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Navigating the High-Pressure of IT Cost Optimization in the Digital Era

KPMG Advisory

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Abstract

Challenges in the current economic environment are forcing organizations to reduce and optimize their IT costs. However, research shows that overall enterprise IT spend is still expected to further grow, driven by digital ambition. Sustainable IT cost management and optimization aims to improve efficiency and reduce expenses, while ensuring continuity, performance, and value realization. Systematically cutting the overall IT budget is insufficient for organizations that want to future-proof themselves and operate at market-speed.

In this paper, KPMG provides insights into how organizations can achieve sustainable IT cost optimization, by obtaining and maintaining transparency on IT cost components and addressing key IT cost optimization levers in a systematic and iterative way, enabling self-funding initiatives and dynamic investment.

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How should organizations address IT cost optimization in current market conditions?

The increasing digitalization and digitization of organizations elevates the role of 'technology' in daily operations and improvement programs. Greater demand for new solutions and systems capacity similarly impacts the 'cost of IT', which has now become a significant expense for most organizations.

In today's challenging economic environment - with persistent high inflation, rising interest rates, scarce & expensive talent, and global supply chain disruptions - being cost-aware is critically important and the pressure on IT costs has only intensified. Reducing or optimizing IT expenditures is now a key objective for many organizations.

It is crucial for organizations to understand that blindly cutting back on the overall IT budget and expenditures, without having clear insights, has been proven to be unsustainable and has often had painful consequences for long-term investment needs. For that reason, KPMG advises organizations to structure their IT cost optimization efforts by taking the following approach:

1. Obtain transparency on IT costs to enable correct benchmarking and insight-driven decision-making

By having a clear and transparent understanding of the costs associated with the respective IT cost components (Software, Hardware, Staff, Contracts..), organizations can identify the most relevant areas where they can optimize expenses without sacrificing the performance and value-enabling capabilities of their systems. To achieve this, organizations should set up a transparent Service-Based IT Cost Model.

- √ **Transparency into the cost and value drivers of IT**
- √ **Insights in cost optimizations, investment planning and IT chargeback discussions**

2. Identify and address IT cost optimization initiatives

Working on the most relevant cost levers (ranging from license optimizations to system landscape rationalization, leaner governance,…) and making informed decisions about the allocation of resources and prioritization of projects, will instantly enable organizations to reduce their IT spend. The freed-up funds can later be used to sponsor more structural and impactful projects, which will subsequently lead to more IT run rate savings.

- √ **Reduced IT spend**
- √ **Rationalized IT landscape**
- √ **Optimized IT Operating & Governance model**

3. Setup and maintain the governance and principles for Lean fit-for-purpose IT Benefit & Investment Management

To embed the continuous optimization of IT funds and expenditures in a sustainable way into the DNA of the organization, organizations should adopt a dynamic and cyclical fit-for-purpose IT Benefit & Investment Management process.

- √ **Fund value instead of projects and leaner funding**
- √ **Decentralized and delegated decisions**
- √ **Clear visibility into portfolio performance (ROI follow up)**

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01. Transparency on IT costs enables insightful decision-making

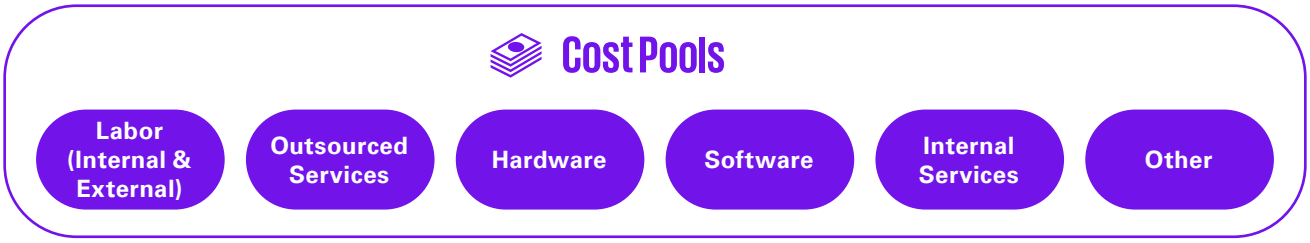
Establishing and maintaining transparency on where and what level of funding is invested for IT purposes is essential to resolving today's challenges, while delivering cost transparency insights into the value of IT and IT spending.

Costs linked to IT spending are associated with an organization's IT systems and services. This includes hardware and software expenses, as well as the costs of maintaining and upgrading these systems, together with other IT-related and 'hidden' costs. To understand the 'cost of IT', the organization needs to gain insight into the 'total cost of ownership'(TCO) of technology assets and IT services. TCO considers not only the initial purchase price, but the entire lifecycle of assets, including maintenance and upgrade costs.

With a complete understanding of these costs, organizations can make more informed decisions about how to allocate resources and prioritize projects.

From a financial perspective, creating transparency starts with categorizing all IT costs into different cost pools. This seems straightforward but in practice can be more complex than expected. Different models exist, but the most common is the Technology Business Management model, which can be used to translate technology investments into business value.

