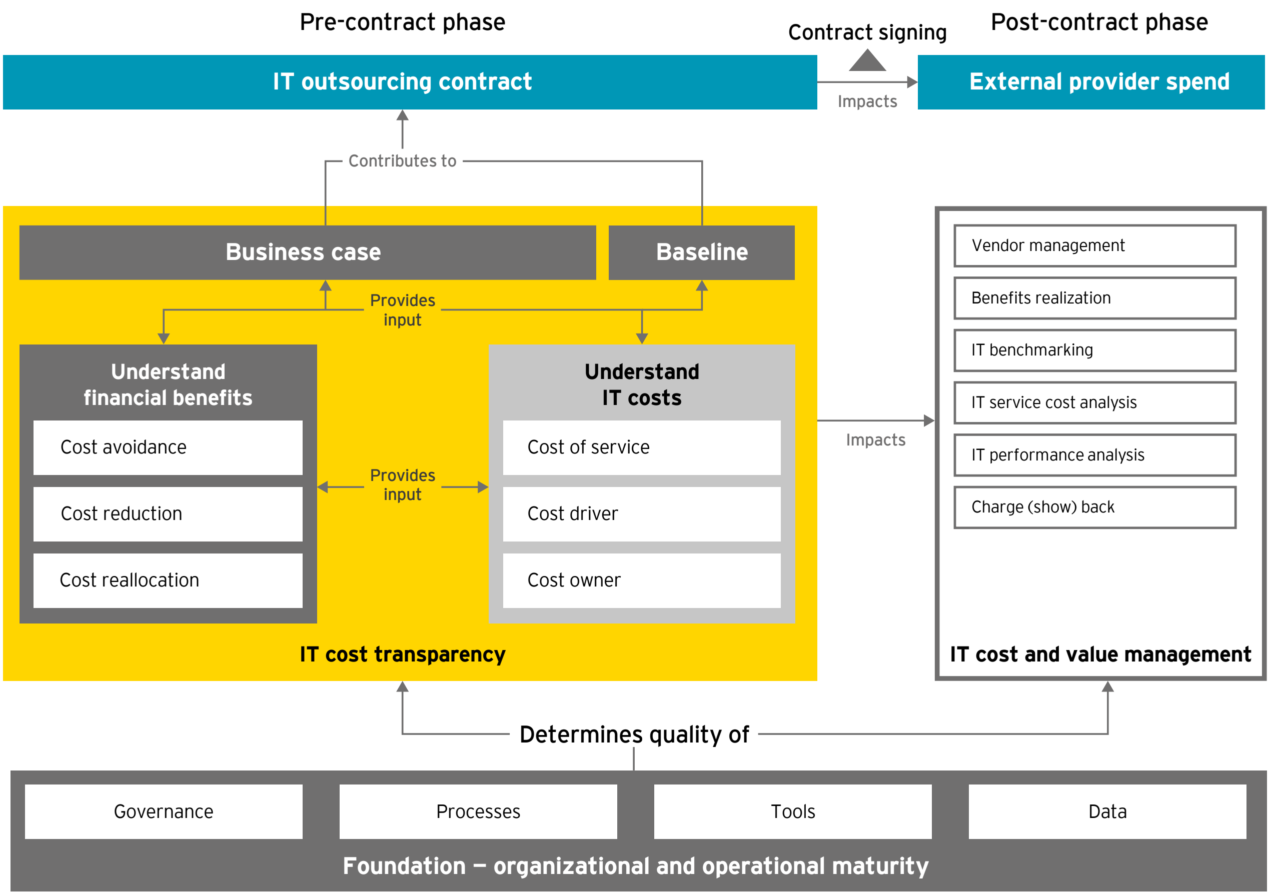
Figure 4. Illustration of IT cost transparency and related interdependencies



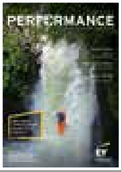
IT cost transparency as the foundation for IT outsourcing contracts

As already mentioned, IT outsourcing decisions are often the result of strategic IT transformation programs. A strategic shift from "make" to "source and manage" will eventually lead to an increased number of IT outsourcing contracts, and they will be more comprehensive.

Transparency on related costs and cost drivers is critical, not only to identifying but also utilizing the full potential of IT outsourcing – and gaining real business value from the IT transformation strategy. In this context, we use the term "IT cost transparency" – this covers IT costs, related cost drivers, the cost owner and value for money. This is necessary to have a reliable understanding of IT costs.

