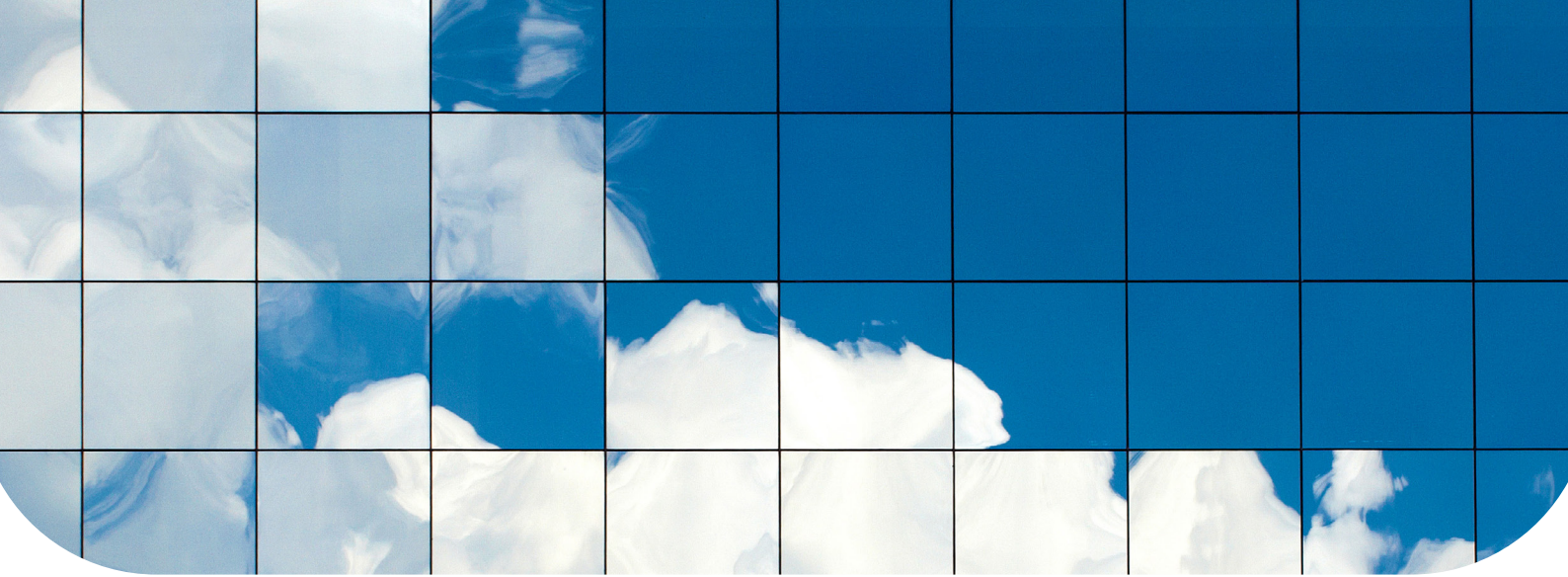eraneos

Whitepaper

Practical tips for Cloud Financial Governance

December 2022

More and more often we see that Governance & Management (G&M) of the cloud is becoming a specific challenge for organizations. In this whitepaper, we focus on one facet: Cloud Financial Governance. What exactly is it that makes Cloud Financial Governance difficult and what are best practices for doing it well?

In this whitepaper we outline, among other things:

- The strength of cloud for financial management is that it enables the transition from CapEx to OpEx.
- Central control of overall IT costs creates a barrier to cloud adoption: cloud requires different financial governance.
- When transitioning to cloud, organizations should have IT costs borne more by the business departments where value is created.

Over the past 10 years, the cloud has grown from an idea into a significant reality. More and more organizations are using the cloud for increasingly more functionalities. Measurements by Quint together with Whitelane Research[1] show that 64% of the 200 respondents predicted that by 2022, more than 30% of their applications will run in the cloud (and 33% even expected it to be more than 50%). And perhaps more importantly, cloud is currently rated higher than other forms of outsourcing: 79% of respondents are satisfied with cloud infrastructure and 74% with cloud applications (compared to an average of only 69% for other forms of outsourcing). If this trend continues, all IT will be running in the cloud by 2030.

