



How Much Does IT Cost?

**A Practical Approach To Costing In Information
Technology Shared Services Units**

A White Paper
Prepared by Armstrong Laing Group

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Executive Summary

In sectors such as telecommunications and financial services, the IT function can account for a quarter of total costs. Yet in many instances there is a limited understanding of what is driving the resources and costs tied up in IT. When CEOs sought cost savings in the past, they typically looked to the direct costs in the business. But these have been shaved back to the bone and now CEOs must seek to understand the costs they have tied up in IT and other corporate shared service functions, as these are becoming the only remaining opportunity for significant cost savings.

Many organizations have introduced shared services business units in order to realize economies of scale and therefore reduce the total cost of corporate support functions. While this may result in a step change in total IT costs, other challenges remain. With all IT support centralized, how do you ensure that IT is accountable to the business units it supports? What methodology should be used for calculating cross charges back to the business units? How can you justify these costs and track them with demand?

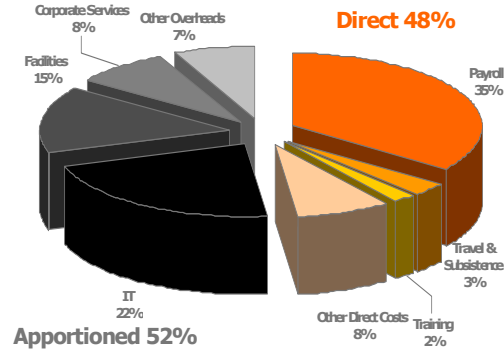
In many organizations, cross charges are a constant source of irritation and bickering between the shared services provider and the business units. This is because there is often a limited understanding of how the demands of the business unit influence these costs with cross charges often being little more than a simple apportionment of total IT costs.

To develop a deeper understanding of how and why IT costs are incurred and provide a firm basis for cross charging, many shared services units are using activity-based costing (ABC). Not only does this provide detailed information to business units about their consumption of central resources, it also provides a common understanding for reducing shared services costs.

This White Paper examines the role of ABC in Shared Services Costing and concludes with two case studies to illustrate how organizations have adopted ABC to successfully manage Shared Services Costing.

Shared Services – The New Focus For Cost Management

After several years of cost reduction in many sectors, business units that carry the majority of direct costs are likely to have little left to cut without impairing their ability to carry out their main activities. The pie chart shows a typical cost center from a telecommunications provider. Here over half the costs carried by the responsibility manager's profit and loss account are allocations from shared services departments or other corporate overheads. Should this enterprise be seeking a modest 5% reduction in costs, essentially this manager only has two options: to try to remove 10% from his own direct costs, most of which are to do with people, or to lobby the executive to critically examine the costs of the shared services functions.



In recent years, many organizations have effectively reduced the costs of providing support services to their businesses simply by concentrating them in corporate shared services departments. This resulted in a step change in the costs of support services such as IT, HR and Facilities and was considered to be "best practice". With the phenomenal growth of outsourcing, there are opportunities to cut the costs of shared services functions even further, moving them to local third party providers or even across continents where the required skills can be sourced for a fraction of local costs. Again this will result in a step change in the cost of support services and may give an enterprise a cost advantage over its competitors.

The Two Challenges That Confront Shared Services

However, despite the gains to be had by building shared services departments and by locating them where the required skills can be obtained at the lowest cost, many organizations still have a limited understanding of the dynamics of the shared services functions. In essence there are two related issues:

Understanding The Cost Of Shared Services

Despite being a large proportion of an enterprise's costs, in many organizations the costs of shared services functions such as IT and HR are simply apportioned to the profit and loss accounts of business units based on some easily available metric, such as revenue, headcount or FTEs (full time equivalents).

