Managing indirect costs

Collinson Grant

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Managing indirect costs

Collinson Grant is a management consultancy that helps to improve the performance of employers in the private sector, in Central Government and in Healthcare. Our work focuses on costs, people and organisation. Helping clients to understand costs and then put in place effective strategies for controlling and reducing them has been a constant feature of our work for forty years. The notes at the back will tell you more about what we do.

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1. Introduction

This book aims to help managers to recognise, measure and control costs.

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This book aims to help managers to recognise, measure and control costs.

Collinson Grant has been doing that for forty years. And it is hard. The first challenge is to understand what influences costs and how they can be better related to outputs. The next is to find ways of keeping them under control, so that they rise only slowly when business is growing, but fall fast if turnover declines. These aims apply equally in services, manufacturing and the public sector.

Direct costs are usually better recognised and understood. Managers can see the direct relationship between the output and the effort and materials applied. Those in the front line accept their responsibility to match the two. Productivity, although not now such a common term, is an established concept.

Indirect costs, on the other hand, are a little more difficult to define – as we try to show in this book. *Overhead* is a term more often used, but it is neither precisely defined nor properly understood by most managers. It can assume a grandeur and immobility that defy any rational attempt to bring it under control, let alone reduce it. But ‘indirect activities’ can cover every effort: to support production; to serve customers; to run traditional ‘back office’ processes; and to develop and maintain the organisation. This very complexity offers opportunities and presents risks. It means that managers must learn the interrelationships between activities and costs, and the options these present to tighten control and reduce expenditure.

This overview of indirect costs draws on our experience in FTSE 100 companies, in central Government departments, in the NHS and in many smaller concerns. The knowledge and insights are what we have learned from working closely with all their managers. We have set out:

- to explain how the structure of businesses has changed under the impact of new technology
- to define a framework for managing indirect costs
- to show how the purpose of the organisation (strategy) should inform the capabilities needed to survive
- to lay out some of the fundamental principles in designing organisations that are efficient and serve their purpose
- to classify some indirect costs and show how they can be brought under closer control
- to introduce some ways of analysing and reducing costs
- to describe the pitfalls and benefits of shared services and outsourcing
- to point out the total costs of employing people and how they should be better managed
- to mention some important aspects of communication and culture that affect how well progress is made.

> *"Buy not what you want, but what you need;*
> *what you do not need is expensive at a penny."*
>
> **Cato, 234-149 BC** [1]

And, we have written a short chapter on taking immediate, short-term action to reduce costs when this is necessary and desirable. Finally, there are some comments on how such programmes should be managed effectively to achieve the desired results without damaging the longer-term prospects of a business.

We have tried to reflect what is practical for managers in order to inform their thinking and stimulate some action! Our approach is neither unique nor comprehensive. But it works.

[1] A number of quotations are peppered throughout the text. Notes on their origin are on Page 121.

2. The changing world of business

Business has changed in the last hundred years. Manufacturing has declined: service industries have grown like Topsy. Direct costs, under intense scrutiny, have shrunk: but indirect costs are increasing. Why? Is technology being properly used? What are the truly central activities for a business today? Are supporting activities as lean as they could be?

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2 The changing world of business

The profile of business is changing

In the early part of the twentieth century, most large enterprises were involved in manufacturing. Factories were labour-intensive. So it was the efficiency of direct labour that determined profitability. Even when Henry Ford and others introduced production-line methods to raise productivity, they still depended on armies of manual operators to assemble, weld and fix things together. Gradually, investment in equipment and automation reduced unit costs, so machine utilisation was added to direct labour as a second main measure of effectiveness. Ancillary, supporting activities, in contrast, occupied only a small proportion of the workforce, at little cost.

