

IT Financial Management

IT Cost Model
&

IT Chargeback Considerations



Goal of Financial Management for IT Services

- To provide a cost effective stewardship of the IT assets and financial resources used in providing IT services

Objectives

- To be able to account fully for the spending on IT services and attribute these cost to the services delivered to the organization's customers
- Control and managed the overall IT budget
- Control spending, make IT values and cost visible – ensure customers are aware of actual cost providing the IT service
- Contribute to the assessment and management of changes from a financial perspective and assist in management decisions
- Influence customer behavior towards use of IT services and resources by charging if required
- Encourage more effective use of resources
- Help identify cost of unavailability
- Produce cost models
- Ensure economic health of the organization

Definitions & Terminology

- **Cost Model**
 - Models per Customer, per IT Service or per Location etc.
- **Cost Types**
 - Cost types are high level cost categories enabling costs to be grouped in a logical way. Hardware, Software, People, External services, Accommodation, Transfer cost.
- **Cost Elements**
 - Categories of costs with more detail than a major cost type. An example hardware can be broken down into servers, PCs routers, switches, hubs and main frame devices
- **Unabsorbed Costs**
 - Costs which can not be attributed to a product, IT Service or customer that are typically recovered from all products, IT Services or customers and allocated by means of some formula that approximates usage.
- **Cost Units**
 - Breakdown of the total cost of a service into a small unit than can be allocated to a customer i.e. cost per mailbox for email service or per users for PCs
- **Total Cost of Ownership**
 - A method of measuring the total lifecycle costs of an IT Service or asset

Definitions & Terminology

– Charging Policy

- Notional Charging – Invoiced but not to be paid
- Communication of Information – Cost awareness
- Pricing Flexibility – Charged on an annual basis (subsidized or promotions)

– Pricing Method/Policy

- Cost – Cost = price
- Cost Plus – cost plus a profit margin of x%
- Going Rate – comparable internal cost with other departments
- Market Price – matched with external providers
- Negotiated Contract Price – can include investment cost for new IT services

– Depreciation

- Reduction or consumption of a capital assets value over a period of time or usage. Types of depreciation include - straight line declining balance or by usage.

Costing Model – IT Services

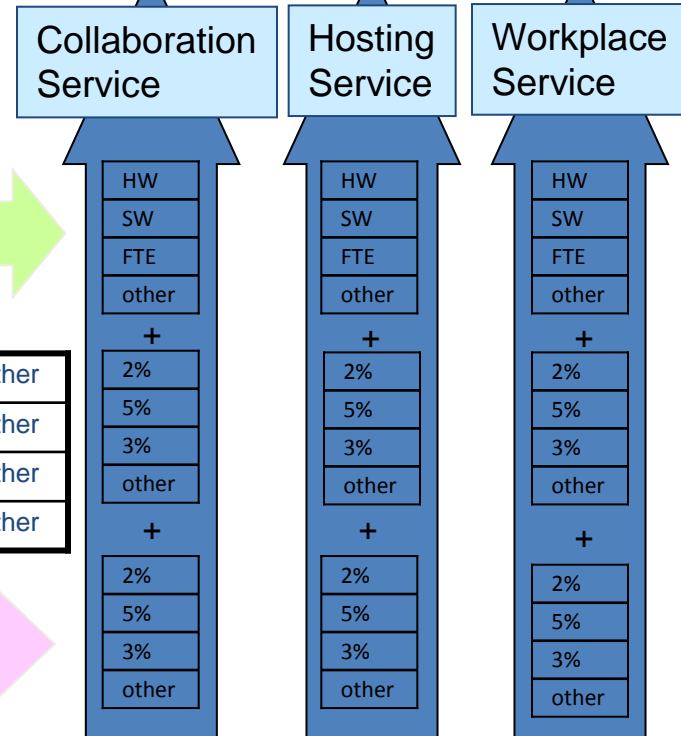


Cost Elements

Cost Of Client Facing IT Service

$$= \% \text{ Overhead} + \text{Indirect Cost} + \text{Direct Cost}$$

Client Facing IT Services



Direct Cost

Cost of HW, SW, FTE etc. that are **dedicated** to the client facing IT Service

Network	HW	SW	FTE	other
Hosting	HW	SW	FTE	other
Storage	HW	SW	FTE	other
etc.	HW	SW	FTE	other

