Funding IT

Outline

- Funding the IT resources
- How much does it cost?
- IT portfolio management
- Valuing IT investments
  - Balanced scorecard

Funding the IT resources

- How are costs associated with designing, developing, delivering and maintaining IT systems recovered?
- There are three main funding methods:
  - Chargeback
  - Allocation
  - Corporate budget
- The first two are done for management reasons, while the latter recovers costs using corporate coffers

Funding Method	Description	Why do it?	Why not do it?
Chargeback	Charges are calculated based on actual usage	Fairest method for recovering costs since it is based on actual usage	Must collect details on usage Often expensive and difficult
Allocation	Expenditures are divided by non-usage basis	Less bookkeeping for IT	IT department must defend allocation rates
Corporate Budget	Corporate allocates funds to IT in annual budget	No billing to the businesses. Good for encouraging use of new technologies.	Have to compete with all other budgeted items for funds

Figure 10.1 Comparison of IT funding methods

Chargeback

- IT costs are recovered by charging individuals, departments, or business units
- Rates for usage are calculated based on the actual cost to the IT group to run the system and billed out on a regular basis
- Pros: chargeback systems are popular because they are viewed as the most equitable way to recover IT costs
- Cons: creating and managing a chargeback system is a costly endeavor

Allocation

- Recovers costs based on something other than usage, such as revenues, log-in accounts, or number of employees, etc.
- Pros: it is simpler to implement and apply
- True-up process is needed where total IT expenses are compared to total IT funds recovered from the business units
- There are two major problems:
  - The 'free rider' problem: not based on usage, equitable?
  - Deciding the basis for charging out the costs

Corporate Budget

- Rather than levying charges on specific users or business units, corporate allocates funds to IT as part of annual budget
- Pros: No requirement to calculate prices of the IT systems and hence no financial concern raised monthly by the business managers (no billing to businesses)
- Cons:
  - Compete with all other budgeted items for funds
  - Arise the issue: "it's free"

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HOW MUCH DOES IT COST?

- Most basic method of determining costs is to add up all of the hardware, software, network, and people involved in IS
- **Real cost is not as easy to determine**
  - Activity Based Costing (ABC) counts the actual activities that go into making a specific product or delivering a specific service
  - Total Cost of Ownership (TCO) looks beyond initial capital investments to include other costs

Total Cost of Ownership

- Total Cost of Ownership (TCO) is an industry *best practice*
  - Costs associated with tech support, administration, and training
  - Estimates annual costs per user for each potential infrastructure choice; these costs are then totaled
  - Soft costs, such as technical support, administration, and training are definable
- TCO helps managers understand how infrastructure costs break down (see http://www.wilsonmar.com/1tco.htm)
  - It provides the fullest picture of where managers spend their IT dollars as TCO results can be evaluated over time against industry standards

TCO Component Breakdown

- See Figures 10.2, 10.3
- For shared components like servers and printers, TCO estimates should be computed per component and then divided among all users who access them
- For more complex situations, such as when only certain groups of users possess certain components, it is wise to segment the hardware analysis by platform
- Soft costs, such as technical support, administration, and training are easier to estimate than they may first appear

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IT Portfolio Management

- IT investments should be managed as any other investment would be managed by an organization
- Often involves picking the right mix of investments
- Goal is to invest in most valuable IT initiatives

Asset Classes

- There are four asset classes of IT investments:
  - **Transactional systems** – systems that streamline or cut costs on business operations
  - **Informational systems** – any system that provides information used to control, manage, communicate, analyze or collaborate
  - **Strategic systems** – any system used to gain competitive advantage in the marketplace
  - **Infrastructure systems** – the base foundation or shared IT services used for multiple applications

