This is the story of poor Robert, who followed what he thought was "best practices." It's a chapter excerpted from the new book, *Internal Market Economics*.

Laugh or cry, Robert's story will hit home. It illustrates mistakes to be avoided, and suggests critical thinking about "best practices" and open-mindedness about new approaches.

It lifts you out of the weeds, inducing a more strategic approach to financial and resource-governance systems and processes.

Allow me to introduce you to Robert, the CIO in a not-for-profit healthcare provider. If his story sounds familiar, it's because Robert is nothing more than a compendium of real-life experiences in so many organizations.

Robert's situation was not a happy one. Business leaders were questioning why IT cost so much. They were accusing IT of unresponsiveness. They were grumbling about cost allocations, and expressing interest in outsourcing. And many were developing their own decentralized IT functions.

How did Robert get himself into this predicament? As Deep Throat said, "Follow the money!" We'll start by observing this company's annual budget process.

Robert's managers prepared their budget proposals with the help of their finance staff. They forecasted what they wanted to spend within each of the general-ledger expense-codes (compensation, travel, training, vendor services, capital equipment, etc.).

The managers' expense and capital forecasts were aggregated, and Robert submitted this as his budget proposal. He then negotiated his budget with the CFO, CEO, and his peers on the executive team, doing his best to defend his need for the money.

This traditional budget process led to some dire consequences….

"We're not going to propose anything new."

As usual, the watch-word was "cut!" Everybody knew that they were unlikely to get much more than last year's budget. They felt constrained by the size of their current staff and spending levels.

Overwhelmed with unchecked demand, and believing that their resources were constrained, the last thing Robert's managers wanted was more work. So they were reluctant to propose any new ideas, fearing they'd be expected to deliver even more without adequate staff or money. Instead, they did their best to defend their budgets without committing to any additional deliverables.

As a result, there's a good chance that great ideas and high-payoff opportunities were lost — opportunities that Robert and business leaders will never know about.

Meanwhile, the culture shifted away from entrepreneurship, and toward defensiveness.

[For solutions, look up "entrepreneurship, creative ideas" in the Index.]

"You cost too much (for the value we perceive we get)."

Robert's budget was not met with a warm reception. The CEO, CFO, and business leaders all had a general feeling that IT cost too much.

This feeling wasn't based on a rational comparison of Robert's costs with outsourcing or decentralization. (As we'll see, that was brewing.) Executives just felt that Robert's budget was too big.

Although executives suspected that Robert was wasting money,

this wasn't the real reason for their feelings. The problem was that executives clearly saw the cost (in Robert's budget). But they didn't understand all the products and services that IT delivered to them, and they couldn't see how costs were linked to those deliverables.

From their perspective, it was as if they kept pouring money into IT, but they didn't see much bottom-line value coming out. One executive even called IT a "black hole" for money. Hardly much better, another executive called IT a "necessary evil" — something to be minimized rather than an investment that's critical to business success.

Since they didn't know what they were getting for all that money, naturally IT seemed expensive. As a result, Robert was constantly under pressure to cut costs and to deliver more.

[For solutions, look up "value, perception of" in the Index.]

"You're wasting money."

In truth, there was some basis for the suspicion that IT's costs were too high. Consider how managers forecasted their budgets for the following year:

Managers presumed that their current headcount would remain the same (or hoped they'd get a few new positions). They projected vendor costs based on trends and industry knowledge. And they estimated the direct costs of a few new projects.

But did they really need to spend that much, given what was expected of them in the year ahead?

By not asking this question, they missed four opportunities to reduce costs:

1. **Compensation:** Without an explicit analysis of the staff hours required to deliver expected products and services, some managers may have maintained unnecessarily high headcount.

2. **Vendor costs:** Without a link to the specific projects and services to be delivered, it was hard to spot any vendor services that could be eliminated.

3. **Internal services:** Many of Robert's managers provided support services to others within the department. There was no explicit analysis of these services, and which of them might be eliminated to save money. On the other hand, there was no look at which internal support costs might be increased to make everybody else more productive.

4. **Demand management:** Were managers incurring costs to deliver services (or high levels of service) that weren't really needed by the business?

By not planning their costs in the context of planned deliverables, managers might very well have been wasting money.

[For solutions, look up "cost, savings" in the Index.]

"Full cost recovery."

IT continually needed to invest in infrastructure. Robert was able to justify a new data center based on disaster-recovery requirements. But aside from really big capital investments like that, Robert was expected to recover all his costs through allocations — including the cost of additional equipment — under a mandate termed "full cost recovery."