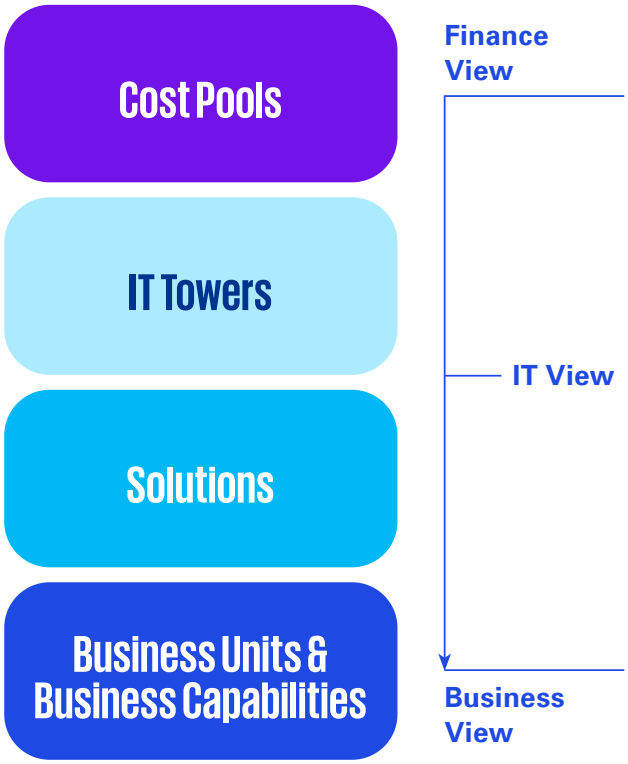
The following simplified IT cost categories ("IT Cost Pools") are defined as a minimum requirement. Note that more complex organizations tend to have a more comprehensive set of IT cost pools defined.



Organizations typically encounter a challenge while categorizing IT costs if they have outsourced. For example when outsourcing data center hosting as part of the Infrastructure as a Service (IaaS) cloud strategy, to which cost pool should you then add the invoices for this contract? If the organization classifies everything as "outsourced services", some costs like hardware or facilities linked to the data center will be less transparent. Depending on the organization's cost structure, it might be better to redistribute data center costs into other cost pools, for example: "outside services", "facilities & power" but also "hardware", "external labor" and "telecom".

Classifying these respective costs into the correct IT cost pools enables organizations to better evaluate whether these expenses are appropriate for the market conditions and whether outsourcing is the right decision. Cost optimizations can be identified from these insights.

We refer to chapter 2 to guide you on how cost optimizations can be identified and addressed.



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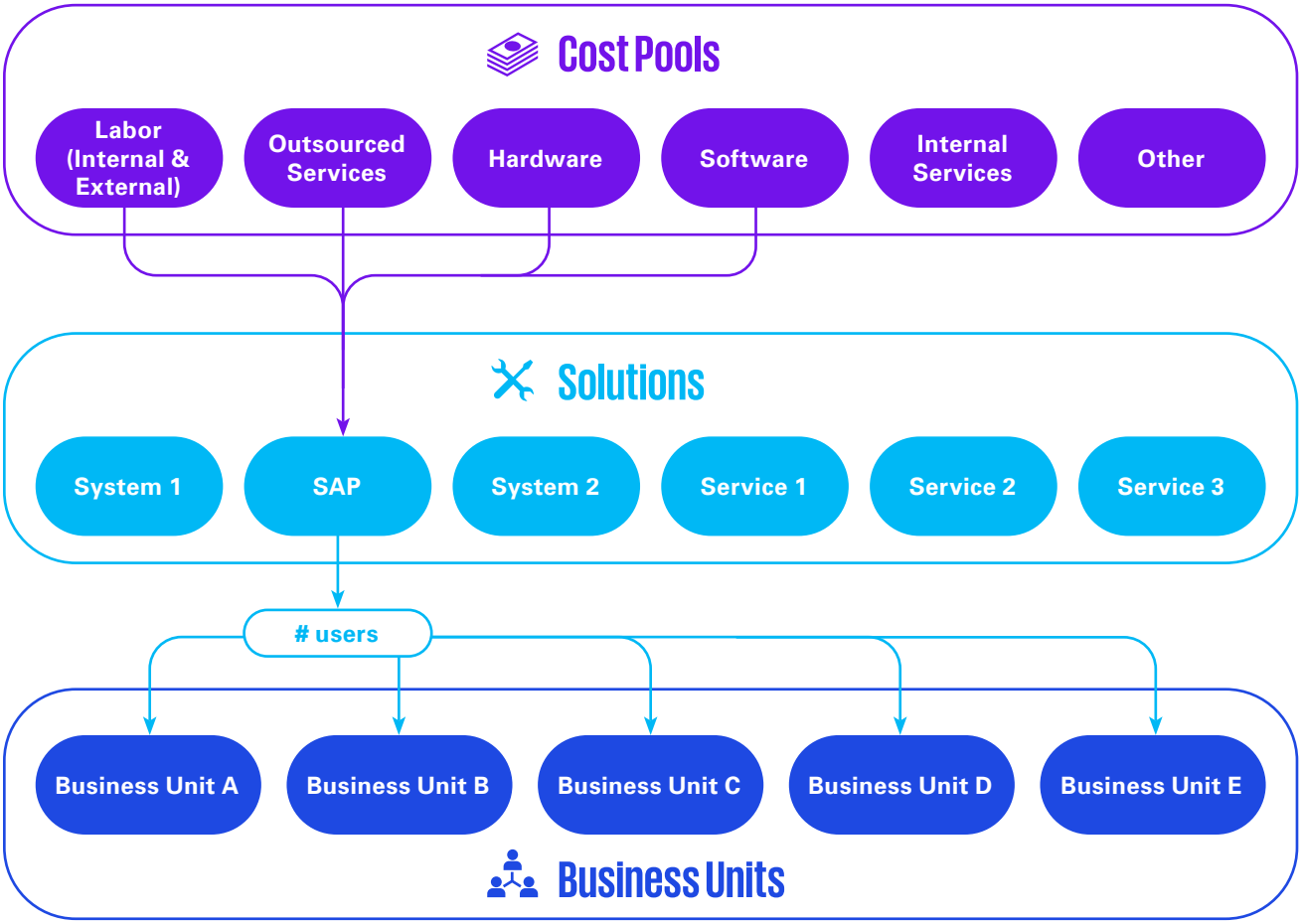
Transparency on IT costs does not end with categorizing all the IT costs into cost pools. For a clearer view of IT costs (e.g., to better monitor the budget or to enable chargeback discussions with business units), organizations typically link the different cost pools to the IT towers (towers are the building blocks to both build and support solutions) and to the solutions that are in place within the organization. As a final step, the costs allocated to different solutions can be further divided amongst the various business units (based on carefully selected allocation keys or on actual usage of the different services/systems).

