Within your IT financial systems, there are two possible places to build a product/service cost model: within your planning tool, or within your actuals-tracking systems. Before exploring the pros and cons of each, let’s define what we mean by a cost model.

Internal service providers like IT are businesses within a business, providing products and services to the rest of the enterprise. Those products and services have a full cost, which includes direct costs and a fair share of indirect costs.

A product/service cost model is what amortizes indirect costs to all of the organization’s products and services.
The Value of a Cost Model

Knowing the full cost of your products and services is beneficial for a number of reasons.

It allows you to manage customers' expectations by explaining exactly which products and services you can deliver for a given level of funding.

It defuses the unrealistic “do more with less” demand and cuts costs strategically by challenging the business to decide which products and services to forgo when budgets are reduced.

A cost model builds trust through transparency, helping you defend allocations and rates.

It's the best basis for benchmarking, allowing you to answer the question, "Can I buy this particular product or service more cheaply from outsourcing vendors or decentralization?"

Communicating the cost of your products and services builds an understanding of the value you deliver.

It changes the executive dialogue from defending your costs to a discussion of the business (and potentially strategic) requirements for your products and services.

A cost model is a critical component of governance as well. By knowing the full cost of your products and services, you can empower clients to decide what they will, and won't, buy from you within available budget. This leads to strategic alignment, since clients will naturally buy those products and services which deliver the greatest value to the business.

Within a cost model, rates include indirect costs. This provides channel funding for innovation and infrastructure.

And if you engage your leadership team in developing the cost model, the experience and the resulting product/service catalog with rates encourages a culture of customer focus and entrepreneurship.

**Benefits of a Product/Service Cost Model**

- Expectations match resources.
- Cut costs strategically (not “do more with less”).
- Defend allocations/rates – trust through transparency.
- Benchmarking: outsourcing, decentralization.
- Build understanding of value delivered.
- Change the dialog.
- Empower clients to decide what they buy (alignment).
- Fund infrastructure, innovation.
- Cultivate customer focus, entrepreneurship.
Two Places to Build a Cost Model

Within the suite of IT financial systems, there are two major components:

- A **planning tool** is used once a year to develop a business plan, a budget, and rates. This is not simply a matter of projecting past trends. A business planning process (and tool) considers trends, but through the involvement of your leadership team, plans future costs and volumes, new products and services, and new fulfillment strategies.

- **Actuals-tracking systems** such as the general ledger, timecards, and infrastructure-utilization metrics log the products and services actually delivered and produce invoices (as well as dashboards and historic data reports).

Embedded in your planning tool, a cost model allows you to convert a demand forecast into an investment-based budget which forecasts the total cost of all the products and services you might deliver in the year ahead.

A cost model embedded in your planning tool also allows you to set rates for the year ahead.

A cost model embedded in the actuals-tracking systems has a different purpose. It allows you to analyze the actual full cost of the products and services you have delivered in the past.
Pros and Cons

Which is the best place to build a cost model?

Some of the benefits accrue no matter where you put the cost model.

Wherever you put it, a cost model will build trust through transparency. Both alternatives give you a good basis for benchmarking. And both build an understanding of the value you deliver.

And wherever it resides, you can design into the cost model funding for innovation, and for infrastructure. And in both cases, leadership participation in the design of cost model cultivates a customer focused, entrepreneurial culture.

Benefits in Either Case

- Expectations match resources.
- Cut costs strategically (not “do more with less”).
- ✓ Defend allocations/rates – trust through transparency.
- ✓ Benchmarking: outsourcing, decentralization.
- ✓ Build understanding of value delivered.
- Change the dialog.
- Empower clients to decide what they buy (alignment).
- ✓ Fund infrastructure, innovation.
- ✓ Cultivate customer focus, entrepreneurship.

However, you can only do investment-based budgeting (a budget for products and services) if you build your cost model within your planning tool. And investment-based budgeting is the key to gaining the remaining benefits.

Investment-based budgeting changes the executive dialogue during the annual budget process. Clients naturally defend their need for your products and services; they feel empowered to decide what they buy; and clients decide what to forgo if budgets must be reduced (strategic cost cutting). Budget decisions are based on the requirements of the business and strategic investment opportunities. And since the budget explains exactly which projects and services are funded, expectations match resources.

Beyond investment-based budgeting, a cost model in your planning tool is required to set rates. Rates should be published at the beginning of the year, and remain stable throughout the year (barring some major change in the business). Rates must represent future costs, not past costs. And rates must be consistent with the budget. For all these reasons, rates must come from the planning tool, not the actuals-tracking systems.

To hold rates stable throughout the year, the cost model must account for various planning scenarios. On the downside, you must recoup your indirect (fixed) costs in your worst-case scenario. On the upside, you must set labor rates that allows you to bring in more expensive staff-augmentation
contractors without charging clients a premium (billing clients two different rates for essentially the same service). To plan rates properly, the cost model must be placed within the planning tool.

Rates provide a basis for benchmarking, and for a business-driven governance process where clients adjust priorities throughout the year within available resources.