That sounds like great news, because cloud offers many new opportunities such as economies of scale, cost elasticity (the famous p and q) and flexibility (not having to wait months for a server to be purchased and installed). Unfortunately, we have not yet fully adapted our governance to this. Many control mechanisms have not yet been set up for the cloud. Perhaps this explains why, in the Quint and Whitelane study referred to above, 41% of respondents regard "Governance and internal capabilities to manage cloud providers/solutions" as a primary challenge in transitioning to the cloud. Incidentally, integration with existing systems and ensuring privacy and security are considered even more challenging.

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1   2020 Dutch IT Sourcing Study conducted by Whitelane Research in collaboration with Quint.

Example 1:

Not in control of cloud spend and capacity

A Dutch organization went to the cloud as a relatively early adopter. The organization now has a landscape in which, in addition to SaaS, a lot of software runs on public IaaS clouds (Azure and AWS). By means of service management and cloud management platforms, operational capacity management is completely automated: as soon as more transactions have to go through the systems, capacity is automatically increased, and when there are fewer transactions, the reverse happens.

As a result, IT capacity perfectly matches business demand. Here, costs are as elastic as capacity (and thus the demand for IT). On a daily basis, the organization sees how much capacity was used and what the costs are. This means it's only afterwards that it becomes clear how much has to be paid. However, the organization is not equipped for this in terms of financial management: the desire is to budget for and control IT costs on an annual basis; after all, the CFO wants predictable costs. Conclusion: thanks to the cloud, the IT capacity is perfectly aligned with the business, but the costs are no longer easy to budget for.

Example 2:

Transition to cloud is attractive in terms of value, but not within the budget of centralized IT

An international organization has business units in various countries and a centralized IT department. The most important systems are delivered by the centralized IT department. Fulfillment of workplace requirements and hosting are also organized centrally. The IT department works with an annual budget to which all business units (indirectly) contribute; it is in fact a cost center. The organization currently has a reasonably well optimized private cloud for hosting, which is provided by several suppliers. The company is publicly traded and privacy standards are high.

The organization sees several advantages in transitioning from private cloud to public cloud hosting. For example, scalability and geographic coverage. They also recognize the functionalities (e.g. PaaS and SaaS) that come with the Azure, AWS and Google Cloud platforms. Certain business units are themselves already deploying public cloud solutions (SaaS, PaaS and IaaS) to access these functionalities. Instead of using the economies of scale of centralized IT, inefficient and sometimes insecure "shadow IT" in the cloud is now being created in various places in the organization.

In a study of the like-for-like transition from private to public cloud, the price per unit (storage and/or processing capacity) in the public cloud turns out to be higher than in the private variant.

Added to this there is the one-time investment in the migration. The business case for the IT department is therefore negative: switching to public cloud means increasing costs. However, the business case for the entire organization is positive, because the increase in value/functionality and flexibility more than outweighs the increase in costs.

Conclusion: the business sees the value of public cloud, but the financial policy, focused on a centralized IT budget as a cost center, stands in the way of an efficient and secure transition, causing the use of shadow IT to grow.

The organization now wants to set up a governance system to be able to control both costs and security and to achieve economies of scale (in both knowledge and costs) at the company level, so that the business case can be met at thecompany level.

Cause of the problems? Outdated thinking!

What we see in both examples is that the organizations view IT as a cost item. These costs are governed by a support department as a cost center. IT is held responsible for ensuring IT costs stay within the IT budget and preferably go down every year. And if that doesn't happen, the IT department is not functioning properly. The strange thing is that although these organizations often recognize the value of IT (albeit reluctantly), they still demand the costs to be predictable (annually) and want them to fit into an IT-level business case.

