



Service Costing 101: Managing Overhead & Shared Costs

Executive Summary

Abstract

As you begin to build your cost modeling processes, you will inevitably come across many forms of overhead and shared costs. Organizations have various definitions and naming conventions for these types of expenses. In this presentation, we will discuss different types of overhead and the various methods for incorporating them into your cost of IT services.

Outline

- ITFM Framework
- Cost Modeling Methodology
- Allocation Method Examples for Overhead and Shared Costs
- Socializing Fully-Loaded Rates
- Recommendations & Take-Aways



Introductory Example: Pizza as a Service



MarketWatch 
@MarketWatch

Follow

The cost to make a Margherita pizza: \$1.77
How much restaurants charge on average for a pizza: \$12
Markup: 580%

How much does it cost a restaurant to make a pizza?

Cost of each item in the dish versus the actual price you pay

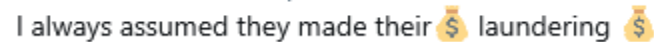
Meat pizza		Margherita	
Item	Cost	Item	Cost
Mozzarella	\$0.60	Mozzarella	\$0.90
Parmesan	\$0.35	Basil	\$0.48
Pepperoni	\$0.24	Flour ("00")	\$0.15
Italian sausage	\$0.18	Olive oil	\$0.13
Flour ("00")	\$0.15	Flour (AP)	\$0.05
Olive oil	\$0.09	Tomato sauce	\$0.05
Black olives	\$0.08	Kosher salt	\$0.01
Mushrooms	\$0.05	Active dry yeast	\$0.00*
Green bell pepper	\$0.05	Total cost	\$1.77
Flour (AP)	\$0.05	Price (average)	\$12.00
Tomato sauce	\$0.05	MARKUP	580%
Red onion	\$0.02		
Kosher salt	\$0.01		
Active dry yeast	\$0.00*		
Total cost	\$1.90		
Price (average)	\$14.00		
MARKUP	636%		

* Cost is less than one cent per meal

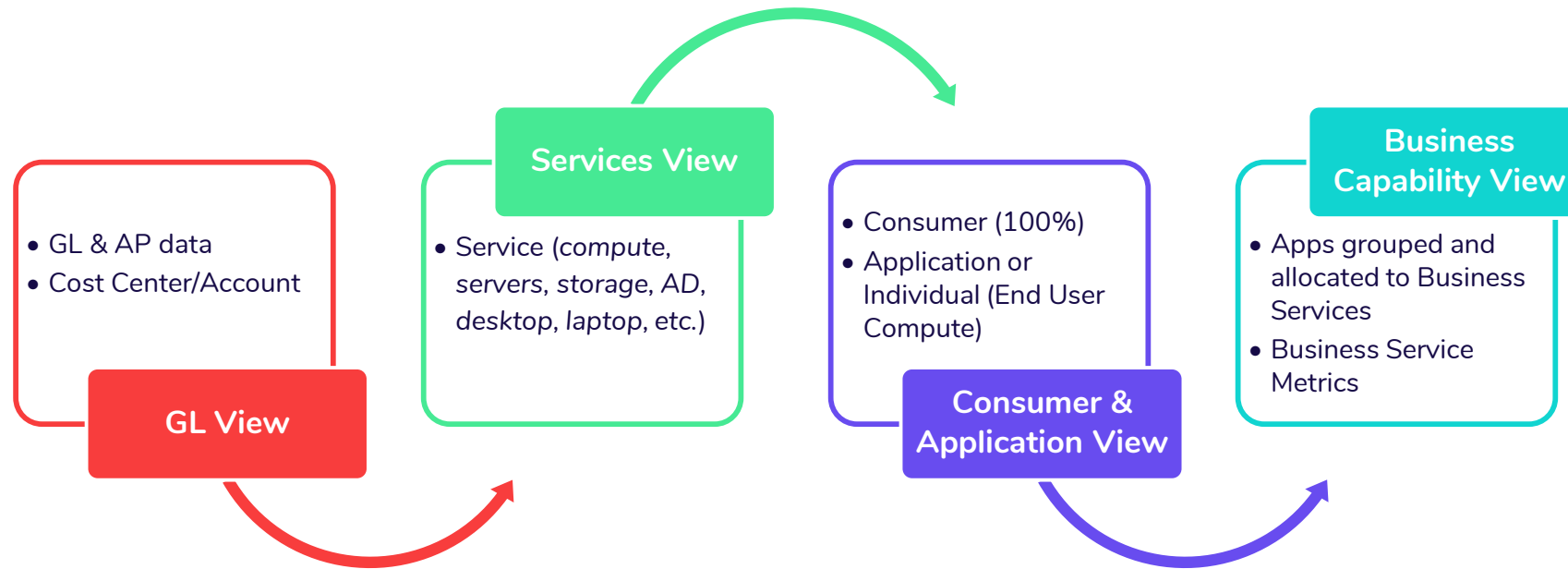




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IT Financial Management – Practitioner's Framework

