

WHITE PAPER

IT Financial Management and Cost Recovery | November 2010

IT financial management and cost recovery

Patricia Genetin

Sr. Principal Consultant/CA Technical Sales

David Messineo

Sr. Services Architect/CA Services

we can



table of contents

executive summary

SECTION 1

The daunting process of implementing an IT financial management and cost 4

The deceptive “simplicity” of total cost of ownership 4

Internal IT charges may seem uncontrollable 4

Establishing meanings for cost drivers and units of measure 4

Resources are limited 5

Is IT still a cost center? 5

The good governance mandate 5

SECTION 2

The winning formula: driving economical behavior 6

The good governance mandate 6

Portfolio management provides insight into costs 7

Vendor management provides insight into contracts 7

Resource management provides insight into usage 8

Building the cost recovery system 8

SECTION 3

Improving economic decisions with cost recovery processes 10

Simplify cost allocations 10

Improve visibility into cost structures 10

Optimize resource management 10

SECTION 4

Conclusions 11

SECTION 5

About the authors 11

executive summary

Challenge

Understanding IT costs and effectively applying IT chargeback and cost recovery methods tends to be daunting from both the practical and organizational standpoints. Many IT organizations lack the formal policies and procedures required to understand the true cost of an asset or service, and in many cases, are not given the budgets to do so due to limited resources. However, as good governance initiatives promote tighter financial responsibility and IT transforms into a customer-focused service provider, the need for better consideration of the factors driving technology decisions and formal cost recovery methodologies continues to grow.

Opportunity

IT financial management processes make it possible to fairly allocate costs for IT services and gain information for assessing options, managing consumption and perceiving the true value of IT. Building awareness within the areas of portfolio, vendor and resource management results in opportunities for financial optimization and helps build cost recovery processes that help IT make cost-effective decisions. Pairing this awareness with formal recovery methodologies in a cost recovery platform enables governance and accountability, and provides a choice of options for insight into costs, contracts, and usage, allowing an IT organization to gain an understanding of the factors needed to drive economical preferences.

Benefits

Developing a concrete, comprehensive IT financial management process provides organizations with insight into how IT's service portfolio, vendor relations and resource allocations will influence the cost structure as a whole. Incorporating this knowledge into a formal cost recovery plan allows IT to play an integral role in improving financial management and fostering economical use of technology resources, helping the organization simplify cost allocations, improve visibility into cost structures, and optimize resource management. Doing so provides a greater understanding of accumulated costs per service, the influence of third-party agreements on procurement plans and the best way to balance supply and demand.

Section 1: Challenge

The daunting process of implementing an IT financial management and cost recovery system

The deceptive “simplicity” of total cost of ownership

Several years ago, the Gartner Group introduced the concept of total cost of ownership (TCO) to illustrate how an asset’s contractual costs were not always representative of its true costs. Because a given asset could be configured in different ways — and therefore carry different workloads — the varying combinations led to the possibility of a wide range of potential costs. Many organizations supported this analysis and implemented procedures attempting to capture an asset’s true cost in order to derive a clear view of TCO.

Calculating return on investment (ROI), a related financial indicator, can be even more cumbersome when you consider that predicting returns often includes a large component of estimation. While ROI is a widely accepted standard and can be a very good indicator of the true value of a project, there’s a tendency to ignore the costs required for changes beyond immediate implementation.

Internal IT charges may seem uncontrollable

As infrastructure costs and environmental concerns continue to escalate, new policies and procedures are required for analysis and control, reuse and disposal and replacement and migration of technology. Meanwhile, executive management no longer assumes that all IT investments will result in a financial windfall and often forgo innovation and technological advancement opportunities in favor of IT’s daily, core activities.

Though management may consider IT costs to be uncontrollable, IT cost recovery is often avoided, as even an utterance of the word “chargeback” elicits thoughts of disputes and mistrust. Yet, without properly charging for IT resources and services, organizations will not receive the critical information they need to properly assess options, manage consumption, or understand the business value of IT. Therefore, IT cost recovery is an imperative IT/business dialogue because it encourages conversation and provides visibility to the key drivers of cost and value.