Indirect Cost

Cost of HW, SW, FTE etc. for services that are **shared** between multiple clients facing IT Service

Overhead / Unabsorbed Cost

Cost of HW, SW, FTE etc. that are not directly attributable to any of then IT Services (e.g. HR, Finance, Management)

Key Business Objectives for IT Chargeback

Simple

- The terms how IT charges for the services must be simple for the business to understand. Complicated IT based calculations must be avoided.
- *“What am I paying for, and is it simple to understand?”*

Fair

- It must be clear that the business is paying for what they are actually using. For example, chargeback based only on head count can be perceived as unfair
- *“I will pay my share, but am I paying for anyone else?”*

Predictable

- Business need to plan and budget for future IT charges, chargeback should be predictable and e.g. “locked” for a specific time period.
- *“Can I reliably forecast my IT cost, will the IT cost increase and put my numbers at risk?”*

Must enable control

- Business should have the option to alter or reduce their service usage at agreed times, to lower their IT charges if needed.
- *“If I cut my budget, will reduced IT Service usage lower the IT cost accordingly”*

Key IT Objectives for IT Chargeback

Guaranteed funding

- Fixed and long term chargeback approaches are preferable for IT that can not be altered over the shorter period, regardless of IT Service usage.
- IT must be able to recover investments and capital cost, even if resources are not utilized fully within the organization.

Easy to manage

- It should be easy and require minimal administration for the IT organization to generate the chargeback for the business for IT Service usage.
- The simpler the chargeback model the easier it will be for IT to manage.

Affect behavior and demand

- The chargeback approach should affect the behavior and demand for IT Service usage by the business.
- Extreme IT Service requirements from the business will be delivered at a high cost and drive the business to scale back on demand or select a more cost effective IT Service

Common IT Pricing Methods

A combination of pricing methods are the norm when building charges for IT Services.

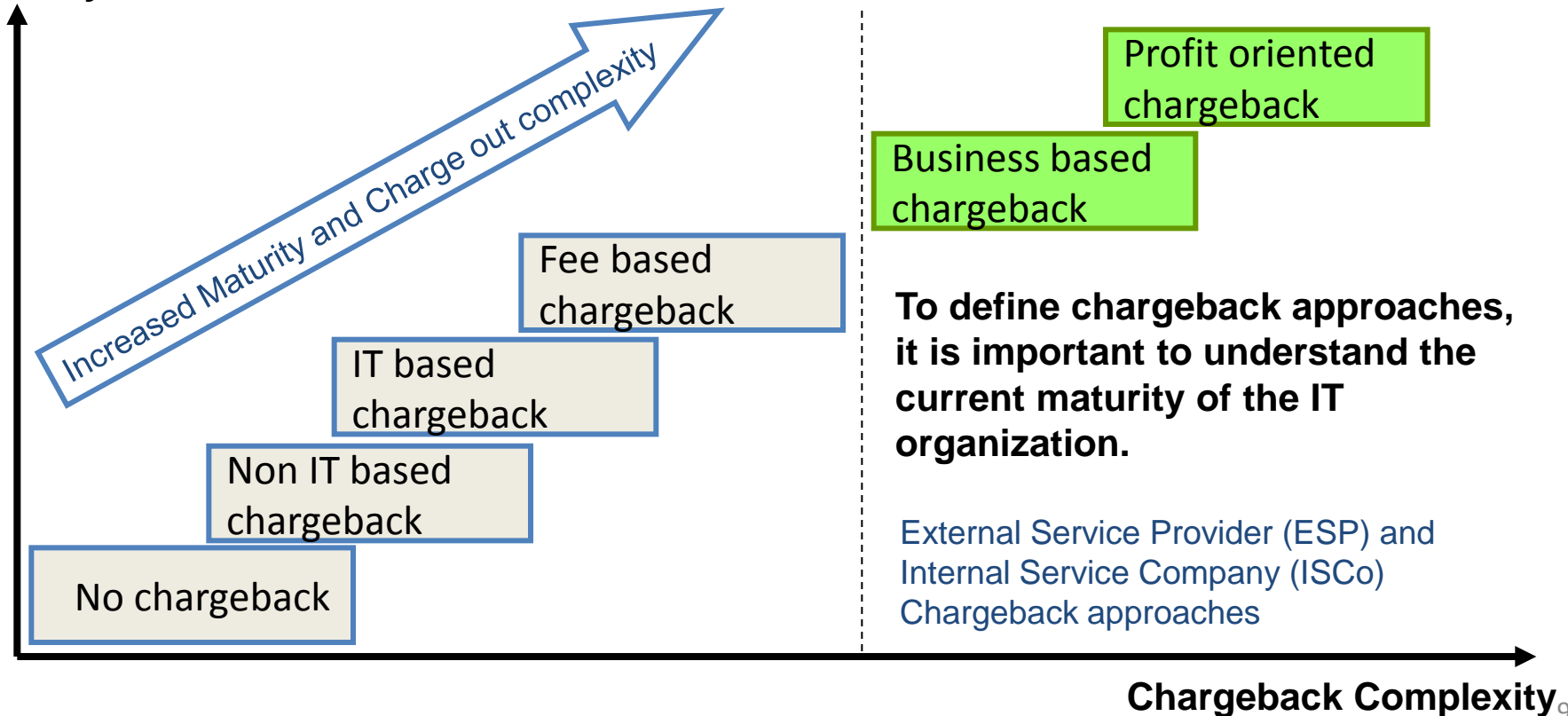
- It is common that IT Services subsidize each other, combining Cost plus with either Going rate or Market rate

