Budget Wisdom

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"Chargebacks Are Killing Us"

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"We've been doing chargebacks for three years now, and they're killing us!"

"Janet, I think they're a good thing. Remember the 'do more with less' era? At least now we're getting the resources we need to do what's expected."

"Bob, that's only partly true. You've got the applications developers, so you're in good shape. You get paid for all your hours. But on my infrastructure side of the house, I've got some serious problems."

"Like what?"

"Well, like my infrastructure engineers."

"Sore subject with me...."

"Why?"

"Janet, I've told you this in the past. My developers need their support to install new applications, but they're always the bottleneck on our projects."

"And why do you think that is, Bob? You think they're lazy or incompetent? Huh?"

"No, no, don't get me wrong. They're good people. There's just not enough of them to go around."

"Because of those darn chargebacks! You know the engineers are lumped into the infrastructure services rates. And since my service volumes are relatively flat, I can't grow the infrastructure engineering team. Meanwhile, you've gotten funding for the whole ERP roll-out, and suddenly you need lots more support. Get it?"

"Well I certainly fund enough of your infrastructure staff through *my* rates!"

"Bob, what are you talking about?"

"All that change control, business continuity, service-level management, blah blah blah...it all gets spread around into my rates as well as yours through overhead, even though most of it's for your benefit."

"That's true. But if I charge you for engineering support, and you charge me for my billing applications, and then I charge you for development cycles, and you charge me for brokering all my service-level agreements...we'd be chasing our tails. That's why we put it all into overhead and just spread it across all the rates."

"Oh, I *know* why we did it. But it still blows me out of the water in rate benchmarks."

"Well, you're not the only one who's sweating the outsourcing comparisons. Like I said, my rates include the engineering time that should be charged to your projects. But on top of that, my rates have to fund all this 'corporate-good' stuff that outsourcers don't have to do—you know, like my consumer-report function for PCs, architecture planning, SOx and security for clients' applications, corporate task forces.... It goes on and on!"

"We're both getting hit with outsourcing on one side and decentralization on the other. And because we charge back, it's clients' money so they can spend it wherever they please."

"It's pretty scary. On top of all this, I'm giving away my infrastructure."

"Giving away?"

"You got it, Bob. When outsourcing vendors need more infrastructure, they just go to the bank, borrow the money, and imbed their loan payments in their rates. But I don't have a bank. I've got to recoup all my costs every year. So what do we do? We put the cost of servers in your applications proposals. Clients fund them, and now clients think they own the servers in my computer center."

"Well, maybe they do own them."

"I guess.... But Bob, did you see the server-consolidation study I had done? $4 million per year—$4 million!—through server consolidation. And the clients won't let me touch 'their' servers. It's ridiculous. Thank you, chargebacks!"

"I've got problems of my own with giving away the store. My rates assume that my developers are 75% billable. If I take any time for training, client relations, product research, process improvement—the sustenance stuff that's so important—well either I'm in the red, or I try to bill clients and they say there's no way they're going to pay for that."

"You're giving them too good a deal, Bob. You need to build those activities into your rates."

"The clients won't let me."

"And they won't fund me to implement service-management processes."

"I don't get it. You'd think clients would be happy that chargebacks put them in complete control of their IT costs. But they're still micromanaging us, questioning our costs, pushing for outsourcing, and setting up their own divisional IT groups."

"I think part of the problem is our rates aren't competitive, like we've said.

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"But also, my rates are for these big service bundles. You know, they can't do without desktop support or networking. But they can't really choose options and save money by giving up things like after-hours support or 24-hour response time on PC fixes. So they feel like we've got them 'over a barrel'—they have to buy from us—because the rates are set at too high a level."

"Not a problem on my end. I just charge by the hour."

"That's true, it's mostly an infrastructure problem where the rates just don't link to purchase decisions like they do with outside vendors."

"So we're in trouble and clients are upset. Now I see why you're upset about chargebacks, Janet."

"I feel so helpless. Mike in IT Finance isn't a bad guy. But he just does all the rate calculations for us, without our real involvement. There's nothing I can do to fix the situation."

The Root of the Problem

Janet and Bob are suffering a number of very common problems associated with chargebacks that are poorly implemented.

Number one, and most important, chargebacks were implemented with the wrong vision in mind. They were designed to allocate costs to clients and to mitigate demand (to solve the "do more with less" problem). They succeeded at these objectives, but they missed the most important goal: create an internal marketplace that empowers clients to make well-informed purchase decisions.

To create an effective internal marketplace, rates must be associated with *discrete purchase decisions.* By focusing on cost allocation, Janet's services were bundled at too high a level, and clients couldn't make meaningful choices. Thus, clients felt they had to micromanage IT to manage their costs.

Number two, rates did not represent the *true cost to shareholders* of IT's products and services. To avoid circularity problems, all internal support services were lumped into overhead rather than assigned to the specific IT groups that benefit from the services. This creates unacceptable distortions.

And to make matters worse, corporate-good activities were buried in the rates instead of charged to the corporation. This was justified under the banner of "full cost recovery," but it made IT look uncompetitive compared to outsourcing vendors. It also deceived corporate executives into believing that corporate-good activities are free.

(Corporate-good activities include policy, security, standards, consumer-report style vendor research, and activities unrelated to the production of IT products/services like corporate committees; but they don't include "mass market" services like networking and email.)

The "full cost recovery" principle also forced IT to charge infrastructure investments (like new servers) to clients, instead of seeking corporate funding (the bank) and imbedding just depreciation in the rates. The corporate bank should fund not only capital, but all the costs of readying an asset for use.

Number three, the rates were set by the IT Finance group with minimal *participation from the IT managers* who deliver the products/services. Thus, managers' knowledge of the business wasn't utilized in the process, and Bob and Janet felt disempowered.

The Way Out

The solution is straightforward.

First, chargeback rates must be set for each and every product/service—each client purchase decision. This is more detailed, but it's absolutely necessary to empower clients to control their costs and to make chargebacks meaningful.

Second, the IT organization needs a mature costing application that gets all indirect costs in the right place, and resolves the issue of circularity in a manner that minimizes distortion.

Third, rate-setting must be integrated with business planning and budgeting. You can't plan a budget without first forecasting the business in the year ahead and planning how you'll fulfill it—i.e., budgets are based on an operating plan. And you wouldn't want to promise one cost in the budget, and then charge a rate that adds up to a different number! Business planning, budgeting, and rate-setting are all parts of a single process.

Fourth, the role of IT Finance is to *facilitate* the process, not to do it. Managers must plan their businesses, their budgets, and their rates—not have it done for (or to) them. This requires a well-documented, step-by-step method to guide everybody through the process.

Practicalities

If you're just now thinking about chargebacks, you've got a chance to do it right from the start. If you've already implemented chargebacks, you have an opportunity to evolve your process and tools to make them more effective.

In either case, you face the classic "make versus buy" choice. You could invent your own process and costing application, or you could buy one off the shelf and adapt it to your unique needs.

But note that either way, you need to understand the full set of requirements, and the mechanical problems and their solutions. The best way to do so is to study a world-class costing application and method, and then decide whether to make or buy. ❑

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