BUDGETING WORST PRACTICES
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On the Defensive

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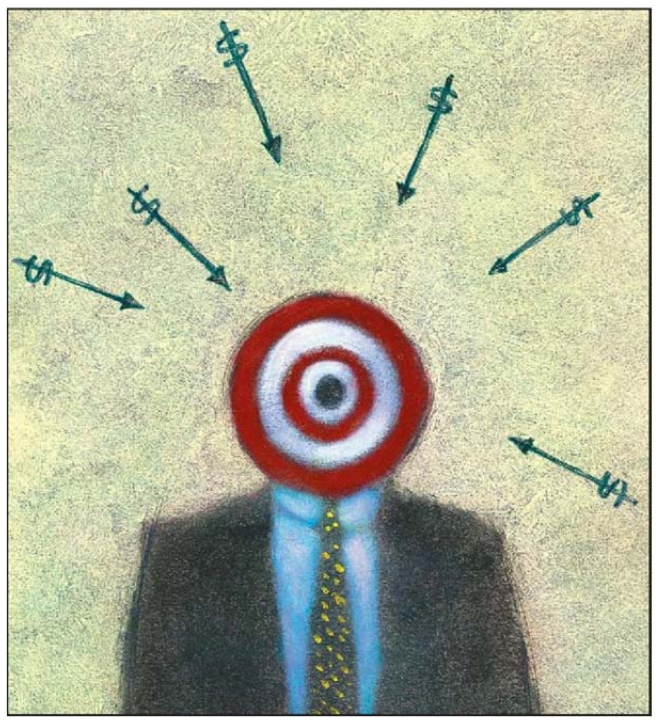
"Howard, it's your turn. Let's take a look at your budget. I'm not going to focus on the three big capital projects that have already been approved by the Board. Let's just talk about the rest of your budget."

"That would be from here on down." [Howard points to the page in front of the president.]

"Yes, what you call your 'base' budget. Howard, you're proposing a budget that's bigger than last year's. You know economic conditions won't support that. What's the deal?"

"Well, sir, we have all the 'keep-the-lights-on' stuff — you know, all the operations. Now, as you know, the costs of computing and telecom have been trending downward. But every time we deploy a new app, it adds to the operational base. So we're actually less expensive on a per-unit basis than last year, but the net effect is a small increase in the operations budget."

"Why don't you shut off some of the old apps when you bring on new ones?"



"What, you want us to shut down the payroll system?"

"Howard, don't give me that! You know I won't be held hostage! Other old stuff. Who reads all those reports you print anyhow!?"

"Sorry, sir. I don't quite know what to say. The legacy apps were all put there for a reason. The business is using them. How am I supposed to know who out there really reads what?"

"Alright, forget that. The delta in operations is minor. But in your so-called 'base', you've also got tons of development hours for unspecified enhancements. What's that about?"

"Those are all the little change requests we get all year long."

"Tell me why you believe they're worthwhile...."

"Well, we can't really know in advance what the users are going to ask for. Some of it's probably required — regulatory stuff, new product intros, you know — and the rest is just keeping their apps up to date, or new requirements. I honestly don't know whether it's all worthwhile. But I do know that if we're not responsive to the business, they'll scream and you'll be on my case."

"Hmph.... Okay, put that aside for the moment. The enhancements budget isn't all that much bigger than last year's anyhow. Let's go after the big fish. You are nearly doubling your budget for these 'technical engineering' groups, whatever they are. And your support budget is up by a third."

"Technical engineering. . . those are the database programmers, data management analysts, and systems engineering folks. We need them to support the development teams on those three big capital projects, which, as you said, have already been approved."

[The president gives the CIO a chilly stare.]

"And support. . . the big-three projects are using lots of project-management support, procurement, training, and administration. And just as the project support winds down, we've got to ramp up the help desk."

"Hang on a minute.... We gave you exactly what you asked for when we funded those capital projects. Now, you're using those big-three as an excuse to increase everything else. As far as I'm concerned, that's double dipping."

