



The relevance of IT cost management and transformation

Executive Summary

In the current low growth business environment, conflated with COVID-19 pandemic impacts, cost control and cost management are high on the agenda for organizations. A survey conducted by IDC in 2020 confirmed that within the Japanese domestic market, IT cost management and reduction indeed topped the list of management concerns for the IT department*1.

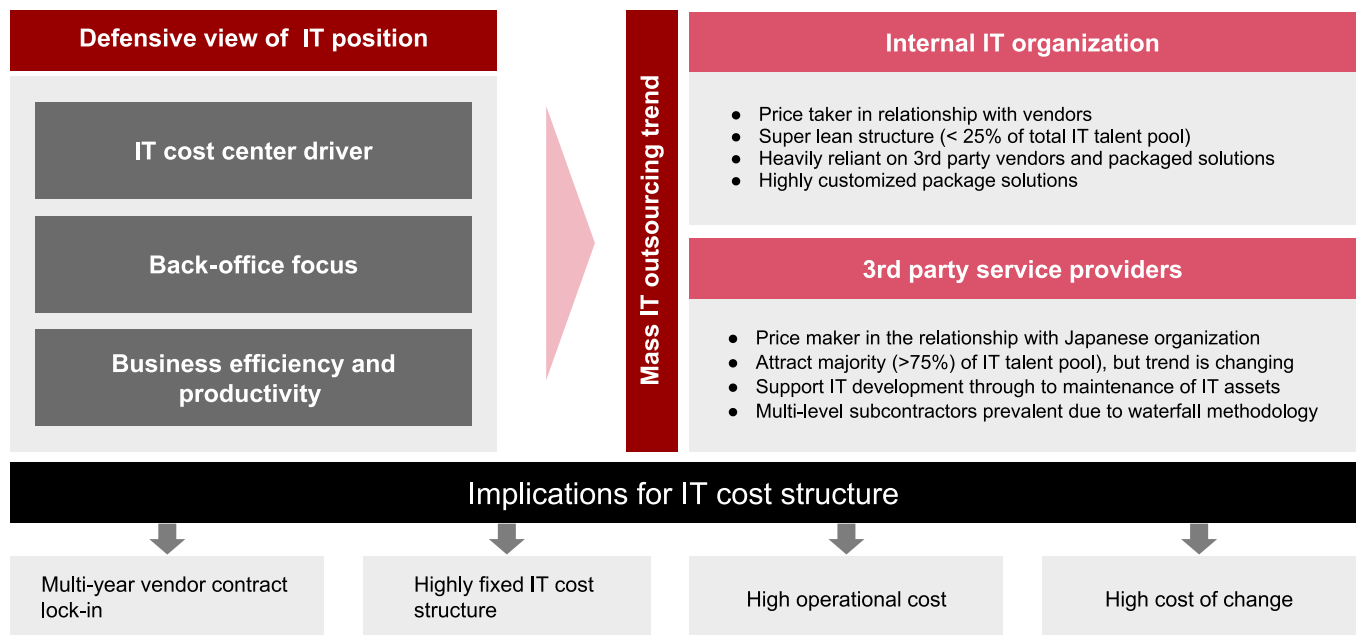
Looking abroad, our **PwC Global CFO Pulse Survey** shows that cost containment remains the top financial action CFOs are considering as a result of the novel coronavirus (81%), with more than half (56%) of respondents considering deferring or cancelling planned investments. CFOs are also not as likely to cut from their planned digital transformation investment (11%), corresponding to findings about their plans to accelerate automation and improve the remote work experience as a priority. The most common area for potential cuts remains (as it has been in all of our CFO Pulse surveys) in facilities/general capex (83%) *2.

IT seen as a defensive necessity in Japanese organizations

Most large Japanese technology-consumer organizations have been viewing IT investments as a defensive position or a commoditized necessity, as opposed to an offensive tool for the business core. This is a reflection of the view of the IT department that was frozen in time at the peak of the mass industrialization era between 1960-1990s. During this time, technology emerged as a solution to driving productivity and efficiency by automating mechanical processes and calculations. Concurrently, there was also a trend to spin-off IT departments

as subsidiaries to drive IT cost efficiencies through increased scale. This enabled mass industrialization of hardware, physical space optimization, and deep specialization of IT resources, all of which helped drive notable productivity improvement.