As illustrated in Figure 4, IT cost transparency also includes an understanding of the financial benefits because in order to quantify these, the IT costs must be known. This is why both an appreciation of the IT costs and the expected financial benefits flowing from an IT outsourcing contract will feed into the business case and baseline, which will typically be directly or indirectly part of the IT outsourcing contract. And the contract itself will impact the future spend for the external service provider.

After signing a contract, the challenge is to manage the vendor and to help facilitate realization of the expected benefits. This will also depend on the level of IT cost transparency: the lower the transparency the more limited the capabilities to manage provider costs and value. Finally, the quality of IT cost transparency depends on the organizational and operational maturity, which includes governance, processes, tools and data. Low maturity will lead to low transparency and, consequently, to an increasing risk of not realizing expected benefits from IT outsourcing.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Cumulating this annual saving over the remaining six years of the contract could result in a saving of €186m.

Case study: How IT cost transparency improved the realization of benefits from IT outsourcing

The situation: rising risk of not delivering expected benefits from IT outsourcing

A multinational organization had decided to outsource its entire IT infrastructure to an external service provider. Prior to this, these services were supplied through a captive IT organization to all group divisions and companies. The objective of IT outsourcing was to help realize a significant cost reduction in the IT infrastructure costs, particularly in the area of RtB.

Once the scope of the IT outsourcing contract was defined, the client identified associated costs. Although the business units were charged back per IT service, a total cost per service (cost to produce or supply the service) was not available. Business units were charged back with different prices for the same or similar services. As this did not reflect the true cost base but internal credits (revenue), the cost baseline for the business case was by cost type (such as personnel, outsourcing, hardware and software).

During the contract preparation, both the client and the service provider conducted a joint due diligence to evaluate the current consumption (demand-driven cost driver) and the existing IT infrastructure (supply-driven cost driver). Because of the low level of organizational and operational maturity, the quality of transparency was low.

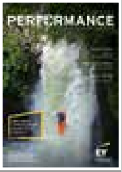
The challenge: bring external provider spend back on track to help realize benefits

While the baseline and business case for the IT outsourcing contract relied on limited transparency regarding costs and cost drivers, this was the only available level of information.

The external service provider calculated and proposed future service fees based on these data. But within the IT outsourcing contract, it was also agreed that the service provider had to charge all services on the basis of actual consumption after service transition. Prior to the IT outsourcing, the captive IT organization had a mix of consumption-based and fixed-price services. For most of the fixed-priced services, the real consumption was not measured – there were no processes and tools in place to do this. But with the transition of those services to the external service provider, these services were required to be measured and billed on the basis of actual consumption.