"Sir, it's really not. We didn't include these expenses in the projects' capital budgets. They're not going to be capitalized. But if you'll recall, we did refer to other ongoing life-cycle costs of ownership."

"Howard, I'm not pleased. I hear you saying you misled the Board in those project proposals, got them approved by low-balling the costs, and now you're demanding a blank check for all these support groups. This doesn't play well! Why don't you take a few days to think about your relationship with the Board, and come back to me next week with a more reasonable budget."

The Root of the Problem

Howard is in trouble. And for good reason.

The president is right. Project proposals should include the full cost of the purchase decision, including all internal project-team members and a fair share of indirect costs and overhead.

Then, when business-unit leaders defend the IT projects that will benefit them, they'll automatically be justifying all the incremental costs the IT organization will have to incur as it grows to take on the additional work.

The same is true of services. When business units expand, they use a greater volume of services (like more desktop support and email accounts). As these service-delivery groups grow, they demand more of other internal support groups, and costs ripple throughout the organization. These services must also be priced at a rate that covers their fair share of indirect costs.

Note that it would be no different if the corporation bought products or services from an outside vendor. Their prices cover all their indirect costs and overhead, and they never ask for money for their internal support services.

Howard's problems stem from him trying to justify indirect costs and overhead separately from the projects and services he provides to the business units.

These internal support activities have no immediate benefit to the business units, so Howard is on his own defending them. And since they can't be justified in terms of ROI, he'll be lucky to get all he had last year, despite the growth in his workload. More likely, he'll have to struggle through with less than last year — far less than he needs to survive.

The Way Out

The truth is, while indirect costs don't immediately grow or shrink based on individual project approvals, they do trend over time to match the overall size of the organization.

Thus, all projects and services should be costed at their fully burdened costs.

Said another way, instead of presenting a budget for each group in the department, the IT budget should be presented in terms of projects and services — deliverables. For each deliverable, the budget should combine both direct and a share of indirect costs across all groups in the IT organization.

This is called an "investment-based budget."

One key implication is that you never ask for funding for things people don't buy from you.

Where from Here?

At this point, all that Howard can realistically do is return next week with a budget that matches last year's, and pray it isn't cut further as the firm downsizes.

But there is something Howard can get started on immediately after next week: His leadership team can re-cast the coming year's budget into an investment-based budget.

Then, with data in hand, Howard can challenge business leaders to make some tough decisions about priorities.

They'll have to cut back on some projects or services to fit within whatever total amount is decided next week. Or they'll have to come up with additional funding (a mid-year budget adjustment) if they really can defend their need for more.

The end result may or may not be more budget. But at a minimum, it will fund internal support functions appropriately, and it will match clients' expectations to available resources.

When should Howard undertake an investment-based budgeting initiative? As soon as possible to get the benefits early in the new year, and to prepare well in advance for the next budget cycle.

Practicalities

The concept of investment-based budgeting is simple, but the mechanics are not.

Some costs are direct. These are easily traced to a project or service. The only tricky part is linking the costs of all the various contributors to a project team to get a total project/service cost.

The tougher challenge is in allocating indirect costs to all the deliverables in the budget.

These include staff's "unbillable" time, for sustenance activities such as professional development, product R&D, and business development (like writing proposals).

Indirect costs also include expenses that are not part of an individual project, but rather are needed to sustain the whole group or support multiple users of a service. These "indirect" costs come from two places: external vendors, and other internal support groups.

Additionally, departmentwide overhead has to be amortized across all projects and services in every group.

This identification and amortization of costs requires a business and budget planning process with the right tools, the right method, and clear definitions and guidelines at every step so that IT managers can learn to plan their budgets as entrepreneurial businesses within a business.

Setting up an investment-based budget the first time takes an investment; but then, each year, the budget planning process takes no longer than traditional methods. And the payoff is felt year after year. ❒

For a library of information and case studies on investment-based budgeting, the method, and the tool, go to fullcost.com. *And CIOs interested in a private sounding board on their resource-governance processes may enjoy a private consultation with Dean Meyer. Contact NDMA at 203-790-1100, or* info@ndma.com.