If an organization knows exactly what it needs in terms of IT resources for the coming years and the capabilities are already in place, it's generally cheaper to manage all IT resources yourself and not outsource anything. A private cloud is usually more expensive in this situation, but it does allow the organization to benefit from the economies of scale of the suppliers both in terms of costs and the certainty that IT resources can be managed and further developed. The public cloud is almost always more expensive in such a situation and, oddly enough, requires additional capabilities for both governance (financial, contractual) and technology (to set everything up properly), especially if IAAS is deployed. In particular, organizations that outsource only to reduce costs run a great risk of not having a positive business case with the public cloud.

However, as an organization becomes more able to predict usage, costs can also be reduced in the cloud by concluding longer term contracts (which in turn, however, reduces flexibility).

For example, legacy applications can be purchased for the longer term (and are thus cheaper). The corresponding development and test server capacity for those same legacy applications can then be purchased on a just-in-time basis. This is more expensive per unit of time, but cheaper overall (because these servers are only used for a short time and therefore no extra server capacity has to be purchased). If organizations can bundle requests for temporary capacity (and therefore provide guarantees regarding consumption) it can be even cheaper.

The above is also why managed service providers can offer cheaper cloud rates. Such providers take care of the bulk demand and manage capacity. However, if you know exactly what you need and deploy it for a longer time, doing it yourself is the cheapest option. But then you have to remember that you will also incur these same costs in bad times!

According to our model (Figure 1), the Governance & Management of digital services is made up of three components: "governing" (setting – and monitoring compliance with – the internal rules such as those for finance, architecture and security), "orchestrating" (having new and changed services selected and set up) and "integrating" (having the operational services delivered, including security incident resolution and settlement of usage). Those handling Governance & Management are therefore preferably facilitators and don't act as conduits for or obstacles to demand (internal and external customers) and supply (internal and external suppliers).

Figure 1. Overview of Governance & Management incl. the role of G&M professionals
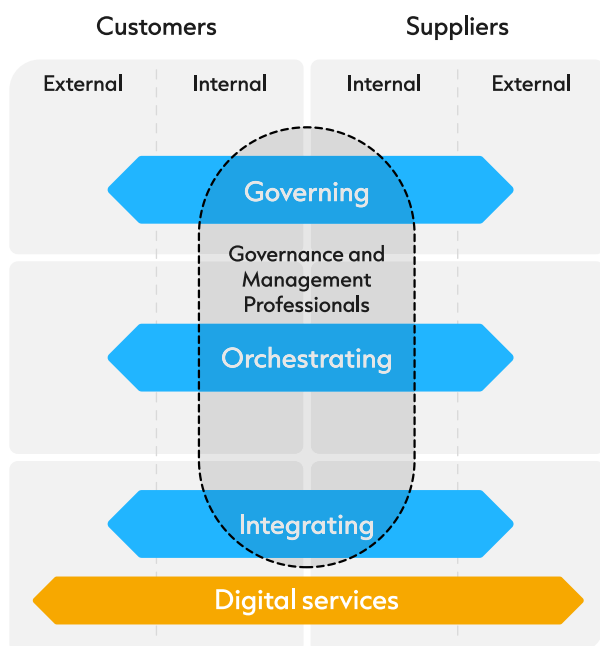
If the identified problem is plotted on the Governance & Management model, one could say there are three problems:

- **Governing:** in what way can the rules in the organization be changed to balance the value of cloud (e.g. flexibility and agility) against the costs of cloud or migrating to it?

- **Orchestrating:** how can the organization set itself up so that internal and external digital services each have their own business case where the owner of these services can weigh the costs and benefits? And perhaps use the principle: anything goes where there are no rules of the game (yet)?

- **Integrating:** how can the business itself become responsible for the operational digital services, both in terms of financial management as well as all other control aspects (such as security and availability)?

A completely centralized model no longerworks these days.

Example 3:

All you can eat?