Exhibit1:Mass IT Outsourcing trend



Mass IT outsourcing trend and implications for the IT cost structure

However, this trend ground to a halt in the 1990s as the economic bubble burst in Japan. In the years that followed, the country saw a unique trend developing around increased outsourcing of information systems and operations to 3rd party providers. Aggressive IT cost efficiency, a pervasive risk transfer strategy, and the strong belief that the IT department was outside the core of the business were the main drivers of this outsourcing practice. Japanese organizations have 88.3% of IT systems delivered by outsourced-developed software, versus its US counterparts which see 33.8% of its systems developed through outsourcing arrangements*3.

The outsourcing arrangement during the build stage often gets further complicated with multiple vendors and subcontractors. Used prevalently in multi-staged waterfall-style project management methodology, the subcontracting approach emphasizes scope and cost control, at the expense of agility and adaptability.

As a result, most large enterprises are still grappling with the cost burden and operational

complexity of managing legacy IT assets. Once deemed a competitive advantage, providing an integrated solution between business operations and customer interactions, most of

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these systems have now become a technical debt burden. Often monolithic in nature, with a tightly coupled architecture, legacy IT systems bring two major cost-related challenges.

Firstly, the **operational cost** is high, whether it is to maintain a custom built solution on COBOL, or vendor negotiations with 3rd party providers on long term lock-in, outsourcing contracts are costly compared to the level of service provided. This in turn can lead to an IT operating cost structure that is highly fixed and difficult to flex to future changes in business demands.

Secondly, the **cost of change** is typically high with legacy platforms, where the legacy architectures are designed for low rates of change and are tied to expensive, waterfall type development processes often undertaken by outsource partners through complex contractual models. They do not natively support the speed, sophistication and agility required by the business at the right price point and rely on formal relationships.

In Japan, within large IT user companies, IT services are still mostly perceived more as a cost center, and less as a business value generator. A serious skills shortage also adds to the challenge of making the internal IT organization sustainable, cost effective and innovative. As a result, a large number of organizations adopt a common approach to outsourcing to 3rd party providers as a measure to control cost and de-risk.

The accumulative effect of this IT outsourcing trend in Japan is a bifurcation between pure technology service providers and in-house IT organizations. While the former has enjoyed steady revenue growth, in-house IT skills level depleted over time. In Japan, over 75% of engineers work with 3rd party providers, with less than 25% of IT talent working in the internal organization*4. Compared this with the US statistics where the distribution is inverted, with over 71% of IT professionals working in internal IT organizations. The lack of in-house knowledge and skills have led to systematic issues for technology-consumer organizations, reducing the arsenal of IT toolkits, expertise and management skill sets required to negotiate vendor contracts and maintain control of IT assets over time.

In the long-term, these have strategic implications for organizations that lack the required skill set to pivot IT from a defensive to a strategic enabler position to support growth and

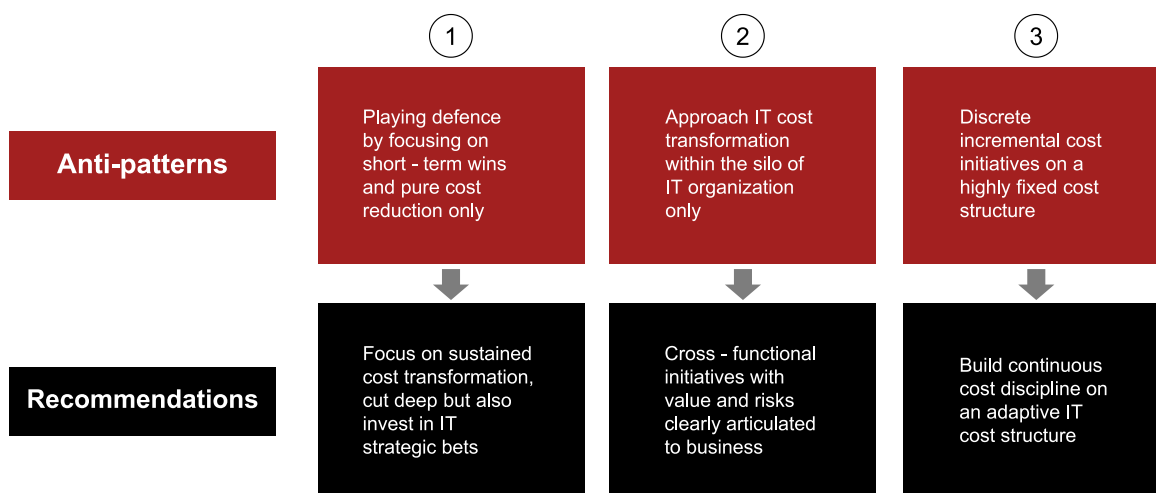
new revenue models. Overtime, these large scale, long term outsourcing arrangements have

