my view

By Paul A. Strassmann

Budgeting for IT in hard times

AS THEY REVIEW information technology budgets for 2004, executives need to think about a fresh approach that takes into account the reality of our times. And that reality is that this year, every dollar they spend will have to be justified. In June, Standard & Poor's Compustat data service reported the following statistics for 3,329 U.S. firms with total revenues of $5.8 trillion, accounting for about 45% of major listed firms:

Returns on shareholder equity declined from 14.7% for 1995 through 2000 to 5.6% for 2001 and 2002. That means that in the last two years, shareholders were not compensated for their cost of capital.

The annual growth rate in revenue has declined from 10.6% for 1996 through 2000 to 2.0% for 2001 and 2002. Immediate prospects for a turnaround are dim.

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Median IT spending as a percent of revenue has not decreased since 1995 and still stands at 3.4%. Meanwhile, profits as a percent of revenue have declined from a decade of 5.8% net profits to only 2.5% since 2001. For the past two years, IT spending has exceeded profits!

One of the most telling measures of IT effectiveness is the ratio of "transaction costs" (such as administrative sales and general expenses) to the cost of goods and services. Despite an estimated three trillion dollars of spending on IT since 1995, this ratio has not declined. Transaction costs related to the sale of goods and services still hover at 29.5% of the cost of those goods and services.

There's no doubt that future budget reviews will concentrate on cost cutting as the only cure for current fiscal pains. Proposals will have to demonstrate how their benefits will be verified.

Current studies are showing that IT has been consuming a rising share of corporate transaction costs, ranging from 11% in industrial firms to more than 30% in banking. To meet tough fiscal targets, this is what the budget reviewers will likely seek:

The 10% to 20% of IT budgets listed as "investment" in the S&P report will be viewed as totally discretionary spending. IT project returns on investment will compete against all investment opportunities.

The remaining IT costs, usually tagged as operations, maintenance, mandatory fixes, and modernization, will be subjected to line-item approvals. Based on my conversations with CIOs, budget examiners will accept vendor claims of rapidly falling prices and ask for better than 15% reductions.

Though cuts in IT spending can deliver respectable savings, if, as the S&P data states, IT costs are only 3% of gross revenue and transaction costs are nearly 30%, we have to examine where the real money is. I have found that even efficient IT operations incur excessive costs because they must support complex and redundant transaction work flows, often involving a seemingly never-ending paper trail from one department to the next. Traditionally, the CIO has neither visibility into this piece of the cost puzzle nor the charter to modify it. If there is to be resumption in the growth in IT, that has to change.

The best possible result of a 2004 IT budget review would be to use savings from the IT budget to finance a revamping of transaction processes aimed at reducing their complexity. The CEO, the COO, and even the CFO would applaud that.

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