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# Costing and Cross-Charging IT Services

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- ▶ *A Practical Approach to Costing in  
IT Shared Services Units*

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Audience: This paper is intended for financial and management accountants involved in costing and cross-charging IT services inside their organization.

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## Executive Summary

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In sectors such as telecommunications and financial services, the IT function can account for a quarter of total costs. Yet, in many instances, there's a limited understanding of what's driving the resources and costs tied up in IT. When CEOs sought cost savings in the past, they typically looked to the direct costs in the business. But these have been shaved back to the bone, and now CEOs must seek to understand the costs they have tied up in IT and other corporate shared service functions, as these are becoming the only remaining opportunity for significant cost savings.

Many organizations have introduced shared services business units in order to realize economies of scale and therefore reduce the total cost of corporate support functions. While this may result in a step change in total IT costs, other challenges remain. With all IT support centralized, how do you ensure that IT is accountable to the business units it supports? What methodology should be used for calculating cross-charges back to the business units? How can you justify these costs and track them with demand?

In many organizations, cross-charges are a constant source of irritation and bickering between the shared services provider and the business units. Why? Because there's often a limited understanding of how the demands of the business unit influence these costs, with cross-charges often being little more than a simple apportionment of total IT costs.

To develop a deeper understanding of how and why IT costs are incurred and provide a firm basis for cross-charging, many shared services units are using activity-based costing (ABC). Not only does ABC provide detailed information to business units about their consumption of central resources, it also provides a common understanding for reducing shared services costs.

This white paper examines the role of ABC in shared services costing and concludes with two case studies to illustrate how organizations have adopted ABC to successfully manage shared services costing.

## Shared Services: The New Focus for Cost Management

After several years of cost reduction in many sectors, business units that carry the majority of direct costs are likely to have little left to cut without impairing their ability to carry out their main activities. The pie chart in Figure 1 shows a typical cost-center from a telecommunications provider. Here, over half the costs carried by the responsibility manager's profit and loss account are allocations from shared services departments or other corporate overheads. If this enterprise seeks a modest 5% reduction in costs, the manager essentially only has two options: to try to remove 10% from his or her own direct costs—most of which have to do with people—or to lobby the executive to critically examine the costs of the shared services functions.

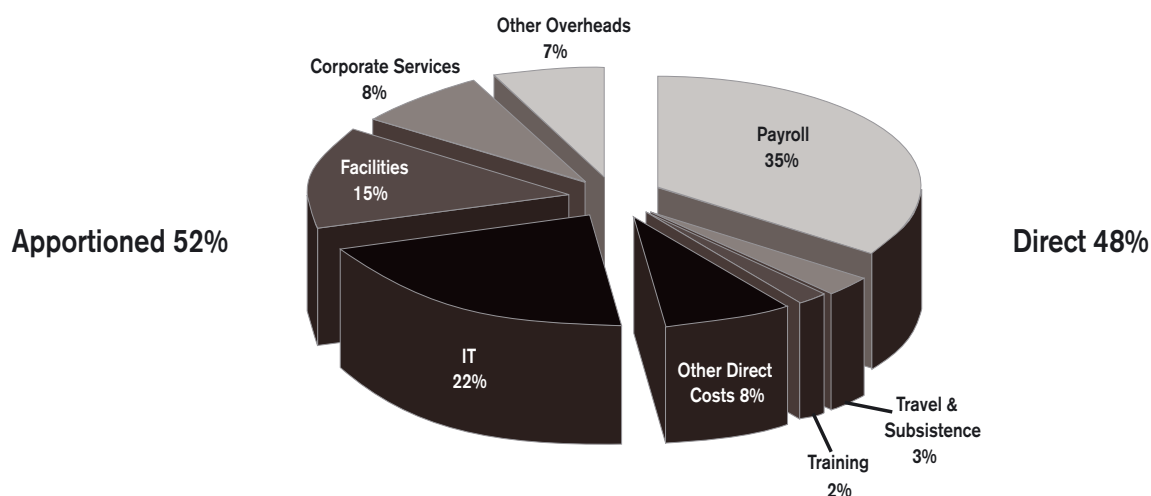


Figure 1.