Chargeback	Description	Pro's	Con's
Cost based	Business units are charged for total IT cost including one time fees and ongoing costs	Full cost recovery	No funding for continuous improvement efforts, will be charged as overhead.
Cost plus	A mark-up might be added to the total cost to fund continuous improvement projects and IT investments for KTLO	Full cost recovery	Funding for continuous improvements covered by service chargeback
Going rate	Comparable internal cost with other IT departments	Aligned with internal cost	Cost not based on market rate
Market price	Matched prices with external providers	Rates comparable with external ESPs	Full cost recovery for IT might not be possible
Negotiated contract price	Can include investment cost for new IT services	Could include service development cost	Operating cost are mixed with development cost

Chargeback Maturity and Complexity

Depending on the maturity of the IT organization and the business, different types of chargeback approaches and cost recovery must be considered.

**Organizational
Maturity**



Approach	IT Service Chargeback Approaches - Overview
No chargeback	The IT organization pays for all expenses and capital acquisitions related to IT through its own budget.
Non IT usage based chargeback	The IT organization charges back all IT related cost to the business based on a standard formula, which could be per headcount or a percentage of revenue or budget, not based on IT Service consumed by each business unit.
IT Based Chargeback	
<i>Subscription</i>	Charges are on a fixed basis, without regards to IT Service consumption. Specific IT metrics are used for total IT budget chargeback e.g. per desktop, laptop or network connection.
<i>Usage</i>	Charges are strictly based on IT Service consumption or usage.
<i>Direct</i>	All costs are charged back to the business unit that "owns" the IT Service (HW and SW), regardless of IT Service consumption. IT Service not shared by other business units.
Fee Based Chargeback	
<i>Tiered</i>	Charges are based on Service Level differences (e.g. Gold, Silver, Bronze). An initial flat fee is charged for the "basic" service level for all "mandatory" IT Services. Additional IT services ordered or moving up/down a 'tier' affects the fee.
<i>Negotiated</i>	IT charges its cost back to the business based on an annual study of the IT Services consumed and used. This is considered the classic "budget approach".
ISCo Chargeback	
<i>Business based</i>	Charges are based on business activities and transaction e.g. \$10 per invoice or \$25 per generated report.
<i>Profit oriented</i>	Most other chargeback approaches are based on recovery cost, this approach treats IT and a business units with an objective to generate a profit.

