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Key Concepts in IT Financial Management: Funding, Costing, Pricing and Chargeback

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This research explores key concepts in IT financial management and how they should evolve during the next few years.

Key Findings

- IT organizations are making progress toward improved IT cost transparency to support IT service management and cost allocation, but few organizations are there yet.
- The move to service-based cost allocation and chargeback is being accelerated by cloud computing.
- Shared IT services without adequate maturity in IT financial management (ITFM) will cause enterprises to spend more on IT on a gross and per-unit basis.

Recommendations

- Assess the maturity of your ITFM practices, and build a road map for maturation for the next three years.
- Review and update the IT chart of accounts to enable faster cost reconciliation and long-term success with IT cost transparency.
- If there is no dedicated IT finance function, then examine the need for an IT CFO type of role to improve the ITFM capability.
- Work with finance to develop an approach that supports the requirements of pricing and allocating IT services.

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Analysis

As IT organizations strive to become service-focused, they need new approaches to funding, pricing, costing and chargeback. As the role of IT shifts from building IT systems to delivering, brokering or integrating IT services, IT organizations must transform their traditional financial management models. Specifically, IT organizations will need to adapt to the following new realities:

- As cloud computing and multisourcing continue to take hold, many of the components of IT services will be owned and/or operated by entities outside the enterprise. This will force IT to rethink its approach to ITFM in general, and to cost allocation and recovery specifically.
- IT funding and procurement decisions will continue to become more distributed throughout the enterprise, making better IT cost transparency more difficult and more important.

ITFM is the process of effectively managing technology expenditures, with the intent to provide the business and the IT organization with a common platform to measure services and plan for future investments that optimize technology spending and business performance. The critical need for effective ITFM is widely recognized. While ITFM has many components, the focus of this research is on the key concepts of *funding, pricing, costing and chargeback.*

Across all four of these concepts, there is a common trend — a movement from looking at them at the level of individual IT assets to a position of looking at them under the auspices of services.

Taking a service-based approach, whereby the IT organization delivers or "brokers" a set of business-relevant IT-enabled services, should result in a change as to how an enterprise funds, prices, costs and charges back for IT. Too often, it does not. While many organizations describe themselves as service-based, and can point to a service catalog, the reality is that, in many cases, the key financial management concepts discussed here are still tied to the practices of the past. The focus of this research is on modernizing these practices to be more in step with the way IT organizations wish to deliver their services.

Throughout this research, we use the term "cost transparency" frequently, and the quest for increased cost transparency is a growing priority for many enterprises. As we use it here, IT cost transparency is the process by which IT leaders can better understand the costs associated with the services they provide. We do not mean to suggest that those exposed costs are to be shown to all stakeholders. In fact, Gartner's position is that exposing too much cost detail to stakeholders merely results in more arguments. Instead, in keeping with the move toward running IT like a business, we recommend that IT organizations publish IT service "prices" for their stakeholders, even in cases where price equals cost.

Most CIOs who expose copious cost details to stakeholders do so in an attempt to "justify" the cost of their services. However, this approach almost never works, and in fact tends to result in more arguments over why IT is not procuring specific assets in a certain way. Rather than justify IT costs through greater transparency, we recommend that IT leaders focus on developing and delivering business-essential services at market-competitive prices. The best justification for the cost of a service is for that service to be of high value to consumers. IT cost transparency, therefore, is principally a tool for IT leaders, allowing them to make optimal choices about how they deliver IT-enabled business services.

Key Concept: Funding

"Funding" means different things to different people. This research addresses two aspects of IT funding: how IT is set up in terms of being a subsidy, a cost center, a service center or a profit center, and how discretionary funding for IT is managed.