In recent years, many organizations have effectively reduced the costs of providing support services to their businesses simply by concentrating them in corporate shared services departments. This resulted in a step change in the costs of support services—such as IT, HR, and facilities—and was considered to be “best practice.” With the phenomenal growth of outsourcing, there are opportunities to cut the costs of shared services functions even further, moving them to local third-party providers or even across continents, where the required skills can be sourced for a fraction of local costs. Again, this will result in a step change in the cost of support services and may give an enterprise a cost advantage over its competitors.

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## Two Challenges Confronting Shared Services

However, despite the gains to be had by building shared services departments and by locating them where the required skills can be obtained at the lowest cost, many organizations still have a limited understanding of the dynamics of the shared services function. In essence, there are two related issues:

### Understanding the Cost of Shared Services

Despite being a large proportion of an enterprise's costs, in many organizations the costs of shared services functions such as IT and HR are simply apportioned to the profit and loss accounts of business units, based on some easily available metric—such as revenue, headcount, or full-time equivalents (FTEs).

### Aligning Shared Services Resources With Forecasted Business Unit Demands

Shared service departments tend to plan their resources and budget separately from the operational planning and budgeting process of business units. As the financial year progresses, the capacity of shared services departments and the demands of operational business units can become grossly misaligned. The following scenario is not uncommon:

- ▶ The business units produce their operational plans and budgets.
- ▶ The shared services units construct their own operational plans and budgets, with a cursory glance at those of the business units.
- ▶ The costs of the shared services functions are fixed and apportioned to the business units P&Ls for the coming year, based on some arbitrary driver.
- ▶ The majority of organizations do not reforecast their operational plans or budgets as frequently as they wish<sup>1</sup> so that, inevitably, the demands of the business units and the capacity of the shared services functions can easily become misaligned.
- ▶ As the year progresses, any variance above the budgeted cost of the shared services functions that appears on a responsibility center manager's P&L becomes an increasing source of frustration and annoyance. The shared services provider cannot adequately explain it; the responsibility center manager, who has been ruthlessly managing his or her own direct costs throughout the year, can only argue that the apportionment is unfair and that other business units should pick up more. Neither the shared services provider nor the responsibility center manager has sufficient insight to have a productive discussion.

At the same time, the boards and executives of many organizations grapple with authorizing continuing investment from shared services functions, such as IT, without insight as to how such spending relates to the demands of the business units, or how it will impact long-term profitability. Regardless of whether shared services are provided in-house or by a third party, organizations need far better insight into these costs—and particularly into the costs of the IT function, which for many is simply a black hole.

<sup>1</sup> Business Objects reforecasting survey 2002-05 found that more than half of the UK's leading organizations would like to more frequently reforecast their financial performance.

## Gaining Insight Into IT Costs

Figure 2 shows some of the services an IT shared services function might typically provide to business units and other shared services providers, such as HR and facilities.