In 2007, a medium-sized Dutch company outsourced virtually all of its IT services to a single IT supplier. A completely normal practice at the time. What was special, however, was the requirement that the company placed on this supplier: agree with us on an annual budget for the total IT costs (which had already been specified on a p and q basis) and ensure that the services (i.e. demand) remain within this budget. The supplier was thus put in the position of being a "demand limiter"! This was done because the experience was that if the business was free to order from an IT catalog, too many IT costs were incurred. The result was that the business was inhibited from improving by deploying the right IT, Governance & Management got busy explaining to the business why things were not possible, and the supplier got frustrated — it saw opportunities to improve the business (and sell more) but was not allowed to cash in on them.

Translated to today, the above-mentioned case is a current problem: If an organization places all its IT services in an ordering portal without further restrictions and delivery is made via the cloud, how do you prevent costs from skyrocketing (and stay on budget)?

The solution to the problem: Decentralize the management of IT costs

Despite the problems described, why are so many organizations still moving to the cloud? We can best illustrate this using startups. Almost all startups are currently working with cloud solutions. This is because they have no legacy systems (i.e. old systems that need to be supported by old technologies) and there is usually a good link between their business (and its revenues) and the use of cloud facilities. As startups grow, they need more cloud facilities. They take it for granted that these services are more expensive per unit because the margin rises with them. In addition, these digital services are usually cleverly designed: server capacity is kept low at night (when there are almost no sales) and test server capacity is only purchased when there is testing to be done. Using the cloud can increase profitability and/or agility. In a startup, costs and benefits are also usually managed in one place and there is no separate cost center to control costs.

Of course, other companies can also use the trick of linking value delivery to the costs of the cloud (as described above). And the same goes for organizing cloud consumption in a smart way. For these reasons, we see the following solution directions:

- We give day-to-day cloud control to the business units, which pay for cloud consumption themselves and can link it to their revenue. The weighing of costs and benefits then takes place in one place: at the business units. By doing this, we delegate orchestration and integration. So, in this situation, there is only a cost center for IT costs control and no longer for execution. The advantage of this solution is a high degree of agility and clear cost allocation.

The disadvantage is that it is more difficult to maintain an overview of the total IT costs (there is no longer a central IT budget) and the risk that the business units do not comply with the governance (the agreed standards) during orchestration, thus eliminating the synergy advantage (including security) of the entire company.

- We allow the IT organization to take over the overall governance & management of the cloud and have it ensure that the costs are also kept under control. This can be done based on annual budgets or — more in keeping with the spirit of the times — quarterly budgets. The advantage is that the costs per unit are likely to be lower (long-term contracts can be concluded) and the overall costs can be managed (the IT department sets limits for cloud consumption and distributes capacity as needed). The disadvantage is obvious: agility takes a big step backwards and the overhead increases (IT has to do more governing). Therefore, this solution does not seem sustainable.

- But as always, there is a middle ground. We ensure that the organization recharges the IT costs to the business units fairly and reliably and we give the business units the right to purchase as much IT as they deem necessary within the agreed standards. Here, the costs of the IT department's overhead tasks cannot be recharged. The advantage is that the business units have control over their cloud consumption and the whole organization can benefit optimally from cloud's inherent scalability. The disadvantage is that additional administration is required to recharge IT costs.

Personnel costs are also booked to the business units themselves and not to the HR department!

The third solution can also be easily justified to a CFO: flexible costs that are related to the turnover are best booked as operational costs. Personnel costs are also booked to the business units themselves and not to the HR department! In this case, the financial power of the cloud is fully utilized, i.e. the organization moves from capital expenditures (CapEx) to operational expenditures (OpEx) and can therefore land the operational costs where they belong. Until recently, recharging was time-consuming, but now there is also enough cloud technology to make these costs transparent and support governance.