In terms of general funding of IT, each approach has its benefits and challenges:

- **Subsidy model:** This model, used by approximately 30% of IT organizations, may involve allocation of IT costs, but no chargeback. Challenges include constant downward pressure on costs and a high level of scrutiny by the business on any attempts by the IT organization to reinvest in IT. The advantage of this model is low administrative overhead. This model is sometimes used as a precursor to the cost center model, and can work if the enterprise has strong demand governance.
- **Cost center model:** Used by approximately 30% of IT organizations, this model has the same cost pressures of the subsidy model, but it usually exploits chargeback as a mechanism to manage demand. However, the approach to chargeback here is asset-based and simplistic — a

straight allocation by head count, most typically. The administrative burden is higher in this model than it is with the subsidy model, but there is also a higher level of accountability for IT consumption.

- **Service center model:** We estimate that approximately 30% of enterprises use this approach, which involves charging back for IT based on consumption of specific IT services. This model is a necessary step for enterprises that wish to run IT as a business, and it can allow for much more strategic funding and business value discussions with business stakeholders. Often, the adoption of this model goes hand-in-hand with the implementation of an ITFM tool, since it can be too labor-intensive to take a service-based approach to cost allocation and recovery without a specialized tool.
- **Profit center (or self-funding) model:** With the self-funding model, which we see in fewer than 10% of IT organizations we work with, IT services are billed at market pricing, enabling a "profit" to be made for reinvestment into IT. This enables IT to run as a business, selecting internal projects based on ROI like any other business. This is the model we see gaining ground in the coming years, even though real profits may not accrue directly to IT.

Going forward, Gartner sees many IT organizations maintaining two "sets of books." In one set, the IT organization manages to a budget and charges the business back at cost (but for services, rather than using a high-level allocation). In the second set of books, IT maintains a proxy profit and loss (P&L) to assess profit that would have been accrued if the IT organization actually did charge market rates for its services. The mock P&L may be used to drive bonuses, profit sharing and future budget-year allocations.

Management of over-recovered (implied in the profit center model) and under-recovered (implied in the subsidy model) costs is potentially the most explosive issue in the relationship between the IT organization and the business units (BUs) it serves. Whatever funding model IT uses, the "rules of engagement" should be formulated and socialized to resolve how to deal with these issues when they arise.

Funding Discretionary IT Investments

Traditionally, there have been four distinct approaches to IT funding, driven by two attributes: location of control and degree of restriction. Location is typically centralized or decentralized. The degree of restriction is either capped, where a fixed amount is designated for IT-related investments (and this pool is effectively rationed among the BUs), or uncapped, where the total amount of investment can vary, driven by the size and availability of business opportunity.

Table 1 shows the four permutations, given these two basic attributes.

Table 1. Discretionary Funding Models

Location of Control	Capped	Uncapped
Centralized	Centralized capped	Centralized uncapped
Decentralized	Decentralized capped	Decentralized uncapped

Source: Gartner (April 2012)

While these funding models are still relevant, we see a shift in how IT organizations approach funding. Specifically:

- The notion of which organizational entity has discretionary IT spending in its budget is increasingly being separated from who *manages* the discretionary IT spending. In other words, even in IT organizations where funding is decentralized, a central organization (IT, a shared-service entity or a portfolio management office) often takes responsibility for the management of the spending and the benefits realization for the investments. This is done to ensure maximum economic leverage, and to eliminate redundant purchases.
- Very few IT organizations control all IT spending today, and cloud computing and consumer IT make it even less likely that they will going forward. Today, about 38% of total enterprise IT spending is done outside of the CIO's central budget. The aim, therefore, should not necessarily be to *control* all spending, but rather to manage all IT investments; that is, to ensure that all enterprise IT investments are tracked and appropriately allocated to IT services.
- Today, most organizations "fund" IT largely based on the asset classes they own, such as infrastructure hardware, software and people. The future state is to fund IT services based on demand and the value that those services provide to the enterprise. Significant progress needs to be made in terms of IT cost transparency to support "service funding." However, funding services would represent a more enlightened approach to budgeting, which tends to be mostly bottom-up, and is often too disconnected from the enterprise strategy.
- As the fight over who controls the IT investment dollars within the organization becomes less relevant, best-in-class enterprises will shift their focus to the *yield* of those investments. For example, leading-edge enterprises are setting ambitious goals to radically change their traditional distribution of "run, grow, transform" IT spending. (This maps to business strategies, which are increasingly focused on growth and innovation.)

