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Dynamic resource management to meet prevailing demand

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Information Management

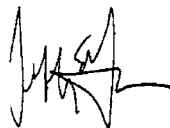
Cognos software

There are any number of ways to NOT control spending. For example, in many companies, the all-too-familiar "use it or lose it" mentality pretty much demands that business unit managers spend in order to use up this year's budget allocation, so their base budgets for next year won't be threatened. It doesn't matter if the expenditures are value-adds or not. And that's just one possibility. As you'll see in Jeremy Hope's latest article, there are others. But there is also good news …

In this series of six articles, Jeremy Hope explains how organizations use innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have eliminated many of the barriers preventing the transition from business-as-usual to create – as Jeremy says – a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, finance can drive enhanced productivity, performance, and profitability.

Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, is an advisor to the IBM Cognos® Innovation Center for Performance Management. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.

In this fifth article in our six-part series, Jeremy explains that effective resource management means choosing the right business opportunities, and then making sure that outlays of resource and effort actually add value. Though accounting and reporting systems can hinder as well as help, smart managers can nonetheless find ways to keep central costs under constant pressure and minimize unnecessary operating expenses.



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Introduction

Most business managers understand intuitively that a very small number (say, 20 percent) of events in a business account for most of the results (perhaps 80 or 90 percent). Peter Drucker reminded us what the real implications of this meant in 1963 when he said that, "While 90 percent of the results are being produced by the first 10 percent of events, 90 percent of the costs are being increased by the remaining and resultless 90 percent of events." In other words, *economic results are directly proportionate to revenue, while costs are directly proportionate to transactions*. The trouble is that by looking at the conventional profit-and-loss account and sub-analyses of it, it would be almost impossible to know which costs are in the 10 percent (good costs) and which costs are in the 90 percent (bad costs) category.

This is Drucker at his brilliant best. He knew that many costs incurred by organizations didn't add value and should be eliminated, but that accounting systems couldn't identify them. And little has changed in the more than forty years since he made this statement. Lean principles and Six Sigma have made some headway in eliminating waste at the process level and activity-based costing has helped some managers better allocate overheads to products and customers. But, for the vast majority of organizations who still use annual budgets to control costs, the problems of knowing which add value and which don't remain unsolved.

This paper examines how a number of organizations have used more imaginative approaches to manage operational resources more effectively. There are primarily two key issues: **a)** how central costs are managed and allocated to business units and **b)** how resources are managed within business units.

Avoid the ‘cost protection’ mentality and the ‘illusion of control’

Cost budgets should be renamed “cost protection budgets” because that’s what they do. Starting from last year’s numbers, no self-respecting manager is going to allow his or her costs to be reduced. You win the budget battle by getting more resources, not by accepting less. Negotiations are based on changes from the previous year. “How can you justify increasing training by 20 percent?” “Why has parking gone up by 10 percent?” “Why do you need another 15 percent for marketing?” These are all typical budget discussion points. Of course, the “justification” answers are easy. You simply tell your supervisor that you can’t run your business or department with your current resources. You must also spend your budget allocation for this year, otherwise you will struggle to justify next year’s increase.

The budgeting system also gives senior managers the illusion of control. Many board members think that control comes from providing funds in thousands of small buckets, then making sure that managers spend no more than these amounts. Once a bucket’s full, then that’s their limit. What they don’t see, of course, is all the creative accounting that goes on around where expenses are allocated in the system. Once one bucket is full, most managers will simply define that bucket’s expenses to another bucket with spending room still available. So control at this level of detail is an illusion— and it’s expensive. Leaders can, of course, control spending with much larger buckets, but more importantly, they need to educate everyone to see controls more in terms of managing risk. If they can make fewer mistakes and turn more of their resources into value-adding outcomes, then everyone is a winner.

Challenge the need for expensive back-office functions

Most finance departments are weighed down with transaction processing and other work that adds too little value. The average billion-dollar organization wrestles with ten different ledger systems, twelve different budgeting systems, and thirteen different reporting systems. There is too much detail, too many spreadsheets and reports, and too many information systems and tools. Some organizations are tackling these problems by creating shared services centers and some are even outsourcing this work.

Consider moving back office functions to shared services centers

Many large organizations have moved their back-office functions such as accounts receivable, accounts payable, and general ledger from multiple sites to a small number of shared services centers saving huge amounts of cost. According to the Hackett group, leading organizations have reduced routine transaction processing work by 16 percent, reduced their number of systems from 30 per billion dollars of revenue to just 2.8 percent, and cut costs by around 50 percent.[1] Spans of control have also increased from 1:7 in average companies to the 1:15 to 1:20 range in world class organizations.[2] Another step change in cost reduction comes from locating service centers in low-cost countries such as India. One global organization has moved from 46 data centers to just 2 shared services centers, saving hundreds of millions of dollars.

