



The IT Financial Management Challenge: Where Is the ROI?

WHITE PAPER

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Disclaimer: Benefit ranges provided in this white paper are based on VMware and Proven IT Finance customer engagement experience. They are intended to provide general guidance to the reader and do not guarantee specific results.

Introduction

Knowing the value of your current, in-production environment is critical for making investment decisions about legacy environments, application rationalization, and technology life cycle management. IT financial management is the single discipline that is emerging as the unifying element in intelligent IT management. No other discipline offers the same level of insight, context, and meaning when it comes to understanding IT value.

If you are reading this white paper, you likely face the daunting task of creating a business case that shows empirically what you know intuitively: Understanding IT cost is critical to driving IT value. If you attempted your calculations by using a traditional ROI methodology, chances are that the results were disappointing. Like IT value, IT financial management value is not a function of how much it costs; it is a function of what it impacts. If you focus only on what IT financial management platforms cost, you will never justify the investment. Creating a proper business case requires an understanding of what IT financial management influences.

As with any discipline, enabling IT financial management capability in an organization requires investment in people, process, and technology. As the discipline has evolved and as its importance to intelligent IT management has increased, platforms have emerged to support the practice. Therein lies a familiar challenge: how to determine the right investment to make in an IT financial management platform.

ROI Approaches

IT cost has two basic elements: the cost of the physical environment and the cost to maintain the applications that run in the physical environment. (Service desk, telecom, and other IT services are ultimately part of the cost to run the physical environment and maintain applications.) IT cost management, it follows, comes from implementing a practice that organizes these two cost drivers into discrete parts that can be effectively and efficiently governed. IT financial management is the practice that oversees the governance of IT cost. Within that practice, one of the key governance mechanisms is a platform that implements the method that defines and aligns IT costs.

An IT financial management platform, like any enterprise application, requires an investment. Developing a thoughtful approach to the business case that supports such an investment is a major challenge when an organization decides to evolve its IT financial management practice. The **classic** ROI approach is designed to illustrate the direct impact of an investment. In the case of an IT financial management investment, that approach will likely result in a negative net present value (NPV) and an unacceptable ROI. Negative results typically make justification of the investment nearly impossible. However, failing to invest in an IT financial management practice will likely perpetuate poor IT investment decisions.

To support a rational business case—and to recognize the value that an IT financial management platform drives—you must use a **modified** approach to the ROI calculation with regard to the platform and people investment. This modified approach leverages traditional ROI concepts but allows for the evaluation of the NPV and ROI in a broader context.

Guiding Principles of a Modified ROI Approach

ROI calculations have two components: the investment (cash outflow) and the benefit (cash inflow). Typically, cash outflow is the investment that is related directly to the purchase. Cash inflow comes from benefit that is driven by the investment (e.g., new revenue dollars and expense reductions). In a classic ROI analysis, the focus is on *attribution* and *measurement*. Attribution is the linkage between a dollar of investment and a dollar of benefit. The more clear that relationship is, the stronger the business case. Measurement is the ability to quantify the dollar value of the benefit that is returned for the dollar invested. The easier it is to predict and measure the benefit, the stronger the business case. Ultimately, the direct relationship is key. Direct investment and direct benefits are commonly referred to as *hard* expenses and *hard* benefits.

Classic ROI calculations also recognize that any investment has associated indirect expenses and will also return indirect benefits. These types of expenses and benefits are commonly referred to as *soft* expenses and *soft* benefits. Many CFOs and corporate finance teams are leery of soft benefits, because tracking the hard benefits associated with IT investments is challenging enough. Soft benefits are nearly impossible to measure and attribute.

The modified ROI approach acknowledges the unique nature of an IT financial management investment through a reasonable methodology for attribution and measurement of soft benefits. In this way, the modified ROI approach overcomes the common CFO and corporate finance objections to including these benefits in the business case. More important, the modified ROI approach recognizes the unique nature of IT financial management. Specifically, recognition is growing across nearly every industry that IT financial management is becoming a required capability—even when the investment benefit is not easily quantified. The modified ROI approach leverages the fact IT financial management expenses and benefits are neither truly hard nor truly soft, and that they therefore require special handling.

Modified ROI Approach Defined

The modified ROI approach analyzes expense and benefit drivers in four key categories: IT financial management labor, infrastructure hardware and software, application development and maintenance, and third-party services. The objective of the categories is to ensure that the elements of the ROI meet the criteria of *attributable* and *measurable*. The categories create attribution through alignment of related investments and benefits. The categories create measurable results by ensuring mutual exclusivity to eliminate double counting of benefits.