IT Service Chargeback Approaches – Non IT Usage Based Chargeback

Two Common Non IT Usage Based Chargeback Methods

Approach	Description	Pro's	Con's
No chargeback	The IT organization pays for all expenses and capital acquisitions related to IT through its own budget.	IT architecture consolidation is easy with this method and has no negative effect on the business.	IT does not provide the opportunity to affect behavior or demand for services. Controlling IT expenses is difficult as business don't understand the cost of each IT Service consumed.
Non IT usage based chargeback	The IT organization charges back all IT related cost to the business based on a standard formula, which could be per headcount or a percentage of revenue or budget, not based on IT Service consumed by each business unit.	For the IT organization, it provides long term stability of funding and is easy to administer.	This chargeback policy can cause dissatisfaction with the business and lack of control as it is not based on IT Service usage or consumption and offers no transparency.

IT Service Chargeback Approaches – IT Based Chargeback

Three Common IT Based Chargeback Methods

Approach	Description	Pro's	Con's
Subscription	Charges are on a fixed basis, without regards to IT Service consumption. Specific IT metrics are used for total IT budget chargeback e.g. per desktop, laptop or network connection.	IT cost for the business is predictable and some control for the business is present. It provides a stable long term flow of funds for the IT organization and is easy to implement and maintain.	Fairness is not satisfied because all users are treated equally, disregards of IT Service consumption or usage. Does not motivate behavior of IT Service consumption.
Usage	Charges are strictly based on IT Service consumption or usage.	Fairness is met as chargeback's are based on IT Service consumption. The chargeback policy motivates IT Service usage behavior.	The cost and administration to measure and charge back is high and can be difficult and complex.
Direct	All costs are charged back to the business unit that "owns" the IT Service (HW and SW), regardless of IT Service consumption. IT Service not shared by other business units.	Considered to be more "fair" as each business unit is separate and exclusively serving one business unit.	Negatively affects IT architecture consolidation as there are no shared resources and IT Services.

IT Service Chargeback Approaches – Fee Based Chargeback, Flat Fee

Two Common Fee Based Chargeback, Flat Fee Methods

Approach	Description	Pro's	Con's
<i>Tiered</i>	Charges are based on Service Level differences (e.g. Gold, Silver, Bronze). An initial flat fee is charged for the “basic” service level for all “mandatory” IT Services. Additional IT services ordered or moving up/down a “tier” affects the fee.	The “tiered” structure allows business units to move up or down “tiers” to adjust and control their IT costs. The business units may see this as a more “fair” chargeback policy.	Future funding levels for the IT organization is not predictable, except in the case of “mandatory” IT Service fees.
<i>Negotiated</i>	IT charges cost back to the business based on an annual study of the IT Services consumed and used. This is considered the classic “budget approach”.	This chargeback approach is best suited for stable conditions like Service Desk or Support Services.	It requires an accurate forecast for future demand. IT has little control of expenses as demand is driven by the business units.

IT Service Chargeback Approaches – Internal Service Company (ISCo) Chargeback

Two Common ISCo Chargeback Methods

When adopting this approach IT organization acts more like an External Service Provider (ESP)

Approach	Description	Pro's	Con's
<i>Business based</i>	Charges are based on business activities and transaction e.g. \$10 per invoice or \$25 per generated report.	This will give business units a clear picture of how IT costs impacts their revenue.	There is an overwhelming number of business transactions to charge for, which makes this policy extremely complex and costly to implement.
<i>Profit oriented</i>	Most other chargeback approaches are based on recovery cost, this approach provides IT and business units with an objective that relates to their profit calculations.	IT is managed like a business unit with P&L, requiring efficient and effective delivery of competitive and high quality IT services that fulfill the needs of the business units.	Required major cultural and organizational change and additional resources to market and define the services and service levels in detail.