But now manufacturing no longer dominates the landscape in most 'developed' economies. And where it does survive, automation and the sub-contracted manufacturing of components or even complete products have dramatically reduced the number of traditional 'direct' workers employed. In the meantime, the service sector – where the distinction between direct and indirect costs is often quite tenuous – has flourished to become the largest element in our economy. Indirect costs are now an increasing proportion of the total. They cannot and never should be treated as 'fixed' costs to be tolerated and accepted passively.

The focus on direct costs has shown huge benefits

The changing profile of manufacturing largely reflects the success in reducing direct labour. As clearly the largest cost, it naturally attracted the most attention. A plethora of analytical techniques, time and motion studies, investments in simpler design, robotics and automation were applied to examine, control and reduce these most visible costs. Employees and trade unions may have resisted, but it has gradually been recognised that if any jobs in direct manufacturing are to survive in the modern economy, productivity must rise – continuously and relentlessly – and unit costs must fall.

But why have indirect costs not fallen too?

Throughout business – in manufacturing and services – the share of total costs found in design, administration, financial control, selling, marketing and logistics has increased. Yet why by so much? Yes, of course indirect costs were bound to rise as a proportion as direct costs went down, if nothing else happened. But something else has happened. In the last fifty years, just as productive processes have been automated, so have office systems, and just as radically. Manual accounting, manual typewriters, and the calculation and payment (of wages and bills) in cash are all gone. But the massive investment in computers was supposed to transform administration, financial control, marketing and selling and do them for buttons. So why have the staffing and cost of supporting activities continued to grow? Why has the much-lauded cost-pruning technology not in fact pruned?

> “*Informed decision-making comes from a long tradition of guessing and then blaming others for inadequate results.*”
>
> **Scott Adams**

Many indirect activities are now ‘core’

One reason is the enormous increase in the goods and services traded and in the sales and purchases handled every day. This simply could not have happened without new technology. Services in which effective administration is vital, such as banking, retailing and logistics, have made tremendous gains in productivity. These in many ways are the new ‘direct’ activities. In service-related businesses, it is harder and harder to tell ‘direct’ jobs from supporting activities (or, traditionally, ‘overheads’ – a term that needs to be re-defined to differentiate what is vital to the success of an enterprise from what indirectly supports its current and future activities).

But non-core still grows

So some organisations and sectors have invested wisely and have exploited the new technology effectively. But not all. Manufacturing and service, trading or retail organisations that have streamlined their main processes are still incurring high costs in supporting activities and in developing, administering and controlling them. The overheads have not gone away. And not all of them are as productive and effective as they should be.

Most managers, for example, now deal with the vast majority of their 'correspondence' themselves – particularly because much of it is in the form of e-mails. And technology should give easy access to managerial information and data on performance.

- So why do organisations still contain so many secretaries and administrators?
- Why do lengthy reports that repeat this information get written, printed and copied?
- Why is there still so much duplication and overlap?

Not only is the technology not being exploited fully, it is sometimes applied self-indulgently to provide so-called enhancements that on closer examination turn out to be unnecessary frills or even downright distractions that waste effort and money.

Technology can be abused or used to create complexity not value

Before the days of word processors – some can remember that far back – a manager would compose a letter or document carefully, pass it on for typing and expect it to come back ready to go. Letters were deliberately kept simple, short and to the point. But word processors make it all too easy to do a rough draft at the outset and then to edit, re-write and re-type it repeatedly before it is deemed fit for purpose, by which time it may be longer and more complicated than is really necessary.

- Do the *additional hours* now spent by managers and assistants re-doing and 'refining' work actually result in a better letter than one careful composition does?
- Has the new office technology really enhanced productivity?

It is doubtful – many fall into this trap.

Don't proceed without a clear plan that demonstrates the return on investment

Evaluate carefully the costs and benefits of overheads that directly support front-line activities. Rank each item on its economy, efficiency and effectiveness. Major reform often depends on investment in systems and software – a healthy contingency is usually advisable.