To illustrate this allocation method, you can find a simplified example below of the TCO for the usage of SAP per business unit.



Given the fact that running SAP means more than just paying licenses, it is crucial to identify and link all related IT costs. The applicable licensing costs (software), infrastructure (hardware) costs, maintenance costs, labor costs, as well as smaller costs (e.g., data storage) are to be structurally linked and categorized, after which these can be allocated to the applicable business units based on allocation keys (e.g. # of users, % of revenue, etc.). For simplicity, we have left the IT towers out of this example.

After obtaining transparent insight into TCO and value drivers, cost optimizations can be better identified (and IT chargeback discussions and monitoring of IT budget can be addressed). As KPMG professionals stress to clients, the journey to cost optimization is an incremental process, starting with cost transparency. Obtaining transparency is a substantial exercise so it is important to involve the necessary expertise so IT cost allocation can be set up correctly from the start. There are various tools on the market that can help organizations to structure and track their IT costs.

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02. Cost transparency paves the way for cost optimization opportunities

Optimizing IT costs while managing business demands in tough market conditions is a common challenge. This chapter will guide you on how best to approach this in an iterative and self-funding manner, together with the attention points to be addressed.

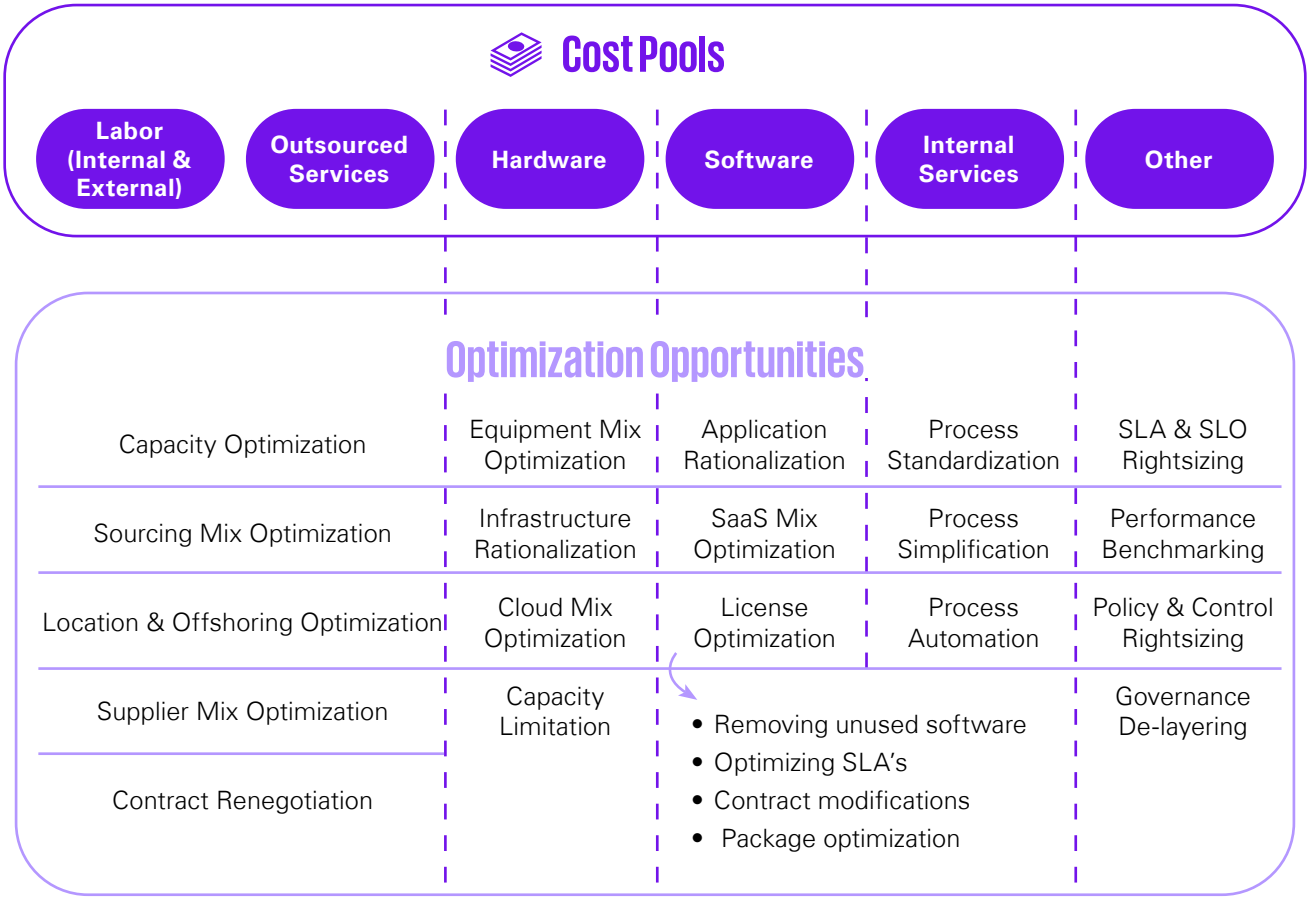
Identifying and addressing Cost Optimization opportunities