This made IT look even more expensive, and clients fought every infrastructure investment that Robert proposed.

Robert also had trouble gaining funding for investments in organizational improvements. For example, he wanted to improve IT's operational processes by studying and applying ITIL (best practices). [2] But business executives fought that too.

From the client's point of view, their resistance made sense. When they work with other vendors, these are not things they're asked to pay for. And what's in it for them? They preferred spending the IT budget on the projects they needed, rather than investing in the long-term success of Robert's organization.

Being forced to get the money from reluctant clients, Robert had to watch his infrastructure grow obsolete, his internal processes languish, and his pace of innovation lag while he endured continual attacks for what appeared to clients as high costs.

"Full cost recovery" turned out to hurt in another way as well. Being the corporate IT function, Robert's organization delivered a number of services for the good of the company as a whole. For example, it coordinated information security policies; Robert coordinated the entire IT community, including decentralized IT staff; IT managed vendor relations and contract compliance, including enterprise agreements with IT vendors; and Robert and his managers participated in various corporate committees.

These enterprise-good services were not things that decentralized IT groups or vendors had to do. But unlike the office of the CEO and the CFO which also did things for the good of the company, Robert had no access to corporate funding for them. Due to the "full cost recovery" mandate, Robert was forced to include these

costs in his allocations to clients. This fueled the fire by making IT look even more expensive.

[For solutions, look up "full cost recovery" in the Index.]

"You don't need all that training."

In the budget process, company executives (led by the CFO) were keenly aware of limited resources. Their challenge was to manage costs within forecasted revenues.

How could they manage IT costs?

Remember that Robert's budget forecasted spending by general-ledger expense-codes. So naturally the CEO and CFO challenged Robert on his component costs. "Hey, you don't need all that headcount, travel, training, consulting, etc."

What else had Robert given them to talk about?

Traditional budgets beg for micro-managing internal service providers in a way that executives would never do to an external vendor. It's as if executives needed to "help" Robert with his tactical management responsibilities, or check up on him.

This was a waste of senior executive talent, taking attention away from the important issues (like discovering how IT might enable enterprise strategies). And in the process, executives disempower-ed Robert, the leader they'd appointed to run the IT department.

In truth, the CFO had no idea what Robert really needed to spend on travel and training to sustain the IT organization. The traditional budget format set her up to make decisions she wasn't qualified to make. But she had to cut costs, and Robert hadn't given her anything else to focus on.

As a result, Robert didn't gain approval for investments he really did need to keep his organization viable in the future. For example, as is common in many companies, the first to go was training — necessary to survival but a favorite target for cuts.

The result was easy to predict: After years of underinvesting in people, tools, and processes, productivity fell; staff skills become perilously obsolete; Robert had to depend on high-priced consultants to deliver new technologies; and turnover rose.

[For solutions, look up "sustenance tasks" in the Index.]

"We know you have some fat in there."

Robert's managers knew that their proposed budgets would be cut. So they inflated costs (built in "fat") such that the inevitable cuts wouldn't inhibit their ability to maintain their headcount and pay their bills.

Executives, knowing this, demanded more cuts, saying something to the effect of, "I don't necessarily believe what you're telling me about your needs. I believe you have fat in there. Go sharpen your pencil and cut another few percent."

So managers cut some of the fat, but they left some in for the next round. And sure enough, executives came back for more cuts.

As this game played out, there was no reason to believe that the right number emerged. There may still have been some fat left in; or the cuts may have gone well into the bone and damaged the organization's ability to meet its objectives.

One result was clear, however. By building in fat and then taking it out, managers reinforced the belief that their numbers couldn't

be trusted. This self-induced mistrust damaged Robert's ability to defend his budget.

Meanwhile, this back-and-forth game took a lot of time, but didn't add value as a meaningful business-planning process. This was one reason why many managers viewed budgeting as a bureaucratic nuisance at best, or at worst as a cynical game.

[For solutions, look up "budget, gaming" in the Index.]

"Do more with less!"

The company faced a tough challenge. Revenue forecasts were flat. But costs were rising due to increased workloads, inflation, and the investments needed to improve efficiency, comply with regulations, and grow the business.

Executives' response was to put pressure on each leader to "do more with less." They demanded that Robert cut costs; but expected IT to go on delivering all that it had in the past (with volumes higher than the prior year), as well as find time for some new projects.

Efficiency is essential. Robert understood this, and for years he and his managers had been improving processes and eliminating waste.