Systems for accountancy and information technology can become too clever

Accountants and specialists in information technology can also be guilty of producing (because, with their new computing power, they can) bafflingly complex reports and analyses. But these fail to clarify the performance and vulnerabilities of a business. Line managers prefer to rely on the relatively few 'key performance indicators' (KPIs) that are transparent and easy to understand, not on the mazy webs of analysis woven by expensive accountants in remote head offices.

Over-complex systems can create more confusion and mis-information than clarity. Activity costing is a valuable tool for indicating the total cost of an activity or product, but it has to be kept relatively simple so that the assumptions are transparent and can readily be adjusted for changing circumstances. Yet systems often have a high dependence on complex algorithms and calculations in sophisticated programmes opaque to everyone but the designers. Such systems are expensive to set up and maintain. The line managers who really know what goes on in a factory might challenge the assumptions used, if they could.

There is a lot to be said for line managers being able to interrogate, model and check such costing systems manually from time to time in order to confirm the correctness of key variables and to aid users' understanding of the information generated. That may mean adopting a simpler (and almost certainly less expensive) form of analysis, but is better to be roughly right than misled by what could be spurious 'accuracy' from a system that few can really understand or question.

Supporting activity should be kept simple and lean

All supporting functions should be challenged to confirm that they operate as simply and efficiently as possible and make the best use of new technology without overcomplicating things. The management of personnel records, for example, should be much easier. Yet HR systems are sometimes badly installed so that they are cumbersome to maintain, and undermine and confuse the ownership of records. Line managers become tempted to maintain parallel manual systems and fail to keep the main records up-to-date. The answer is then to add extra administrators to work round these bad practices without tackling the root causes. So where is the productivity gain?

Controls and innovation are, in the main, well applied where there is a clear and pressing need – in enhancing productivity and in supporting trading and 'front-line' activities that are fundamental to the business. This is not always the case when the competitive pressure has been less and particularly in the control of supporting overheads. Indeed, far from improving the control of indirect costs, it has at times been too easy for organisations to abuse technology, to allow slack to develop and to indulge unnecessary requests for ancillary activities. This can be manifested in over-specified or badly executed investments in IT systems or functions that are simply allowed to grow beyond the true needs of the organisation at the whim of ambitious functional managers. A business grappling with the demands of a competitive global economy has to do better.

> *"There are managers so preoccupied with their e-mail messages that they never look up from their screens to see what's happening in the nondigital world."*
>
> **Mihaly Csikszentmihalyi**

The growth of 'Human Resources'

In many organisations the Personnel function has grown beyond any reasonable expectation. Line managers should manage their own people but seem remarkably keen to devolve this responsibility to HR departments that are usually remote from the realities of day-to-day business. This is often because of fear of having to deal with conflict. But in the long term, the managers have to live with the consequences if they allow discipline to slip and are seen to duck what is one of their main jobs. As is illustrated later, the most effective HR functions are kept small and concentrate on providing limited technical support.

Are organisations facing up to making tough choices?

Industrial relations should no longer be a threat to the local management of people, in most of the UK at least. Trade union power has grown and then withered, so that businesses today face much less resistance to change. Some examples of the older attitudes still exist, mainly in the public sector, but most workers recognise that industrial action rarely helps if their jobs can all too easily be sub-contracted or moved overseas. Unions rarely have any real power to restrain companies that want to cut costs.

This switch of power over the last thirty years has been exploited ruthlessly by many managers in their handling of potential disputes. It has often been in direct manufacturing and customer-facing, service functions that the toughest stances have been taken. So production, call centres and distribution centres have been rationalised, out-sourced and moved to low-cost locations, including some off-shore. In contrast, many back-office activities still reside in central London or other major cities and continue to offer relatively secure tenure and comfortable lives. Why is this? Why are senior managers happy to take the risk, in the name of economy, of dealing aggressively with those serving customers in the front line, while backing off from disturbing the large managerial hierarchies remote from the day-to-day activities? Surely managers need to tackle all functions, even those closest to them.