Once a clear view is established, organizations can leverage benchmarks to verify which IT costs might be excessive and identify key areas in which to focus cost optimization efforts.

If an organization notes that its software expenditures are excessive compared to sector peers and decides to optimize them, KPMG's Elevate framework can be leveraged to identify and address a set of cost & margin optimization opportunities (e.g., license optimization, application rationalization, SaaS mix optimization). Identifying/removing unused software, optimizing required SLAs and maintenance levels with suppliers, contract modification and re-negotiation (payment terms, timing, fees, etc.) are all possible scenarios of what the organization could do. To successfully identify and address these scenarios you need the necessary expertise and insights.

To put this into practice, the 'KPMG Elevate framework' provides organizations with a complete and detailed overview of where and how to achieve organizational cost savings & margin optimization (including best-practices, benchmarks, etc.). The framework provides hands-on examples of cost savings that can be achieved for all the previously mentioned IT cost pools.

Below you can find a snapshot of illustrative optimization initiatives. KPMG has detailed insights & details (sector-based) for each of the boxes. For one of the boxes (license optimization), a bit more detail is shown as an example



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Key optimization areas

Although all areas listed above can lead to cost and value optimization, the following optimization areas are most common to address in the medium-to-long term:

- Application modernization involves updating legacy applications to take advantage of new technologies and improve efficiency.
- Intelligent automation uses automation and machine learning to streamline processes and reduce costs.
- Infrastructure and cloud optimization ensures that an organization's IT infrastructure is cost-effective, scalable, and secure.
- ERP, SCP and CRM optimization, as these systems are often the backbone of an organization's IT operations and can be optimized to improve efficiency and reduce costs.

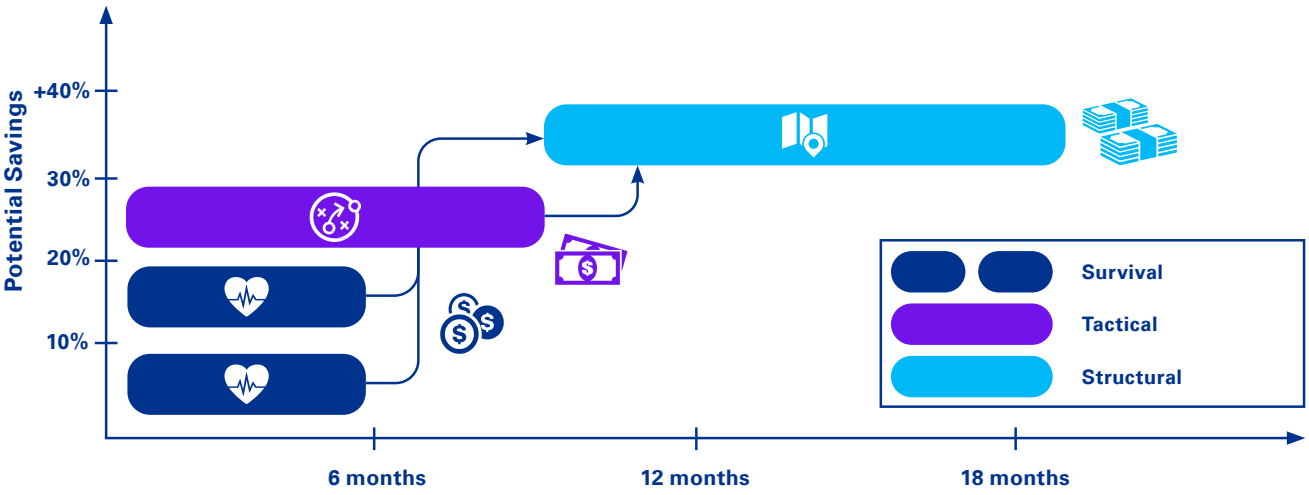
Realizing these initiatives will however require significant short-term investment. To enable the gathering of these funds, it is advised to first focus on quick wins and re-invest these savings in larger optimization initiatives.