Furthermore, his staff worked hard. People weren't sitting around wasting time and money, such that Robert could simply tell them to stop the waste and hence do more with less. An executive edict to do more with less certainly didn't create time and money out of thin air!

IT would continue to improve its efficiency each year; but at that point in time, things cost what they cost.

So the truth is, with budget cuts, IT inevitably had to do *less* with less. The enterprise would get exactly what it could afford to pay for. Reality is as simple as that.

But Robert couldn't prove this. He didn't have the data or the trust. So the IT department was set up to fail when Robert was forced to promise "more with less."

[For solutions, look up "do more with less" in the Index.]

"It's your job to defend my project."

In Robert's company, each department proposed and defended its own budget. IT was no exception. Robert was expected to defend major projects that benefited the business, with only tacit support from business leaders.

Robert couldn't know the real value to the business of IT's products and services — not nearly as well as the clients who would benefit from them. So he wasn't well positioned to provide the information that executives needed to make good decisions. Robert knew there were cases where he just wasn't able to justify funding for projects that would have really paid off.

Of course, clients whose projects were cut from the IT budget were disgruntled, and blamed Robert for not defending their needs properly.

[For solutions, look up "sponsorship of projects" in the Index.]

"We really don't know the total cost of this strategy."

During the budget process, executives discussed a corporate strategy: entering a new geographic region. It looked good on paper, and the expected revenues were very attractive. But what would it cost?

The direct costs — for region-specific facilities, marketing, sales, and service-delivery staff — were easy to identify.

But this was just the tip of the iceberg. The total cost of a business strategy such as this is far more than its direct costs. It places an incremental burden on support services like IT, HR, purchasing, etc. And these functions may, in turn, draw more heavily on those who support them. Costs ripple throughout the enterprise.

In many cases, indirect costs add up to as much as (or more than) the direct costs. Ignoring them puts the company at risk of making an unprofitable choice.

Robert knew that IT would play a key role in executing this strategy, but he couldn't say exactly what it would cost to implement the required changes and support the new region. His peers throughout the company weren't in any better shape.

Ultimately, in the budget process, the executive team had to make a go/no-go decision half blind — not knowing the full enterprise-wide costs of going into that new region.

For lack of knowledge of the real cost of strategies such as this, executives approved initiatives that were exciting but perhaps not profitable. And they may have glossed over strategies that weren't quite as grand but offered excellent returns.

[For solutions, look up "strategy, cost of" in the Index.]

"Last year's budget plus/minus a percentage."

Toward the end of the budget process, under time pressure and lacking any better way to make the final decision, executives settled on an IT budget of last year's spending plus two percent. (The two percent was to cover a few big projects.)

Of course, the prior year's budget had little to do with this company's unique strategies and the coming year's investment opportunities, or the operational needs of the business. But there really wasn't much else they could have done. Consider this….

The right way to decide an organization's budget is to fund all the good investment opportunities, and not those with poor returns.

But executives couldn't judge the returns on investments (ROI) in costs such as compensation, travel, training, and vendor services — costs which were not linked to any specific results, and hence the benefits portion of the ROI formula couldn't be calculated.

So instead of allocating scarce resources to the best available investments throughout the enterprise, executives were forced to make seemingly arbitrary budget decisions. Wrong as this may be, executives didn't have the data to do anything else.

As a result, the company probably overspent on some functions (wasting money on lower-return services), and underspent on others (passing up really good investments).

Ultimately, Robert was forced to accept less than he knew IT needed to deliver what was expected of it. And Robert was certain that many high-payoff projects went unfunded. Clearly, this budget process was not a reliable way to maximize shareholder value (or the company's goals).

And after all managers' work on the budget, the outcome seemed predetermined. This was another reason why they viewed the entire budget-planning process as a waste of time.

[For solutions, look up "budget, level of" in the Index.]

"My allocation is too big."

After the budget was finally decided, the money was given to the business units (IT's clients). Then Robert collected it up via allocations.

Robert did his best to be fair. He divided costs into high-level pools, and distributed them among the business units based on "cost-drivers" such as their headcount and the number of transactions on their major applications.

The CFO was a strong advocate of allocations. It gave her a better view of the total costs within each business unit. However, Robert paid the price.

Like a slap in the face, these allocations reminded everybody of how expensive IT was. But since they were based on cost-drivers rather than actual consumption of IT products and services, there still wasn't any clear connection to value delivered. Allocations just exacerbated the general perception that IT cost too much.