Establishing meanings for cost drivers and units of measure

Perhaps the most challenging issue IT must deal with when developing a cost recovery model is the process of identifying and establishing appropriate measures. Certainly, measures are necessary. But, what makes a measure appropriate? Consider the SMART acronym that is frequently used when setting objectives — units of measure should be specific, measurable, relevant, and timely.

Also, consider that some measures have different meanings based on context. Varying interpretations are driven by timing, roles, responsibilities, comparisons, inferences, perceived alternatives, and a myriad of other factors. IT must clarify contextual differences by:

- Identifying the factors that drive costs
- Establishing control over how metrics are identified and collected
- Defining specific policy and rules around the aggregation and presentation of metrics
- Explaining how measures are calculated and why

A primary reason that service level management has become a priority discipline for IT is that service level agreements (SLAs) attempt to coordinate and confirm communication about what's required from IT, and at what cost and quality. It is critical that IT understand the needs of the business and the influence of the various service levels required to support those needs. Likewise, the business must understand and rely on what IT can provide; measurements must be specifically identified so they can be monitored to automatically raise alerts when performance or availability degrades to warning levels.

Resources are limited

IT is often instructed to do more with less, while continuing to adequately protect its assets and improve service. If resources were unlimited, IT could certainly — and constantly — provide the highest level of service possible. However, funds are limited, making tradeoffs an inherent part of the process.

Economists define cost in terms of opportunities that are sacrificed when a choice is made. Conversely, benefits are sometimes quantified as costs avoided. When making tradeoff decisions, it is critical for organizations to understand that IT exists to support business objectives, and as such, optimal investment and operational decisions demand collaboration between IT and the business it supports.

Is IT still a cost center?

It has been generally accepted that IT operates as a cost center that makes only indirect contributions to revenue. Even though management relies on IT as a strategic asset, the historical focus was primarily on back-office efficiency gains. However, IT has become a crucial mechanism through which an organization's activities with its customers, suppliers, partners, and other key resources are performed — making it a direct contributor to revenue.

The discipline of IT Service Management (ITSM) helps transition IT from its technology-centric cost center role to that of an internal, customer-centric service provider focused on managing demand and encouraging a competitive attitude that drives business goals.

The good governance mandate

Today, good governance initiatives, such as ITSM, are driving IT priorities by requiring the tighter responsibilities, proven controls, and enhanced resource stewardship that force organizations to assess and improve their processes. These mandates allow IT to play an integral role in business transformation and best practice frameworks by promoting continuous improvement and building competitive advantage. In order to provide the insight required to make the best choices and manage and control costs, IT must develop appropriate cost models with adequate levels of detail. When creating these methodologies, IT must consider the factors most relevant to sound economical behavior.

Section 2: Opportunity

The winning formula: driving economical behavior

The good governance mandate

Properly charging for services allows organizations to provide adequate information and accountability for assessing options, managing consumption and determining the true value provided by IT. IT financial management processes make it possible to simply and fairly charge for IT services.