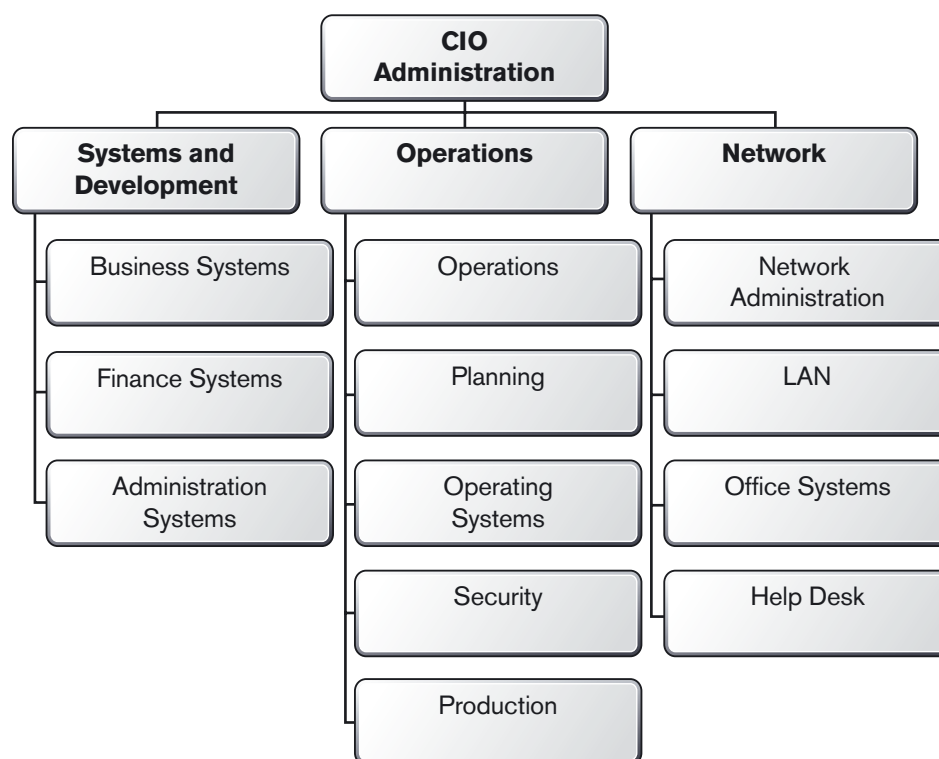


Figure 2.

To fully understand the costs of the IT function so they can be allocated to the business units, in line with the way in which they consume IT resources, any costing methodology needs to:

- ▶ Correctly allocate IT costs from the general ledger to the services that IT provides to the business units.
- ▶ Capture and incorporate other costs from other departments that should be allocated to the provision of IT services. These may include such things as property costs from the facilities cost-center, and recruitment and payroll costs from the HR cost-center.
- ▶ Realistically reflect that—just as HR provides services to IT, IT provides services to HR – and that to calculate the true cost of providing a service, these reciprocal costs should be passed between these departments reiteratively until they become insignificant, while still providing an audit trail.

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- ▶ Capture and reflect the fact that different business units use different IT services. For instance, some business units may have a need for secure payment processing over the web, in addition to more general firewall and antiviral security on the desktop network.
  - ▶ Capture and reflect the fact that certain parts of the business may use the same service differently. For example, an IT service such as help desk support may be allocated to business units based on the number of times they use it. However, due to a lack of internal expertise, the time taken to resolve the help desk queries for some business units may be far in excess of others.

Given the complexity that can result from multiple line items, services, cost drivers, and business units—as well as the need for being able to trace cross-charges right back through the allocations to line items in the general ledger—the only way to reliably understand complex shared services costs is by adopting an activity-based costing (ABC) methodology and deploying an application capable of managing the true multidimensionality of the costs involved. The need to better understand and manage IT costs prompted IT analyst Gartner to recommend, as a tactical guideline, to “implement activity-based costing techniques that track the cost of delivery.”<sup>2</sup>

<sup>2</sup> Enterprises Should Assess How Their IT Spending Stacks Up, Gartner Research Note, Article IGG-08132003-01, 13 August 2003.

## How ABC Might Apply to IT Shared Services Costing

While some line item costs that appear in the general ledger of an IT department might be relatively easy to understand and can be directly allocated to a business unit, many line item costs will need to be reallocated to new cost pools, where they can be combined with other costs from the departments that provide support to IT—such as HR and facilities. Some of these cost pools may then be allocated directly to services, but the majority will be allocated to the activities that IT staff perform to better understand how they relate to the services the IT function provides. Figure 3 shows how ABC might be applied to IT shared services costing.

