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Cost of IT shared services

Shedding light into the black box

2016

Global competition and economic uncertainty are driving companies to reexamine their operating models to better understand operating costs and the value that support services bring to an organization.

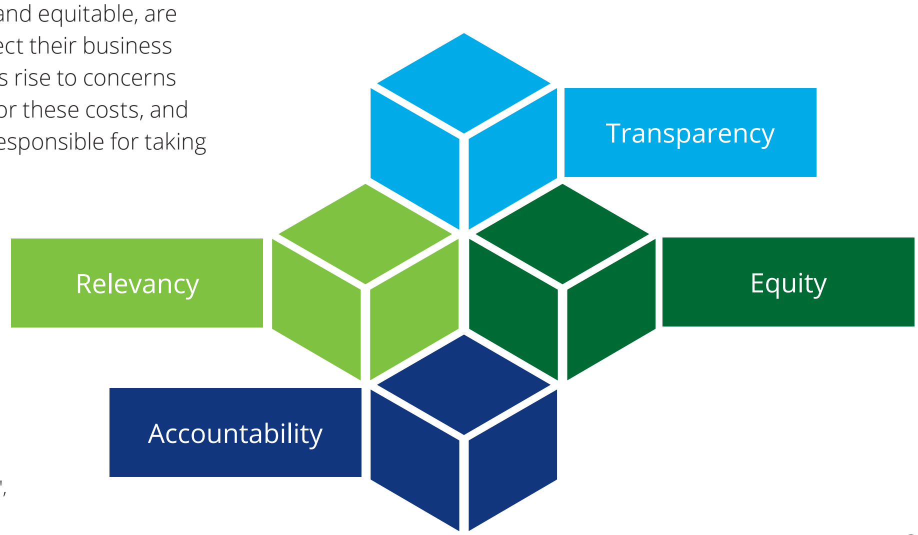
Introduction

When asked what's included in their allocated information technology (IT) costs, IT customers or service consumers, also referred to as business unit (BU) owners for this paper, are often unable to answer, or even explain, what they are paying for. But this question is being posed more frequently as organizations face increasing global competition and economic uncertainty. This growing competition and uncertainty is resulting in the need to reexamine operating models, with a focus on better understanding operating costs and the value that support services bring to an organization.

Average IT spend (cross-sector) increased by 2.6 percent in 2013 and is expected to increase by an additional 3.2 percent in 2014.[1] As a percentage of revenue (cross-sector), average IT spend is anticipated to reach 3.3 percent in 2014.[1] However, business divisions often view allocated IT shared services costs as a "black box" of charges, because they are frequently provided with minimal information regarding what those services are or the basis for the charges to their operating results, creating tension between the business divisions, corporate and IT shared services. Furthermore, BU owners might feel that the charges are not fair and equitable, are outside of their control, or may not reflect their business division's actual consumption. This gives rise to concerns regarding who should be accountable for these costs, and whether it is IT or the business who is responsible for taking action to improve service or cost efficiencies. As a result of these issues, businesses may consider looking for alternatives to opt out of using additional internal IT services, which can end up costing the company more in total.

Having more transparency into the types of IT expenses being allocated, as well as the basis for the allocations, provides BU owners greater insight into the value the IT shared services provide to their operations. It also provides information necessary for strategic decisions, such as cost savings initiatives or new IT investments. Lack of transparency into IT shared services costs raise two key concerns:

1. How can companies and IT shared services centers improve the transparency of IT cost information, establish more equitable allocations amongst IT services users and provide BU owners with more relevant and meaningful information for decision-making?
2. When considering changes to IT shared services cost allocations, what are the most effective ways to roll out those changes and promote accountability?



[1] Guevara, Hall, & Stegman.
"IT Key Metrics Data 2014: Executive Suammary",
December 16, 2013, Pg 1.

