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Our IT Allocation Is Too Small!

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"Dave, I need to talk to you about this IT cost allocation you're hitting me with."

"Sure, Larry. Happy to talk about it. When can we get together?"

Following up, Dave, the CIO, set up a meeting with Larry, general manager of the company's largest division. It's an annual ritual. IT publishes its budget, and the divisions scream.

Normally, Dave dreaded this time of year. But this time, he cheerfully looked forward to the meeting. Wait until you see what he had up his sleeve!

The Challenge

"Dave, our IT cost allocation is just too big!"

"What do you mean, it's too big?"

"Well, it's not right. I think you're charging us more than our fair share, and the other divisions are getting off easy."

"But we used the same formula for all of you. How can that be?"

"I don't know, but I still think it's too big."

"Why do you feel that way, Larry?" Dave encouraged Larry to get it all out on the table.

"Well, you cost too much. IT is too big an expense item for us. We can't afford to go on giving you this much money."

"So you want me to reduce your allocation?"

"Yes. Exactly. At last you're listening to me."

"Happy to do that, Larry. By how much?"

"Huh? What are you up to, Dave? It can't be that easy!?"

"Absolutely, it's that easy. If you want it cut in half, I'll cut it in half. Whatever you say, Larry."

"Dave, for years, we've fought over this. Now you're saying you're happy to reduce our allocation as much as I want. I don't get it. What's the catch?"

The Answer

"It's pretty simple, Larry. I hear you saying you have too much money in your pocket."

"What!? No! Your allocation is taking money *out* of my pocket."

"It may appear that way. But look at it this way. I'm a supplier to you, right?"

"Right."

"I sell you products and services, right?"

"Right."

"Which you pay for through the allocation, right?"

"Right. Where's this going, Dave?"

"Here's the deal. Your allocation puts money on deposit with us to pay for the projects and services we sell you. It's like a pre-paid account – a checkbook that you fill up at the beginning of the year, and then spend on us all through the year."

"You could look at it that way."

"So we could cut your allocation in half. You'd have half as much in your checkbook. You'd only be able to afford to buy half as much from us. Of course, you'd have to decide what you're going to not buy from us. But that's your problem, not mine."

"Wait a minute. We need all the stuff we're getting. I'm not letting you off the hook on any of it. But you have to charge us less."

Larry folded his arms over his chest and scowled. Dave laughed.

"Yeah," Dave teased, "we all want a Rolls Royce for the price of a Chevrolet. I know you want everything for half price. But let's get real. Things cost what they cost. We're not adding in any markup or padding. We're charging you the true cost to shareholders of what you buy. Larry, compare like-to-like, and you'll see we're a lot cheaper than outsourcing or your little decentralized group. You're getting a good deal. The problem is, your people are buying too much."

"Dave, why should I believe you?"

"Well, we did our budget a little differently last year. Instead of just listing our costs by manager, we calculated the cost of all our products and services. Here, take a look at exactly what you're buying from us…."

"Wow, this is a lot of data. Hmm, is that what this project is really costing? And I didn't know we had so many hand-helds. Hey, wait a minute, why should I believe these numbers?"

"Well, I can show you exactly where the numbers came from, in detail, if you want. I can show you which of my groups are involved in each project and service, how much time each is putting in, the direct costs, the indirect costs, everything. Do you want to take the time to look? Or do you want to send your divisional controller over to audit me, and we can continue this conversation later?"

"I'll have my controller go over it with you. But Dave, I've got to admit, now that I see all you're doing for us, the numbers don't look that far off."

"By the way, Larry, the supply chain project that you presented to the Board isn't even in these numbers. You said your allocation couldn't go any higher than last year, and that project wouldn't fit in the budget. You pretty much used up your checkbook with just the 'keep the lights on' stuff."

"Dave, you know that project is Board approved. You've got to do it."

"We'd love to. But how do you plan to pay for that project? As you know, I'm a break-even shop. I don't have the money to pay for it."

"We're giving you a lot of money. We expect you to make it happen."

"And you know exactly where that money is going – what you're buying with it. Nobody is giving me a slush fund to pay for your projects, Larry. If you want more, you're going to have to either stop buying something else or ante up more money to fund the true cost to shareholders of that incremental work."

"Alright, alright, I get your point. Maybe we could cut some of these small projects and enhancements. And maybe we could shut down this legacy system that my people aren't really using anyhow."

"Now we're talking, Larry! I want you to shut off any projects and services that aren't paying off all that much for you. Spend your money on the important stuff, the strategic stuff, like the supply chain project."

"I can see some things we can do without. But looking at the numbers, cutting them isn't going to cut costs all that much. And Dave, I'm really committed to that supply chain project."

"I know you are. And I'm still hoping you'll find the funding to pay for it. I think you probably can trim some other stuff a bit, like you were saying. And you should. But you're right, the numbers don't add up."

"Dave, I get it…. My allocation is too small."

Dave smiled.

"Well," Larry continued, "if the Board wants me to pursue the supply chain strategy, they're going to have to fund it. And now that you mention it, my own division has some implementation costs that weren't covered in my budget. I've got to go back to the Board with a clear view of the cost of the strategy, and either they fund it or we don't pursue it. That's all there is to it."

How They Did It

What Dave's IT department did differently this year – and the key to answering Larry's challenge – was this: They calculated the true, full cost to shareholders of all their products and services.

They went beyond just a simple catalog and rate model. They forecasted demand for their products and services – sales of catalog items to specific customers – and associated all their costs with those sales. It's called "investment-based budgeting."

To do this, the managers used an off-the-shelf business and budget planning tool, which came complete with a step-by-step methodology.

Each manager listed the products and services they planned to sell to each division – the keep-the-lights-on things as well as all the speculative projects and service enhancements that clients were demanding.

They forecasted the billable hours (not FTEs) required to do each of these deliverables. They also set aside time for necessary, but unbillable, sustenance activities like training, vendor research, and client relations.

Then, they planned the mix of employees and contractors they'd use in the year ahead. The software put all that data together and calculated a compensation cost per billable hour, which it applied to the deliverables.

Next, they forecasted their costs in each general ledger account, both direct (project-specific) and indirect ("fixed") costs. The software made sure they'd recover fixed costs regardless of the eventual size of the IT budget. And the software dealt with apportioning indirect costs to just the right deliverables, in just the right proportions.

Then, the managers linked up "primes and subcontractors" within IT project teams, and the software reported the total IT-wide cost of each product and service.

Dave scrutinized all the numbers to be sure his managers had been frugal, using a set of reports designed for that purpose. The inputs were tuned until Dave was absolutely confident that the data represented the best they could do in the year ahead.

Then, he reported the data by division, and set the allocations based on what they were going to consume in the way of IT products and services.

The rest was easy. With absolute financial transparency, Dave had the facts on his side. Either divisions came up with more money, or they had to make tough trade-offs and set priorities within the limits of their allocations.

In either case, Dave's managers were happy. They had the resources they needed to meet all expectations, and enough to reinvest in essential sustenance activities (like training and client relations) as well. ❒

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.