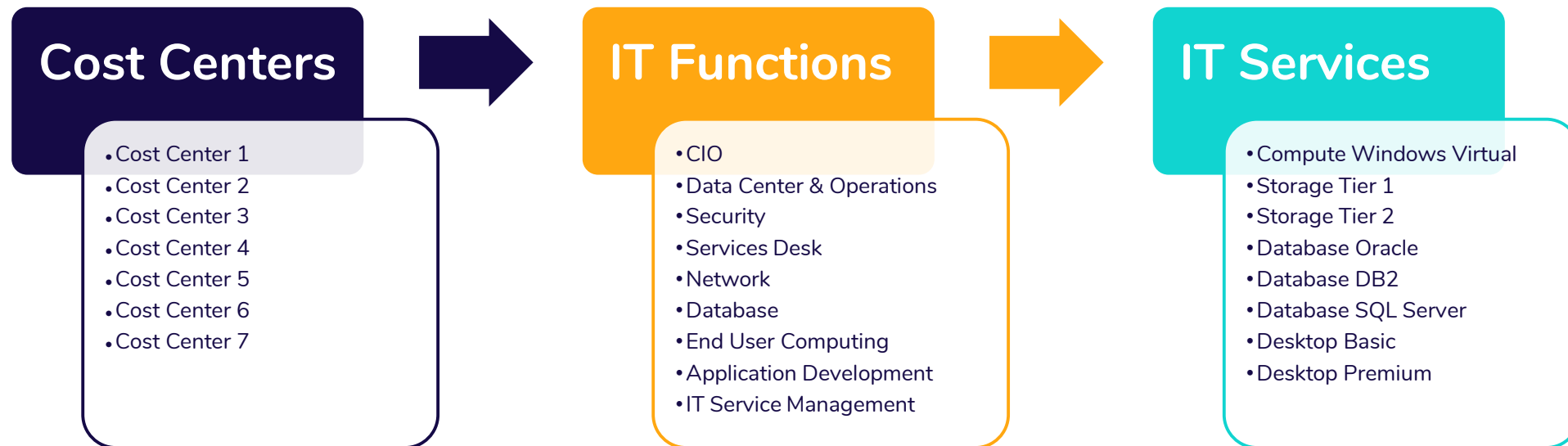


- ITFM is basically *allocated* views of IT spend
- Each view is generated by a separate module
- Each view provides value to key stakeholders
- **Services View**: Provides insight into technology service costs and unit rates. Enables Service managers to *drive down* unit rates and *benchmark* against outside suppliers and peers

- **Consumer View**: Provides insight into what organizational entities benefit from IT and helps the CIO demonstrate value
- **Application View**: Provides the Total Cost Ownership (TCO) of Applications and enables *application rationalization* exercises
- **Business Capability View**: Provides insight into costs to support business capabilities. Helps the CIO *align* existing spend and new IT investments more directly to business functions