It’s about quality, not quantity

In our experience, organizations that provide their BUs with more insight into their allocated IT costs use consumption-based costing models, as opposed to traditional costing models. A consumption-based approach defines costs in terms of services outlined in a service catalog; organizations can then analyze the nature of the services used by each business division. Services are comprised of activities that consume costs or resources via defined allocation drivers and reflect causality between costs generated and activities completed. Service catalogs enable organizations to standardize and define the services offered by their IT shared services group and include information on the level of effort for each service, how costs for the service will be allocated to each BU and the cost per activity/service. In using service catalogs to define and allocate costs to BUs, organizations also have information to identify if and when business divisions use incremental services above standard levels and the resulting additional cost.

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Sample IT service catalog

IT service
Application access, maintenance and support
Project
Fixed telephony
Video conferencing
Desktop computer
Network-WAN
Mobile phone and smartphone
Air card access
Audio conferencing

Service catalog details

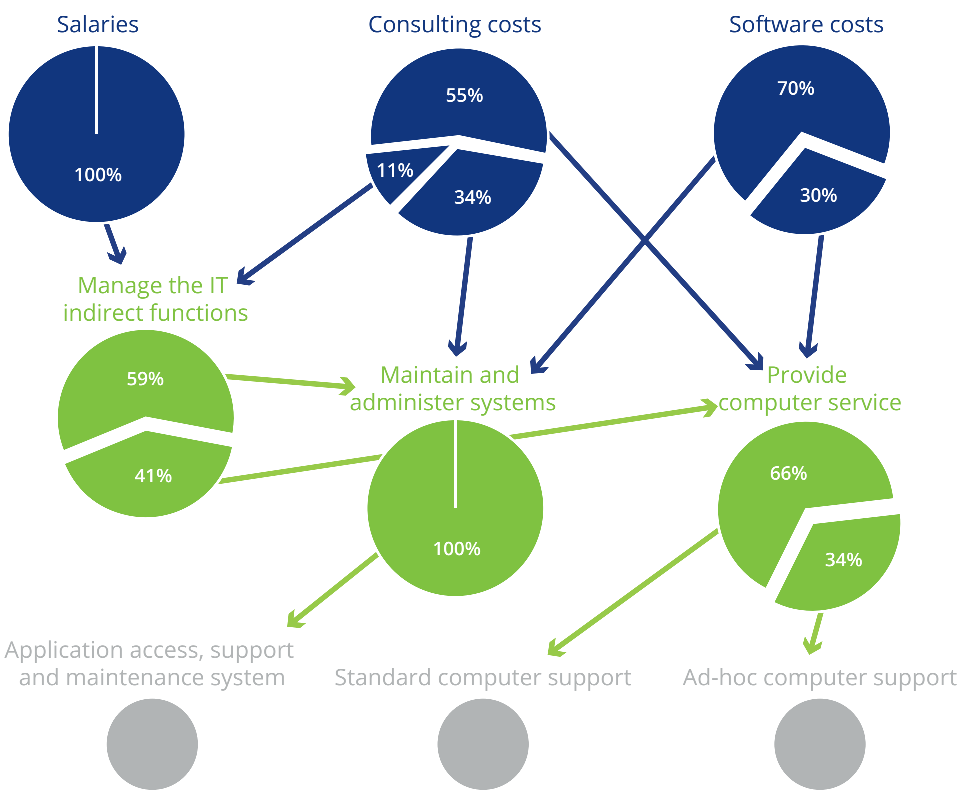
Catalog	Desktop computer
Service description	Provide a standard laptop/desktop with a company computer image, an email mailbox, access to internet, access to shared files, on-site support, web conferencing, helpdesk
Chargeback calculation rule	Unit price x volume
Unit of volume	Number of standard PC in the population
Volume type	Usage
Unit price	$1,100

Note: This illustration is an excerpt from IT service catalog.