Where to start?

It is important to note the process of cost optimization should not be seen as linear but rather as a funneled process from 'quick wins' or 'survival mode' towards more structural projects.

These 'quick wins' - or short-term cost reductions - will leverage opportunities to 'pay the way' forward and enable organizations to tackle the larger structural cost optimization and dramatically reduce the IT cost structure.

Leverage short term cost reduction opportunities to "pay the way" forward and enable your organization to tackle the larger structural cost optimization and dramatically reduce your IT cost structure.



Examples of quick wins organizations typically encounter, which can result in an immediate and significant impact on EBITDA (non-exhaustive):

- Infrastructure run and maintenance costs.
- Licensing costs, including over-subscription and the use of costly licenses for simple activities.
- Unmanaged spending on cloud resources.
- Duplicated investment in technologies and solutions.
- Time-intensive 'management' overhead (minimizing things like stage gates, council reviews, layers of reporting, etc.)

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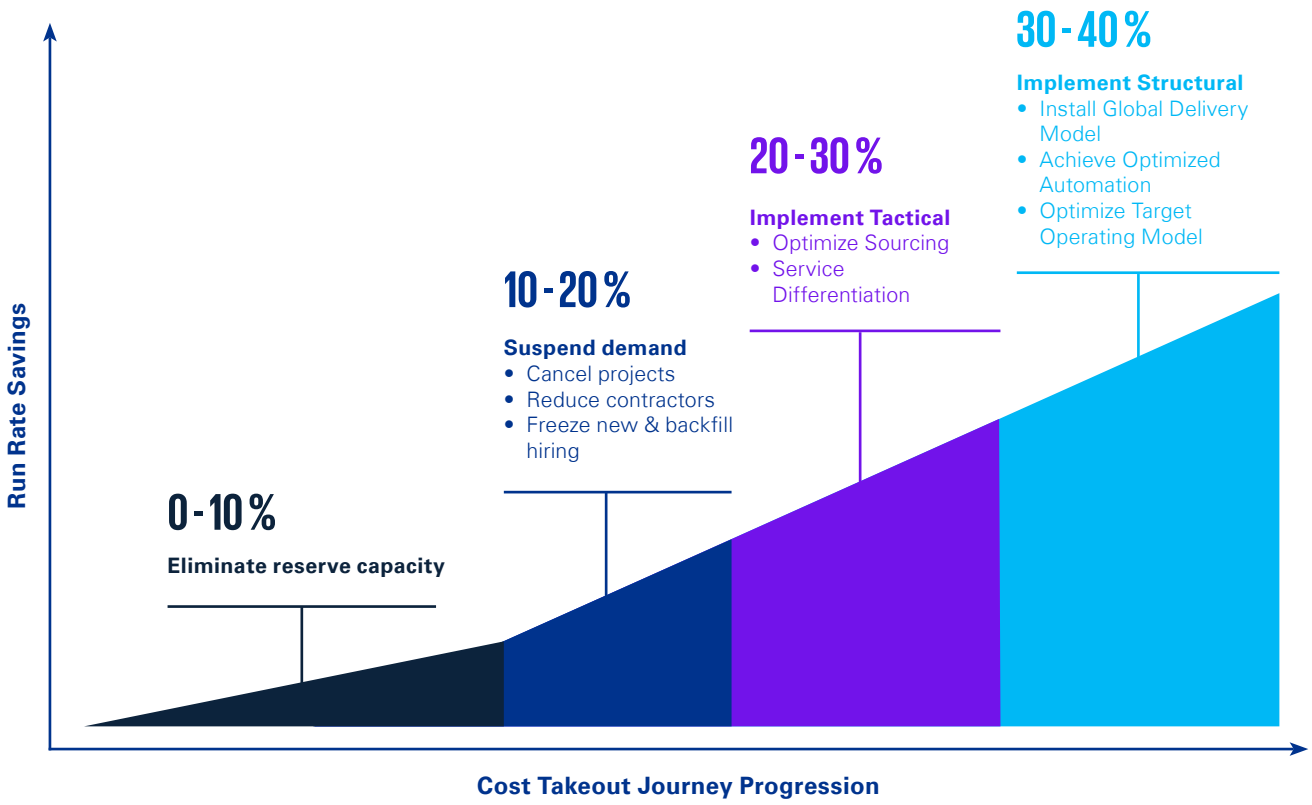
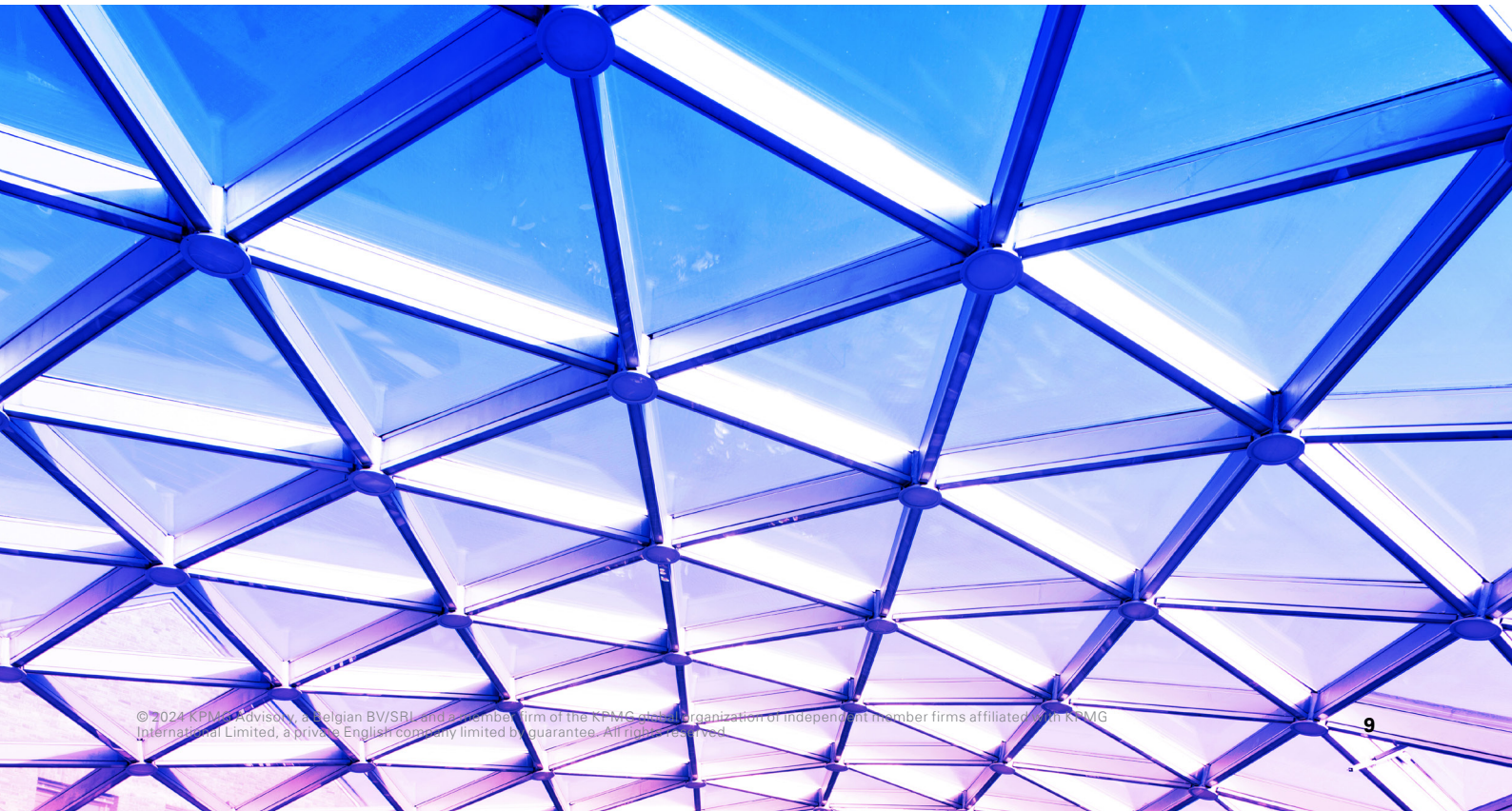
The ‘pay the way’ principle allows organizations to tackle the larger structural cost optimization and dramatically reduce the IT cost structure, for which the required investments are freed up by short-term cost optimization initiatives.

A typical ‘pay the way’ journey:



Reducing IT spend, rationalizing the IT landscape and optimizing the IT operating & governance model are not one-off tasks but require continuous effort from the organization. In the next chapter, we will introduce a more structural approach to how organizations can invest their funds while keeping their optimization initiatives sustainable.