Robert had hoped that having to pay IT costs would limit clients' demands. But that didn't work. Allocations are not a "pay for what you bought" model (fee for service), where charges directly result from specific purchase decisions. There were cost pools for desktop computers, network services, applications hosting, and so on. But the details were fuzzy. And clients couldn't choose not to buy any of these high-level cost pools.

So clients didn't believe that limiting their demands would materially reduce their allocations.

To make matters worse, since allocations seemed unrelated to clients' purchase decisions, they were viewed as "taxation without representation." Of course, nobody likes being out of control of their costs, especially business-unit executives in this margin-conscious company. Naturally, business leaders attempted to gain back some degree of control. Their bonuses were on the line!

Since they didn't believe they could control costs by limiting their demands, clients attempted to reduce allocations by micro-managing Robert. They challenged Robert's costs at every opportunity.

For example, Robert tried to establish an "account representative" function to improve relationships with the business and better align IT with business strategies. Despite the proven value of such a function, executives refused to pay for it through their allocations.

(Imagine telling any of your vendors that you want them to remove the cost of their sales force from the price they charge you! But that's essentially what business-unit leaders did to Robert.)

By the way, these same executives expected regular account reviews. And they complained that the IT department didn't understand their businesses. They just didn't want to pay for the account representatives who would do exactly that. Sadly, this issue became so politicized that Robert shelved the initiative.

This meddling further strained relations; and it created a political distraction, when the dialog really should have been focused on identifying the best investments in IT's products and services, and opportunities for savings through demand reduction.

Adding to the controversy, everybody felt that the allocations were unfair. (Funny, they all thought they were paying more than their fair share.... Figure the math!?) Executives challenged the formulas, which were logical but crude. Countless valuable hours were lost justifying why costs were apportioned as they were.

Robert tried to improve the calculations, breaking big cost-pools into smaller pools that were allocated with more refined formulas. But this didn't reduce the controversy. In fact, the more detailed the allocation formulas got, the worse the politics got. The granularity implied that clients had control over their purchase decisions when, in fact, they didn't. And the formulas were even more difficult to understand, engendering even more mistrust.

Allocations succeeded at the CFO's objective of assigning IT costs to business units. But all this effort contributed nothing to sound financial decision making; it didn't control costs; and all this controversy sure didn't help Robert's relationships with his peers.

[For solutions, look up "allocations" in the Index.]

"It's your money; do the best you can with it."

After business units submitted their allocations to Robert, the real trouble began.

Once the money was turned over to Robert, clients viewed everything as free. Of course, when price is zero, demand approaches infinity. Like the proverbial kid in a candy story, clients wanted everything because they didn't have to pay for anything.

It seemed clients were saying, "Hey, we gave you all that money. Now we get to demand anything we can dream of. We paid for PCs — why are ours three years old? We paid for email — why

are we limited in storage capacity? We paid for applications hosting — why can't we increase volumes by 20 percent and implement a never-ending list of enhancements?"

Robert had no basis for telling clients, "That wasn't covered in our budget; we'll need incremental funding." Budget was associated with costs like travel and training; so nobody knew which projects and services were funded by IT's budget, and which weren't.

Absurd as it may seem, the company gave Robert a finite amount of money, and, in trade, expected infinite services.

When he complained, Robert's boss told him, "Look, it's your budget; it's your job to do the best you can with it. *You* make decisions about priorities."

So the kids clamor for everything in the candy store. Daddy says no because he knows the limit of his checkbook and is aware of other competing demands. And of course when Daddy says no, Daddy is the villain.

Being the one to say no made Robert an obstacle — an adversary whom clients had to convince of the merits of their needs. Beyond that, it made Robert appear arrogant, as if he thought he knew what was best for the company.

The fact is, judging clients' ideas in this way is the opposite of customer focus. Robert had unintentionally set a precedent that his managers began to follow. IT staff came to believe that it was their job to control those "unruly users."

As IT managers judged and filtered clients' requests, and as they set their own priorities (often based on who screamed the loudest, or who had the most political clout), relationships with clients deteriorated further.

Frustration with IT grew far worse when clients realized that they had no way to satisfy even really pressing needs. Since Corporate IT had a monopoly on infrastructure, they couldn't go elsewhere. And Robert had no effective mechanism for receiving additional funding for incremental work.

On occasion, he'd take on additional projects and charge business units the direct costs such as contractors. But then he found that the rest of the IT organization didn't have enough time to support these additional project teams. So everything fell behind.

As clients felt trapped and helpless, their resentment grew.

One of the IT managers suggested that Robert request additional budget to satisfy all these requests. But Robert knew that this wouldn't help. Even if his budget were doubled, clients' demands would still exceed IT's resources. And, realistically, there was no way he was going to get more money.