Having evolved from the cumbersome and often complex activity-based models of the 1980s, consumption-based models provide a less complex approach, balancing service-based and charge-back costs with the desired benefits and transparency gained from allocating costs based on the use of key services. Alternatively, traditional costing models often use a broad set of static and/or generic metrics (e.g., accumulated costs that are not based on consumption) to allocate shared IT costs to different BUs within an organization. These ineffective and often overly simplified costing models do not link the costs incurred to the services required for a particular business' function. As a result, BUs may not see the true value behind the costs or understand how they can influence efficiency, IT cost reduction initiatives or driver-based planning/forecasting activities.

As illustrated below, in a consumption-based costing model, costs from the general ledger ("resources") are allocated using appropriate cost drivers to the activities that consume them ("IT activities"). These activities are then allocated to services ("IT services") where a unit cost per service is calculated, which becomes the basis for the chargeback to BUs:

Consumption based costing model



Resources

1. Align general ledger amounts to standard resource categories and determine activity allocation drivers (%)

IT activities

2. Allocate resource costs into activities using drivers. Determine service allocation drivers to funnel activity costs into IT services

IT services

3. Allocate activity costs into IT services using drivers

Note: This model, a subset of an entire IT services costing model, is for illustrative purposes.

Bridging the information gap between the IT department and business divisions is at the heart of opening the allocation black box. When implementing a consumption-based IT shared services methodology, as previously noted, organizations typically develop a service catalog of the activities performed by the IT group. Recommended practices for developing the service catalog and its costs are as follows:

- Jointly develop the service catalog. We recommend that the service catalog be jointly developed by the IT and finance organizations. Developing the service catalog in terms of the service buyer's perspective will be more meaningful to the BUs, easier to understand, and provide cost information at the level of detail they need for decision-making. For example, when implementing a new application, the IT group may consider every step in the process a chargeable service. Business divisions, however, may see the availability of the new application as a single service, with the requisite steps for the application to be available for use as necessary to complete the task. A collaborative approach ensures BUs are provided with meaningful information on the IT services charged to their business and the value of those services in supporting their operations.

- Define the key consumption drivers. We find that the most effective consumption based allocation models for providing users with the information they need to manage costs and for decision-making follow the 80/20 rule: Sophisticated drivers to address the complexity of certain services are used for the few and more significant costs, while other, less significant, costs are allocated using drivers or metrics already in use or using a simple driver, whichever is more directionally accurate. This approach balances the level of effort needed to manage and explain allocated IT costs and their drivers to stakeholders, with the benefit of more transparent and accurate allocations.

- Communicate detail to BUs in terms of services. IT cost reporting to business divisions should reflect consumption-based information on the services used, rather than simply providing them with data on the costs charged without this context. Organizing the information by services consumed gives BU owners more insight into the IT costs incurred and provides information in a format that facilitates more informed decision-making.

- Develop BU cost portals. To enhance the availability of cost information detail to business divisions for decision-making purposes, cost portals should be developed that enable businesses to access cost data and develop reporting and analyses on their own, rather than through requests to the IT shared services group. Such initiatives enable organizations to disseminate information more efficiently and facilitate timely decision-making.

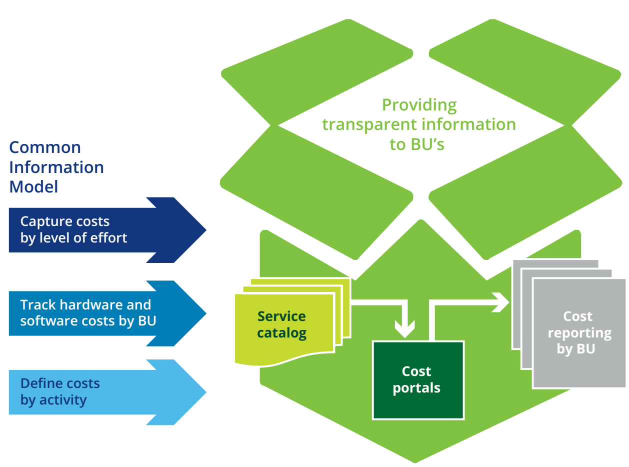
Set a path to transparency

We find that many companies address questions regarding IT shared services costs by providing more data on the charges allocated to businesses, however, business divisions may need more insightful information in order to evaluate the services they use. Although consumption-based costing models provide companies with more detail on the IT services consumed and by which divisions, not all service catalogs — and the cost data they contain — are created equally. To enhance the effectiveness of this costing methodology and the transparency of the information reported, we recommend the following leading practices:

Capture the level of effort

In order to provide BU owners with meaningful information regarding the activities of IT shared services resources, existing tracking systems should be leveraged to capture the level of effort required to perform specific IT services. Examples include aligning dedicated resources to provide services to specific business units, defining roles and responsibilities by key positions in order to support the allocation of time by activity or using time tracking tools, such as time sheets. We find that many organizations only use time-tracking tools for specific project work. By expanding tracking to monitor employee time spent supporting users with applications, performing hardware/software maintenance, or implementing new software, for example, companies would obtain better insight into where IT employees are spending their time. Consideration should also be given to capturing time spent by IT resources that reside within BUs ("Shadow IT" resources) where these costs are reflected as BU costs, rather than IT costs, in order to understand the total IT costs to support business divisions. Sharing this detail with the businesses provides them with better transparency regarding the services provided and the related costs.

As illustrated below, capturing quality cost data, organized in terms of a service catalog, and leveraging cost portals for reporting can provide more transparent information to business units.



Track hardware and software by BU

Each business division may have a different complement of hardware, software, and application requirements. Tracking what is used by each BU provides the organization with better information regarding where its IT investment resides and what groups are benefiting from the software employed. Organizations may be able to leverage third-party service providers to obtain some of this information, including usage of mobile device assets or leased assets, as well as voice and data services. Managing this information may be part of the organization's broader software asset managment program that we have seen companies implement to address their broadening technology and software requirements and the growing complexity of licensing and service arrangements. With information by business, companies may then accurately charge BUs for the support services they consume and provide business divisions with better information to manage their spending.

Align accounts and cost centers to a service catalog

Contrary to popular belief, providing more detail doesn't mean creating additional general ledger accounts to track IT shared expenses; rather, we recommend implementing better data tracking within your existing chart of accounts. Information on IT shared services usually reside in ten or fewer main line items in the income statement, with the largest expenses typically relating to employee costs, external consultants, and external contractors. Through the use of consistent account definitions and account and cost center mapping across the company, the nature and magnitude of these expenditures will be better understood. In addition, by aligning and grouping cost centers to a services catalog, organizations would have reporting based on services consumed and the corrsponding cost drivers, providing BU owners with meaningful information on the basis of IT spend. While obtaining additional cost detail may require changes to how data is captured, coded and structured, this will drive value to the organization by providing visibility into costs incurred and how much is allocated to each business division.

Employ a single allocation tool to standardize and harmonize cost detail across a complex organization

One of the challenges we find in many organizations is that cost data is maintained in different Enterprise Resource Planning (ERP) systems across the organization, where each ERP may use a different chart of accounts, as well as different classification systems and categories for organizing similar cost data. It may not be possible or practical — for a variety of reasons — for the company to move to a common ERP platform. In these situations, we recommend implementing a common information model and single allocation tool that sits on top of existing systems and can be used across the organization. (See the the illustration on page 5.) These cost management software tools enable cost data to be imported from multiple data sources, such as general ledgers and transaction systems, organized using a common account and cost center structure, and the costs grouped or classified in terms of a service catalog. Cost information can then be analyzed by activities and services and used to develop cost allocations and chargebacks. In addition, these tools provide organizations with the ability to generate reports that offer a clear picture of IT shared services costs incurred across the organization. Such tools and the transparency they provide to management and BU owners can give organizations a perspective on overall costs and cost drivers that they previously did not have and better equip organizations for performing driver-based business planning and evaluating plan scenarios.