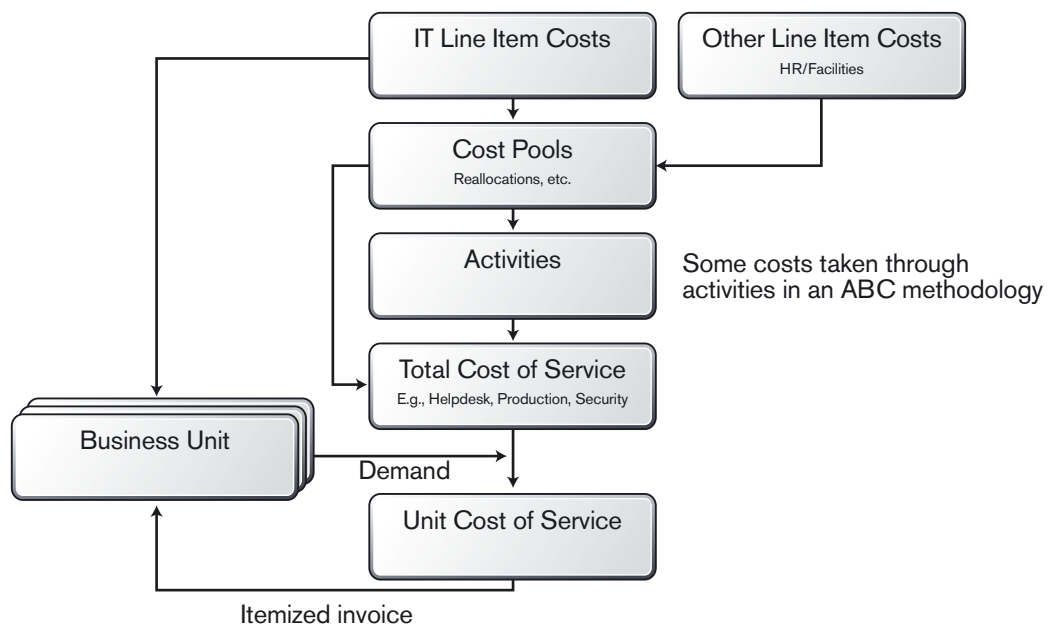


Figure 3.

Evidently, the costs of hardware and software need to be amortized over their lifetime to avoid spikes in calculated costs at the time of the investment. Much of this data can be directly imported into the ABC model from the asset register. Similarly, many IT departments deploy time capture systems to record the amount of time that staff—such as programmers—spent on individual projects, and data from these systems can be directly imported, saving considerable effort in collecting nonsystem driver data.

### Standardized Service Definitions

Organizations frequently benchmark their IT costs against their industry peers, and this has led to companies that use ABC to adopt one of the standardized service definitions as cost objects. The IT Infrastructure Library (ITIL), which was created by the UK government, is rapidly being adopted across the world as the standard for best practice in the provision of IT services. However there are others in use.

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## Options for Cross-Charging

Once the total cost of a service is calculated, there are various options for calculating a unit rate for cross-charging the business units for their use of the service.

### Demand-Based Pricing

If an organization wishes to fully allocate the total cost of the IT function across the business units, the unit rate charge is typically based on the total cost of the service during the period, divided by the actual demand for the service during the period. This leaves the IT function with no residual costs.

### Capacity-Based Pricing

However, other options are possible. The rate could be based on the total cost of the service during the period, divided by the amount of the service available during the period; that is, it's based on the capacity of the IT function rather than the demand of the business units. Here, if the service is overresourced and IT is able to provide more than the business units consume, IT will be left with residual costs—and this may drive them to reduce capacity during the next period.

Some shared services units are operating as profit centers and, in these instances, ABC may be used to calculate a rate based on either of the methodologies above—to which a fixed or percentage markup may be added before being charged out to the business units.

Ultimately, the choice of pricing methodology can lead to an underrecovery or overrecovery of IT costs. Unless rules are set for how any under- or over-recovery of IT costs will be balanced out in future periods, this may give rise to resentment from the business units, who could feel that they're "overcharged."

Organizations should also explore whether it's prudent to have underrecovered or overrecovered amounts in their year-end accounts, and they may wish to involve their auditors in this discussion.

## Benefits of Using ABC in IT Shared Services Costing

Having adopted an ABC methodology for costing IT services, organizations will have a detailed understanding of the services provided by IT, the activities involved in providing them, and how they consume resources and costs. Detailed invoices can be produced showing the business units' use of the service, the unit price and the total cross-charge, and—should more detail be required—with an ABC methodology, the costs can be traced back to their origin.