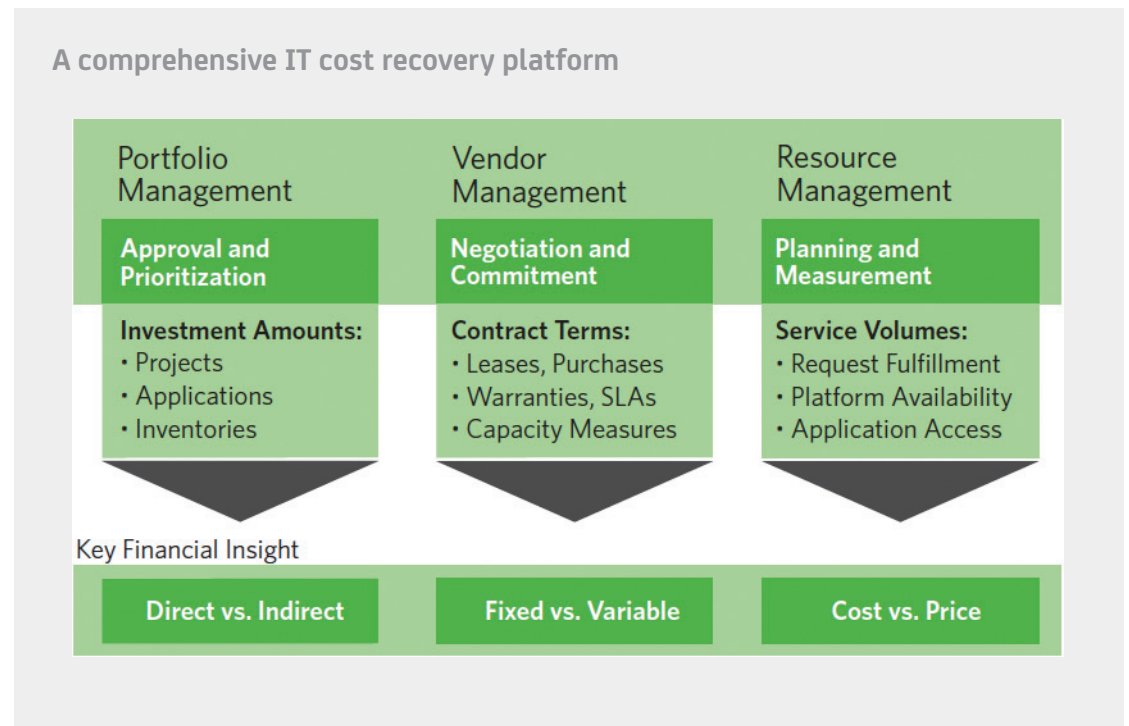
There are three primary domains where IT can look to gain knowledge and provide insight when creating cost-recovery models:

- Portfolio management
- Vendor management
- Resource management

Good IT governance requires IT/business collaboration across these primary IT domains:

Figure A

A comprehensive IT cost recovery platform provides insight into the influence service portfolios, vendor relations and resource allocations have on an organization's overall cost structure.



Portfolio management provides insight into costs

Portfolio management offers a means to validate the rationale for cost recovery methods and policies, while supporting stakeholders' cost/benefit tradeoff decisions. Performing corporate budget preparation and expense analysis based on costs processed through the general ledger or accounts payable system provides valuable insight into planned expenditures.

Service costs, another piece of the portfolio, are computed by recording general ledger and budget amounts as a baseline and distributing these costs up the hierarchy to arrive at an accumulated charge per service. For example, the cost to provide email service actually includes portions of hardware, software, and labor costs. Redistributing these amounts to the proper areas helps organizations compute an aggregated cost of providing email.

Consistent measures need to be used to determine the portions allocated to each business unit. Typically, accumulators and multiple rounds of allocations are performed to arrive at an aggregated service cost. These collected charges represent shared services such as operating system support or administrative overhead, which once computed, are allocated to the next level in the business service hierarchy.

To improve the reporting and analysis of portfolio allocations, cost elements need to be classified as:

- operational or capital
- direct or indirect
- fixed or variable

Automated financial allocation rules and features within portfolio management tools simplify this process by helping distribute indirect costs to components or services. Additionally, a unit of measure such as counts of user ids, serial numbers, or transactions should be identified for each cost type.

Scenarios help IT facilitate the planning and design of models for distributing shared costs. Insight from these discussions can also help identify opportunities for cost optimization and influence operational initiatives and prioritizations.

