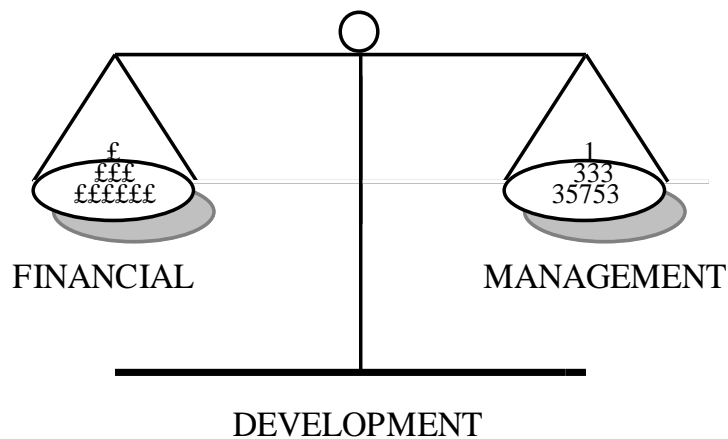


FINANCIAL MANAGEMENT DEVELOPMENT

DISCUSSION TOPICS

NO 803

JUSTIFYING IT EXPENDITURE



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT
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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

JUSTIFYING IT

THE CASE FOR FINANCIAL JUSTIFICATION FOR INVESTMENT IN IT

Francis Bacon said “knowledge itself is power” but being powerful does not mean being effective. Too many organisations are knowledge rich but information poor. Frequently the cause is poor evaluation of new IT systems or system enhancements. The mere availability of data, of itself, does not add value.

Cash is a major limiting factor in most businesses and IT projects should be made to compete with other investment opportunities for this scarce resource. Justification involves clear explanation of cash costs and cash benefits, together with a reasoned proposal analysing risks and sensitivities. In too many proposals, the emphasis is on the quantification of the costs. It is vital to include quantification of the benefits when you formulate your investment proposals to prove they are worthy of implementation. The cash cost of the acquisition of more knowledge must be justified by being shown to be less than the cash benefit, preferably within a reasoned proposal analysing risks and sensitivities. True “Knowledge Management” includes reviewing the acquisition methodology just as true Asset Management includes appropriate capital appraisal and evaluation procedures.

IT Systems have a value to the business they are used in. It can even be calculated. It can be added to, by investing in enhancements, or it can be destroyed by allowing the systems to become obsolete, and the information produced being of no assistance in decision making. However the fact that many IT Department costs are treated as a charge against profits does not mean that it is money wasted. The value of systems is rarely shown on Company Balance Sheets, but this does not mean that they have no value. Many financial commentators would say that the Financial Statements show the cost of everything and the value of nothing.

In many organisations IT costs are written off against profits in the year they are incurred. However there is a very strong argument for taking development costs (salaries, overheads, etc.) out of the Profit and Loss Account and showing them as an asset in the Balance Sheet, just as hardware costs are. In 1925 capital expenditure was defined as **"any expenditure which brings into existence an advantage for the enduring benefit of the trade."** This describes most system enhancements.

Most companies will write off the cost because managers rarely set out clearly the enduring benefit and because there are possibilities that the tax bill might be higher if they treated the cost as an asset. However the accounting treatment should not obscure the fact that almost all expenditure on IT is really an investment. Nor should it excuse IT managers from the need to quantify benefits before incurring costs.

Sometimes IT investment is wasted and that is wrong because what is wasted is not just the money but the time and effort which could have gone into a proper investment to yield real, quantifiable rewards.

How can YOU ensure that you invest in systems rather than waste your time and money?

SEVEN KEY STEPS TO ASSIST IT INVESTMENT DECISIONS

1. Identify the Current Value of the Outputs from the system
2. Identify how that value could be increased
3. Identify the actions necessary to increase their value
4. Calculate the cost, including the cost of time, of the necessary actions
5. Compare the relative benefits and costs with other alternatives
6. Implement the most cost effective actions
7. Review the impact to gain information to assist future decisions

1. Identify the Current Value of the Outputs from the system

The value of Information System outputs to an organisation can be described as:

The excess of the value created by the users of the output by making better decisions based on information provided, than they would without it, over the cost of its provision and use.

In practice the costs (including full allocation of overheads and depreciation of the system) are fairly identifiable, it is the benefits which are more difficult to quantify precisely. But this is a management not a financial accounting exercise so approximations are perfectly appropriate. Take two examples: a Stock (Inventory) Control system and a Sales Invoice system.

The Stock Control system adds value by enabling buyers to judge when to reorder and the quantity. This results in lower stockholding which reduces the risk of obsolete stock and reduces the costs associated with storage and financing, resulting in additional profit to the organisation. There may also be a saving in audit costs because the statutory duty to report on the stock value may be performed on a test basis rather than counting every item. It might also help reduce the likelihood of stock shrinkage. There may be additional benefits if the system is also used to make decisions on whether a sale can be made or whether to premium price or discount particular stock units.

The Sales Invoice system enables faster invoicing, giving rise to interest savings on cash outstanding. Reports on overdue amounts enable faster chasing of slow payers, earlier action to stop supplying, etc. thus reducing the risk and impact of bad debts. There may also be marketing benefits if salesforce time allocation is directed towards particular customers whose accounts are analysed to show characteristics or trends.