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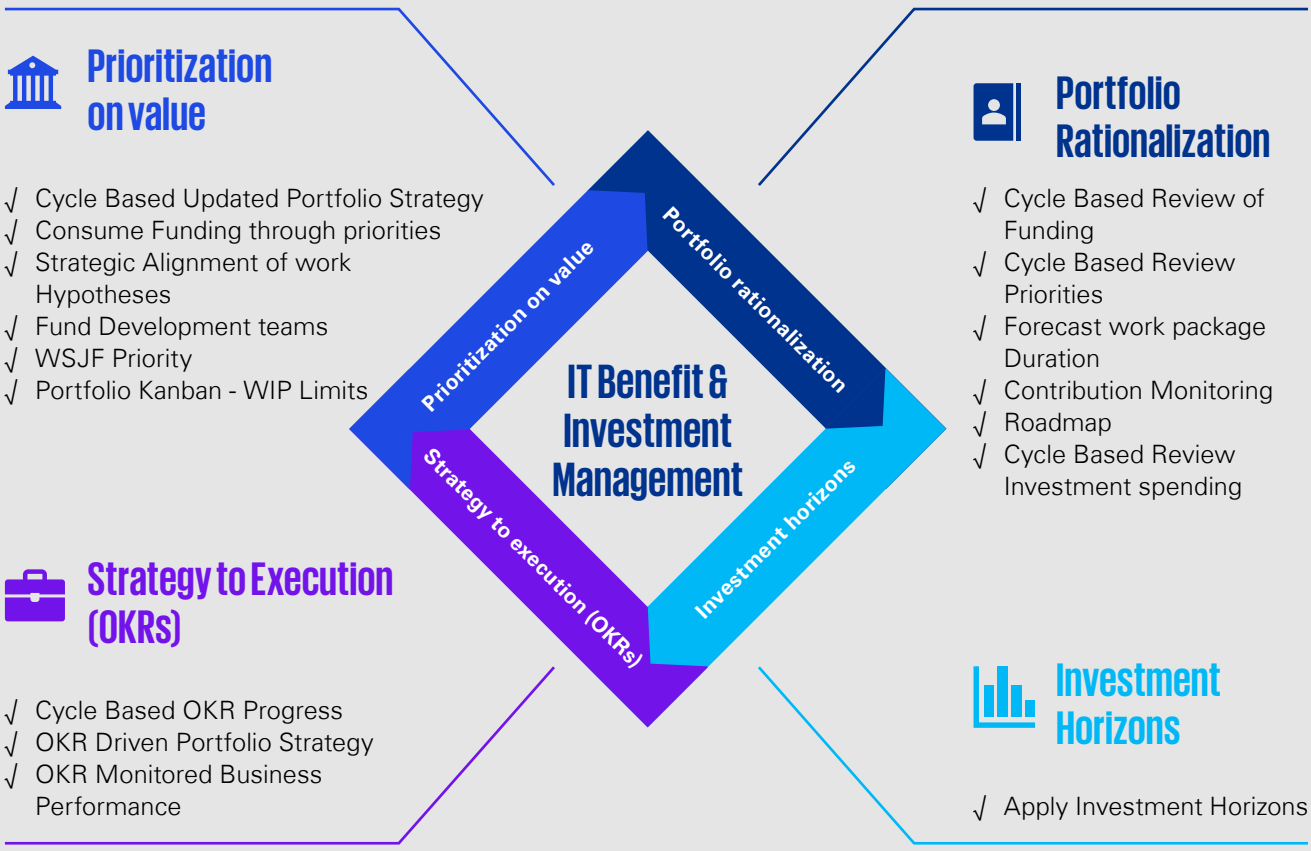
03. How to keep IT cost reductions and investments sustainable in the long run

Fit-for-purpose and lean IT portfolio investment decisions are essential for any company seeking to remain competitive in today's fast-paced and challenging business environment. To enable fit-for-purpose and lean IT portfolio investment decisions using this dynamic investment and cost optimization process, it is critical to have a clear understanding of the organization's IT objectives and how they align with business goals. This requires a thorough analysis of business needs and objectives, together with an evaluation of the IT capabilities required to meet them. Once the organization's IT objectives have been defined, it is important to continuously review, monitor, and prioritize the funding of IT portfolio investments based on greatest value, both past and future, as well as on market needs and strategic fit. This means continuously evaluating each investment's potential impact on the company's overall performance and determining whether the investment still generates the greatest value for the organization's strategic goals.

This will lead to continuous re-evaluation of funding and reprioritizing of initiatives based on their value and adjusting investments to stay aligned with changing business needs. The execution of this strategy is ideally driven by a cycle-based OKR framework to enable more transparency, better strategic alignment, and more impactful result. Dynamic investment is hence about funding innovation at scale; it requires a culture of innovation, speed, and agility to succeed. Organizations need to develop the ability to re-prioritize and re-allocate resources to deliver value as business opportunities emerge.



