A new financial architecture for IT

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Abstract - Businesses are changing the way that they view IT, moving towards a position where IT is treated as a business service. This transition generates significant improvements in business agility and enhances IT-business alignment. However, this transition needs a new *financial architecture* as much as it needs investment in new technology, and the changes are being led by the CFO rather than the CIO.

Introduction

Preserving capital to use in driving growth through innovation is far more important to business success than maintaining an ageing IT infrastructure. Treating IT as a series of business services is central to a strategy of improving business agility and IT-business alignment by focusing capital resources on business priorities.

New budgeting and planning approaches are developing in response to these changes, and moving beyond the accepted triumvirate of capital planning, operational finance and project budgeting. Even when a business wants to more effectively utilize capital, there are practical constraints on its availability and these are unlikely to change in the near future. The new focus areas for IT budgeting include: asset lifecycle management, asset utilization, cashflow and working capital management.

CFOs today play an increasingly significant role in IT planning, given the prominence of IT in the overall corporate budget. Longitudinal research by Datamonitor shows that CFOs have greater responsibility for IT purchases that at any point since the start of the recession in 2008.

New technology and finance paradigms enable the transition

A number of trends are facilitating the transition to a business service-focused approach to IT; chief among them a move toward treating computing as a utility.

Two technology strategies are evolving to implement the move towards a utility model. The first sees companies using virtualization, to improve the sharing of IT assets, increase asset utilization and improve flexibility. Virtualization is one of the fastest growing technologies globally. The second sees companies consuming IT resources via the Internet, through cloud computing or software-as-a-service. Again, the market for these technologies is growing very quickly.

Whichever approach is taken the goals are to address:

- the proliferation of ageing applications and "IT sprawl";
- the utilization of IT assets and avoiding waste;
- the link between IT and business value; and
- the ability of IT to drive business change.

It is a combination of new technology, such as cloud computing, and financing strategies such as sale and leaseback that empower CFOs to take a radically different approach to IT funding – generating greater business value and business alignment.

Challenging capital dominance

Capital planning once dominated the IT budgeting landscape. Instead, CFOs today are seeking to free up capital for business expansion and innovation, rather than committing it to an IT infrastructure focused on sustaining the business. Ovum research indicates that a minimum of 91% of purchasers would consider financing IT purchases of more than $250,000. For larger purchases the figure is still higher – and interest in financing has grown over the past 2 years.

Capital-dominated budgeting has a number of disadvantages when applied to modern IT management. Capital assets are typically depreciated over a fixed period, usually somewhere between 3 and 7 years. While this does have P&L advantages it also means that updating technology can be difficult, given that existing assets still have value – even when newer technologies offer significant business advantages.

This is often called the "stranded assets problem" where there is still book value in an IT asset, but users no longer receive optimum business value from it. This can mean that newer technologies need to prove they can justify themselves AND the write-down of older technology, if they are to gain immediate adoption and start generating business return. If the stranded asset problem is not tackled, the ability to reduce costs is curtailed.

At a wider level there are many calls on the capital reserves of a company, not just from IT. In a challenging economic environment companies have sought to preserve capital for acquisitions and growth-capital investments. Companies with poorer financial reserves have found themselves more exposed to economic failure and take-over. So, the avoidance of capital spend on IT has been higher in the past 2-3 years. This pattern is likely to continue.

The new model

The new model has many interesting facets, working together to produce a much more flexible operating

and financial model for IT. These are illustrated in the figure below.

Figure 1: The new financial model

The two foundation blocks are asset lifecycle management and asset utilization optimization.

Asset lifecycle management – involves planning to optimize the business alignment at each stage in its lifecycle, from asset acquisition through to eventual disposal.

Asset utilization optimization – maximizing the use of assets, whether equipment or personnel, to avoid the acquisition of excess assets.

The supporting traits are then:

Variable consumption contracts – to allow costs to decrease or increase to align with commercial needs, the contracts for basic hardware and software assets are struck as variable capacity contracts.

Asset use chargeback – sees businesses being charged for their actual utilization of assets at any point in time – in many ways returning to the charging model of bureau operations. It is a fairer charging model than many alternatives; reflecting value, not cost.

Cash flow from IT investments – looks at individual business projects that use IT and seeks to maximize free cash-flow benefits from each investment, rather than take an ROI-only focus. Projects that generate free cash flow earlier are given greatest priority in the portfolio. Projects are also encouraged to minimize their working capital requirements.

Transition management

It can initially seem daunting to move towards a service-centric budget model, in this new financial architecture. However, in reality the transit can be managed at controlled pace and with measured risk. A number of instruments can aid the transition:

- sale and leaseback agreements – these will allow expensive but ageing capital assets to be sold, gaining an immediate financial return from the sale, allowing the continued use of the same equipment but moving straight to operating cost model
- leasing – this encourages replacing or upgrading equipment on a programmed basis, holding down maintenance costs and freeing up capital for other uses. It affords payment predictability and also builds in regular updates as new generations of technology become available
- utility contracts – these allow IT computing capacity to be varied, according to business need at a point in time, and for the business to pay based on their usage levels
- outsourcing – the careful use of external service providers can also be a useful way to move fixed to variable costs, with the service provider bearing the capacity arbitrage risk.

All of these are well proven techniques and combinations of them can readily be deployed to move towards the new financial architecture that we see emerging.

Conclusions

Traditional capital-dominated approaches to IT budgeting are being seriously challenged, driven by:

- much lower prices for many technology items, negating the advantages of capitalization
- a need for greater business flexibility, being able to reduce costs or scale growth – something that is difficult with fixed depreciation cycles
- the increasing link between IT investment decisions and wider investments

Taken together, these drivers are encouraging business leaders to transition towards a services-centric approach to IT. This is complemented by increased CFO engagement in designing a financial architecture for IT that reduces the focus on capital investment in favor of flexible financing options. This is a multi-year transition and must be driven by CFOs and their teams in partnership with CIOs.

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