Cost Modeling Methodology

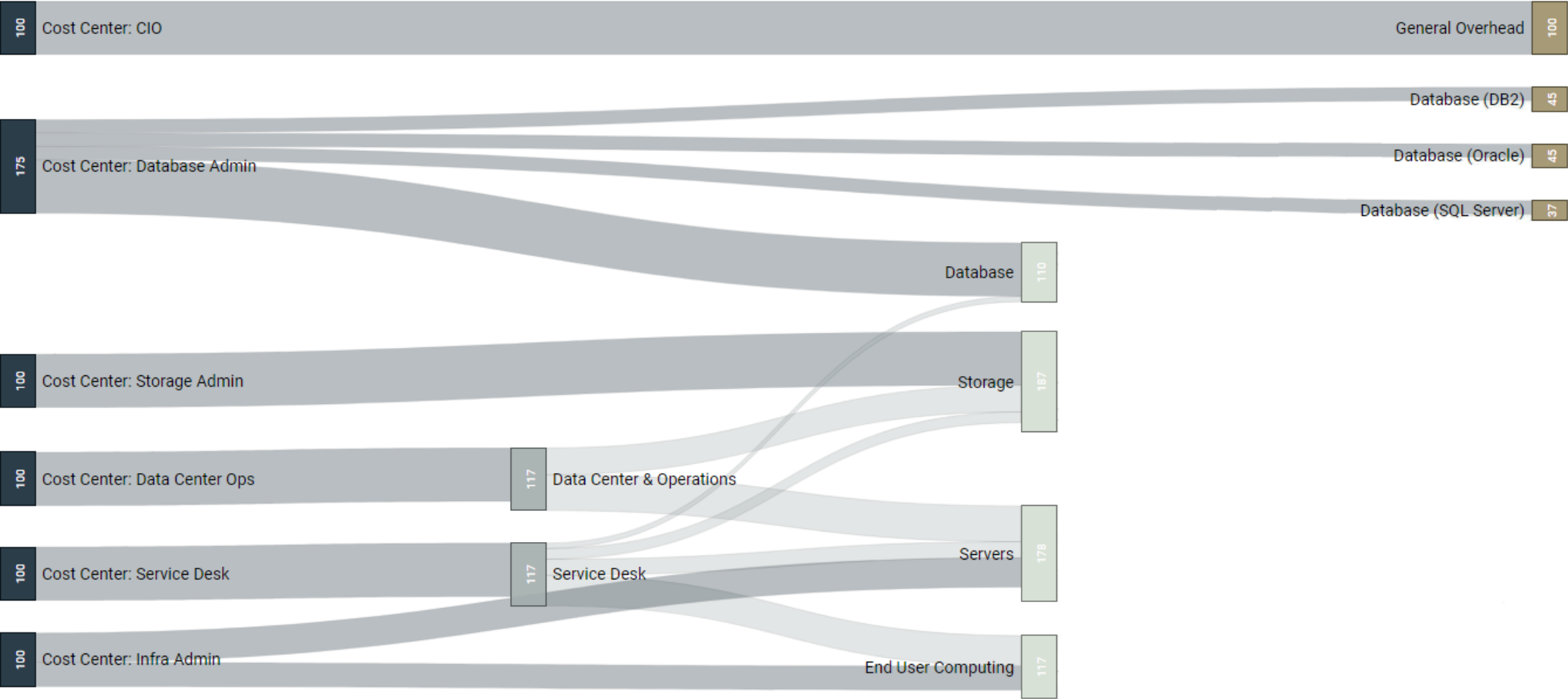


Definitions

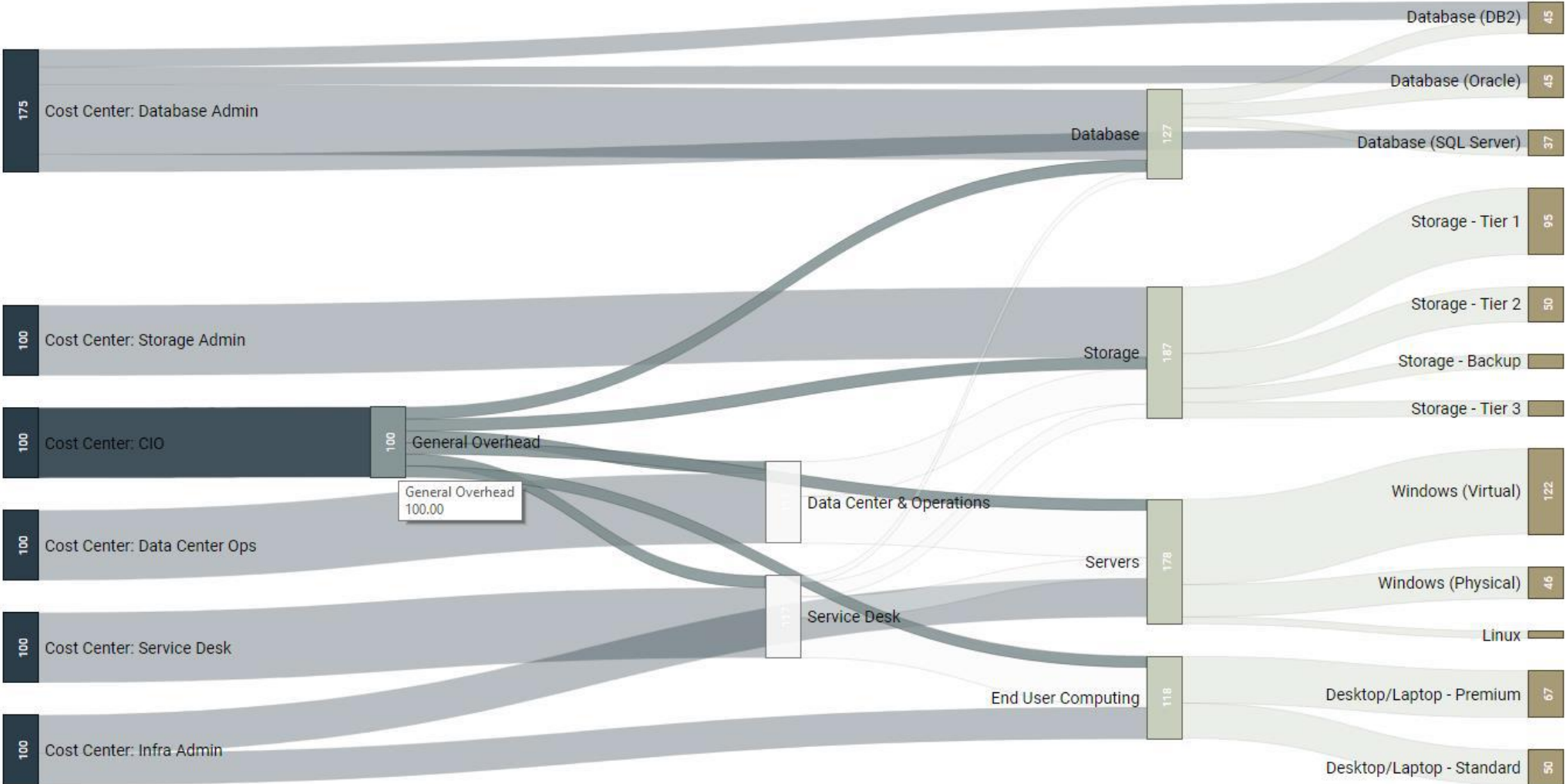
- **IT Function** –A shared IT function supporting several (or all) IT services (e.g. Security).
- **IT Service** –A product “sold” to an internal consumer (e.g. Storage or a Desktop).
- **Cost Object** -The term Object refers to the Object that holds the costs at a point in time.
- **Source Object** –Source Objects are those Objects whose costs are distributed to Target Objects. At each Level of a Model, Source Objects are allocated to Target Objects.
- **Target Object** -Target Objects are those Objects who receive costs from a Source Object. At each Level of a Model, Source Objects are allocated to Target Objects.
- **Quality Driver** –Allocation data used to execute an allocation, that is repeatable, defensible, and understood.
- **Proxy Driver** –An intermediate set of data used in place of a Quality Driver due to the lack of quality data. Results of cost models using a large volume of proxy drivers should not be used extensively.



Sample Model Cost Flow



Sample Model Cost Flow



Cost Model Allocation Examples

Source Object	Target Objects	Quality Driver(s)	Proxy Driver(s)
Service Desk	<ul style="list-style-type: none">• Security• Desktop/Laptop• E-mail• Server• Database• More...	Incident Counts	% of Costs in Target Objects
Data Center	<ul style="list-style-type: none">• Server (Windows)• Server (Unix)• Mainframe Compute• Storage• Tape Drives• More...	Floor Space Floor Tiles Power/Cooling	% of Costs in Target Objects