As hard as he tried to make the right decisions, clients blamed Robert when IT didn't have sufficient resources to deliver projects that they saw as critical to their businesses.

[For solutions, look up "demand management" in the Index.]

"You're so bureaucratic."

Robert knew that he wasn't making friends by saying no to clients. He wanted to get out of that villain role.

Naively, Robert thought that a more fact-based prioritization process would be better received. He designed a detailed service-request form that asked clients to justify why they needed IT products and services.

Once clients submitted service-request forms, IT staff provided cost estimates. The combination of benefits and costs produced a "balanced scorecard" for each request. Robert established a set of principles for evaluating requests, using what industry pundits told him was a "best practice."

Robert remembered having dinner with a CIO from another company who actually said out loud that by making it difficult, only clients who really needed something would persevere through the request process; so only the best investments would actually surface! Secretly, Robert hoped that there was some truth in this.

As it turned out, this seemingly rational approach made things worse, not better. From the clients' point of view, this whole process was infuriating. Why did they have to prove their needs to a *support* function to buy anything from them? Why all this onerous paperwork? And why the long waits before they got an answer? External vendors didn't treat them this way!

Naturally, clients felt that IT was bureaucratic.

In a meager attempt to ease this process, Robert put the form online. But all that did was make IT seem even more distant.

This service-request process did succeed at filtering demand. Robert declined many requests, pointing to the principles to defend his decisions. Of course, that just reinforced clients' belief that IT was the obstacle — an adversary, not their business partner.

For those requests which were approved, the process didn't provide clear guidance on priorities. For the most part, it was "first come, first served." In some cases, managers adjusted priorities based on their limited understanding of payoff to the

business, or on technical priorities. If the truth were known, behind-closed-doors political processes also came into play.

From the client's perspective, all these processes were opaque and frustrating. They resented being disempowered — unable to control one of their critical factors of production. And as hard as IT staff worked to get projects out the door, clients grew increasingly angry.

[For solutions, look up "bureaucracy" in the Index.]

"You're unreliable and incompetent."

Robert had always preached the importance of being responsive, and his staff took his admonitions to heart. They sincerely wanted to please their customers and serve the business.

But with his demand-management process only marginally successful, his staff were still under a lot of pressure to do the impossible.

Facing demanding clients, staff felt they had to say yes even when they knew they didn't have sufficient resources to deliver on their promises. They made promises they couldn't keep — dates they couldn't make, or a Rolls-Royce for the price of a Chevrolet.

The results were devastating. In the futile attempt to satisfy the unrealistic expectations of the business — far more than they had resources to deliver — Robert's staff tried to do as many projects as possible. As you might imagine, something had to give:

*   They "robbed Peter to pay Paul," stretching timeframes so that everything came in late and they got blamed for being unreliable.

*   They cut corners on quality and took unadvisable risks, and gained a reputation for poor quality.

*   They didn't have time for customer relationship building, so clients grew increasingly disenfranchised.

*   They cut internal support services (overhead) and other critical sustenance activities, making everybody less productive.

*   Infrastructure investments were postponed, so services became less reliable and more costly.

*   Internal process improvements and organizational improvements were not resourced, so productivity fell and costs rose.

*   Their pace of innovation was decimated for lack of training and product research.

*   Managers demanded more of their staff — more hours and more productivity. Robert's organization became an increasingly uncomfortable place to work — a high-pressure assembly line, surrounded by irate customers, with limited career-growth opportunities. Of course, the best people left. The remainder felt burned out and abused, and many became cynical and gave up trying.

These false economies amounted to "eating your seed corn." Maybe these shortcuts allowed IT to get one or two more projects out the door. But despite all their hard work, Robert's staff still couldn't come close to satisfying clients' unbridled demands.

What they *did* do was sacrifice their organization's capability, quality, competitiveness, credibility, and reputation.

[For solutions, look up "delivery, problems with" in the Index.]

"I haven't got time to help on your project team."

Another unfortunate casualty of unbridled demand was teamwork.

Robert's staff were, by nature, friendly, supportive, and worked well together. Nonetheless, teamwork collapsed.

They didn't need team-building. The problem wasn't a lack of desire to help one another, or a lack of trust in others' capabilities.

The root cause of the problem was resources. Even when one group wanted to help another, it was overcommitted and couldn't be counted on to deliver on its promises.

When staff can't trust one another (due to differing priorities and overcommitments, not a lack of personal integrity), they learn to be self-sufficient. "Stovepipes" developed as managers, who had jobs to do, replicated each other's skills so as not to be dependent on one another.