But by fully understanding what activities are consuming resources and costs, and which are value-adding or nonvalue-adding, the business unit and the IT function are better placed to enter into a dialogue and understand how they can work together to reduce costs. This may involve no more than taking simple steps to adjust service levels, such as response times or batching transaction processing, to give reduced setup costs. Removing nonvalue-adding activities can help to reduce costs by as much as 5%,<sup>3</sup> far in excess of the cost of deploying ABC, giving an immediate return on any investment.

<sup>3</sup> Source: Accenture CFO Project Vol 2 October 2003.

## Realigning Shared Services Resource With the Business

A second challenge for organizations is to frequently realign the resource and capacity of shared services functions with the needs of the business units. For this to happen, organizations need to progress towards more frequent reforecasting so that business units are routinely updating the key nonfinancial data that drives their shared services demands. The shared services functions can then use this information to realign their own resource requirements for the coming periods, taking their actual costs through an ABC methodology to calculate monthly cross-charges that are passed back to the business units.

Figure 4 represents where an organization's shared services functions might lie in terms of its costing and planning. The vertical axis represents the reliability and robustness of its shared services costing, while the horizontal axis represents the degree to which the planning and budgeting of the business units and the shared services provider are integrated.

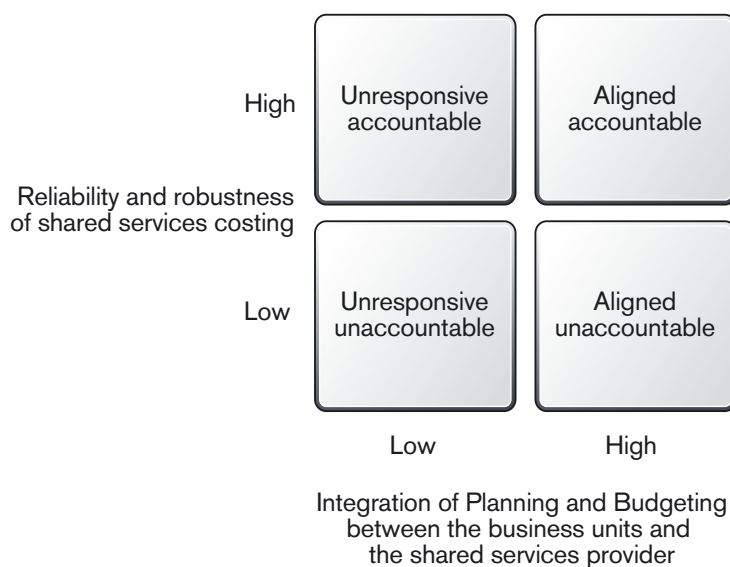


Figure 4.

As such, the top left quadrant represents any organization that has already adopted an ABC methodology for costing IT shared services and is highly accountable to the business units. But having implemented a reliable and robust costing methodology, the organization's challenge is now to receive more frequent forecasts of demand from the internal business users so that it can keep its own resources and operational costs in line. Once it achieves this and IT resources are more closely aligned with the needs and demands of the business units, the organization would move to the top right quadrant.

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## Case Study Examples

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### Cooperative Insurance Services (CIS)

Formed in 1867, Cooperative Insurance Services (CIS) is the only cooperative in the UK insurance sector, with 4.5 million customers and more than £20 billion of funds under its management. Its parent, The Co-operative Group, is one of the world's largest consumer cooperatives, owned and controlled by its members, and serving millions of people across the UK with a diverse product offering—including food retailing, holidays, banking, insurance, cookware, and funeral services.

As the insurance market has become more competitive following successive mergers and new entrants, David Grattan, chief accountant at CIS, recognized the need to develop a better understanding of how individual products were incurring costs. To provide reliable costing information in a complex multiproduct, multichannel business, however, traditional costing techniques, it was believed, would be insufficient. Fortunately, the costing accountant at CIS had previous experience with ABC and knew that it could provide a robust methodology for allocating expenses when costing products.