Key Concept: Pricing

Cost and price are not the same, of course. A key concept in ITFM involves determining the price of IT services to the internal stakeholders. Traditionally, in most organizations, cost and price were the same. However, there have been many instances in which enterprises have over-recovered or under-recovered their costs to support strategic goals or asset refresh. To be sure, many IT organizations have learned the hard way that it is easier to uplift the cost of an IT service to fund sustainment of the service than it is to ask for funds later to keep the service "fresh."

One issue of which IT organizations should be aware is the expectation of ongoing price reduction around service pricing. Our work with clients suggests that business customers have a tendency to expect year-over-year reductions in the prices of the services provided by the IT organization. This can be problematic, particularly with cloud computing, where we foresee lower unit costs that do not necessarily transfer into lower overall costs due to increased consumption. Therefore, we recommend that IT leaders expose unit prices as well as the overall price of a service.

While the expectation of price reduction over time is also a reality in the traditional world of IT chargeback, this issue is more visible in the service pricing arena (because IT customers have greater visibility into the cost of specific IT services). Simply put, it's harder to conceal IT cost increases in the environment of service pricing. For this reason, we recommend that IT organizations do long-term planning when determining the cost of IT services. In this way, investment spikes that come with upgrades and refreshes can be spread out over several years, provided the IT organization is able to over-recover the cost of services. If long-term planning is not done, then it will be almost impossible to demonstrate year-over-year cost reduction in IT service pricing.

IT organizations should also be aware that the IT/customer relationship is typically transformed with the introduction of service pricing. IT organizations that have gone down this road warn of being treated "like any other supplier." For example, if a BU is under pressure to reduce its operating costs, then it may underestimate its demand for a particular IT service. Therefore, it is important to charge customers based on actual — not estimated — IT usage.

The Commercial Factors of Price

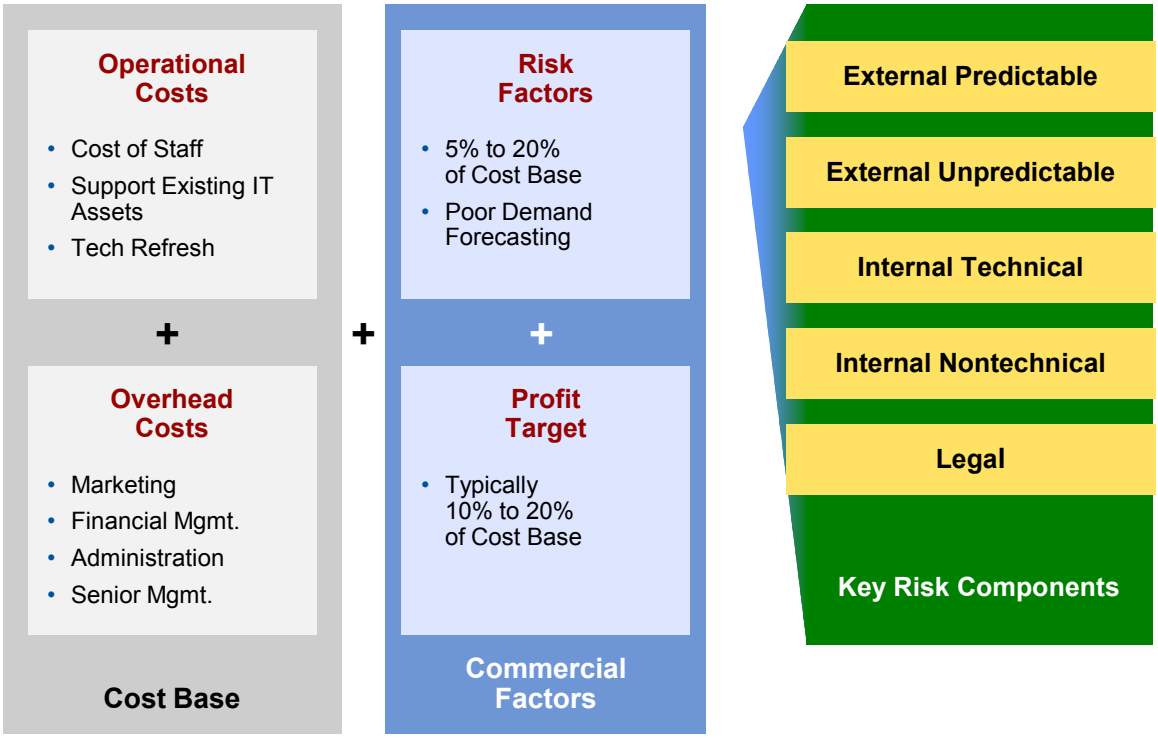
Today, many IT organizations arbitrarily "pad" their numbers to cover unforeseen expenses, and this padding can annoy BUs more than anything else. To eliminate this problem, the IT organization can use a modeling approach to discuss with the BUs what the risk contingency should be. There are two outcomes from such a strategy:

- The BUs understand what the risk contingency is, and can track its accumulation and disposition.
- The BUs elect to have no risk contingency added to their service prices, opting instead to pay for unexpected costs as they arise.

Either option above allows the IT organization to avoid blame for "unexpected" costs, and serves to empower BUs to manage IT cost risks in the way they deem most appropriate. Therefore, we recommend that IT leaders build some kind of risk component into their pricing structure (see Figure 1). To do this, they should consider the factors that are most likely to present a cost risk to IT services. They should ask themselves, "What factors could cause this service to cost more to deliver than we currently estimate?" The list of factors will include internal and external risk — some of which are predictable and some of which are not. For example, poor demand forecasting is a common internal, nontechnical risk. In the external realm, things like vendor pricing increases are of the more unpredictable variety. Generally, IT organizations will underestimate the cost risks because they are trying to keep their prices competitive and do not wish to be seen as "padding." However,

having to pass on unexpected price increases due to poor risk estimating can, over time, be quite deleterious to the credibility of the IT organization.

Figure 1. Key Drivers of Risk for IT Service Pricing



Source: Gartner (April 2012)

Key Concept: Costing

The traditional view of IT costs provides very limited visibility to support the direction in which most IT organizations are heading. Improving IT cost transparency is a key step on the journey to operating as a service brokerage. For many, this journey began years ago with Gartner's total cost of ownership model, which is still relevant for comparing costs of assets. Increasingly, however, organizations are moving toward looking at IT costs by service line.

Many organizations have multiple methods of tracking IT costs and allocating them to users. These methods, however, are still largely manual and often driven by simple spreadsheet management. The ad hoc nature of IT cost transparency and a general lack of automation are problematic for IT leaders; they can result in a poor level of visibility into IT costs for the IT leaders who must price these services.

IT Cost Transparency

IT cost transparency consists of:

1. Creating IT policies, actions and behaviors that enable fact-based visibility into IT costs for IT leaders, and better support decisions about IT resources to internal and external stakeholders
2. Gaining visibility into IT costs to establish legitimacy, responsibility, accountability and comparability for the services that IT offers
3. Enabling fact-based trade-offs between supply costs, and future demand for resources and service levels, and ultimately discovering and sourcing the lowest costs for required service levels
4. Enhancing the implementation of supply-side cost controls that better manage assets and capacity, and that track current and future consumption of IT resources in a more self-regulating and less dictatorial way
5. Developing an understanding of emerging (yet informal) industry consensus for IT per-unit costs and their ultimate drivers, inhibitors, and trends
6. Developing competencies to understand, manage, change, control, and influence current and future IT costs

IT cost transparency contains several elements that can be viewed as a maturity model or a list of areas on which to focus meaningful attention. For example, many organizations have information about IT costs scattered in multiple systems, and these various systems can expose costs in different ways. For example, most organizations have some IT cost data that is mapped to an enterprise or IT chart of accounts. However, this data, in and of itself, may not provide a complete picture of the total cost of IT services. It is often the combination of information from various sources — financial systems, an asset management system and the service catalog — that provides the most complete IT cost transparency to IT leaders.