Aligning Shared Services Resource With Forecast Business Unit Demand

Shared Service departments tend to plan their resources and budget separately from the operational planning and budgeting process of business units. As the financial year progresses the capacity of shared services departments and the demands of operational business units can become grossly misaligned. The following scenario is not uncommon:

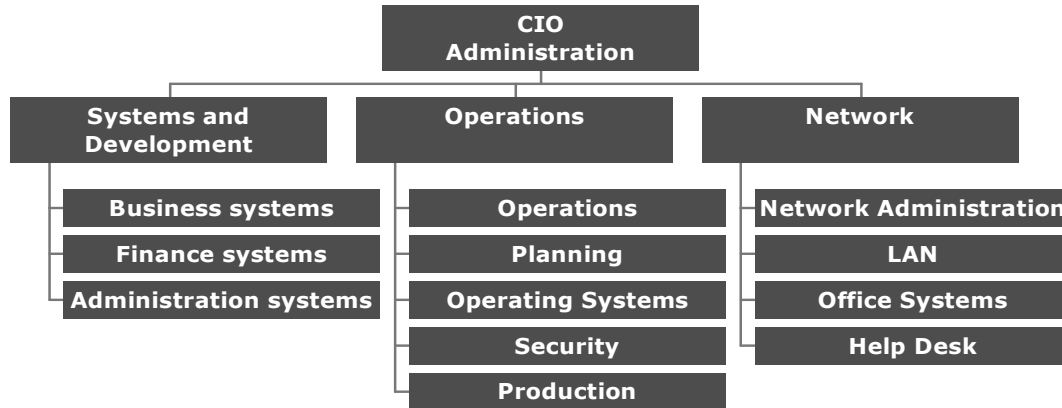
- The Business Units produce their operational plans and budgets.
- The Shared Services Units construct their own operational plans and budgets with a cursory glance at those of the Business Units.
- The costs of the Shared Services functions are fixed and apportioned to the Business Units P&L's for the coming year, based on some arbitrary driver.
- The majority of organizations do not re-forecast their operational plans or budgets as frequently as they wish¹ so that inevitably the demands of the Business Units and the capacity of the Shared Services functions can easily become misaligned.
- As the year progresses, any variance above the budgeted cost of the Shared Services functions that appears on a responsibility center manager's P&L becomes an increasing source of frustration and annoyance. The Shared Services provider cannot adequately explain it; the responsibility center manager, who has been ruthlessly managing his own direct costs throughout the year, can only argue that the apportionment is unfair and other business units should pick up more. Neither the Shared Services provider nor the responsibility center manager has sufficient insight to have a productive discussion.

At the same time, the boards and executives of many organizations grapple with authorizing continuing investment from shared services functions such as IT without insight as to how such spending relates to the demands of the business units or how it will impact long term profitability. Regardless of whether shared services are provided in-house or by a third party, organizations need far better insight into these costs and particularly the costs of the IT function, which for many is simply a black hole.

¹ ALG / Real Finance Re-forecasting Survey 2003 as reported in Real Finance magazine September 2003 found that approximately half of the UK's leading organisations would like to re-forecast their financial performance more frequently.

Gaining Insight Into IT Costs

The diagram below shows some of the services an IT Shared Services function might typically provide to Business Units and other Shared Services providers such as HR and Facilities.



To fully understand the costs of the IT function so they can be allocated to the business units in line with the way in which they consume IT resources, any costing methodology needs to:

- Correctly allocate IT costs from the general ledger to the services that IT provides to the business units;
- Capture and incorporate other costs from other departments that should be allocated to the provision of IT services. These may include such things as property costs from the Facilities cost center and recruitment and payroll costs from the HR cost center;
- Realistically reflect that just as HR provides services to IT, IT provides services to HR – and that to calculate the true cost of providing a service, these reciprocal costs should be passed between these departments reiteratively until they become insignificant, whilst still providing an audit trail;
- Capture and reflect the fact that different business units use IT services in different ways. For instance, some business units may have a need for secure payment processing over the Web in addition to more general firewall and anti-viral security on the desktop network;
- Capture and reflect the fact that certain parts of the business may use the same service differently. For example, an IT service such as Help Desk support may be allocated to business units based on the number of times they use it. However due to a lack of internal expertise the time taken to resolve the Help Desk queries for some business units may be far in excess of others.