created complicated contractual situations which lock in the organizations to single, large scale IT assets and providers, further restricting the ability for the organizations to rapidly innovate or create cost efficiencies through competitive tension or contract renegotiation.

Three anti-patterns to watch for in approaching IT cost transformation, and what else to do instead

Considering the domestic Japanese landscape, contrasting the local trends with those in other markets, Strategy& has observed three key challenges/ anti-patterns to addressing sustained IT cost transformation impacts in Japanese market.

Exhibit 2: Three anti-patterns to watch for in approaching IT cost transformation and recommendations



Antipattern 1: Only playing defense by focusing on short-term wins and pure cost reduction

When IT executives are pressured to reduce their IT budget to meet targets, they often first turn to short-term IT cost cutting to yield immediate results. Traditional IT cost responses in this category include postponing IT initiatives in the pipeline, freezing recruitment, reducing contractor engagements, and lowering service levels.

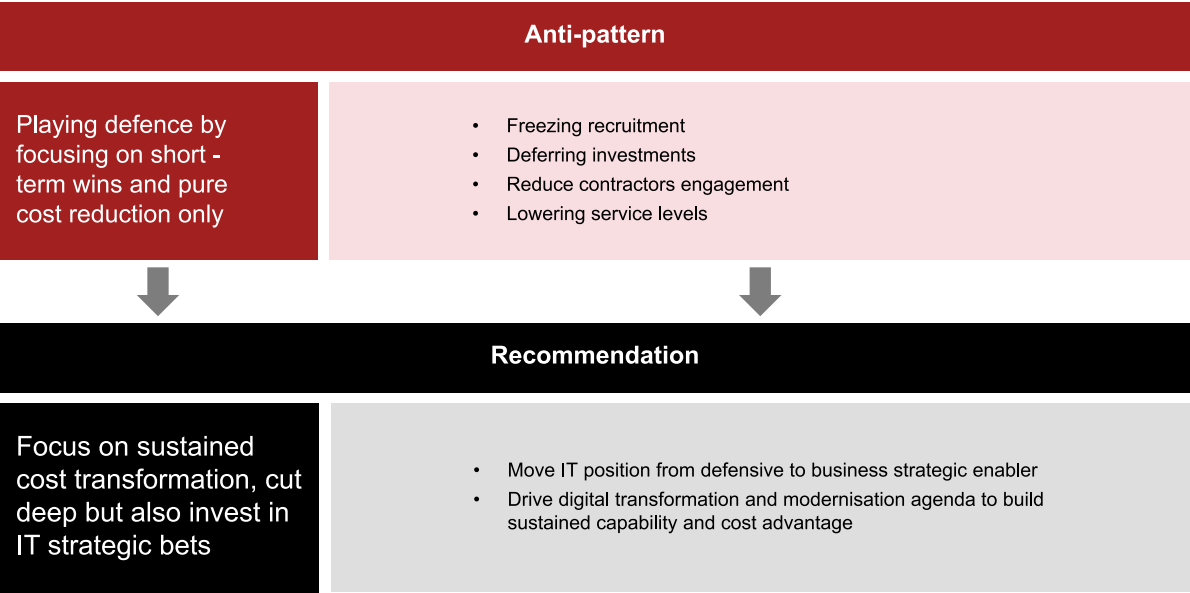
However, overemphasis on short-term wins risks missing the long-term opportunities in bold strategic bets that deliver long-term IT cost transformation. A short-term focus could lead to a vicious cycle of degraded IT quality, agility and flexibility of IT capabilities leading to a greater perception that the IT function does not deliver value and is not a true business

partner. If not planned carefully, IT organizations might find themselves in a difficult situation, with limited runway to grow and play offense after a sustained period of defensive cost reduction.