3. A framework for managing overhead costs

No programme to reduce costs or control them better takes place in isolation and many fail to live up to expectations. Managers need to understand the context, what is happening externally and internally, and what the real capabilities of the business should be.

3 A framework for managing overhead costs

To sustain improvements, companies need an integrated plan

Many businesses are facing long periods of reduced demand and extreme competition. Organisations that are publicly funded are having to cope with reduced budgets. So all types of enterprise desperately need a new approach to reducing costs in the long term. Much has been written about how to cut operating costs through 'lean' and other techniques but not about how to apply disciplined and rigorous thinking to reducing indirect costs and overheads, including the Finance, Personnel, IT and Legal functions. No organisation can sustain a long-term programme without tackling these critical supporting activities, where costs typically match the profit margins of many of today's businesses and are often growing faster than revenues.

Why most programmes to reduce overhead costs fail

Programmes to reduce overhead costs can be the most difficult form of organisational change to maintain, for four reasons:

- By their very nature they tend to sap morale by disrupting working rhythms and by creating a distraction that permeates the managerial structure, especially when the staff is cut.
- Managers invariably want to enlarge their empire, not trim it. The temptation for them is always to switch the focus back to expansion.
- All organisations operate in an economic cycle. Initiatives to cut cost are often born in downturns. As growth revives, managers find it easier to avoid difficult decisions and revert to type.
- Most managers closely track how operating costs change, but quite often fail to pay attention to overhead costs that keep on creeping up.

The fundamentals of transforming overhead costs

Three related factors determine the cost structure of an organisation's supporting functions:

- Organisational capabilities specify what an organisation can do. It may, for example, provide specific types of financial reports and HR support. This in turn raises the question whether it is appropriate to contract out those supporting services.
- Demand indicates the extent to which those capabilities are used. How often, for example, are reports generated and other forms of support provided throughout the organisation?
- Efficiency is to do with the quality, timeliness, and cost of the supporting services. It is assumed that most organisations want to make these services 'lean'.

Companies that want to remove overhead costs in the long term must consider these three factors in sequence. Executives eager to deal with inefficiencies frequently jump straight in, ignoring broader questions about capabilities and demand. But the right set-up is vital to achieve the best result and maintain momentum.

Shape the organisational capabilities to strategy

Cost-cutting should sharpen a business's focus and create supporting functions that clearly add value to the operating units. Managers must examine the 'what' (the value created by each organisational unit) before analysing the 'how' (the way the organisation seeks to achieve that value). There is no magic formula for spotting waste in supporting functions (such as Finance, Personnel, and IT). Only detailed scrutiny will reveal which activities to keep and which to cut.

A review of capability can highlight opportunities to reshape functions radically. Moreover, a company that shows its employees how the reshaping of capabilities will help it to sustain itself, survive, and grow focuses attention on the positive aspects of change. To undergo the discomfort associated with any effort to reduce costs, employees must understand what's in it for them. Without some vision of the way the goals are linked to the company's overall strategy, a cost programme can deteriorate into a 'race for the numbers' and, in the process, lose the support of the workforce.

Reduce the demand for services

Once managers decide which capabilities are essential, they can turn their attention to demand – that is, to how often these capabilities are used. Optimizing overhead activities before assessing demand for them risks misjudging both the total amount of work to be done and the staffing needed.

Companies can best control demand by:

- **Removing internal management centres and layers.** In time, organic growth and geographic expansion tend to produce anomalies in reporting relationships and spans of control, particularly when companies set up smaller operating units that replicate operating structures appropriate to larger ones. Simple ratios of staff to managers generally highlight these discrepancies (we discuss this in more detail later). De-layering by drawing the staff into broader groups of pooled expertise cuts costs and eliminates the need for dispersed skills in diverse locations. It also enhances the professionalism of the people who remain.
- **Cutting time intervals and the number of end 'products'.** Examples of reducing demand include actions:
  - to change payrolls from weekly to every other week
  - to provide information 'on demand' rather than routinely
  - to redesign financial information
  - to eliminate reports that are no longer crucial to the business or are duplicated unnecessarily.