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Example of IT Chargeback Model

IT Service
IT Service Component

of units / year
Growth / Decline

Unit Cost
Efficiency

Chargeback approach

IT Service Charges

Baselines	2008 numbers			Cost			Chargeback Approach	Charges				
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3		Year 1	Year 2	Year 3		
Workplace Services	Growth: 3.0%	3.0%	3.0%	Efficiency: 2.9%	2.9%	3.0%		Efficiency: 2.9%	2.9%	3.0%		
Desktop Management (2008: 3029 PCs and Laptops)	\$4,715,352											
PC	# of units											
Standard PC	1,500	1,545	1,591	Unit Cost	\$1,000	\$971	\$942	IT based chargeback (subscription)	Unit Price	\$1,100	\$1,068	\$1,036
Sales force tablet PC	200	200	212	Unit Cost	\$1,200	\$1,165	\$1,130	IT based chargeback (subscription)	Unit Price	\$1,000	\$971	\$942
Premium PC	500	515	530	Unit Cost	\$1,500	\$1,457	\$1,413	IT based chargeback (subscription)	Unit Price	\$1,800	\$1,748	\$1,695
One time provisioning fee			68	Unit Cost			\$942	(Usage)	Unit Price			\$1,884
Premium Delivery Option			5	Unit Cost			\$942	(Usage)	Unit Price			\$942
							\$2,556,607					\$7,096,853
Laptop			3.0%	Efficiency:			3.0%		Efficiency:			3.0%
Standard Laptop			849	Unit Cost			\$1,413	IT based chargeback (subscription)	Unit Price			\$2,355
R&D Laptop	100	103	106	Unit Cost	\$2,500	\$2,428	\$2,355	IT based chargeback (subscription)	Unit Price	\$3,500	\$3,399	\$3,297
Premium Laptop	125	129	133	Unit Cost	\$2,500	\$2,428	\$2,355	IT based chargeback (subscription)	Unit Price	\$3,500	\$3,399	\$3,297
One time installation fee	24	31	32	Unit Cost	\$1,000	\$971	\$942	(Usage)	Unit Price	\$2,200	\$2,136	\$2,072
Premium Delivery Option	2	2	3	Unit Cost	\$1,000	\$971	\$942	(Usage)	Unit Price	\$950	\$922	\$895
							\$1,788,900					\$20,536,807
Desk Phone	Growth: 3.0%	3.0%	3.0%	Efficiency: 2.9%	2.9%	3.0%		Efficiency: 2.9%	2.9%	3.0%		
Standard Desk Phone	2,950	3,039	3,130	Unit Cost	\$100	\$97	\$94	IT based chargeback (subscription)	Unit Price	\$100	\$97	\$94
VIP Desk Phone	50	52	53	Unit Cost	\$150	\$146	\$141	IT based chargeback (subscription)	Unit Price	\$175	\$170	\$165
Voicemail (no desk phone)	3,000	3,090	3,183	Unit Cost	\$50	\$49	\$47	IT based chargeback (subscription)	Unit Price	\$50	\$49	\$47
One time installation fee	90	90	93	Unit Cost	\$150	\$146	\$141	(Usage)	Unit Price	\$150	\$146	\$141
Premium Delivery Option	9	9	10	Unit Cost	\$150	\$146	\$141	(Usage)	Unit Price	\$125	\$121	\$118
							\$467,350					\$70,974
Sub Total				Desktop Management:	\$4,795,750	\$4,820,915	\$4,816,731		Desktop Management:	\$91,230,000	\$89,444,924	\$87,704,734
Identity & Access Management	Growth: 3.0%	3.0%	3.0%	Efficiency: 2.9%	2.9%	3.0%		Efficiency: 2.9%	2.9%	3.0%		
New user on-boarding, Termination of user access, Modify user access System access provisioning	\$2,268,156											
	# of headcount											
Charged back per head count in the BU	2,968	3,057	3,149	Unit Cost	\$750	\$728	\$706	IT based chargeback (Usage)	Unit Price	\$800	\$777	\$753
Premium Delivery Option	100	103	106	Unit Cost	\$500	\$486	\$471	(Usage)	Unit Price	\$500	\$486	\$471
							\$2,276,000					\$275,051
Sub Total				Identity & Access Management:	\$2,276,000	\$2,276,296	\$2,274,247		Identity & Access Management:	\$850,000	\$801,415	\$754,051
On Demand Requests	Decrease: 3.0%	3.0%	3.0%	Efficiency: 2.9%	2.9%	3.0%		Efficiency: 2.9%	2.9%	3.0%		
Job scheduling	\$2,880,824											
	# of requests											
Charged back per requested job	5,000	4,850	4,705	Unit Cost	\$440	\$427	\$414	IT based chargeback (Usage)	Unit Price	\$500	\$486	\$471
Data restoration												
Charged back per head count in the BU	2,000	1,940	1,882	Unit Cost	\$100	\$97	\$94	Non IT based chargeback	Unit Price	\$100	\$97	\$94
Report generation												
Standard Report generation charged back to all BUs	2,000	1,940	1,882	Unit Cost	\$100	\$97	\$94	Non IT based chargeback	Unit Price	\$100	\$97	\$94