Other functions can be centralized and standardized as well. Human resources and information technology are two primary candidates. In fragmented organizations, error rates in benefits administration are 2.5 times higher, payroll costs are 3 times higher, and the costs per paycheck are 98 percent higher than in firms that have centralized these processes. IT costs are similarly reduced. The cost of application development is reduced by 41 percent.[3] Another area where centralization can have a profound impact is in procurement. By automating the procurement cycle from requisition through purchase order processing to ordering and shipping, companies can realize huge cost reductions through faster cycle times and better accuracy.

Consider outsourcing but look at the full cost/benefit picture

In some cases, the economic case for outsourcing is overwhelming, particularly if the same job with the same level of competence can be done in India for $10,000 per person against a cost of $75,000 in America or Europe. However, for many outsourcing contracts (especially in areas like IT and human resources), the economics are not so clear.

However, there are some traps to avoid. For example, outsourcing contracts are invariably negotiated on the basis of the budgeted costs of the department under consideration, but it is usually difficult to determine whether these budgeted costs cover all the *problem-fixing work* undertaken by a department. In other words, as many activity-based studies have proved, much of the work undertaken by one department stems from inefficiencies and problems caused in and by other "upstream" departments. So, in this situation, who will take on this (often unseen) workload after the department has been outsourced? The answer is that the remaining staff must work even harder, or the outsourcing contractor will return to negotiate more favorable terms.

Other hidden problems can occur in service industries. The experience that many of us have had with call centers is a classic example. Let's assume for a moment that a company has outsourced its customer service to a "specialist" service operator that offers a much lower cost-per-call. But let's also assume that their rate of staff turnover is high and that the quality of staff is poor. What then happens to customer service and, more importantly, customer loyalty? The likely answer is that customers will soon react with their feet (or mice!) and take their business elsewhere. The cost to the outsourcing company would be incalculable.

After an onslaught of complaints, computer maker Dell stopped using a technical support center in India to handle calls from its corporate customers. Some US customers complained that the Indian technical support representatives were difficult to communicate with because of thick accents and scripted responses. Corporate customers account for about 85 percent of Dell's business, with only 15 percent coming from the consumer market.[4]

One could say that outsourcing has many of the attributes of anorexia nervosa. People with anorexia have a distorted self-image that makes them feel fat even when emaciated; preoccupation with food, low self-esteem, and emphatic denial of the problem characterize most anorexics. Similarly, executives in companies with poor financial performance seem to concentrate on downsizing as the preferred method for restoring competitiveness.

Smart organizations will outsource if it is strategically compelling (i.e. if it takes advantage of somebody else's capacity to accumulate knowledge faster than it can be done in-house). But they don't outsource on the premise of cost-cutting alone.

Make operational resources available when needed and justified

Some organizations are moving away from the annual allocation of central costs toward systems that enable business unit teams to access operational resources closer to the point of need. The benefits are that resources are more closely connected to current need and value creation. This reduces much of the waste endemic to traditional system. There are a number of different approaches. One is to create an internal market. Another is to hold resources at a higher level and make units justify their need and "bid" for them. Yet another is to devolve decision-making so that small capital decisions can be made at lower levels.

Consider using an internal market approach

Handelsbanken provides a good example of how the internal market can work. All central costs are allocated to profit centers such as regions and branches, but they are not simply presented as a *fait accompli*. There is an annual round of negotiations, whereby cost estimates and the services underpinning them are presented and discussed with representatives of all those involved. Regional and branch managers have every right to challenge these costs and even reject them. It is an internal market where the central service "sellers" meet the business unit "buyers." Buyers check the prices against similar services in the marketplace and ensure that they receive value for money.

It is a system designed to put central services under the same sort of market pressures that customer-facing teams operate under. Thus, where possible, market rates (or lower) are determined, using benchmarks, for the prices of the outputs of the central service departments. Under the supervision of the EVP Finance and group controller, four representatives of "sellers" (central service functions) and four representatives of "buyers" (profit centers such as regions and branches) meet to hammer out a price for each possible process or transaction (around 500 prices in total).

There is nothing worse than operating managers receiving internal service invoices that are opaque and unfathomable. It just makes them suspicious and resentful about the "head office burden" that their business unit has to carry. The golden rule is to keep the basis of charging as simple as possible. Operating units can then clearly understand the basis of charging and, more importantly, how they can influence the costs that they incur. Thus, if they are incurring high charges for a service they don't value, they can use it less or complain and demand that it is improved. This transparency exerts far greater pressure on central costs and makes them feel much more like external suppliers with conditions of satisfaction to meet.

