

## IT Cannot be a Profit Center

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**Of late, there is a lot of emphasis on IT ROI. While this is commendable, extending this argument to convert the ITO into a profit center is taking it to another extreme.**

Are HR, finance, and marketing profit centers?

No, but they are still necessary for running the business. IT is a similar, necessary evil and therefore the model of the internal ITO as a profit center just does not work.

The concept of profit centers is built around profitability, which in turn requires an unwavering focus on the business model. Consequently, profit centers must meet certain minimum criteria:

- **Revenues and costs:** Accurately quantifying revenues and costs.
- **Market:** A focus on customer relationships that are generating higher profits and either discontinue or deemphasize those that aren't.
- **Product Mix:** The creation of a portfolio of products and services driven by market demand.
- **Product pricing:** Price products and services to maximize profits.
- **Timing:** It is often said that, in business, timing is everything. Profit centers are profitable when they can quickly respond to a market opportunity.

This is by no means an exhaustive list but it should be sufficient to provide an idea of the general focus and direction of "profit-driven" enterprise.

But, since companies also expect IT to work, hand-in-glove, with the business to create shareholder value the more closely an IT capability is aligned with business requirements the more shareholder value generated by the enterprise. But this is at odds with the ideal of being a profit center as I will explain later.

Based on the example above, this discussion boils down to answering two key questions: Does an ITO meet the criteria of a profit center? And, if it were to operate as one, can it still meet the expectations of alignment and shareholder value?

For starters, we cannot determine the revenues and cost associated with the IT department with a high degree of certainty or accuracy. How do we allocate the company's revenues to a department, say Marketing or HR? In what proportion did they contribute to creating those revenues?

Some have approached this problem from the other end, i.e. determining the value generated by IT. Theoretically, each IT project creates value in some form, say, increased revenues, increased productivity, or cost savings.

In theory, adding all these up would give us the value generated by the ITO as a whole. However, there are obvious flaws in this approach. Can IT generate this value without the other business units? If not, then, how do we separate IT's revenue contribution from theirs?

Having been involved in many project portfolio rationalization efforts, I have learned that adding the projected value generated by individual IT projects often exceeds the total value generated by the entire organization!

The bottom line is we just do not have an accurate way of allocating enterprise revenues to individual functions.

The cost side of this equation is somewhat easier because we have departmental budgets. However, budgets do not account for all the costs associated with a function nor do they accurately reflect the cost of doing business.

## Held Captive

The revenue and cost allocation issue is just the tip of the iceberg. An ITO cannot work as a profit center because it has a captive relationship with its "customers," the other business units.

Since IT's customers cannot generally bid the work out to other providers and IT cannot focus on its more profitable customers over unprofitable ones, how can IT be viewed as a profit center when free market forces are not at play?

An ITO cannot manage its product mix for profitability either. It cannot reject projects or discontinue services because they are not profitable. Often business requirements dictate investment in "unprofitable" initiatives. These could be requests for one-of-a-kind or custom-tailored products and services which do not provide economies of scale or require specialized resources and invariably cost more.

If there is a one-of-a-kind request from a business unit, should IT engage in price increases, just like any "profit-driven" business would? If there is a need for express delivery, can the charge be different?

In the absence of the ability to price products and services to market conditions, the discussion on IT as a profit center is moot because a profit center's profitability is determined by using all levers at its disposal.

For example a profit center can use:

- **Innovation to generate substantial profits:** New and improved products are priced at higher margins. IT cannot introduce new products that its internal market does not need. Consequently, it cannot reap the benefits from innovation, to the extent real profit centers can.
- **Financial management to impact profits:** IT does not have the freedom to invest its "spare" cash and generate higher returns.
- **Distribution channels to creatively leverage partnerships for profits:** IT cannot leverage its channels to deliver other providers products for a profit.

If an internal ITO overcame all these issues and considered operating as a profit center it would not meet the expectations of alignment and value placed on it because the ITO is created to address the unique needs of a specific business.

Hence, the more IT hones in on its business customers' requirements, the more shareholder value is generated. This is the converse of focusing on many client's needs and leveraging economies-of-scale to save cost and therefore increase returns.

Over time business and IT alignment results in increasingly lower costs as the logical benefit of climbing the learning curve but there are no economies-of-scale to speak of unless the company grows significantly without expanding the current infrastructure and/or base of applications.

## Independent IT

Some have argued that for IT to succeed as a profit center it must become an independent entity. But this type of organization is profit-driven and serves both internal and external clients (partners, suppliers, VARs, etc.). It also competes for business with other providers even for internal clients' projects.

While this model is market-driven and hence fulfills the premise of profitability driven enterprise it fails on the alignment and value criteria outlined above and will not result in the desired benefits to the enterprise.

An external provider is not motivated to align its capability to one business' requirements as it will lose other customers -- it is nearly impossible for any provider to align themselves with all or most of their customers.

An open-market model also dictates that companies have multiple suppliers. As with the above example, it would be impossible for a company to align with all or most of its suppliers either.

## Strategic Value

Strategic advantage from IT comes when it is tailored to a specific business' needs. By definition, profit-driven providers focus on economies-of-scale. Hence, they will create generic products that are of use to many customers. Customizing these products to meet specific needs of a particular business will, in the least, cost extra.

This lesson was learned by many companies, when they implemented off-the-shelf ERP packages. The package cost a fraction of what it took to implement it!

Using financial measures and placing "profit" expectations are unreasonable and unproductive. If the goal is to ascertain and assure that IT is efficient and effective there are many more accurate and reliable ways of accomplishing this.

### Additional Information:

**Sourabh Hajela, StartSmart Consulting**, is a management consultant with over 17 years of experience creating shareholder value for his Fortune 50 clients, including Prudential, Citibank, Bank of America, Allmerica, Solomon, Smith Barney, HP, MCI, and IBM. Mr. Hajela's work has created multimillion-dollar payoffs for his clients - quickly, verifiably, and sustainably.