Improve the efficiency of internal services

Once managers have worked out which overhead capabilities to cut and reduced internal demand for overhead support, they should consider the efficiency of the remaining overhead services.

> *"Remind people that profit is the difference between revenue and expense. This makes you look smart."*
>
> **Scott Adams**

Questions to ask include:

- **Can costs be cut by consolidating activities?** Benefits of scale often result from the consolidation of activities. Services that have many employees but are used only part of the time can be concentrated into shared services with fewer employees, lower costs and higher quality. Businesses that have not been reorganised recently may find opportunities of this kind, notably in Finance but also in the Procurement, Personnel and Legal departments.
- **Can costs be cut by moving activities to new locations or organisations?** Once the opportunity to aggregate an activity has been recognised, debate can turn to the best place to provide it and whether it should be contracted out. This option can improve the effectiveness of services and offer continuing reductions in cost that many organisations find hard to match in-house. Moreover, the larger the block of services offered to an outside contractor, and the better managers understand the cost of providing them internally, the more favourable the negotiating position should be.
- **Can activities be further improved?** The previous questions define the 'who' and the 'where' of functional services. When these broad criteria have been set, the focus can shift to optimising the execution of each activity – the 'how'. Analytical techniques such as value stream mapping, process activity analysis and process re-design usually come into play at this stage to reveal the causes of any barriers to improved performance. Although many traditional cost cutters start here to seek quick wins from better processes, overlooking the preliminary steps compromises a programme's long-term sustainability. The aim should be to reduce costs in a way that everyone can adopt. But it takes effort to create and develop the appropriate skills and practices. Such an initiative needs a common language, analytical tools, enabling measures, and the authority to make rapid decisions and sustain change.
- **Does the change cut the costs of the staff?** Most initiatives involve reducing or reallocating the staff. A rigorous initial analysis of capability should also highlight opportunities to retain and redeploy as much talent as possible, thus preserving the skills and experience that embody the organisation's institutional knowledge.

Well-designed and well executed programmes can help companies to sustain reductions in cost. An early concentration on strategic capabilities and on controlling demand builds the foundation for the longer term, enhancing the commitment and excitement of employees throughout the organisation and positioning it for high-margin growth.

Make some improvements incrementally – without waiting for agreement on major organisational reform

Create a momentum for change even before a final 'optimum' business model has been agreed on. Big savings can be achieved in steps. And there is a better prospect that they can be sustained.

4. Linking organisational capability to strategy

Every organisation should be clear about the optimum business model – the mix of activities, processes, organisation and skills – it needs to succeed in its market place. Efforts – core, supporting and improving – must then be combined to match the demands of this model in a balanced manner. The structure selected will have a critical influence on the future costs and competitiveness of the enterprise. So essential competences should get adequate investment, while all other activities should be kept lean to minimise cost. The model should be challenged regularly to make sure that it can meet evolving demands and perceived threats and opportunities.

4 Linking organisational capability to strategy

What is the right model for sustained progress?

Any assessment of the indirect activities and costs of a business starts with a rigorous and perceptive appraisal of its market, its business model and the competences required for success.

- What really matters?
- What brings success?
- What will create competitive advantage now and in the future?

So – what therefore requires and justifies investment and the allocation of effort to sustain these capabilities?

And:

- What will that cost?
- Can the business afford it?

To keep on prospering in the face of increasing competition, companies need to pinpoint their vital competences and maintain them efficiently and at low cost. These critical elements should have first call on a business's scarce means. All else must be subject to ever-increasing scrutiny to determine what is really needed.