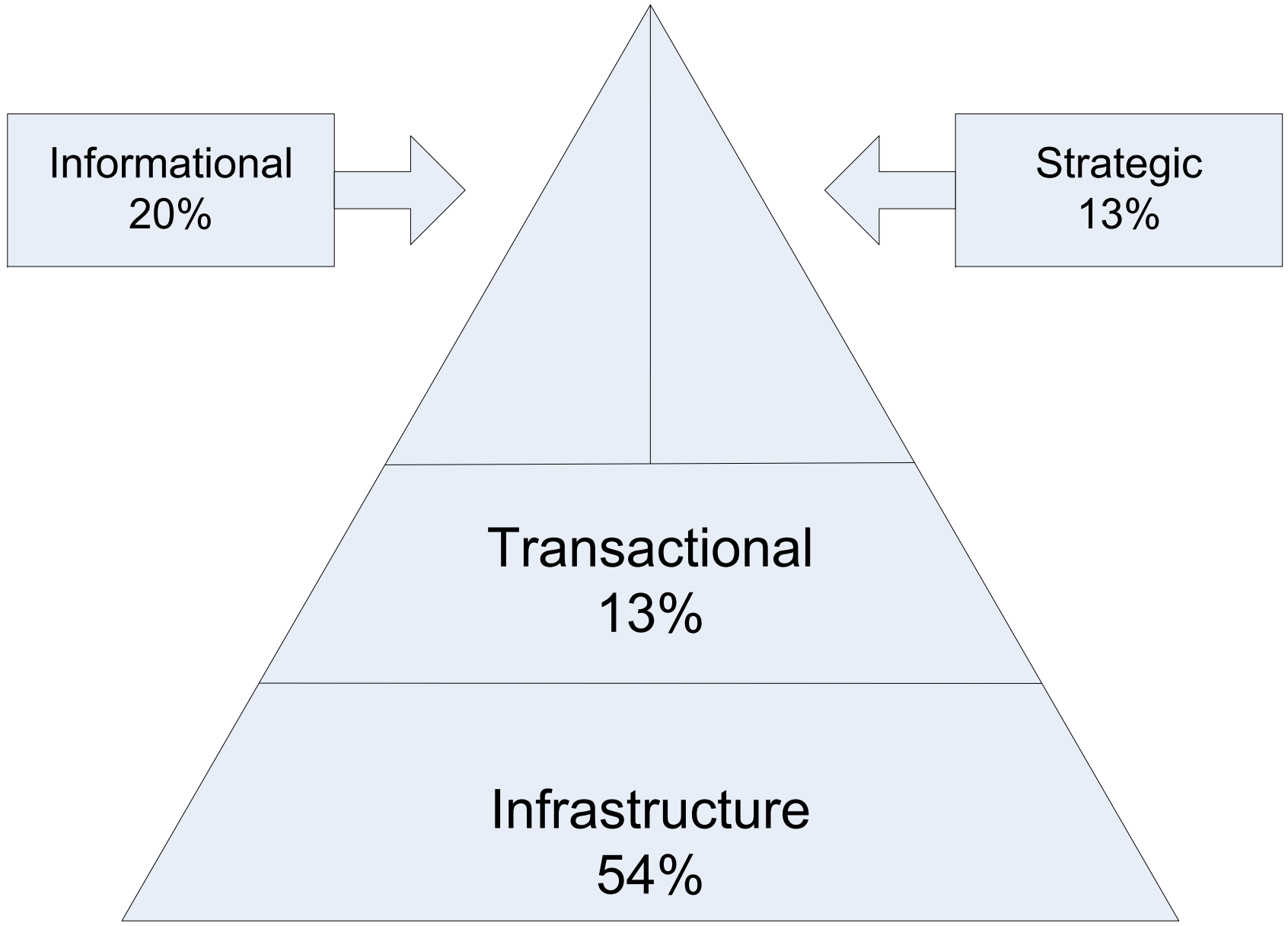

Figure 10.7 Average Company's IT Portfolio Profile

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Valuing IT Investments

- Soft benefits, such as the ability to make future decisions, make it difficult to measure the payback of IT investment