Each category has a specific type of expense and benefit that defines the content. Under this approach, any one category can be changed without affecting the remaining categories. In this way an organization can customize the analysis to fit its individual needs. Ensuring that the benefits can be measured and attributed, and allowing for customization, enables an organization to make clearer decisions regarding its IT financial management investments. Figure 1 shows the elements of the modified ROI approach.

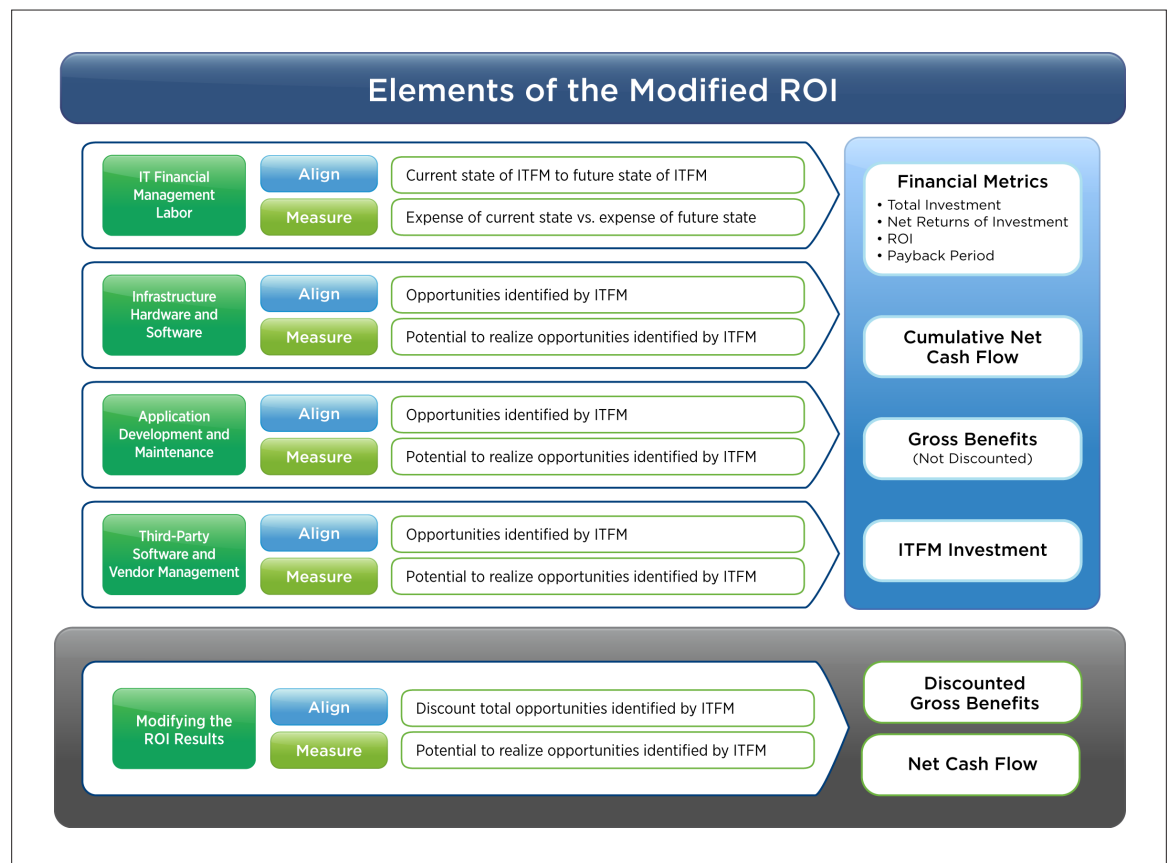


Figure 1. Elements of the Modified ROI Approach

Table 1 compares the classic and modified ROI approaches.

