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Smart Insights:
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The Effective Way to Fund Innovation

Without resources, even the best ideas stall. Here are three common errors and a glimpse of the best way to fund infrastructure and innovation.

By N. Dean Meyer

You may have plenty of practical innovation ideas, yet struggle to get funds to implement them. I'm not referring to innovative projects for the business—business clients pay for those, whether by defending their projects within the IT budget or by coming up with their own budget to support the effort.

In this column, I examine channels of funding for innovations within IT—things like new infrastructure technologies, new tools for IT staff, new skills training or internal process improvements.

In my experience, there are ineffective ways to gain funding—short-term expedients that may come back to haunt you—and then there's the effective way by thinking like a business within the business. I offer insights into the ideal approach as well as a few fall-back positions that will take you in the right direction.

> **To appreciate the proper sources of funding for innovation, think like a business within a business.**

The Ineffective Ways to Fund Innovation

◆ **Error #1: Internal funding.** Many IT departments embed the cost of innovation in application projects and expect business clients to justify the total.

If the innovation is a specific skill or infrastructure asset that would be of little or no use beyond the one application, embedding the cost in the client's project is fine. But if it's a matter of keeping your staff's skills up to date or expanding your infrastructure in ways that serve many applications, this approach often leads to trouble.

With regard to skills training, imagine a consultant saying, "Pay me to learn something, then I'll sell you the advice." This would not only antagonize clients; it would make you uncompetitive. If internal IT costs include training, but vendors or contractors are already trained … Hello, outsourcing!

And in the case of infrastructure assets, you run an even greater risk. For example, an entertainment company in Dallas built needed servers into its application proposals. When I visited, IT had more than 300 Windows servers, each supporting only one application, and most were being used at less than half capacity. Despite a server-consolidation study that promised millions in savings, clients (understandably) weren't interested, saying, "That's my server. I paid for it. You're not touching it!"

Asking business clients to pay for your innovations relinquishes control of your future services and your assets.

◆ **Error #2: Embed costs of innovation in rates.** Some IT departments are expected to break even on a cash-flow basis each year under the banner of "full-cost recovery." They get all of their funding either through chargebacks or through business-unit allocations.

An IT department in the U.S. Army, for instance, saw the need for a next-generation server. The CIO, a great planner, bought the equipment just ahead of the business need—which happened to be in fiscal month 10. Under the requirement of full-cost recovery, user rates jumped immediately by orders of magnitude for the next two months, then settled back to something reasonable the following year. A couple of months later, clients demanded an outsourcing study, knowing that their IT charges were unreasonable.

The lesson? Trying to embed in your rates the cost of innovations that will pay off in years to come is bound to make you look extremely uncompetitive.

◆ **Error #3: Counting on windfalls.** Some IT departments count on year-end funds (unused budget) or on cost savings during the year (a surplus) to fund innovation.

What are the odds that these will magically match the needs of high-payoff innovation projects? Just consider the economy over the past few years—midyear budget cuts, no year-end surpluses, and reclamation of any midyear cost savings. Experience tells us this is an unreliable source of funding for innovation.

The Effective Way to Fund Innovation

To appreciate the proper sources of funding for innovation, think like a business within a business.

First, a key concept: Think of your budget not as a way to cover your costs, but rather as a payment for products and services you deliver. Even if you don't charge costs back to client departments, you impute rates for your products and services by promising to deliver a certain number of projects and services for a given budget.

As in any business, ongoing training and innovation are built into those rates. That plan may work well, but where is the money for big, one-time investments to come from?

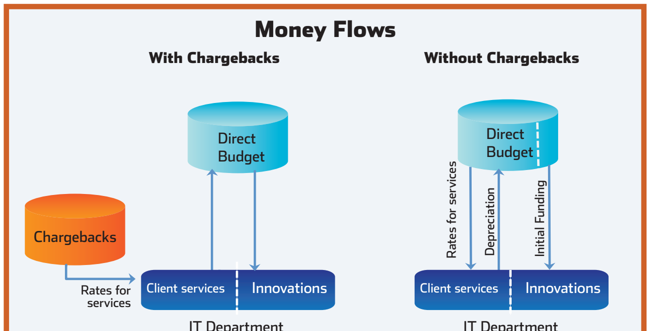
Here's one scenario: Imagine that as a home computer user you sign up for Internet service—just $24 per month. But you're the straw that breaks the camel's back and just as you sign on, the provider needs a new server. That's not your problem, of course. The provider presents a business plan to its bank, borrows the money and buys the needed infrastructure. It pays the bank back, and these "mortgage" payments are embedded in that $24 monthly subscription rate.

It's no different for a business within a business. You need a bank. Funding for large, one-time investments in IT innovation and infrastructure should come from your direct budget—that is, from your boss, not from clients. Any depreciation can be embedded in your rates.

Of course, it's up to you, not your clients, to defend these investments to top management. Justification is based on the eventual payoff for the business as a whole in the form of business proposals, just as you'd present the case to a real bank.

If you charge back business clients, you still need direct funding from your internal "bank." And if you do not charge back, some of your direct budget needs to be set aside for your own department's use, not subject to clients' approvals and not designated for clients' deliverables.

To set aside this reserve and also manage clients' expectations, you should be clear on what the rest of your budget pays for in the way of specific products and services. In other words, you need to know the full cost of your products and services to clients, as well as the full cost of innovations. The Full-Cost Maturity Model explains how to calculate the true cost of all your products and services.



Direct funding for innovation is needed, with or without chargebacks.
Source: NDMA Inc.

And If That Fails…

Okay, let's say you absolutely must do full-cost recovery—that is, collect 100 percent of your funding from business clients. If you cannot get direct funding then what are your fallback options?

The next-best alternative is to ask your CFO or budget office to allocate these enterprise costs to the business units, perhaps as part of an enterprise overhead allocation.

If your CFO isn't on board, you may need to do the allocation yourself. It's important to base the allocation on some factor other than the amount that business units buy from you. IT innovation is an enterprise cost, and not one the business should be able to evade simply by decentralizing or outsourcing IT. In other words, funding for IT innovation should not be a "sales tax" on your client deliverables, which creates an artificial disincentive for doing business with you and favors decentralization or outsourcing.

The important point is this: In no case should these one-time costs of IT innovation be imbedded in your current-year rates or allocations, or in the cost of your deliverables to clients. Doing so makes you look uncompetitive and induces outsourcing for the wrong reasons. Instead, IT needs an explicit channel of direct funding for large, one-time investments in infrastructure and innovation.

ASK THE EXPERT

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N. Dean Meyer has been teaching, writing and consulting about what he calls 'organizational health' since 1968. He founded NDMA Inc. in 1982 to focus on organizational transformation. Meyer is the author of eight books and numerous monographs, research reports and articles published throughout the past three decades. He is an early proponent of running IT as a business-within-a-business and has implemented this philosophy in corporate, government and nonprofit organizations. Meyer coaches CIOs on organizational and political issues, and invented Full Cost, a business and budget planning and product/service costing solution.