With less teamwork and staff dabbling in others' domains, there was less use of qualified specialists. As a result, costs rose, and quality and reliability diminished further.

[For solutions, look up "teamwork" in the Index.]

"You're not aligned with business strategies."

Every year, corporate executives revised the company's business strategy. Once the plan was published, people throughout the company were expected to align their work with those strategies.

Robert always did more than just distribute the plan. He met with his management team to ensure that everybody really understood

each corporate strategy. He even put "contribution to strategy" in their performance objectives.

Why, then, did he repeatedly hear the complaint that IT was not well aligned with strategy?

The answer was pretty obvious: Managers were too busy responding to clients' day-to-day requests to think about new strategic projects. Every year, IT ended up with less money and more "keep the lights on" operational work than before. That left less each year for new projects, and hence less and less opportunity to contribute meaningfully to business strategies.

So Robert pulled together a small team to study corporate strategies and decide how best to serve them.

This team recommended a short list of projects, including a couple of infrastructure projects that could be justified under the strategies, plus a number of applications-development projects that they thought would help clients deliver their business strategies.

Accustomed to defending IT projects in the budget process, Robert sponsored these projects. He declared these to be the IT organization's top priorities, and began rejecting even more clients' requests to free resources for these "strategic" projects.

Clients were upset. But Robert pointed to the strategic plan when he told them that their requests were not as important as the projects that his team had generated. For some reason, this explanation didn't go over very well.

Faced with challenges from business-unit leaders, Robert had to justify the infrastructure projects to the CFO and CEO. He was adamant about the need, and gained their support. He'd won that battle (and his peers on the executive team felt that they had lost).

However, things didn't go so well for the applications projects on that strategic-projects list. Most required CFO approval for the capital involved, and were killed when the business units that were supposed to benefit from them publicly panned them.

IT was able to complete the few projects which were approved. But clients resisted when Robert tried to foist these solutions on them. It didn't matter whether Robert was right about the payoff. They weren't going to incur the risks and costs of changing their business processes to make Robert look like a hero.

Having been the one who sponsored these projects, Robert had to defend his reputation. He pushed harder to get clients to use his solutions. This further strained relations. And despite his efforts, even good investment decisions turned sour when the expected benefits weren't realized for lack of business commitment.

At the next CIO conference, Robert whined to a friend, "They accuse me of not being aligned with strategy, and then shoot me down when I try. There's nothing I can do."

[For solutions, look up "strategy, alignment" in the Index.]

"We need governance (in the form of a steering committee)."

At this point, Robert got serious about demand management. He set up a "governance process" to foist the villain role off on a steering committee of business-unit executives. While convincing his boss, he cited numerous other CIOs who had done this, and labeled executive steering committees as a "best practice."

The committee's job was to set priorities among the major projects competing for IT's limited resources. Robert hoped this would

build clients' understanding of the value of IT and align priorities with business needs, as well as filter demand.

It wasn't a bad idea, but "the devil's in the details."

Of course, the committee only oversaw a portion of Robert's budget — just big projects (perhaps 20 to 30 percent of IT's total budget). The other 70 to 80 percent went to "keeping the lights on" — operations and small projects. So executives still didn't understand where the bulk of the IT budget was going. This governance process did little to address the general feeling that IT cost too much and wasn't delivering enough value for the money.

Meanwhile, the demand for those operational services and small projects remained unconstrained by the committee.

Actually, the steering committee didn't do much to constrain demand for the major projects either. It dutifully rank-ordered the projects. But executives on the committee didn't know where to "draw the line." They lacked two key pieces of information: One, they didn't know how much they were authorized to spend. And two, they didn't know what those major projects would cost.

So they went on expecting *all* the projects — in the sequence they'd specified. Now, instead of yelling at Robert individually, the committee gathered all the top executives together to yell at him in unison!

So Robert had his staff calculate the applications-engineering hours required by each project, and told the committee how many hours in total were available. Now, they knew where to draw the line. But new problems emerged.

At this point, expectations were limited by existing development staff. Were there some high-payoff projects that would have

warranted bringing in contractors? Probably, but we'll never know. The committee's job was simply to prioritize projects within currently available hours.

And in many cases, indirect supporting functions which were necessary to deploy these projects (and whose hours were not visible to the committee) became a bottleneck. Approved projects routinely came in late.

In the IT industry, Robert had been reading about "portfolio management." But this sure wasn't it.