	CLASSIC ROI	MODIFIED ROI
Methodology	<ul style="list-style-type: none"> • ROI calculations have two components: the investment (cash outflow) and the benefit (cash inflow). • Typically, cash outflow is the investment related directly to the purchase. Cash inflow comes from benefit driven by the investment. • The focus is on <i>attribution</i> and <i>measurement</i>. • Attribution is the linkage between a dollar of investment and a dollar of benefit. The more clear that relationship, the stronger the business case. • Measurement is the ability to quantify the dollar value of the benefit returned for the dollar invested. The easier it is to predict and measure the benefit, the stronger the business case. • Ultimately, the direct relationship is key. Direct investment and direct benefits are commonly referred to as <i>hard</i> expenses and <i>hard</i> benefits. 	<ul style="list-style-type: none"> • Analyzes expense and benefit drivers in four key categories: IT financial management labor, infrastructure hardware and software, application development and maintenance, and third-party services. • The objective of the categories is to ensure that the elements of the ROI meet the criteria of <i>attributable</i> and <i>measurable</i>. • The categories create attribution through alignment of related investments and benefits. The categories create measurable results by ensuring mutual exclusivity to eliminate double counting of benefits. • Each category has a specific type of expense and benefit that defines the content. This approach enables any one category to be changed without affecting the remaining categories.
Features	<ul style="list-style-type: none"> • Recognizes that any investment has associated indirect expenses and also returns indirect benefits. • These types of expenses and benefits are commonly referred to as <i>soft</i> expenses and <i>soft</i> benefits. Many CFOs and corporate finance teams are leery of soft benefits because tracking hard benefits associated with IT investments is challenging enough. Soft benefits are nearly impossible to measure and attribute. 	<ul style="list-style-type: none"> • Acknowledges the unique nature of an IT financial management investment through a reasonable methodology for attribution and measurement of <i>soft</i> benefits. • Overcomes the common CFO and corporate finance objections to including these benefits in the business case. • Leverages the fact that IT financial management expenses and benefits are neither truly hard nor truly soft, and that they therefore require special handling. • An organization can customize the analysis to fit its individual needs.

Table 1. Comparison of Classic and Modified ROI Approach

Category 1: IT Financial Management Labor

An organization that develops an IT financial management capability will incur labor costs that are associated with the development of the capability—whether or not it uses an automated platform. The business case for the investment in a platform should include the benefit that the organization would realize from the labor lift that an automated solution provides.

Guiding Principle of IT Financial Management Labor Benefit

To calculate this benefit, a set of assumptions about the headcount necessary to support the initial capability without a platform should be determined. Then, a similar set of assumptions about the headcount necessary to support the initial implementation with a platform should be determined. The modified ROI leverages the delta between these two sets of assumptions. The difference between the cost to implement the practice without a platform and the cost to implement it with a platform is a legitimate benefit that is related to the investment in that platform.

Measurable and Attributable Benefits from an Existing IT Financial Management Practice

The only classic ROI hard benefit of investing in an IT financial management platform results from the efficiency that the platform delivers to the current IT financial management practice. Typically, implementing an automated solution from a platform reduces the total labor that is needed to maintain the current IT financial management practice. The savings amount varies by organization and depends on the overall maturity of the IT financial management practice and the total headcount supporting the practice at the time of implementation.

Typically, an organization with a moderate maturity level that has adequately staffed the IT financial management practice can expect to see a 15–25 percent reduction in the labor needed to support its current IT financial management practice.

Measurable and Attributable Benefits When No IT Financial Management Practice Exists

IT financial management is a new practice for many organizations. An organization with no IT financial management practice has no current expense related to IT financial management. In this case, the modified ROI still recognizes the labor benefit of investing in an automated platform, through a broader context.

Category 2: Infrastructure Hardware and Software

Infrastructure costs typically represent 25–40 percent of an organization's IT expenditure. The range depends on the industry and IT delivery model, and it includes both labor and non-labor expenses. Infrastructure labor typically makes up 45 percent or less of the infrastructure cost, while hardware and software make up the rest. Given this balance, the key drivers of infrastructure spending are *capacity* and *utilization*. Infrastructure teams that cannot adequately forecast business demand—or that historically have been held accountable for failure to deliver capacity in a timely manner—tend to over-order capacity. Idle capacity leads to underutilization and increases the organization's costs. Further, underutilization prevents the company from taking advantage of industry trends around infrastructure refresh that help to reduce annual hardware costs.

Guiding Principle of Infrastructure Hardware and Software Benefit

A well-implemented IT financial management practice enables an organization to better understand demand and therefore better predict capacity and utilization needs over a longer period. Accurate utilization and capacity predictions enable the organization to time purchasing better, avoid stockpiling capacity, and avoid purchasing capacity under emergency circumstances (which tends to be more expensive).

An additional benefit from a well-developed IT financial management solution is that you align costs more accurately to the demand driver. This capability enables a higher correlation between the business decision that drove the need for additional investment in infrastructure and the cost of that investment.

Measurable and Attributable Benefits from Infrastructure Hardware and Software

The modified ROI approach recognizes how an organization benefits from improving management of infrastructure capacity, utilization, and demand. The modified ROI approach also recognizes that the less capable an organization is of managing capacity, utilization, and demand, the higher the ROI it will achieve from investing in IT financial management—compared to an organization that better manages capacity, utilization, and demand. Because numerous gradations are possible in this scenario, high-level analyses should be kept relatively simple. A reasonable benefit (3–8 percent) that is inversely based on the maturity of the organization in managing capacity, utilization, and demand should be achievable.