Responding to specific CFO questions and doing the IT cost analysis that is essential to CIO success are challenging in the absence of systems for tracking IT costs and allocating them back to users. CIOs must work with the finance department to develop an IT cost tracking system that meets the needs of the enterprise. IT executives must also "enlighten" their business executive colleagues to the challenges of capturing hidden IT costs, such as telecommunications and other BU IT charges that often reside outside the central IT budget.

Without the benefits of sound IT cost information, the discussion of IT strategy with business peers is often about who has the right information and whether the business can trust IT's numbers. When there's no debate on the data, business and IT can focus on making the right decisions for the company.

Given the reach IT has across all facets of company operations, having visibility to understand the impact of IT costs on business operations can help identify the technology investments that will drive the strongest return. It will also help the IT organization understand how changes to its strategy affect the strategy of the business.

Start the Transformation to Service-Based Costing

For most companies, costs are tracked based on high-level categories like hardware, software and labor. To get an accurate picture of IT costs and their effects, companies need to move to service-based or activity-based costing, where the high-level spend categories are mapped to the actual services IT provides.

Some companies start this journey by aiming for an optimized state of ITFM without understanding what needs to be fixed internally for service and project delivery. Start this process by understanding IT maturity — it will help guide the evolution.

Don't wait for the data to be perfect. It will take some time before the enterprise has identified and cleansed all the data sources needed to provide a complete picture of IT cost transparency. However, don't wait until the data is perfect before you start using it. With stakeholders, acknowledge that there may be issues with data quality, but also that it is continuously improving.

Whatever costing method is chosen, IT must work with finance to define how costs will be tracked at the organization level to support the tracking of IT expenses, and to determine whether it is beneficial to track these costs on a continuous or ad hoc basis. In addition, CIOs must decide where they will maintain their IT cost data. This decision will vary depending on how the information will be used.

Organizations that see IT cost data as essential for making management decisions will invest more time and effort in creating an IT financial system of record (see "Best Practices in Implementing IT Financial Management Tools"). Organizations that do not see IT cost information as strategic usually put up with the limited views they get of IT costs from whatever data they get from finance. However, with IT becoming more strategic to more organizations (and IT budgets accounting for substantial costs to the firm), more and more CIOs will feel pressured to address IT cost transparency.