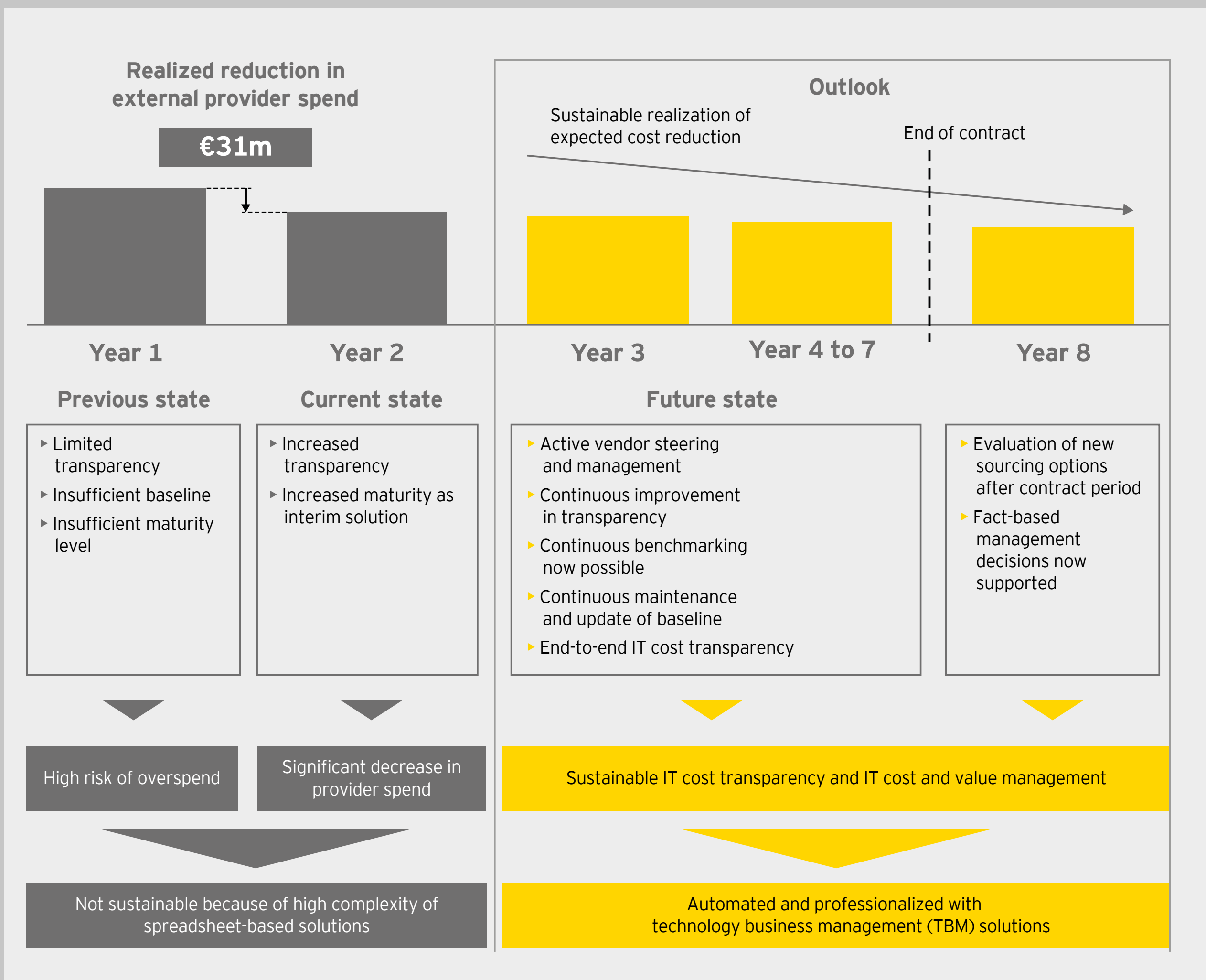
The contractually agreed level of granularity to order, measure and bill IT services was higher than it had been prior to the IT outsourcing – yet the required level of data was not available to build the bridge from services before transition to after. In addition, immediately after the service transition, it was not possible to measure actual consumption volumes consistently. As a result, it was not possible to determine an annual charging fee that was fair, transparent, compliant with the contract and aligned across all stakeholders (i.e., group IT, business units and service provider).

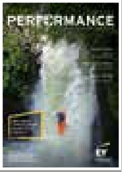
As a result, there was a high risk of significant deviations between planned and actual spend for the external service provider. Increased spend on the external service provider would represent a failure to meet the business case that was approved and expected by the supervisory board. The challenge was to bring down service provider spend based on transparent data and fact-based management decisions.



IT cost transparency can help save money. The benefits are not limited to IT outsourcing initiatives, but can help to manage IT like a business in itself.

Figure 5. Overview of client benefit and outlook





The response: increase transparency and enable fact-based management decisions

The response was to increase transparency by building a bridge from the previous level of service billing to a future level of service billing, and enrich missing data, such as consumption volumes. This was achieved in four steps:

1. **Analyze** existing data to identify most significant services, related cost drivers and data gaps
2. **Define** conversion of services in current billing structure to services in future billing structure
3. **Align** service conversion and consumption values across all stakeholders
4. **Execute** corrections to provider billing

Client benefit: €31m reduction in annual service provider spend — and business case is back on track

For the first contract year, the parties negotiated and agreed on a total annual charging amount based on the available information, even though it lacked the required granularity and accuracy. Continuing this mode of operation for the following years would have led to a failure of the business case. During year two, however, the client saved €31m compared with the previous year. Cumulating this annual saving over the remaining six years of the contract could result in a saving of €186m.

This serves as an example of how IT cost transparency can help save money. The benefits are not limited to IT outsourcing initiatives, but can help to manage IT like a business in itself.

Outlook: technology business management (TBM) can help provide sustainability

TBM is a practical discipline for increasing value by enabling technology leaders and their business partners to collaborate on business-aligned decisions. Relying on transparency, TBM empowers fact-based decision-making to improve RtB spending (cost-for-quality), improve change-the-business investments (innovation) and execute in line with business priorities (agility).[6] ■

6. TBM Council, 2017.