Cost Model Allocation Examples

Source Object	Target Objects	Quality Driver(s)	Proxy Driver(s)
Database – Labor <ul style="list-style-type: none">Includes all salary, benefits, and other staff-related costs; and department manager	<ul style="list-style-type: none">Database – OracleDatabase – DB2Database – SQL ServerMore...	Time tracking data.	Estimated % split of staff (DBAs) across each database platform
Database – Non-labor <ul style="list-style-type: none">Includes hardware, software, other non-labor	<ul style="list-style-type: none">Database – OracleDatabase – DB2Database – SQL ServerMore...	Direct mapping of line items is often required. <u>Examples:</u> Oracle License Cost DB2 License Cost	Use Database - Labor allocations



Cost Model Allocation Examples

Source Object	Target Objects	Quality Driver(s)	Proxy Driver(s)
Network – Back End (WAN)	Physical Address/Locations	Direct mapping of line items is often required <i>Example: Mapping individual circuits to each address</i>	<ul style="list-style-type: none">• Apportion all backend network costs into Network – Local• Combine with Data Center costs
Network – Local (LAN)	Desktop/Laptop Network Connectivity More...	Device inventory (active only)	Head count



Cost Model Allocation Examples



Source Object	Target Objects	Quality Driver(s)	Proxy Driver(s)
Overhead <ul style="list-style-type: none">• Office of the CIO• IT Service Management• Vendor Management• More...	All Objects	% of Costs in Target Objects	N/A



Fully-Loaded Rates?