Inversely based means that the more mature an organization is in its capacity, utilization, and demand management, the lower the savings potential from investing in an IT financial management platform.

Category 3: Application Development and Maintenance

Numerous factors contribute to the cost of applications within an organization. A well-implemented IT financial management practice can help manage nearly all dimensions of application costs—from new investment impact analysis to application rationalization. Although these application-management efforts are important to the overall health and cost of the application portfolio, the modified ROI approach does not take any of them into account.

Guiding Principle of Application Development and Maintenance

Focusing the scope of application expenses on expenses that can be measured and attributed to IT financial management defines a set of opportunities that relate specifically to applications in production. Focusing only on application-maintenance activities that are directly tied to in-production applications avoids double-counts with other business cases related to application investments. It has the added benefit of being clearly attributable to decisions driven by the IT financial management practice.

This focus creates an opportunity to better manage the time spent and the expense incurred on activities that the business typically does not communicate, understand, or prioritize well. Specific examples of activities that drive application maintenance include mitigation of defects in production, ad-hoc reporting or output requests, and small enhancements. These expenses are part of a business's expectation of IT services. The cost for these services, however, is highly variable and—like infrastructure—requires oversight of demand, capacity, and utilization.

Measurable and Attributable Benefits from Application Development and Maintenance

To avoid double-counting benefits from other categories of the modified ROI approach, this portion of the calculation deals exclusively with labor expense. (Infrastructure for an application is part of the ROI's utilization and capacity management component, and third-party software and vendor management falls into a separate category.)

The modified ROI approach focuses on the surplus labor within application teams that is maintained solely in response to unmanaged business demand. The modified ROI approach recognizes the benefit an organization gets from improving application maintenance capacity, utilization, and demand management. It also recognizes that the less capable an organization is of managing capacity, utilization, and demand, the higher the ROI it will achieve from investing in IT financial management—compared to an organization that better manages capacity, utilization, and demand. Because numerous gradations are possible in this scenario, high-level analyses should be kept relatively simple. Again, a reasonable range (3–8 percent) inversely based on the maturity of the organization in managing capacity, utilization, and demand should be achievable.

Category 4: Third-Party Software and Vendor Management

Just as a well-established IT financial management practice drives demand management—and therefore better investment in capacity and utilization for infrastructure and application-maintenance labor—it can do the same for third-party vendors of both software and services. In many organizations, third-party vendors have multiple contracts with multiple labor rates that don't reflect equity or provide a consistent level of cost for services delivered. The primary way that IT can manage these kinds of expenses is through the purposeful and intentional management of an external rate card system that is generated from the contracts negotiated with third-party suppliers.

Guiding Principle of Third-Party Software and Vendor Management

A well-implemented IT financial management practice provides insight into contracts and total spend by vendor. It also enables an organization to better leverage and manage its vendor relationships. By emphasizing the total spend with a vendor and leveraging service level agreements (SLAs) and rate cards, an organization can better negotiate prices, eliminate duplicative contracts, and measure suppliers' cost-effectiveness.

Measurable and Attributable Benefits from Third-Party Software and Vendor Management

The modified ROI approach recognizes the benefit that an organization gets from better demand management of third-party software and services. The modified ROI approach also recognizes that the less capable an organization is of managing third-party demand, the higher the ROI it will achieve from investing in IT financial management—compared to an organization that better manages that demand. Because numerous gradations are possible in this scenario, high-level analyses should be kept relatively simple. A reasonable range (2–5 percent) inversely based on the maturity of the organization in managing third-party demand should be achievable.

Calculating the Modified ROI

The next step in using the modified ROI approach is calculating the ROI itself. The modified ROI mathematics works the same as a traditional ROI calculation and includes NPV and payback period. A discounted set of cash flows is determined by using a discount or hurdle rate. To make the calculation as meaningful as possible, each organization should use its own internal cost of capital to discount the cash flows.