Some organizations use a form of activity-based costing to calculate prices. While this is transparent to users, it does give central services providers a better method of analyzing, explaining and charging their services. It also means that if costs are too high compared with external providers (it also facilitates benchmarking), then central services managers can see where costs add value and where to cut those that don't.

Consider holding discretionary spending at a higher level

Some organizations have taken discretionary spending away from business units and held these funds at higher level. This avoids placing spending on an "automatic pilot" whereby budgets for expenses such as "training" or "parking" are spent mindlessly just because they are there. In a large multi-divisional business the savings can be huge. In one public sector case in Australia, the organizations saved A$100 million over three years. In essence, what they did was fund core expenses, but make each unit bid for discretionary spending. What was interesting was that they had to do this in front of their peers. So everyone could see fair play and only the high priority bids were approved.

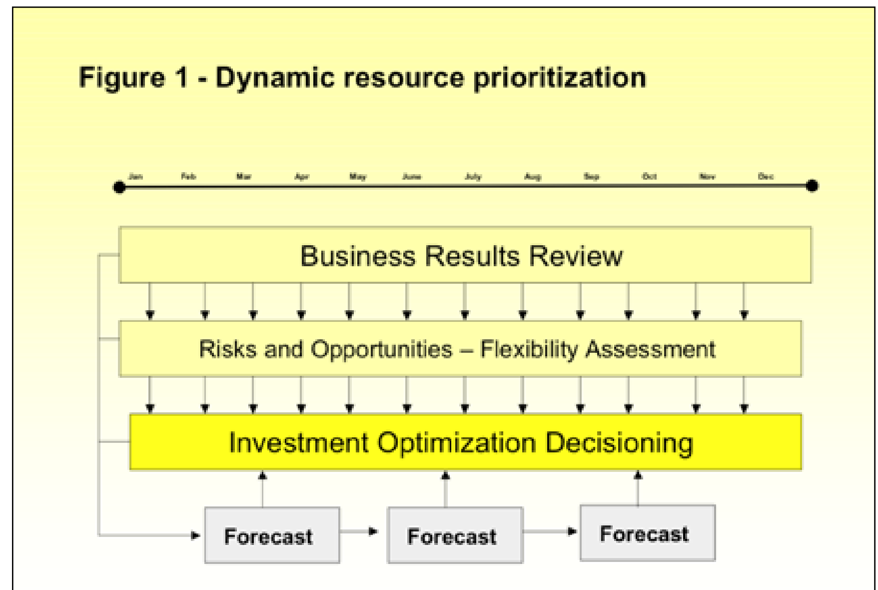


Figure 1 - Dynamic resource prioritization

Some organizations are moving to a system of *investment optimization* (see Figure 1) where they take all the dollars spent every year on operating expenses and, instead of just giving them to businesses in the form of annual budgets, they regulate them in the form of thousands of small projects. In this system, business leaders know that they have to justify all their spending plans. The trade-off is that they don't get them as a right, but they can put new projects in for approval at any time to support their latest initiatives. Using rolling forecasts to support this process, senior executives are able to release funds in the investment pool once a month rather than once a year, and ensure that these funds are clearly tied to some strategic purpose. By using this process, one large financial services company was able to invest 20 percent more funding over their base plan, which led to an 8 percent increase in new credit cards. It has cut out a lot of unnecessary cost and is a tangible benefit of the switch to more flexible planning.

Use ratios, trends and moving averages to monitor cost centers and departments

While senior executives may well accept that managers should be accountable for managing total cost (as opposed to line-by-line budgets) for a cost center, they may still want to set overall cost targets and manage performance against them. This can be done by setting ratios (e.g. cost-to-income), or moving averages (e.g. a 2 percent decrease over a period) and then managing cost center performance by exception. At Danish petrochemicals company Borealis, accountability is devolved to operating managers who monitor trends within a medium-term target. No specific targets are set for costs (except for a "default" reduction level of between 0-2 percent) *unless there is a step-change required*. In the absence of such a step-change, costs are simply tracked on a monthly moving average (year-on-year) basis. This is an important part of the reporting system. Again there is no "micro" picture, just the broad-brush view of cost trends. Nor does it require an annual review. It is a rolling system of cost management. This overcomes the "use it or lose it" mentality. The moving average picture is sufficient for most purposes. For example, it answers the broad questions such as: "Are costs under control?" and "Are they moving in the right direction?"

Management by exception is hardly new, but it is appropriate for cost management purposes in devolved organizations. While the primary cost control is at the unit level, senior controllers are also watching trends on a weekly or monthly basis. If costs drift "out of bounds" then they will want to know why and what is being done about it. But if the action taken isn't to their satisfaction, then they will act and ultimately replace the team management. They will also impose a "rehabilitation program" to enable the unit to regain its trend line or re-set goals to a more attainable level.