Y1: 1,500 PC
 Y2: 1,545 PC
 - Growth 3%

Y1: \$1,000 / PC
 Y2: \$971 / PC
 - Efficiency 2.9%

Y1: \$1,100 / PC
 Y2: \$1,068 / PC
 - Growth: 3%
 - Efficiency 2.9%

Charges are on a fixed basis, without regards to IT Service consumption. Specific IT metrics are used for total IT budget chargeback e.g. per desktop, laptop or network connection.

Example of IT Chargeback

Chargeback for “Standard PCs” for Business Unit A

Standard PC

- **One time provisioning fee: \$2,000**
- **Ongoing fee \$1,100/year**
 - Chargeback approach: IT based chargeback (subscription) - Charge per standard PC

Pricing:

- **Current standard PC users: 325**
 - **Estimated new standard PC users: 150**

 - **IT Service Cost for Business Unit A (Standard PCs)**
 - **One time fee: $150 * \$2,000 = \$300,000$**
 - **Ongoing cost: $(325+150) * \$1,100 = \$522,500$**
- Total = \$822,500**

Business Unit A needs to budget \$822,500 for their Standard PCs within the Workplace Service offering

Potential Finance/Accounting Considerations Related to IT Chargeback

What will chargeback entries be based upon?

- ✓ Budget Estimates

How often adjustments based on actuals will be performed (quarterly, yearly)

- ✓ Actual Charges

How often are chargeback entries are going to be processed?

- ✓ Monthly
- ✓ Quarterly
- ✓ Yearly

Will chargeback entries pass through the ledger or only treated as adjustments for management reporting?

- ✓ Pass through the ledger – real time entries may be less cumbersome than offline adjustments, easier for recordkeeping and audit trail, may offer more automation opportunity
- ✓ Adjustment only for management reporting – no potential intercompany out of balances affecting the financial statements, no potential tax implications

How will accounting for chargeback be designed/executed?

- ✓ One Inter company (I/C) account for both outgoing and incoming charges per chargeback category (should balance to zero); two I/C accounts per chargeback category (ending balances should offset each other)
- ✓ Entries will be automated or manual (both sides of the entries can be performed by one person (pros: decreased potential for I/C differences; cons: both sides have to agree on charges prior to entry being processed, more work for one individual)
- ✓ Inter company differences resolution process (seller or buyer prevails)
- ✓ Any System modification requirements to process chargeback

Potential Finance/Accounting Considerations Related to IT Chargeback Cont.

How will the chargeback will be presented to the business?

- ✓ Invoice distributed every chargeback period
- ✓ Spreadsheets with detail breakdown distributed every chargeback period
- ✓ Chargeback details included in Service Level Agreements

How will chargeback affect the budgeting process?

- ✓ Potential changes to the budget time tables
- ✓ Necessity to develop process of establishing, agreeing on and communicating budgeted chargeback

What KPIs/Metrics will be considered and who will be responsible for tracking them?

- ✓ % of overall costs allocated
- ✓ Frequency of review of cost models
- ✓ % of costs allocated automatically
- ✓ % of disputed costs by users
- ✓ % of service bills accepted/paid by users
- ✓ % of variance around budgets, forecasts, actuals
- ✓ % of users satisfied, very satisfied from survey

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Questions

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