Valuation Method	Description
Return on Investment (ROI)	ROI= (Estimated lifetime benefits-Estimated lifetime costs)/Estimated lifetime costs
Net Present Value (NPV)	Calculated by discounting the costs and benefits for each year of system's lifetime using present value
Economic Value Added (EVA)	EVA = net operating profit after taxes

IT Investment Monitoring

- "If you can't measure it, you can't manage it"
- Management needs to make sure that money spent on IT results in organizational benefits
- Must agree upon a set of metrics for monitoring IT investments

The Balanced Scorecard

- Focuses attention on the organization's value drivers (which include, but not limited to, financial performance)
- Companies use it to assess the full impact of their corporate strategies on their customers and workforce, as well as their financial performance
- This methodology allows managers to look at their business from four perspectives:
  - Customer (how do customers see us?)
  - Internal business (at what must be excel?)
  - Innovation/learning (can we continue improving & creating values?)
  - Financial (how do we look to shareholders?)

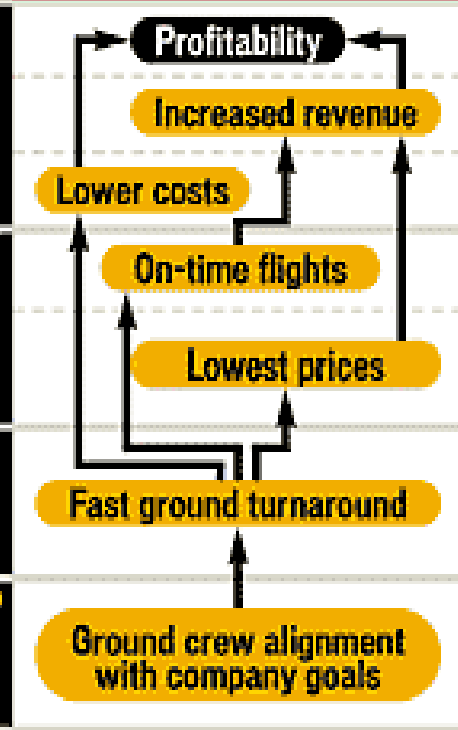
Dimension	Description	Example IT Measures
Customer Perspective	Measures that reflect factors that really matter to customers	User defined operational metrics
Internal Business Perspective	Measures of what the company must do internally to meet customer expectations.	IT process metrics, project completion rates, system operational performance metrics
Innovating and Learning Perspective	Measures of the company's ability to innovate, improve and learn	IT R&D, New technology introduction success rate, training metrics
Financial Perspective	Measures to indicate contribution of activities to the bottom-line	IT project ROI, NPV, IRR, cost/benefit, TCO, ABC

Figure 10.8 Balanced Scorecard applied to IT departments

SWA Balanced Scorecard Solution

SOUTHWEST AIRLINES' BALANCED SCORECARD:

What It Looks Like



Objectives	Measures	Targets	Initiatives
Profitability	Market value	30% CAGR*	
Increased revenue	Seat revenue	20% CAGR	
Lower costs	Plane lease cost	5% CAGR	
On-time flights	FAA on-time arrival rating	No. 1	Quality management
Lowest prices	Customer ranking (market survey)	No. 1	Customer-loyalty program
Fast ground turnaround	Time on ground	30 minutes	Cycle-time optimization program
	On-time departure	90%	
Ground crew alignment with company goals	% ground-crew shareholders	Year 1: 70%; Year 3: 90%; Year 5: 100%	Employee stock option plan
	% ground crew trained		Ground-crew training

* CAGR = compound annual growth rate

■ **A balanced scorecard takes a broad, holistic look at organizational goals – not just the financials.**
For example, this Southwest Airlines scorecard shows that well-trained ground crews mean faster turnaround and more on-time flights, which lead to higher customer satisfaction, lower costs and greater profits.

Summary

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- Next lecture: chapter 11