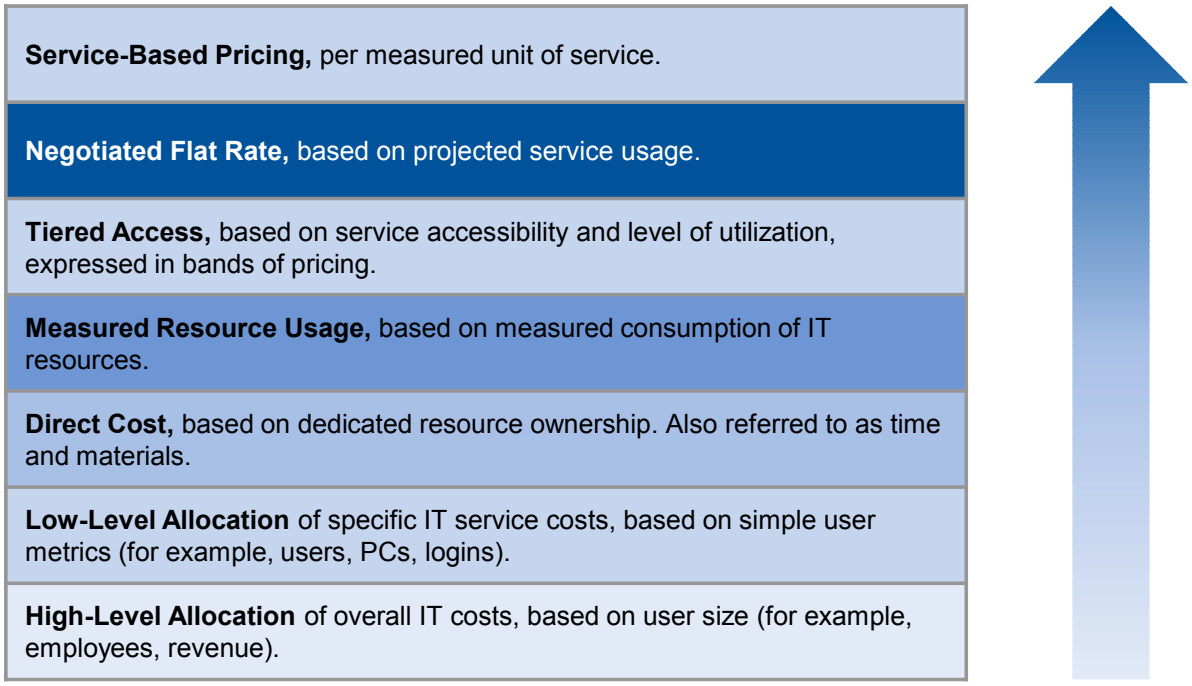
Key Concept: Chargeback

One major benefit of chargeback is that it links IT spending directly to BU activities based on usage, access, capacity, or some other metric that apportions IT service costs. Also, it motivates the BUs to avoid special requests that do not contribute to their bottom lines or lack a solid business case. Thus, the customers of IT provide budget justification via their willingness to pay for the services rendered, and to balance the supply, demand, and price for services.

In addition, chargeback provides the business with a more accurate costing base from which pricing decisions can be made. For many end-customer business products and services, IT support can be significant, and therefore it needs to be included in the price-setting decisions.

We see chargeback in most organizations, and an increasing desire to mature current models toward service-based chargeback. That said, there are still many models of chargeback in use today (see Figure 2).

Figure 2. Seven Common Methods of IT Cost Allocation and Chargeback



Source: Gartner (April 2012)

The Move to Service-Based Pricing

Determining the cost of IT services is an exercise in activity-based costing, whereby the costs associated with a particular service are tracked and considered when determining the "price" of a service. What makes this task complex in IT is that many IT resources are shared among multiple services. Also, the sheer number of IT resources makes the task of developing service pricing daunting.

For example, infrastructure is one area where enterprises are often confounded by how to distribute the costs of the thousands of IT resources that compose infrastructure. Gartner recommends that IT organizations begin by looking at the key components of their infrastructure, such as servers and network services.

Many specific infrastructure components can be assigned to the key IT services provided by the IT organization. However, it is not practical — or even feasible — for organizations to do a one-to-one mapping between every IT resource and a single IT service. Ultimately, the cost of all IT assets — including fully loaded labor for human assets — must be allocated to IT services. However, some assets can have their cost spread proportionately across multiple services that use the assets. This is common for assets that are part of a shared infrastructure, such as storage area networks. The tools to support service-based pricing have improved substantially during the past few years, and many organizations that are serious about service-based costing are migrating away from Microsoft Excel as a chargeback tool.

Still, we see a lot of organizations with questions about service-based pricing that lack well-defined services and service portfolios. We also see many organizations looking to migrate to service-based pricing that have poor IT cost transparency. In fact, chargeback is often the forcing function that spurs organizations to make the necessary investments in improving IT cost transparency.

While the focus of this research is on evolving key ITFM concepts, chargeback cannot evolve much in isolation. It requires improvements in IT cost transparency and pricing models. Also, if it is to be done around services, the implication is that the organization has well-defined services and service portfolios. However, we still see many organizations putting chargeback initiatives ahead of cost transparency and even service definitions.

We also see a hybrid approach combining several methods of chargeback in most large enterprises, and we expect this to continue. Very few enterprises apply one chargeback model to their entire portfolio of services, and we don't see this changing in the next few years.