Vendor management provides insight into contracts

Vendor management tools help IT assess procurement processes, improve their understanding of existing third-party agreements, and discover opportunities for cost optimization. When vendor costs are fixed, IT should encourage usage to optimize the investment. Costs are variable, IT should foster an understanding that expanding usage can lead to increased costs. Communication is critical for appropriately influencing business behavior — as are the following questions:

- Does IT pay for unlimited use software licenses, but then encourage limits through policies that charge per use?
- Are there prepaid maintenance or warranty agreements that the business does not take advantage of because they do not know they exist?
- Are there various rate options available when setting up conference calls or webcasts that could influence user choices if cost factors were known?
- How do the costs of printing options differ?

Only by using a service catalog to quantify cost and service level options can organizations understand the financial impact of their choices. Armed with this information, management can implement vendor-related policies and procedures to appropriately control IT usage.

Resource management provides insight into usage

Resource management ensures assets are identifiable, usage metrics are available and cost drivers are understood. Tools can help track owned resources and automatically discover hardware and software related to those resources within the IT environment. Likewise, time-tracking systems provide insight into labor costs and automated reconciliation provides management with an efficient means of identifying discrepancies.

The fundamental economic concepts of supply and demand influence the cost of resources, and must be considered as well. For example, when demand on IT increases, resource spending increases in order to provide the services needed to meet demand. Many organizations incrementally increase resource levels beyond demand, meaning they often plan for a capacity that will not be realized.

To avoid this situation, it is important to account for the four areas of resource planning:

- planned demand
- unplanned demand
- planned capacity
- unplanned capacity

Financial management methods help IT estimate — or plan — demand and develop a budget that accounts for new expenses. To protect against unplanned expenses, an estimate is often added for additional demand and an extra level of capacity is built into budget estimates.

Models that define and account for customer demands should be implemented to provide visibility into resource costs and enable proper management. The business will pay for access to, rather than actual use of, resources and become conscious of identifying real needs, quantifying requirements and prioritizing by value. For example, instead of requesting disk space consumers will pay for the ability to access and store email for a specific number of users, or instead of buying bandwidth consumers will request system access with a quantifiable response time.

Demand-focused charging or cost recovery models such as these shift the business conversation to a discussion of value and facilitates a consensus about how IT resources should be contributed. Responsibility for managing capacity, and its cost, is left appropriately with IT specialists.

Building the cost recovery system

Understanding the distributions of costs and assets across the areas of portfolio, vendor, and resource management provides organizations with the information needed to achieve financial optimization. Pairing this awareness with cost recovery processes grants IT the ability to improve financial management and steer stakeholders toward cost-effective decisions. IT cost recovery should be used as a key technique to encourage and provide an incentive for the efficient, effective and economical use of technology resources.

A comprehensive cost recovery platform enables governance and accountability, and provides a choice of options for insight into costs, contracts, and usage, allowing IT to gain an understanding of the factors needed to drive economical preferences.

Organizations should follow these practical steps for implementing a cost recovery and chargeback methodology:

1. Define and catalog IT services, including business-oriented descriptions, scope, service levels, measurements, owners, customers, and users
2. Determine the components that make up services, including people, hardware, operating systems and application software
3. Identify the cost elements related to each service
 - a. Review accounts payable listings to determine which costs may be assigned directly to services, and which are overhead or indirect costs
 - b. Categorize direct and indirect costs by specific ownership accountability
 - c. Review contracts and identify important terms and conditions
 - d. Categorize costs as fixed or variable
4. Determine how low-level services relate to higher-level offerings
 - a. Analyze usage patterns
 - b. Identify metrics as cost drivers
5. Develop a chargeback strategy for each service offering and formulate a model that best drives economical behavior
6. Review operating and financial principles with corporate functions such as controlling, budgeting, procurement, tax and general accounting
 - a. Determine how account coding structures assist in the automation of cost distributions
 - b. Consider standards and naming conventions for use in verifying appropriate identification of cost attributes such as fixed, variable, direct and indirect
7. Build awareness around adopting chargeback methodology
 - a. Build business relationships and share IT/business objectives and strategies
 - b. Educate and communicate
 - c. Focus on policies and exception management
8. Gather appropriate approvals and ensure buy-in
9. Implement chargeback methodology, including baseline reporting and key performance indicators (KPIs)
10. Measure and report on savings realized, then solicit feedback and provide continuous review for ongoing process