Cost Component	Rate Component	Status
Non-management Labor	\$79.00	Included
Management Labor	\$22.00	Included
Non-labor Costs	\$19.00	Included
Overhead	\$17.00	Included
Rate	\$137.00	

Fully-Loaded Rate:

- Quality service TCO
- Leverage for benchmarking
- Compare to outside suppliers
- **May not be competitive rate**

Cost Component	Rate Component	Status
Non-management Labor	\$79.00	Included
Management Labor	\$22.00	Excluded
Non-labor Costs	\$19.00	Excluded
Overhead	\$17.00	Excluded
Rate	\$79.00	

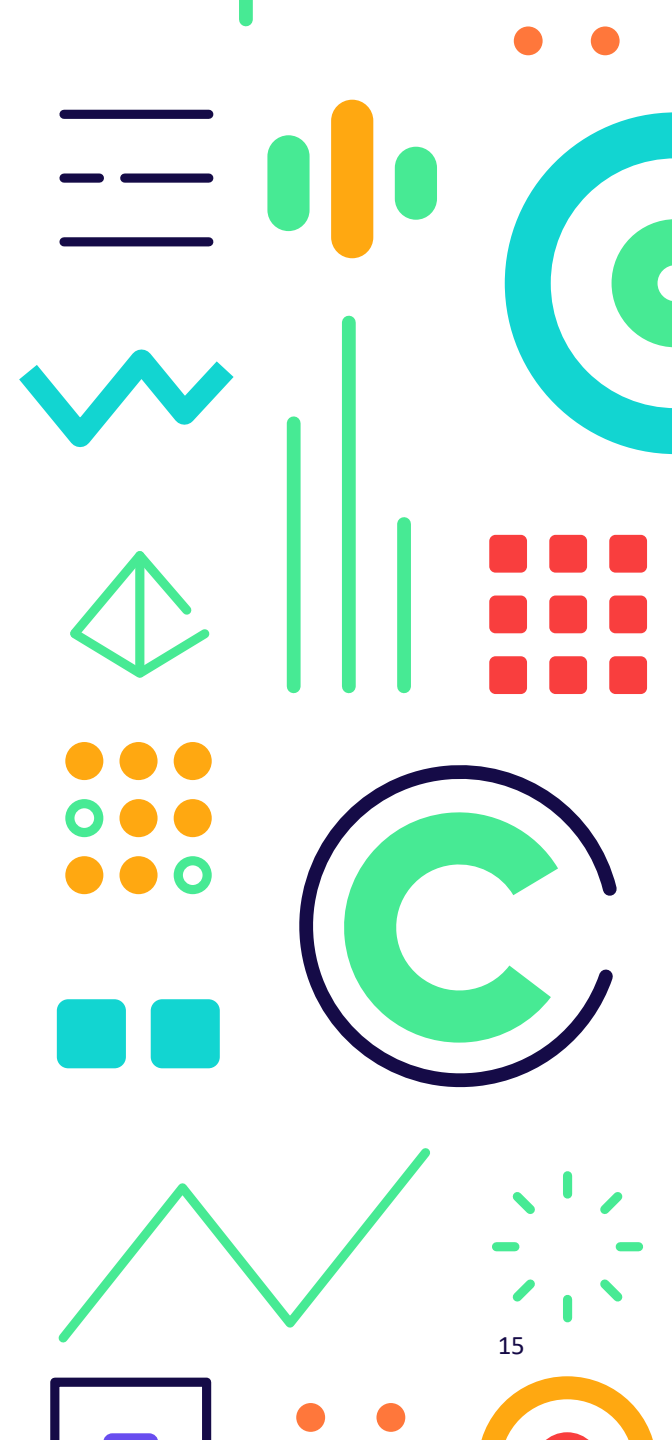
Partial Rate:

- Not a service TCO
- **May not be competitive rate**



Recommendations & Takeaways

- **Limit inventory of IT Functions and IT Services** – A high volume of cost objects will invariably require more inter-function and inter-service allocations; thus overcomplicating the model.
- **Manage complexity** – Balance accuracy and fairness against maintainability and practicality
- **Proper sequencing is critical.**
- **Never stop educating and socializing** – You will need to continually share your model and educate consumers on how costs were derived.
- **Stay focused on value and enabling smarter decisions** – Keep in mind your primary purpose is to enable decision-making. This thought should be at the core of every modeling decision you make.





Thank You