Values should be put against each benefit and totalled to compare with the cost. In both cases the value only arises from use of the data. If information is not used, or if the costs if avoidable exceed the identifiable benefits, then stop producing it.

If you cannot work out an approximate value for the benefit from every item of system output, then how did you justify producing it in the first place?

2. Identify how that value could be increased

Using our two examples it is not difficult to consider how value might be increased:

<u>Stock Control System</u>	Reduce stock levels (less money invested in stock)
	Automate the reordering (less administration cost)
	Stock outs avoided (more sales income)
<u>Sales Invoice System</u>	Faster invoices to customers (cash received earlier)
	Direct Debiting (reduced cash in transit)
	More focused Sales information (increased sales)

The review must always be compared against the impact of doing nothing. For some organisations the answer to avoiding the cost of expensive stock control systems is the two bin systems. Each bin has enough to cover the reorder processing time and an order is placed each time one of the bins is empty. It is simple, involves no complicated equipment and may be the most cost effective method. Many individuals employ a similar system at home called a bread bin or a fridge.

Knowledge need not be computer generated, eyes and ears can be just as effective but they need to be connected to decision makers.

3. Identify the actions necessary to increase their value

Information availability is only part of the process, but it is an important part. It needs the commitment of the user if the right actions are to be identified to produce the desired outcome. The use analysis is a key part of this process. To be successful both the user and the producer must understand how they can add value and be sure that the outcomes are feasible as well as desirable. There is no point in investing in information to help sell more, if the additional business cannot be processed because production is at full capacity. Enhancements to information must be viewed as part of the Strategic Plan. The organisation should review the constraints upon growth and profits, identify the information which would help remove or reduce those constraints and then specify the action required.

The start point is the organisational need: “What information would be helpful” not “What could we do with the information”.

4. Calculate the cost, including the cost of time, of the necessary actions

The full cost includes not just the costs of new hardware and software but also the opportunity cost of the time spent by the user. Opportunity cost is the benefit lost by being unable to do something else which would have added to profit. If a user already has too much information to use properly, then more, or faster information will not add a benefit unless they stop doing something else. Information overload is already a feature of most recipients of financial data, few of whom understand all of the information they get. There may be an argument for fewer, shorter reports.

Just as products and customers need pruning to ensure maximum profit, there needs to be a constant review of information generated to ensure it is fit for purpose. Too many organisations add new systems and procedures without removing the old. The result is worse than mere duplication of cost since the good information is hidden by the bad.

The cost of new information includes the time spent using it. If reports are not user friendly there may be no benefit.

5. Compare the relative benefits and costs with other alternatives

Specifically the alternatives should include other ways of achieving the same objective: statistical projection, outsourcing, additional staff, etc. The avoidance of the cost of some of these alternatives can be the key financial justification for investment. However since IT budgets are limited, it is vital that the financial benefit anticipated from proposals is quantified, so that the IT manager and the organisation can gain maximum return on investment. Avoid the "look how much cheaper than a taxi is giving me a company car" approach; try the evaluation of the opportunity cost of walking.

Realistic appraisal of alternatives is vital to true investment appraisal. This includes the real cost of no action.

6. Implement the most cost effective actions

There seems little point in identifying the appropriate action and then not doing it. If the benefit from investing in IT can be shown to outweigh the cost then you are wasting money by not implementing it.

Failing to implement valid proposals is a misuse of assets tantamount to burying your talents (see Matthew 25:24-30). Whilst some organisation may cite lack of cash as an excuse, too many have cumbersome approval processes which delay implementation and thus cost money. Perhaps a short investment proposal to automate the capital expenditure process justified by the saving from earlier implementation would be justifiable if delays are commonplace.

Explaining the benefit to users and ensuring the use of new information to maximum effect is an essential part of the process.

7. Review the impact of the actions to gain information to assist future decisions

"As with any management action, it is vital that the actual results are compared with the planned results so that blame can be apportioned."

NO!... The only reason to review the results against plan is to assist future decisions.

Examples include:

If benefits are always over estimated, reduce them as appropriate in future analyses.

If costs are always underestimated, adjust future forecasts accordingly.

If expected results are not achieved, identify why not, and act to rectify that in future.

If the IT investment is not translated into improved performance in the workplace,

consider how to amend working practices.

The Post Implementation Review is a sadly under used technique in the IT industry. Don't bury mistakes, learn from them and tell everyone else about how you got it wrong....you may save them from doing the same thing.

REMEMBER

Organisations gain benefit from investment in IT only if as a result of the investment, decisions or actions are taken which do one or more of the following:

1. Increase Sales Volume
2. Increase Sales Profitability
3. Reduce Cost Levels
4. Increase Cost Effectiveness
5. Improve Cash flow

If there will be a net benefit, quantify it.

Your proposal should state:

"This project will cost £100,000 and save £300,00. If you fail to approve it you are effectively approving the wastage of £200,000."

(Perhaps you might word this in a less career limiting manner.)

If there is no net benefit, don't waste time proposing IT!

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).