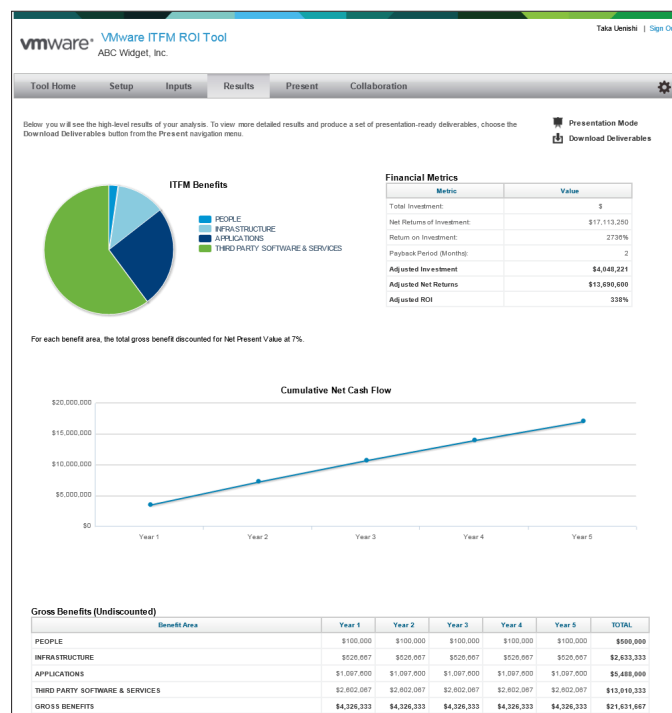


Figure 2. Sample Analysis of Modified ROI in an IT Financial Management Platform

The cash outflows of the model should include the cost of the software (license and maintenance or software-as-a-service amount), the cost of hardware if hosting is internal, and the cost of any professional services needed to install the software and make it functional.

Cash outflows of the model should not include the cost of establishing an internal IT financial management team. Those costs should be part of the broader business case that compels the organization to invest in the IT financial management capability. Including them in the ROI calculation would double-count the expense and produce an unmatched set of results.

Cash inflows of the model are the four categories outlined previously in this white paper.

Warning: The final ROI that you calculate will look extremely high—anywhere from a few hundred percent to several thousand percent. Those results are correct!

Interpreting the Modified ROI Results

The next step in using the modified ROI approach is to interpret the seemingly astronomically high return that the methodology produces. The math is correct. The results are so high because the investment in the platform is relatively small compared to the total IT expense that the platform impacts. If the modified ROI stopped there, however, its usefulness in determining whether the platform is a good investment would be limited.

Guiding Principle of the Modified ROI Approach

The modified ROI approach recognizes that the IT savings that a platform identifies are not realized simply from identification. In nearly every case, some additional investment or effort is required to capture the identified savings. Only a portion of the savings measured by a platform should be attributed to the platform. Most of the measurable benefit will likely need to be invested in achieving the savings that the platform identifies. Those savings should therefore be attributed to the investment that is required to achieve it—not only to the investment that is required to identify it.

Measurable and Attributable Benefits of the Modified ROI Approach

As the final step in applying the modified ROI approach, the total return should be reduced by a reasonable amount to adhere to the principle of *attributable*. The amount will likely be determined by the most skeptical business case reviewers. A reasonable reduction of benefits (cash inflows) between 60 percent and 80 percent should satisfy even the most critical evaluators. After the reduction is made, the modified ROI approach typically shows a positive net present value and realistic rate of return for an investment in an IT financial management platform.

Enterprises that are new to IT financial management practices can expect initial returns of 15–20 percent. Enterprises that have basic IT financial management with only manual capabilities can expect a 10 percent initial return. It has been fairly consistently demonstrated that use of IT financial management software gives most medium-to-large organizations the opportunity to find cost reductions within IT in the 3–5 percent range.

Conclusion

The purpose of the modified ROI approach is to produce a logical and reasonable assessment of the value of investing in an IT financial management platform. By calculating the impact of IT financial management on total IT expenditure, the modified ROI approach demonstrates not only the value of an IT financial management platform, but also the value of building an IT financial management capability.

About VMware

From the leader in virtualization and cloud infrastructure, VMware vRealize Business Suite enables CIOs to have unprecedented visibility into their cloud costs to make fact-based decisions. Our suite gives you financial discipline, SLA management capability, and vendor governance for your entire service portfolio.

Cloud computing is bringing unprecedented innovation and change. This kind of change requires that IT leaders have visibility into their investments, manage expectations of their services, and create governance frameworks for vendors. These processes need to work hand-in-hand to provide IT leaders with a single pane of glass from which they can make fact-based decisions. VMware vRealize Business Suite is designed to simplify cloud management through the lens of business. Further, by providing a common language that IT and the business can use to measure and communicate, it creates transparency and trust in all IT innovation.

Find Out More

VMware vRealize Business solutions provide transparency into the cost, quality, and value of IT services. They enable organizations to make fact-based sourcing decisions that facilitate the transition from being a builder to being a broker of IT services.

For more information, visit the VMware vRealize Business Web page at <http://www.vmware.com/products/itbm-suite>.

To learn more about the VMware ROI calculator for investing in an IT financial management solution, visit: <http://www.vmware.com/products/itbm-suite/itfm-roi-tool.html>.



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