CIS uses ABC data to accurately assign IT costs to the departments and products that consume IT activities. The IT department itself carries no residual cost, as all costs are continually allocated out of IT into other departments. IT provides seven principal services under the following headings:

- ▶ New systems
- ▶ Mid-range system support
- ▶ Laptop services
- ▶ Mainframe system support
- ▶ Desktop support
- ▶ Communication services
- ▶ Data preparation

IT personnel enter their activities on timesheets and mark them against the 1,000 codes in their database. Each of the codes represents an activity against one of the services listed above, categorized by product or product group. So, for example, when employee Andrew requests IT support to run a data extract, the cost of performing that activity is allocated out of IT into Andrew's cost-center.

According to the cost accountant, the key success factors for implementing shared services costing were having an existing timesheet system in place and an IT manager with a strong customer focus.

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## Groupe Casino

With over 7,000 stores throughout France trading under 40 fascias—including Géant, Casino Supermarché, Monoprix, Casino Superstores, and Casino Supermarkets—Groupe Casino has gained a leading edge in the French food retail trade and has an enviable financial performance, with an improvement in earnings per share in each of the last five years.

To streamline its IT costs, Groupe Casino created a dedicated division, Casino Information Technology (Casino IT), to coordinate all of its computer assets under one roof. Organized into departments (analysis, production, technical, financial, etc.), Casino IT provides all subsidiaries of Groupe Casino with its IT services.

Previously, Casino IT used a complex system based on data collected from various Excel spreadsheets for costing and cross-charging. This proved difficult to use for controlling the company's activities and communicating across the entire organization. Concerned with transparency and wishing to establish optimal cost management, Casino IT sought a reliable solution that would enable it to:

- ▶ Receive input automatically from upstream systems (measurement data, time tracking, etc.)
- ▶ Calculate the costs of services provided
- ▶ Automatically cross-charge these costs to its 40 internal customers, based on their use of the services with a fully detailed invoice of how these charges were calculated

Following an in-depth evaluation process, Casino IT's chief of analysis, Joel Rouressol, explains the reason for selecting Business Objects Activity Analysis: "What convinced us to select the Business Objects application ahead of the competition was its open architecture. Plus, its ability to operate on a UNIX platform, the modeling capabilities using an activity-based costing method, and the ease with which data collection occurs and accounting reports can be generated and circulated via our intranet."

BusinessObjects Activity Analysis will help Casino IT achieve its goals by ensuring each and every department, branch, or subsidiary in Groupe Casino is billed with the highest degree of accuracy for the IT services it uses. Casino IT will also gain the visibility to ensure each user becomes responsible for its consumption of IT services and has better control over the volumes of services and hardware it purchases. It will also provide Casino IT managers with a tool for controlling costs of the projects they personally manage. "We were sold on the product's flexibility for modeling, as well as the ability of the Business Objects team to understand our particular requirements," says Cecile Boissonnet, administration and finance director at Casino IT. "This project falls under a global move to reshape our management methods."

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## Conclusion

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### How Business Objects Can Help

Business Objects shared services solutions make superior forecasting and management decisions possible for shared services executives and their customers. Business Objects offers a range of applications suitable for organizations of varying size and complexity, the most recent addition being IT Services Costing. With the click of a mouse, key stakeholders can analyze performance results in a graphical, web-based interface and quickly access critical information at the right level of detail. At the core of this solution is Business Objects advanced activity-based management (ABM) calculation engine, which provides the information to enable better decisions on cost reduction, service level agreements, and resource deployment strategies.

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## Resources

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Accenture CFO Project, Volume 2, October 2003.

BusinessObjects, reforecasting survey, 2002-2005.

[www.businessobjects.com/news/press/press2005/20051129\\_businessweek\\_epm\\_study\\_comp.asp](http://www.businessobjects.com/news/press/press2005/20051129_businessweek_epm_study_comp.asp)

Gartner Research Note, Enterprises Should Assess How Their IT Spending Stacks Up, Article IGG-08132003-01, 13 August 2003. [www.gartner.com](http://www.gartner.com)

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