The starting point for chargeback implementation or reform must be a standardized chart of accounts that supports accurate IT cost capture at a sufficient level of granularity to support decision making at any level that the chargeback committee deems necessary. If a service portfolio is defined, then the chart of accounts should be based on that portfolio, and the cost categories should roll up to the specific services provided. Remember that too much granularity will confuse administrators, and breeds mislabeling or nonlabeling of expenses. The chart of accounts should be reviewed jointly by the IT and finance organizations to eliminate ambiguity about where each cost element is recorded. If the organization has selected a benchmarking provider, then it can provide a pro forma chart of accounts that will render cost comparisons with its database considerably easier.

The higher the method is in the hierarchy shown in Figure 3 (see below), the more sophisticated the IT organization must be to run it. For example, high-level allocation only requires knowledge of total IT cost and the size of the BU, whereas negotiated flat rate requires project management, risk management and estimation skills, as well as a working contingency model to meet agreed-on project budgets.

In addition to those skills, service-based pricing requires service catalogs, tight workflow processes, market price comparisons and service levels to make the system work.

Choosing the Right Chargeback Method

It is tempting to believe that selecting a chargeback method that meets business needs in a sophisticated manner will reduce or eliminate complaints from users and BU leaders. Sadly, the truth is more fractious: Arguments never really go away with chargeback systems. The reason why is because no single chargeback method can deliver everything the BU wants (that is, simplicity, fairness, predictability and controllability). Therefore, the inherent weaknesses in each method will always be legitimately challenged by those who are discontent with the chargeback environment.

Each chargeback method has its strengths and weaknesses, and there are successful working examples for each. The challenge is to balance the desire for a perfect solution with the BU's needs and the administrative capabilities of the chargeback team. It is of paramount importance that the IT

organization understands all the chargeback options that might apply to a particular scope of work, and that it helps the BUs understand the options.

As a result, choosing a chargeback system essentially means choosing which of a number of weaknesses the organization is willing to accept and live with, and ensuring that BU leaders understand the trade-offs (see Figure 3).

Figure 3. Comparative Strengths and Weaknesses of Different Chargeback Methods

Chargeback Approach	Simple	Fair	Predictable	Controllable
Service-Based Pricing	○	●	◐	●
Negotiated Flat Rate	◐	◐	●	●
Tiered Access	◐	◐	◐	○
Measured Resource Usage	◐	●	○	○
Direct Cost	◐	◐	◐	●
Low-Level Allocation	●	◐	◐	○
High-Level Allocation	●	○	●	○

Key to Support: ● Strong ◐ Average ○ Weak

Source: Gartner (April 2012)

Conclusion

The reality is that many organizations will have to start from scratch when developing the key component of ITFM to meet the future needs of the enterprise. Existing costing and chargeback models — which were largely device-driven — are not very transferable to the new model of IT service pricing that is emerging. The work done in device-driven chargeback, however, can be useful in understanding service component costs.

When tackling service pricing, IT organizations should ensure that the "basics" of sound ITFM are there first, as well as well-defined IT services. In addition, maturing the key concepts of ITFM requires a good working relationship with finance, solid IT service definitions, and appropriate visibility into IT costs. The goal should be to provide a mechanism for the IT organization and its customers to manage costs and extract the maximum business benefits from information technology.

Recommended Reading

Some documents may not be available as part of your current Gartner subscription.

"The 10 Biggest Chargeback Myths: Nurture Them at Your Peril"

"Most IT Leaders Charge Back IT Costs; What About You?"

"IT Metrics: IT Cost Transparency Action Plan, Definition and Performance Metrics to Start the Journey"

"IT Metrics: New Economic Rules of IT Spending and Staffing Metrics"

"IT Metrics: Align IT Investment Levels With Strategy Using Run, Grow, Transform and Beyond"

"Cloud Computing: Economic, Financial and Service Impact on IT Planning Assumptions"

"Using IT Financial Management to Improve Business Outcomes"

"Ten Lessons Learned as an IT CFO"

"Best Practices in Implementing IT Financial Management Tools"

"IT Budgeting: Fundamentals"

"Jump-Start the IT Budget Process"

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