In Japan, new investments in IT have experienced a sustained downward trend. IT budget as a percentage of revenue has also been flatlining, considerably lower compared to peers in the US market. All these signs point to the fact that at large domestic Japanese organizations, for the past decades or two, there has been very little IT investment related to business growth, demonstrating that IT has been mostly managed for cost efficiency.

What to do instead: IT organizations need to find opportunities to move out of the defensive corner of short-term wins and continual IT cost reduction. The long-term game is to play offence and make bold strategic bets which couple cost transformation with capability creation. Good examples include application modernization, digital transformation initiatives where the focus moves beyond optimizing business operations, towards supporting and generating new business value.

Exhibit3:Anti-pattern & Recommendation①



Antipattern 2: Approaching IT cost initiatives within the silo of the IT organization only, and not a company-wide management concern

To break the vicious cycle of increased pressure to cut costs, leading to reduced service quality and agility, resulting in IT organizations not meeting performance goals, executives need to elevate IT cost programs beyond the remit of the IT executive team. IT should move

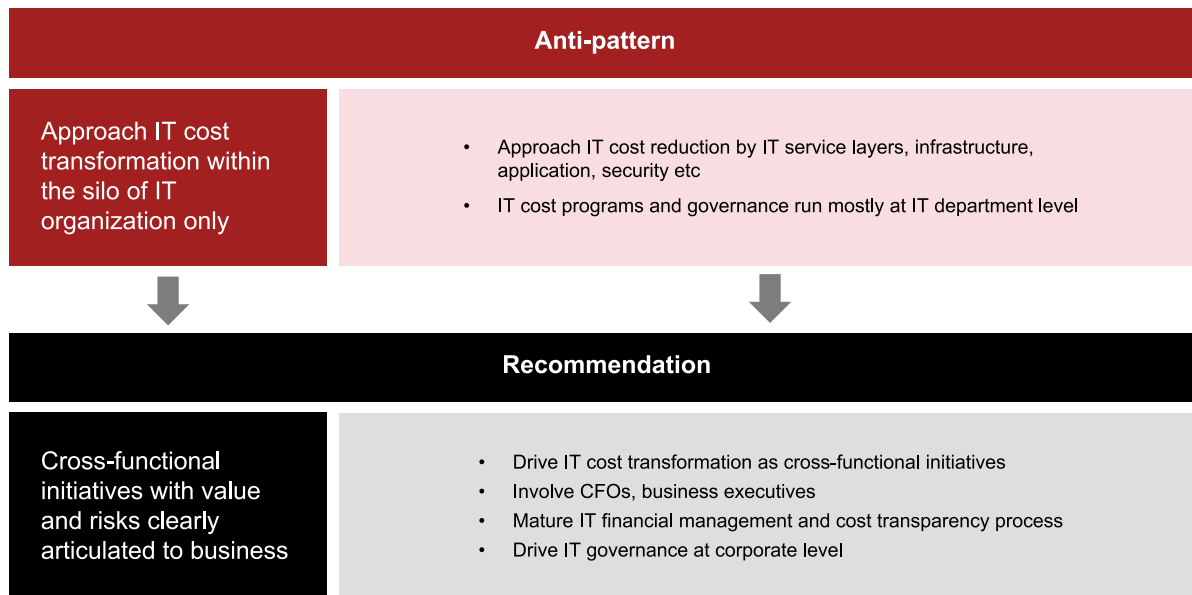
beyond being a simple service provider and order taker required to seek efficiencies. Cost reduction exercises should be a joint effort between the CIO/IT executives and the CFO and Business Executives.

This is particularly poignant in the Japanese market, where the role of CDO/ CIO, while on the rise, only exists in a small number of organizations. The majority of organizations still relegate the management of IT to a Head of IT department role resulting in the topic of IT cost reduction becoming an inwards facing exercise focused on maximizing efficiency within the walls of the IT department.