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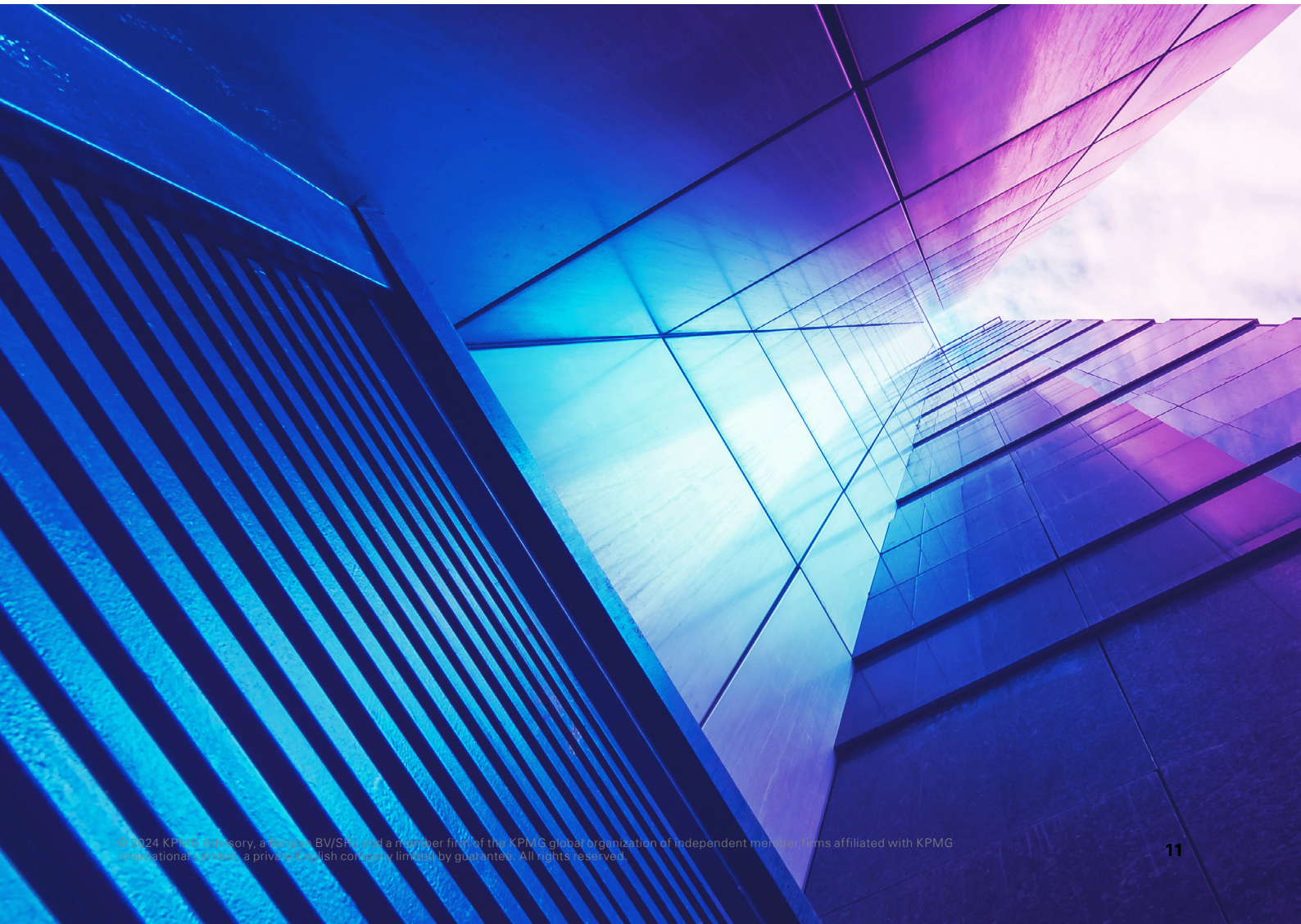
To achieve success with lean investment decisions, companies should use a structured and data-driven approach to evaluate investment opportunities and priorities. The prioritization of these opportunities may be done using a scenario analysis/modelling which results in a clear view on how to maximize business value. Connection to other forms of value is important, with controls put in place to manage IT investment via backward-looking analysis of scope, schedule, and budget performance.

> **“Combining quantitative considerations with qualitative data and metrics can help deliver crucial insights to businesses.”**

Success factors for enabling dynamic funding

Combined with ongoing optimization of past spend, adopting a principled, forward-looking, dynamic investment model makes holistic spend management possible by:

- Replacing static budgeting cycles with dynamic funding to fund innovation on a rolling basis. The key to this process is that funding adjusts to prevailing needs.
- Implementing product financial management: Enterprises need to shift from project financial management to product financial management.
- Changing funding governance: Governance of funding is critical to replacing traditional project budgeting with product funding. A new governance model should include guidance on roles, decision-making authority, and the processes by which funding decisions are adjudicated.



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04. Key takeaways

While straight cost-cutting may seem an attractive solution, an optimization approach serves a more sustainable and effective long-term strategy. Once cost transparency is achieved, organizations can benchmark their IT spending against industry standards, identify areas of improvement, and start with launching and prioritizing value-based, self-funding, IT cost optimization initiatives. This not only reduces costs but leads to value creation and dynamic investment decisions, which ultimately leads to overall business excellence. Therefore, it is paramount for organizations to prioritize IT cost transparency operations and adopt a dynamic and cyclical, fit-for-purpose, IT benefit & investment management approach to achieve long-term cost savings and business success.

1. Creating Transparency

Obtain transparency on IT costs to enable correct benchmarking and insight-driven decision-making

- Categorize IT costs
- Cost Baseline & Benchmark
- Synthesize, Prioritize, and Quantify
- Validate and Build the Plan

2. IT Cost Optimization

Implementation of quick wins to generate immediate value to the bottom line and help fund long term transformative sustainable changes to the business

- Deliver Quick Wins
- Tactical Changes
- Structural Changes

PROGRESS

3. Lean fit-for-purpose IT Benefit & Investment Management

Continuous tracking and management of value identified and communicated to leadership to manage program costs and ensure transparency in transformative efforts.

- Manage and Track Value

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Contact

Are you looking to prioritize IT cost transparency to achieve long-term cost savings and business success? Our teams can help you benchmark your IT spending against industry standards, identify areas of improvement, and launch initiatives to reduce costs.

Contact one of our experts today to learn more.

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