Portfolio management is supposed to optimize the overall return on a portfolio of investments. But the steering committee didn't know the ROI on proposed projects, and didn't really manage an investment portfolio.

For example, in one case, they chose as their first priority a big project with a very good payoff, calling it "strategic" because of its size. By investing all the available hours in that one big project, they inadvertently passed up a number of small projects that together would have added up to a much higher payoff.

And thanks to the committee, IT was now looking more bureaucratic than ever. The committee demanded request forms that were even more detailed. Clients had to wait for consideration by the committee. And they had little opportunity to defend their requests; they submitted their paperwork and hoped for the best.

Going from bad to worse, it wasn't long before the steering committee began to overstep its bounds.…

On some occasions, business leaders offered Robert incremental funding for projects that didn't get past the steering committee. Robert wanted to use their money to hire contractors and get the

jobs done. But the steering committee stepped in and blocked those projects, perhaps out of concern for the delays caused by the shared support function. The committee wasn't just prioritizing Robert's budget; it began managing his entire workload.

As a result, business leaders with money to spend were forced to hire their own IT staff or go directly to vendors to get their needs satisfied — sources which are generally more expensive and less effective than a shared-services function. [3]

It got worse. Rather than simply deciding priorities among major projects, the committee began to act like a board of directors. They presumed they had the power to approve Robert's internal decisions and meddle in IT's operations. They demanded that Robert present infrastructure plans, process changes, and even key hiring decisions.

In short, the steering committee did a poor job of managing demand. It made poor investment decisions. And it became a political albatross for Robert.

[For solutions, look up "steering committee" in the Index.]

"Cut X percent."

Late in the year, bad news arrived. The company anticipated a five percent drop in revenues.

As could be expected, the edict came from on high. Everybody had to take an across-the-board cut. It was left to executives like Robert to figure out how to do this.

Robert didn't have any magic up his sleeve. So he tasked his managers with cutting their costs by five percent. The results were disastrous.

Each manager independently decided what not to do within his/her group. As a result, the decisions on which deliverables were postponed had little relationship to business strategies.

Meanwhile, one manager's top-priority project was cut by another manager whose support services were critical to its success. So even deliverables that weren't supposed to be cut were delayed.

Of course, this further impressed managers that they couldn't depend on one another, so teamwork deteriorated even more. Productivity continued its downward slide.

The managers cut back on training and innovation projects. This affected a number of high-profile deliverables that weren't sup-posed to be cut, but which required new skills and technologies.

Instead of focusing on doing fewer things, this across-the-board cut led to widespread ineffectiveness, undermining the organiza-tion's ability to do anything (even important things) well.

In the end, the five percent cut in costs led to a nearly 20 percent decline in results. Clients might have understood the need for a few sacrifices, but this disaster affected virtually every business unit is some critical ways. Executives were livid.

[For solutions, look up "cost cutting" in the Index.]

"We should outsource you."

Over time, clients grew increasingly unhappy with IT's costs and results. They began grumbling about outsourcing. At least that way they'd have control of their costs and their priorities, and they'd be treated with respect.

Eventually the grumbling grew to a groundswell. So the CFO

initiated an outsourcing study, asking if the company could save money by outsourcing all or a major portion of IT.

Why do people think that outsourcing saves money, despite the fact that vendors have to make a profit on the deal? Vendors' sales pitches can be deceiving:

* "We'll give you 50 percent of what you're getting today for 80 percent of the cost. That's a 20 percent cost savings!"

* "We'll do it for 25 percent less. (Just don't ask us about the quality of service.)"

* "We'll give you the base work for 15 percent less than your internal costs (and then charge a huge premium whenever you ask for anything beyond that)."

* "We'll give you everything for 20 percent less than internal costs (this year... with escalation to make the deal very profitable by the end of the contract)."

To preclude such trickery, the CFO hired a well-known consulting firm to perform a benchmarking study. This consultant had a database of other companies' outsourcing costs, divided into what they called "towers." Each tower represented a major area of IT activity, such as computer infrastructure, network services, applications, and PC support.

The consultant sorted Robert's costs into the same towers for the purpose of comparison. The results were not pretty. Analysis showed that the company could save money with outsourcing in almost every tower.

Robert pointed out that his costs could be higher for any number of reasons.... Unlike other companies in the database, Robert's

company had many small healthcare clinics scattered throughout the country. They provided critical healthcare services, 7 days a week, 24 hours a day, with no down-time — lives depended on it. They faced unique regulatory requirements. All these differences drove costs up.

Meanwhile, Robert reminded executives that they had refused to invest in updating his infrastructure; so Robert couldn't bring costs down there.