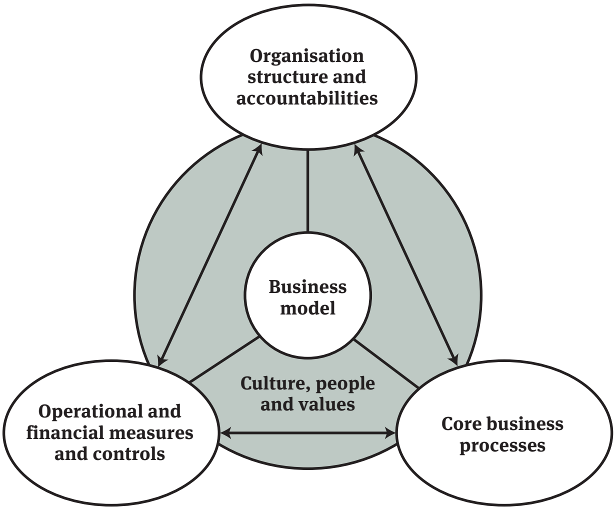
Other indirect activities are also necessary. But what is truly essential to support, control and administer the model? How can these things be done effectively but at minimum cost? How much has to be spent to maintain a credible image and good relations with stakeholders without drifting into excess? What needs to be done to develop the business for the future? It is remarkable how many ways these questions can be interpreted and how many people get the balance wrong, so that effort is applied in ways that do not add value, while necessary competences and opportunities for development are starved.

A balanced business

Growing organisations develop complex, intertwined activities. The requirements for success are constantly changing. The task is to unpick the complexity and focus on the strengths and competences that need to be developed, to optimise the efficiency of administrative functions, and to devote enough – but not too much – effort to long-term opportunities. It is to find the right balance between core, supporting and improving activities.

The framework that offers a balanced perspective is shown here:

A balanced approach to organisational design



A business keeps its balance only when each part of the structure responds to changes in the others and to the evolving strategy. To define an overall structure, it is necessary to determine managers' accountabilities; to specify jobs fully; to design processes to meet customers' needs; and to apply powerful but simple controls to monitor performance and prompt the right managerial behaviour.

The elements depend on each other. Any alteration in the status quo, anywhere in the cycle, will change the structure, accountabilities, processes or controls and will affect the culture and values. Before any one element is subjected to wholesale change, it essential that the senior team agree on what should be the main elements of the business model – on the core, supporting and improving activities on which they should focus.

The next chapter discusses how to fine-tune specific functions. But their place in the bigger picture must be established first. The temptation is to chase efficiency everywhere. But priorities have to be set, so that effort can be correctly directed rather than wasted on ultimately fruitless work to upgrade processes later found to be of such peripheral value that they could be abandoned or contracted out.

> *"Consider the vice president, George Bush, a man so bedeviled by bladder problems that he managed, for the last eight years, to be in the men's room whenever an important illegal decision was made."*
>
> **Barbara Ehrenreich**

A zero-based analysis

So the task of the senior team is to go back to first principles. History offers useful lessons, and encumbering baggage. To shed that and start afresh is the aim – in theory at least: to set aside the complexity that has grown up and to pinpoint the minimum requirements to run the business.

- How can all customers' needs be met without compromise?
- What combines to achieve this most cost-effectively? What is the heart of the business model?
- What contributes to these essentials by providing complementary support?
- Can the company afford everything needed to fulfil these tasks well? (If not, the fundamentals of the business model need further examination.)
- How can administrative support and managerial control be optimised – and minimised?
- How much effort should be devoted to long-term development? Where should it be focused?
- What should be done in-house and what should be bought-in or sub-contracted?

Any comparison of the actual with the ideal business will suggest that 'You shouldn't start from here!' The changes indicated by a zero-based model can be too extensive, costly, disruptive and impractical to be considered. And in that case, some realism is needed to avoid over-ambitious plans for transformation that do more harm than good. Compromise is necessary. The trick is to pinpoint what must be upgraded and what curtailed to achieve success without damaging effective operation. Both will almost certainly be necessary: so that the effort saved in some functions can be switched to enhance essential competences. Those who think otherwise are deluding themselves and avoiding the difficult but necessary discipline that all organisations have to rein in inessential activities.