Achieving cost transparency requires clear communication

Communication within an organization and with its BU owners is key when shifting to a consumption-based allocation methodology or when making refinements to the allocation methodology used by an organization. No one appreciates surprises, particularly when it comes to the costs they are responsible for managing.

Here are some key considerations for managing allocation methodology changes and the related communications:

- Buy-in and support from senior management is key to the effective roll-out of methodology changes. Communicating the business case for changes and linking them with the strategic priorities and goals of BUs, and the organization as a whole, is an effective approach to gaining change acceptance. Business divisions are more likely to take a constructive view of methodology changes with the right messaging from leadership.

- Before implementing changes to an organization's cost allocation methodology, we recommend providing business divisions with information and analysis on the expected changes to help BU owners understand how the methodology changes will impact their allocated costs and build buy-in throughout the organization. Approaches to consider in performing this include:

  – Shadow billing. Business divisions are provided with new methodology cost data while still being billed under the existing model.

  – Retroactive billing. BU owners are provided with prior year actual or budgeted data using the new methodology to help explain differences in costs as compared to the old method.

  Helping businesses understand how the costs of the services used will change and providing information to help BU owners make strategic decisions regarding any changes to their service consumption can limit surprises.

- Another approach to limit surprises is to communicate cost allocation changes during the initial stages of the organization's budgeting process. Such communication provides the businesses with the opportunity to plan or modify their IT shared services usage for the upcoming year. Discussions between IT shared services and BUs may include potential changes to driver data based on actual consumption experience, expected service level requirements for the upcoming year or the application of cost reduction levers, for example. Any changes expected to allocated costs may then be incorporated into the budget for comparability with next year's actual costs.

Helping businesses understand planned changes to the costs of the services they use and providing information to help BU owners make strategic decisions regarding these changes can limit surprises.

Case study: Significant budget cuts: A driving need for transparency

A large multinational energy and resources company recently implemented a consumption-based allocation tool in an effort to understand IT shared service costs and target areas for cost elimination. Below is the situation the client faced, the costing solution implemented and benefits obtained:

Situation

- Significant cuts in budgeted IT spend generated a need to better understand the cost structure of the IT organization
- The link between IT services being consumed, associated costs and relevant cost drivers were not easily identifiable, making it difficult to allow for targeted IT cost reductions
- The lack of a coordinated/harmonized IT chargeback billing policy across BUs created inconsistencies with billings
- A consistent and transparent business understanding of the IT catalog of services and their alignment with a chargeback methodology was not in place

Solution

- Business rules were developed, master and transactional data were translated and mapped within a common information model to link financial data to the IT service catalog and enable chargebacks to BUs
- Cost allocation design was incorporated into the allocation technology requirements and a single allocation tool was deployed across the global company

Benefits

- Achieved a globally consistent allocation model based on a defined changeback methodology and IT service catalog
- Self-service reporting capabilities for BUs were developed within a common information model
- Significant IT cost reductions were achieved as a result of the solution implemented

Conclusion

Opening the black box and achieving improved transparency into IT shared services costs often requires an organization to make an investment in time and resources to refine its current processes. The focus for IT cost reporting should be to communicate IT costs to BU owners in terms of services and the value provided, rather than simply providing more cost detail at a functional level. In addition, implementing systems and processes to capture detailed cost data and report information consistently across an organization are key to providing information that facilitates effective business planning and decision making. In advising clients and equipping organizations with better information, we have seen significant percent reductions in company IT spend, implementation of IT service improvements that address business division needs and concerns, and senior management provided with the transparent reporting they require to evaluate the effectiveness of their overall IT strategy. By improving the transparency and relevancy of IT shared services cost information, IT and operating divisions can work together to formulate equitable allocations and foster accountability for the cost of IT shared services.

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Contact us

To discuss your IT cost challenges and explore next steps to improve the transparency of your cost allocation reporting, please contact:

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