When the topic of IT cost transformation is discussed and governed within the IT department only, the risk is high that it is treated as a list of one-dimensional cost levers only. Without partnering with the business to truly tie the values and services provided by technology investments, IT department will find it hard to pivot out of the defensive corner into a strategic business enabler.

Most conversations regarding IT cost reduction are still happening at the IT service layer, for example, license optimization, cloud infrastructure uplift, consolidation of network service contracts etc. Very few organizations can conduct this type of conversation in a language that is more business-outcome-focused. This requires a highly mature IT financial management and allocation structure that regularly helps communicate the value of IT to business, and conversely the impacts to customers, and the business, by function, by service level, if cost levers are pulled.

What to do instead: IT cost transformation should be considered a cross-functional initiative. As much as possible, CIOs should look into expanding the circle of influence by involving CFOs, business executive teams, pushing IT cost programs to be governed at the corporate level with cross-functional executive buy-ins. Investments to build out IT financial management maturity is key to uplift IT cost and value transparency as a key foundation to establishing trust and working relationships with the business. This also helps elevate the role of IT from one of cost center to one of business value creator and further supports breaking down the silos between IT and business at a daily operational level.



Antipattern 3: Approaching IT cost transformation as discrete, incremental initiatives on a highly fixed IT cost structure

When IT cost transformation is set up as a discrete one-off initiative, the risk is that it is typically driven top-down, requiring high upfront activities to align while at the same time will be quickly outdated. This pattern is particularly prevalent in times of crisis, where there are very specific mandates to achieve a cost saving target.

At the core of this challenge is the highly fixed nature of the IT organization's cost structure. In Japan, the technology consumer organizations see 70-80% of their technology investment allocated to the maintenance and operations of existing systems*3. A large portion of this cost is tied up with 3rd party vendor contracts on legacy systems that were implemented several decades ago. These contracts are typically multi-year vendor lock-ins, with rather rigid cost structure, leading to limited flexibility to cancel or update the make-up, or level of services. In addition, since most IT professionals work in the vendor organizations rather than user-organizations, the internal skills required to manage, and negotiate IT sourcing contracts are constrained.

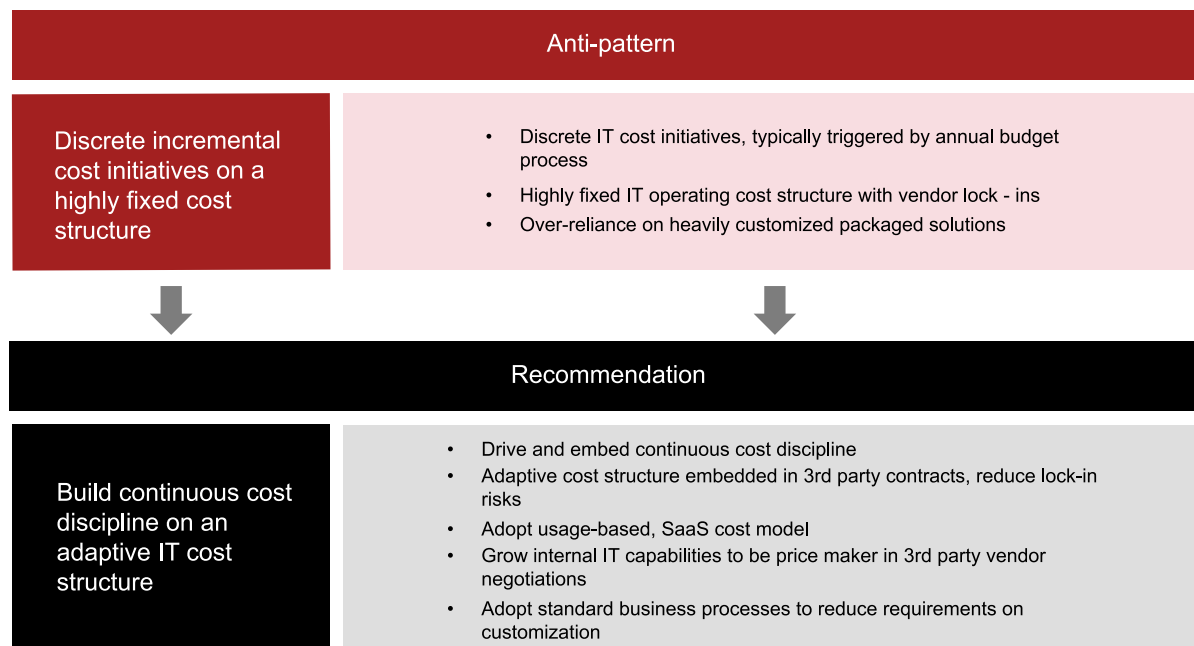
Up until now, most IT operating cost reduction measures stayed around the fringe of the current cost structure, unable to make significant sustained reduction due to high numbers of vendors on locked-in contractual arrangements.