Shared Services – How Much Does IT Cost?

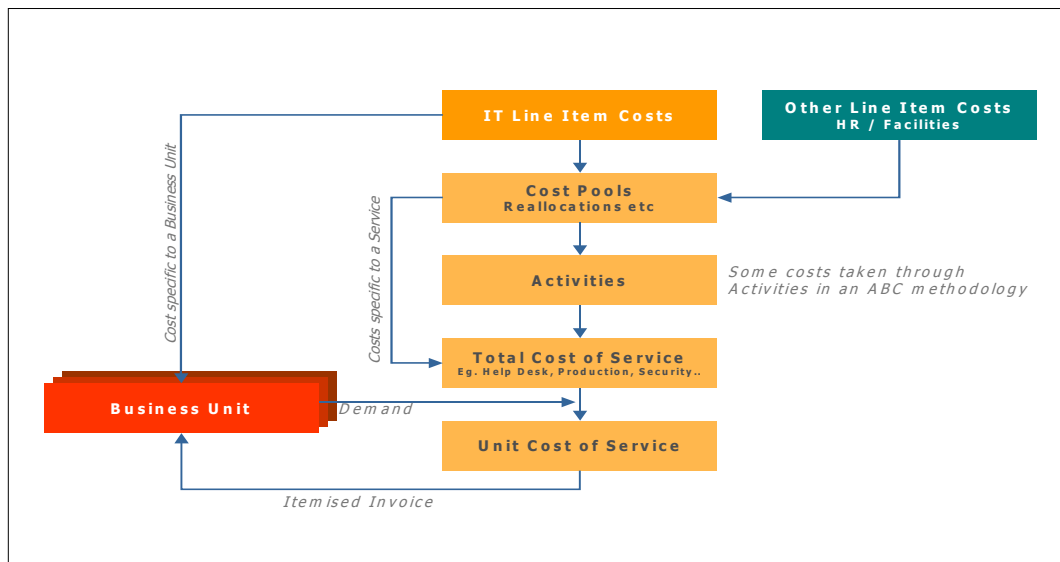
Given the complexity that can result from multiple line items, services, cost drivers and business units, as well as the need for being able to trace cross charges right back through the allocations to line items in the general ledger, the only way to reliably understand complex shared services costs is by adopting an activity-based costing methodology and deploying an application capable of managing the true multi-dimensionality of the costs involved. Writing on the need to better understand and manage IT costs, prompted IT analysts, Gartner to recommend as a tactical guideline:

“Implement activity-based costing techniques that track the cost of delivery...”

Enterprises Should Assess How Their IT Spending Stacks Up
Gartner Research Note, Article IGG-08132003-01, 13 August 2003

How ABC Might Apply To IT Shared Services Costing

While some line item costs that appear in the general ledger of an IT department might be relatively easy to understand and can be directly allocated to a business unit, many line item costs will need to be re-allocated to new cost pools, where they can be combined with other costs from the departments that provide support to IT, such as HR and Facilities. Some of these cost pools may then be allocated directly to services, but the majority will be allocated to the activities that IT staff perform to better understand how they relate to the services the IT function provides. The diagram shows how ABC might be applied to IT Shared Services Costing.



Options For Cross Charging

Once the total cost of a service is calculated, there are various options for calculating a unit rate for cross charging the business units for their use of the service.