And, of course, there was that "full cost recovery" mandate which inflated Robert's costs with enterprise-good services that were excluded from the outsourcing deals in the consultant's database.

Cashing in a lot of political chips, Robert finally convinced the CFO that the towers approach to benchmarking was unfair. He promised a more granular comparison of internal costs with vendor costs. This bought him some time.

The following year, Robert made an attempt to calculate rates for some of IT's services, which he compared to vendors' rates.

But often, rates were calculated for big bundles of services. For example, the rate for PCs included a lot more than the hardware. Bundled in were costs of the help desk, network connections, and PC repairs. Naturally, clients believed they could buy a PC for a lot less from outside vendors.

In the applications development group, Robert set a rate per hour for an experienced engineer, complete with office space, tools, and management. Clients compared this ready-to-go employee with a contractor who they'd have to house, equip, train, and manage.

Robert priced storage services at the highest level of quality — response time, frequency of backups, and change control. Clients

knew they could buy storage from "the cloud" for far less, but they didn't necessarily recognize that external services were at a much lower level of quality.

Robert's finance manager did the best he could in the time allotted, but the cost model underlying the rates was admittedly crude. It was based on simple activity-based costing, cost pools were large, and the calculations were far from transparent.

Robert couldn't be certain that he wasn't making a profit on some products, while undercharging for others. Of course, clients focused on the rates that seemed high, and ignored those that seemed low.

Even if the cost model had been more accurate, Robert was at a disadvantage due to the "full cost recovery" mandate which forced him to put into his rates many things that vendors didn't include in theirs.

The benchmarking exercise was confusing, controversial, and inconclusive. Again, no outsourcing decision was made.

Robert had won another battle; he wasn't forced to outsource any of the IT function. But he'd lost the war. The experience left clients even more critical of Robert's costs, suspicious due to his lack of transparency, and resentful of his defensive attitude.

And from then on, whenever business units had additional money to spend on IT, they went directly to vendors rather than working through Robert.

[For solutions, look up "outsourcing" in the Index.]

"This consolidation process is a fiasco."

Robert faced an interesting challenge when his company acquired another company of almost equal size. Being the more senior of the two CIOs, he was given responsibility for merging the two IT functions.

After spending some time getting to know his counterpart and the other management team, he placed each of their groups under the appropriate senior manager in his organization.

Obviously there were winners and losers. The managers who came from the other company felt disenfranchised and unfairly treated. Most of the good ones left, taking with them critical institutional knowledge. IT began failing to deliver commitments inherited from the other company, many of which Robert didn't even know about.

The damage went deeper than that. Although many of the labels in the boxes on their organization chart seemed familiar to Robert, they did different things. For example, Robert's applications engineers did their own database engineering. But in the acquired IT group, it was done by the infrastructure group. Now, nobody knew where to go for support services, and the confusion resulted in badly engineered systems and delayed projects.

Robert was under pressure to deliver "synergies" in the form of headcount reductions. So he laid people off to achieve the target savings. But his managers had not had time to integrate the two organizations and gain any real synergies. In fact, with all the chaos, both organizations were *less* productive than they'd been prior to the merger.

The math is simple: Less headcount plus lower productivity equals

far less results. IT became noticeably less reliable in project and service delivery.

To his dismay, Robert found himself being the poster boy for an acquisition gone awry.

[For solutions, look up "consolidations" in the Index.]

The Bottom Line

Every step of the way, poor Robert had followed industry best practices and tried so hard to solve very real problems of resource governance. Finally, he began to understand that so-called "best practices" may be nothing more than the mistakes everyone else had been making.

Traditional resource-governance processes have a cost — both to the enterprise and to the people involved. They are the root cause of much all-to-real pain, and take an organization in a direction exactly the opposite of what most leaders envision — away from customer focus, entrepreneurship, clear accountability, empowerment, and teamwork. They undermine strategic alignment, shareholder value, relationships, and careers.

After years of struggles and disappointments, Robert was finally ready to try a fresh approach.

The conventional view serves to protect us
from the painful job of thinking.

John Kenneth Galbraith

Internal Market Economics

*practical resource-governance processes
based on principles we all believe in*

by

N. Dean Meyer

INTERNAL MARKET ECONOMICS: practical resource-governance processes based on principles we all believe in

Meyer, N. Dean

Key words: finance, budget, investment-based budgeting, rates, business planning, governance, priority setting, chargebacks, show-backs, allocations, demand management, managing expectations, cost transparency, activity-based costing, service costing, shared services, internal service provider.

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