Of course, in this option you can also decide to distinguish between fast movers and slow movers. You can conclude fixed contracts for slow movers (often present in support departments such as HR and Finance), and you must link fast movers (that usually generate the turnover) to your business model. You can also govern across all the different stages of each service's lifecycle: the internal startup may make a loss, while the cash cow should make a profit.
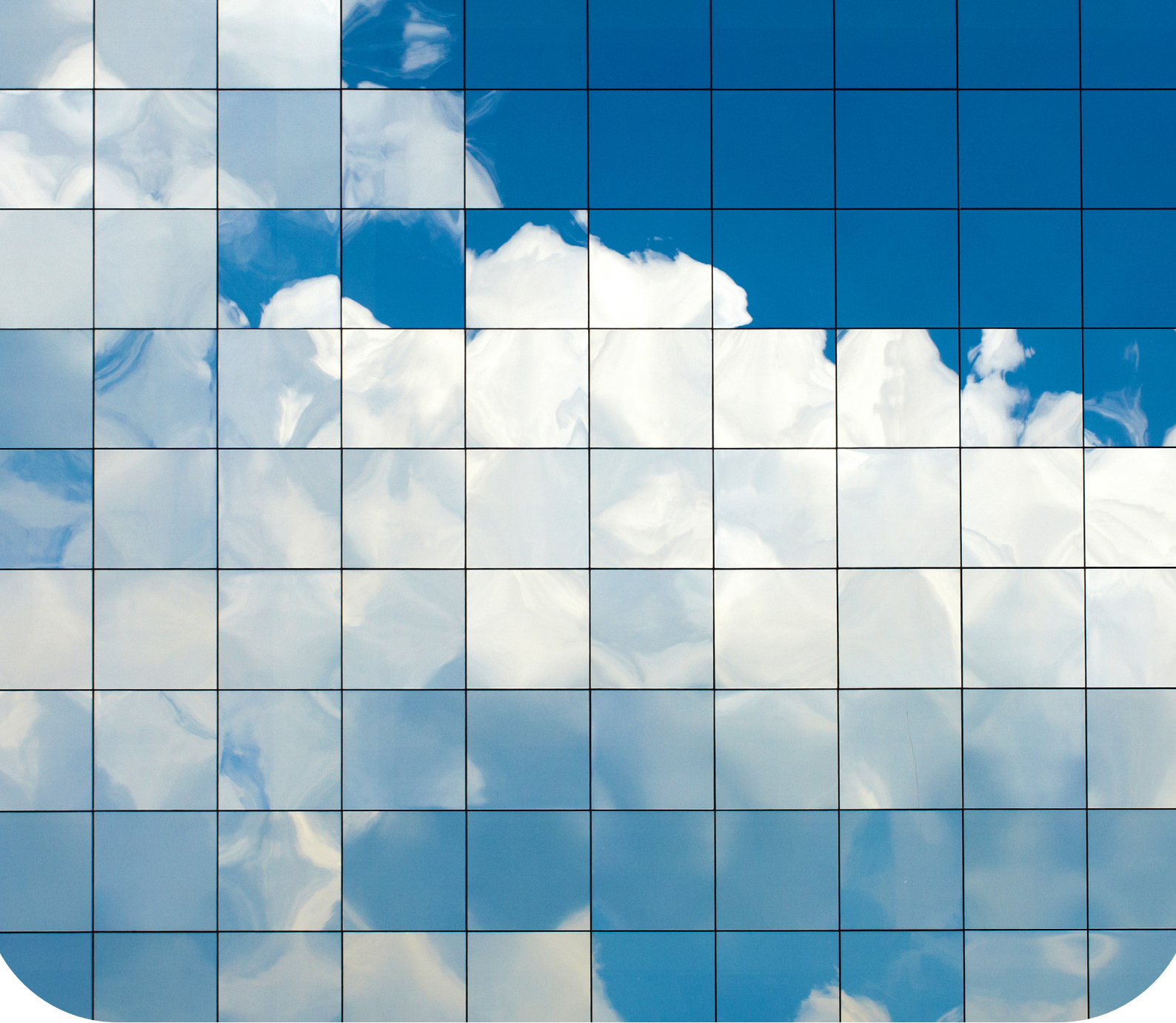
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Experienced in a wide **range** of industries

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