Section 3: Benefits

Improving economic decisions with cost recovery processes

Building and implementing comprehensive IT financial management processes provides a basis for understanding how IT's service portfolio, vendor relations and resource allocations will influence the organization's overall cost structure. When built into a formal cost recovery plan, knowledge in these three areas allows IT to play an integral role in improving financial management and fostering sound economical use of technology resources. Specifically, IT can help the organization it supports simplify cost allocations, improve visibility into cost structures, and optimize resource management.

Simplify cost allocations

IT financial management and cost recovery processes provide insight into how IT service costs factor into an organization's overall service portfolio by recording budget amounts and determining accumulated costs per service. Using automated allocation rules, these tools help organizations better define cost elements and improve the distribution of service costs across the enterprise. Additionally, a strong understanding of service costs and allocation processes provides insight into the planning and design of future cost models and creates opportunities for ongoing financial optimization.

Improve visibility into cost structures

By gaining knowledge into the influence third-party agreements have on procurement processes and the cost structure as a whole, organizations can improve their understanding of vendor relationships and discover opportunities for cost optimization. IT financial management and cost recovery methods clarify usage costs, helping IT determine if a particular third-party product has a fixed cost, or if expanding usage will lead to increased expenses.

Optimize resource management

IT financial management and cost recovery processes help define and account for customer demand, allowing IT to prioritize demand by business value and increase the supply of resources accordingly. An accurate view of the influence of supply and demand helps organizations develop a demand-focused cost model that fosters a greater understanding of the best methods of resource allocation and improves overall resource management.

Section 4: Conclusions

Organizations looking to establish IT cost recovery processes do so in order to understand the true cost of a service or asset. However, many struggle to achieve this goal because of tight budgetary constraints and a lack of insight into the steps that need to be taken along the way. Gaining insight into the distributions of costs across portfolios, vendors and resources opens the door to developing clear, comprehensive IT cost recovery processes. Using this knowledge to build concrete IT financial management and cost recovery processes allows IT and the organization it supports to better align economic planning and budgetary decisions with business goals and simplify cost allocations, improve visibility into cost structure and optimize resource management.

Section 5: About the authors

Patricia Genetin is a Certified Public Accountant (CPA) and Senior Principal Consultant in the Technical Sales organization at CA Technologies. She is an expert and a leader with experience over 20 years spanning software development, business operations, management, and corporate governance. She achieved the highest IT Infrastructure Library (ITIL) v2 certification, ITIL Service Manager, and currently uses this knowledge, along with her deep technology and financial expertise, to advise organizations on measuring the value of their IT portfolios and potential investments.

David Messineo is an ITSM Practitioner with more than 20 years experience developing and deploying enterprise-level software solutions focused on IT management. He is currently a Senior Architect and Researcher at CA Technologies where he is responsible for implementing a holistic performance measurement framework across CA's solution portfolio. David holds both an ITIL Service Manager and eSCM Certification.

To learn more about the CA Service Management solutions, visit ca.com/itsm. For more information on CA and ITIL, visit ca.com/itil. And to discover how you can define and publish services and provide financial insight into service consumption, take a look at ca.com/servicecatalog.

CA Technologies is an IT management software and solutions company with expertise across all IT environments—from mainframe and distributed, to virtual and cloud. CA Technologies manages and secures IT environments and enables customers to deliver more flexible IT services. CA Technologies innovative products and services provide the insight and control essential for IT organizations to power business agility. The majority of the Global Fortune 500 rely on CA Technologies to manage their evolving IT ecosystems. For additional information, visit CA Technologies at ca.com.