Another dimension to this highly fixed IT cost structure is the over-reliance on heavily customized packaged solutions. Domestic Japanese organizations have traditionally favoured highly customized package solutions or even custom-built software to tailor to their unique business needs. This approach has had significant impacts to the IT cost structure in two fundamental ways. First, due to the uniqueness of the local market, a large percentage of 3rd party providers are local Japanese companies operating across both software development and ongoing maintenance. This highly localized market concentration likely restricts the flow of global innovative solutions into the local market. Secondly, highly customized packaged solutions typically cost more to develop and run. The accumulative effect is that domestic Japanese organizations have to pay a lot more to develop and maintain their IT assets.

In recent years, Japan has seen a growth in modern usage-based structure, e.g. infrastructure-as-a-service is, at 24.7%. 2018-2023 CAGR, contrasted with traditional physical servers at negative growth of -11% to -13%*3. This pattern suggests that organizations are now open to technologies such as cloud, software-as-a-service model, and capacity-on-demand as measures to build additional agility and flexibility into its IT cost structure.

What to do instead: Organizations should consider going beyond discrete IT cost reduction initiatives, and moving into cost transformation via fundamentally changing the IT cost structure. This requires taking back more control by reducing dependency on 3rd party customized solutions and building a continuous cost discipline. This can be achieved by changing the sourcing approach to minimize vendor lock-in risks, while adding flexibility in cost structure, by adopting pay-per-usage, capacity-on-demand, IaaS/ SaaS model. This will also require business to further adopt standardization in business processes, reducing the customization level required, while investing in internal IT capabilities to do strategic IT management.

Exhibit5:Anti-pattern & Recommendation③



Conclusion

In summary, while temporary cost reduction measures are a necessity to ensure businesses have a sufficient buffer to ride through the current level of economic uncertainty caused by the pandemic, it is prudent to ensure IT cost transformation is assessed with the long-term view in mind. More than ever, as COVID-19 has accelerated the pace of digital transformation, the role of the IT organization has been put under the spotlight, to pivot from that of defensive position to that of business and strategic enabler. The opportunity is ripe for IT organizations to create some fundamental shifts in IT cost structure, governing IT cross-functionally and increasing collaboration with CFOs and the business while reducing a high dependency on 3rd party providers. Together, these measures will enable a more sustained approach to IT cost transformation that likely lasts beyond the current crisis and can convert the rusted IT department to a strategic business partner.

*1 : IDC, 2020. "Survey of domestic users in 2020: Trends and Challenges in IT Inventory by Industry and Enterprise Size"

*2 : **PwC's COVID-19 CFO Pulse** Insights from global finance leaders on the crisis and response, May 2020

*3 : Ministry of internal communications and affairs, 2019. **"Information and communications in Japan White Paper**

2019"

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*4 : Mizuho Bank, 2018. “Structural changes in the Japanese IT services market caused by the digitization of industry”

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About the author

Nhu Le is a manager at Strategy& with over 10 years of advisory experience across Australia, Hong Kong, Japan and Malaysia markets. She has extensive experience in designing and leading digital transformation programs. She has advised clients in banking and insurance on getting the best values from technology investments and enablement, such as core system modernization, strategic IT investments, IT operating model optimization and organization-wide digital transformation.

Contact us



Daisuke Yabuki

Partner, PwC Japan

Email



Jonathan Sharp

Partner, PwC Japan



Email



Toshiya Tsutsumi

Director, PwC Japan

Email

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