**Benefits If in Planning Tool**

- Expectations match resources.
- Cut costs strategically (not “do more with less”).
- Defend allocations/rates – trust through transparency.
- Benchmarking: outsourcing, decentralization.
- Build understanding of value delivered.
- Change the dialog.
- Empower clients to decide what they buy (alignment).
- Fund infrastructure, innovation.
- Cultivate customer focus, entrepreneurship.

Thus, a cost model embedded in your planning tool delivers all of the expected benefits of product/service costing, and it’s required in order to publish rates.

**Does Actuals Tracking Require a Cost Model?**

The actual-tracking systems convert utilization data into invoices for the products and services you've actually delivered. Does this require a cost model?

No. Invoices multiply actual utilization (volume) times published rates. Using published rates is critical. Actual costs of products and services are bound to deviate from published rates, since costs fluctuate throughout the year. Of course, the business will not tolerate rates that change unpredictably from month to month.

Actuals-tracking systems may also produce an "income statement" (profit and loss statement) for each manager. On one side of the ledger, it shows actual costs by general-ledger code – compensation, travel, training, vendor services, depreciation, etc. On the other side of the ledger, it shows revenues by product and service (from the invoices). The net (revenues minus expenses) shows a variance from the plan. A cost model is not required to produce this key management metric.
**Income Statement (P&L) by Manager**

<table>
<thead>
<tr>
<th>Actual Spending by General-Ledger Code</th>
<th>Revenues by Product/Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation</td>
<td>Actual volume X Published rates</td>
</tr>
<tr>
<td>Travel</td>
<td>Reimbursables (pass-throughs)</td>
</tr>
<tr>
<td>Training</td>
<td></td>
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<tr>
<td>Vendor services</td>
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<tr>
<td>Depreciation</td>
<td></td>
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<tr>
<td>Etc.</td>
<td></td>
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</tbody>
</table>

NET (Profit/Loss)

Consider the questions that can be answered so far with a cost model in the planning tool but not in the actuals-tracking systems.

- You'll know whether spending is in line with plan by looking at variances in costs by general-ledger code.
- You'll know whether deliverables are in line with plan by looking at revenues by product and service.
- And you’ll know whether planning assumptions were reasonable by looking at the net: costs versus revenues.

So far, no cost model is required in the actuals-planning systems.

**Why Build a Cost Model in the Actuals-tracking Systems?**

Why, then, would anyone advocate building a cost model in the actuals-tracking systems?

Note that a cost model in the actuals-tracking system does not obviate the need for a cost model in the planning tool. You’ll always need to publish forward-looking rates at the beginning of the year.

The only benefit to cost model within your actual-tracking systems is the ability to analyze the profitability of specific products and services. Invoicing gives you revenues by product/service (without a cost model). The cost model gives you actual costs by product/service.

Why would you want to analyze the profitability of your products and services?

Generally, it’s not for "cream-skimming" – deciding which products and services you will and won’t offer. Most internal service providers strive to be the “vendor of choice” to the business, and therefore must be full-service suppliers.

However, they may wish to outsource unprofitable products/services. Actual product/service costs may be useful for benchmarking. But you can accomplish the same thing by benchmarking published rates.
If the published rates (from the planning tool) are competitive, then the income statement will tell you whether you're meeting your plan or you need to investigating sourcing alternatives.

The only real value of product/service profitability analysis is to find targets for efficiency improvements – specific products and services that are unprofitable and need scrutiny.

Of course, there are other ways to achieve this same purpose without incurring the expense of building a second cost model in the actuals-tracking system. When the net (revenues minus expenses) is negative, a focused analysis of that specific managerial group is an efficient way to find out which costs are out of line.

If you do build a cost model in your actuals-tracking systems, there is one important caveat: It must precisely match the cost model in your planning tool. You would create confusion and gain no value if published rates were calculated with one cost model, and actuals are analyzed with another.

**Suggested Strategy**

Since the cost model in your planning tool is necessary in any case to produce an investment-based budget and forward-looking rates, and since it delivers all the intended benefits of product/service costing, this is the right place to start. A robust planning tool begins with your product/service catalog, forecasts demand, plans the resources required to fulfill that demand, and produces an investment-based budget and rates – all as an integrated process.

Step two may be to utilize those rates for invoicing and governance. This requires an investment in utilization tracking (both time and infrastructure usage). Volume metrics are then converted into invoices, either to collect fee-for-service revenues (chargebacks), or in a governance process to allow clients to set priorities within your budget, with knowledge of the cost implications of their decisions.

Once the actuals-tracking systems are producing invoices, the data can be mined in a variety of ways. You can produce income statements by manager, and track variances from plan. You can also set up dashboards both for internal and client consumption.

Finally, if you feel you need to track the profitability of every product and service on an ongoing basis, then it may be worthwhile to invest in replicating the cost model within your actuals-tracking systems.

**Suggested Strategy**

1. Cost model in planning tool.
2. Invoicing, governance.
3. Income statement by manager.
4. Optional: Replicate cost model in actuals-tracking