Demand Based Pricing

If the organization wishes to fully allocate the total cost of the IT function across the business units, the unit rate charge is typically based on the total cost of the service during the period, divided by the actual demand for the service during the period. This leaves the IT function with no residual costs. This can be represented by the equation below where $TC(x)_t$ is the total cost of service (x) during period t, $TD(x)_t$ is the total demand for the service during period t and $UP_{dem}(x)_t$ is the unit price of the service based on demand for the service during the period

$$TC(x)_t / TD(x)_t = UP_{dem}(x)_t$$

Capacity Based Pricing

However other options are possible. The rate could be based on the total cost of the service during the period, divided by the amount of the service available during the period; that is based on the capacity of the IT function rather than the demand of the business units. Here, if the service is over resourced and IT is able to provide more than the business units consume, IT will be left with residual costs and this may drive them to reduce capacity during the next period. The formula now becomes:

$$TC(x)_t / TCap(x)_t = UP_{cap}(x)_t$$

However some shared services units are operating as profit centers and in these instances, ABC may be used to calculate a rate based on either of the methodologies above, to which a fixed or percentage mark-up may be added before being charged out to the business units.

Benefits Of Using ABC In IT Shared Services Costing

Having adopted an ABC methodology for costing IT services, the organization will have a detailed understanding of the services provided by IT, the activities involved in providing them and how they consume resources and costs. Detailed invoices can be produced showing the business units' use of the service, the unit price and the total cross charge, and should more detail be required, with an ABC methodology the costs can be traced back to their origin.

But by fully understanding what activities are consuming resources and costs, and which are value adding or non-value adding, the business unit and the IT function are better placed to enter into a dialogue and understand how they can work together to reduce costs. This may involve no more than taking simple steps to reduce the number of re-works or batching transaction processing to give reduced set up costs. Removing non-

Case Study Examples

Co-Operative Insurance Services (CIS)

Formed in 1867, Co-Operative Insurance Services, (CIS) is the only co-operative in the UK insurance sector, with 4.5 million customers and more than £20 billion of funds under its management. Its parent, The Co-Operative Group, is one of the world's largest consumer co-operatives, owned and controlled by its members, serving millions of people across the UK with a diverse product offering including food retailing, holidays, banking, insurance, cookware, and funeral services.

As the insurance market has become more competitive following successive mergers and new entrants, David Grattan, CIS' Chief Accountant, recognized the need to develop a better understanding of how individual products were incurring costs.

To provide reliable costing information in a complex multi-product and multi-channel business, it was also recognized that traditional costing techniques would be insufficient. Fortunately, Andrew Booth, Costing Accountant at CIS, had previous experience of ABC and knew that it could provide a robust methodology for allocating expenses when costing products.

Shared Services Costing

CIS use the ABC data to accurately assign IT costs to the departments and products that consume IT activities. The IT department itself carries no residual cost, as all costs are continually allocated out of IT into other departments.

IT provides 7 principal services under the following headings:

- New Systems
- Desktop Support
- Mid Range System Support
- Main Frame System Support
- Communication Services (email)
- Laptop Services
- Data Preparation

IT personnel enter their activities on timesheets and mark them against the 1,000 codes in their database. Each of the codes represents an activity against one of the services listed above, categorized by product or product group. So for example, when Andrew requests IT support to run a data extract, the cost of performing that activity is allocated out of IT into his cost center.

According to Andrew, having an existing timesheet system in place and an IT Manager with a strong customer focus were the key success factors for implementing Shared Services Costing.

CIS uses ALG Software's Metify ABM application.

Shared Services – How Much Does IT Cost?

The Mutual Group

The Mutual Group is Canada's first and oldest mutual life insurance company, providing life and healthcare insurance, corporate loans, commercial and residential mortgages, financial planning and other assorted financial services for over 120 years. The organization has C\$39 billion of assets under management.

In 1993 The Mutual Group began to implement centralized shared services for its various business units by forming the Corporate Services Division, which was composed of five main areas:

- Information Systems (IS)
- Finance
- Corporate Affairs
- Strategic Planning
- Shared Business Services (including HR, Administrative Services & Legal)

At the time Corporate Services employed over 800 people and had a cost base of over C\$100m, which was one-third of the company's total non-sales related expenses.