Ensure that all projects are necessary and add value

Capital expenditure decisions are usually based on financial criteria—invariably involving some "hurdle rate" based on the risk-adjusted cost of capital. Thus, the system is biased against high-risk projects that cannot easily establish predictable and precisely calculated returns. Other problems are evident. Projects can become highly political as managers "champion" their own pet initiatives. Less than half of major projects support a company's strategy. That means that half the capital expenditure budget is probably adding little value. Leading-edge organizations derive initiatives from strategy reviews and prepare the investment case thoroughly and implement quickly.

Many initiatives are driven by the vested interests of local teams whose primary aim is to maximize their own resources compared with their business unit rivals. This leads to many investments that have little or nothing to do with the firm's strategy (at one large US bank, few initiatives passed the strategy test). With often hundreds of initiatives in play at any one time within large organizations, this can be a huge problem and represents a significant waste of resources. Initiatives are, more often than not, easier to start than finish. Thus, many projects often linger on well past their sell-by-date.

One software company actually took an inventory of how many strategic initiatives they had placed on the organization over the past year and found that it was around 450! And a lot of them were overlapping and expressed differently. For a company with only around 3,300 employees, they began to wonder how they could possibly move in their chosen direction with this level of complexity. So they took those 450 strategic objectives and, after preparing their own strategic roadmap, boiled them down to just 13 high priority objectives.

Prioritize projects according to their strategic impact and value creation

Isn't it amazing how quickly, and with such scant knowledge, that some major investment decisions are made? This particularly applies to acquisitions where huge risks are taken based on fluffy estimates of synergy-type cost savings and additional market penetration. Huge investment case packs are prepared full of numbers and charts that justify the bottom line estimates. But there is too often a political motive behind the proposal rather than a compelling (and rational) strategic case. It is no wonder that most acquisitions fail to create wealth for the acquiring company's shareholders.

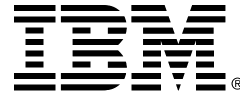
Funding for projects can come from three sources: **(i)** cash flow generated by continuing business operations, **(ii)** fund raising capabilities of business units, or **(iii)** a company investment pool. The responsibility and funding for different initiatives can be optimized by considering their impact on the *company* (whether global, regional, or local) and *value* (whether strategic or non-strategic).

1. **Global – strategic.** These projects are likely to benefit many business units and thus should be decided and funded by corporate. A new corporate branding exercise or the implementation of an enterprise-wide computer system would be examples.

2. **Global – non-strategic.** These projects also impact a number of business units so a corporate decision is again appropriate.

3. **Local – strategic.** In this case, the impact of the initiative lies within a particular business unit. Because it is strategic, corporate will want to know about the proposal and ensure that it complies with its definition of a worthwhile strategic investment. In one large organization, business units are provided with a "sustaining capital pool" each year. This is based on their four-quarter forecast for the fiscal year, usually available during the last week in October. They can use this pool for their spending plans without recourse to head office. Only new projects above $500,000 need express approval and this can often be done with a conference call. So access to capital is swift and enables unit teams to respond rapidly to new opportunities. Each business is self-sufficient in terms of support services. There are no shared services in the group.

4. **Local – non-strategic.** If decisions involve relatively small sums and need to be made quickly, that is exactly what should happen. Teams should look at the options and decide. At one engineering group, new initiatives can be agreed to and begun at any time, provided they meet a number of criteria (modified rate-of-return, cash payback, consistent with strategy, pass holistic criteria, and pass risk assessment tests). Investment proposals include capital requirements, start-up costs, and operating costs as well as income streams generated. Whereas in the previous regime, capital expenditure submissions were made *after bid proposals were agreed upon* (e.g. for a potential major order), now they must be agreed to in advance of bids. To facilitate this accelerated timing, senior executives regularly make themselves available for video or teleconferenced oral presentations of the business case supporting the bid and give the nod right there if it passes muster. The art of managing resources lies in selecting the right business opportunities and then ensuring that all the work done and the costs incurred are converted into value-adding outputs. However, this is not easy to monitor through the accounting and reporting systems. Instead, managers have to find proxies. They do this by using mechanisms that place central costs under continuous pressure and exposing unnecessary costs in their operating processes. It is no coincidence that organizations such as Toyota, Handelsbanken, Dell, and Southwest airlines are the lowest cost operators in their peer groups.



About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – *Transforming the Bottom Line* (1995) and *Competing in the Third Wave* (1997) with Tony Hope and *Beyond Budgeting* (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book *Reinventing the CFO* will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

About the BBRT

The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.

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Endnotes

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