Initially the business units viewed Corporate Services as an overhead function that added little value, so they placed tremendous pressure on Corporate Services to cut expenses quickly. The business units also requested cost information to support their pricing decisions. Many of the business units believed that the cost system used by Corporate Services was inaccurate and that in some cases actually motivated the wrong behavior.

Because of these concerns, Corporate Services used Activity-Based Management (ABM) in order to:

- Identify costs that could be eliminated or reduced
- Provide a mechanism to accurately charge costs to business units based on their consumption of the shared services on a monthly basis
- Provide accurate cost information to support pricing decisions and profitability analysis
- Communicate the service levels provided and the cost of varying levels so that users could help determine the most cost-effective level
- Provide a means for comparing internal costs to the costs of outside service providers for evaluating outsourcing decisions
- Provide a better tool for facilitating budgeting by internal services and products

Corporate Services soon evolved from being perceived as an overhead department that added little value to being viewed as a business partner that was critical to the success of the business units and the organization as a whole.

The Mutual Group built an ABM model that included all shared services and activities. With ABM, both Corporate Services and the business units now have a better understanding of the costs that are assigned to the internal products and services. Corporate Services can now identify and bill consumers of the products and services it provides based on actual consumption, and because Corporate Services now understands the drivers of its costs, it can better manage them.

The Mutual Group uses ALG Software's Metify ABM application.

Conclusion – How ALG Can Help

ALG's Shared Services solutions make superior forecasting and management decisions possible for Shared Services executives and their customers. ALG offers a range of applications suitable for organizations of varying size and complexity, the most recent addition being Activity Analysis. With the click of a mouse, key stakeholders can analyze performance results in a graphical Web-based interface and quickly access critical information at the right level of detail. At the core of this solution is ALG's advanced ABM calculation engine, which provides the information to enable better decisions on cost reduction, service level agreements, and resource deployment strategies.

Integrating Planning, Budgeting and Costing

Predictive Planning is an advanced operational planning and budgeting application that can help companies to better predict and manage their financial performance. Designed to replace traditional calendar-based budgeting processes, Predictive Planning enables finance managers to continually adjust their operating plans and budgets with new data that reflects changes in their organization and markets and have these changes rapidly consolidated through to the standard financial reports such as the profit and loss account and cash flow statement.

Menu Driven Shared Services Costing - The integration of non-financial data within Predictive Planning and its linkage to expense line items allows the demand for shared services departments to be modeled and automatically charged out to other internal customers, providing both customer and provider with visibility as to how these charges are derived. Internal charges can be based on full cost recovery, cost plus or on any other basis you wish to choose, with Predictive Planning calculating the unit costs and managing the charge between the shared service function and the internal customer.

About The Authors

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Richard Barrett is Vice President of Global Marketing at ALG Software. He started his career within the pharmaceutical industry and gained an MBA in 1981. He has a wealth of experience in consultancy and holding national and international positions in consumer marketing, insurance and as well as business-to-business marketing with DHL Worldwide Express. Richard first became involved in product and customer profitability whilst with DHL during the late '80's and continued his interest in the topic in the insurance market, where he claims there are too many actuaries looking at loss ratios and not enough people looking at profitability.

Pamela Kearns, BSc

Pamela Kearns is the Product Manager for Metify ABM and Activity Analysis at ALG Software. After gaining her Bachelor of Science degree in Business Management from the University of Hull in 1997, she went on to work for WHSmith and British Telecom. Pamela has over five years marketing experience working for Allianz Cornhill PLC and ALG Software.

About ALG Software

ALG Software is a global provider of Enterprise Performance Optimization applications that can be implemented across an entire enterprise and across a broad spectrum of industries. ALG Software applications and service solutions assist organizations in understanding and controlling their costs, formulating and executing strategy, achieving greater responsiveness to change and boosting profitability and shareholder value. Ultimately ALG Software provides the foundation of profitable strategic and operational decision-making. ALG Software operates across Europe, North and South America, Australia, New Zealand, the Far East, the Middle East and South Africa.