Challenge managers to avoid excess

- Does the business present a professional face to the world without extravagance and unjustifiable gloss?
- Do senior managers and others enjoy appropriate and justifiable rewards?
- Is the balance right in every respect?
- Does every asset earn its keep? If not, why is it retained?

Match the business and organisational structure

Once the business model has been determined, it should be used to agree on the optimum organisational and business structure. The challenge is to create an agile organisation in which:

- managerial accountabilities are clear
- lean structures promote rapid decision-making
- responsibility is delegated appropriately – as much as possible – to local managers in order to promote enterprise
- clear but simple tools are used to monitor and control the business, but with the teeth to enable senior managers to intervene quickly when required
- tasks are done once and once only by the right people – not repeated at different layers in the organisation
- assets can be shared effectively – with transparent mechanisms for inter-company trade or charging

- simple measures are used to monitor and control performance
- activity at the centre complements the front line and helps develop the business
- integrated systems speed the flow of essential data and information.

New competitors have a clear focus and avoid historical 'baggage'

It is not uncommon for apparently unknown companies to come from nowhere and overtake established market leaders without appearing to break sweat. Peter Drucker, in a celebrated article in Harvard Business Review, pointed out that the newcomer invariably enjoys a tremendous cost advantage, often in the region of 30 per cent.

The reason – the new business has a superior method of managing costs along the supply chain from procurement to the customer. And Drucker's paper was written long before the Chinese and Indian economies became as vibrant and threatening as they are today.

What we have learned from these high-performing companies is that they constantly challenge conventional business thinking. They have replaced a long-established emphasis on products and revenues with increased stress on customer and profit-centric business models that focus all activities on the fundamental demands of the market environment – with no tolerance of excess costs. The result is processes that maximise the full profit possible from every customer. This approach relies on the application of systems that keep track of transactions throughout the business.

Centralisation v devolution

Large enterprises with several divisions and/or locations need to decide what should be done centrally and what devolved to local teams. This can be difficult, but not because there is a genuine rationale for either option. Managers at the centre, reluctant to trust or to devolve responsibility to others, may find comfort in the control – often, sadly, illusionary – that a large, central organisation affords.

So the temptation is to add layers of control and extra cost by doing things twice. Managerial information gathered from local sources and analysed to provide local managers with an immediate picture is then re-evaluated when the centre determines that it needs to check everything again. This rarely improves control. A manager with problems can be very adept at hiding things. The bigger and more complex the controlling mechanisms, the less often there is real visibility.

Similarly, basic tasks that are best done locally – close to the action – are brought to the centre for reasons of 'efficiency and quality' that are often spurious. Rarely do centrally generated schedules for production or delivery fully reflect local factors, yet many companies try to micro-manage such operational activities. Yes, it might be appropriate to set a high-level master schedule for activities to promote coordination between units and functions, but there has to be some delegation of the fine detail of how the schedule is applied. Similarly, the recruitment and management of people is better done locally. Central HR functions impose unnecessary constraints that add cost but rarely value.

So – devolve wherever possible. Let local managers manage with the minimum of – but adequate – checks and balances and no unnecessary 'interference'. That lets them get on with the job, reduces distraction and allows central control to be kept to a minimum.

The exception might be activities more efficiently brought together in a shared service centre (SSC). We discuss this in Chapter 8. But this is not centralisation, and should never be referred to as such. Indeed, if properly configured, it implies complete delegation by all parts of the business to a stand-alone unit, charged with handling tasks for which it is the centre of excellence – with appropriate performance measures – but certainly not under the day-to-day control of the 'centre'.

> *"In large organizations the dilution of information as it passes up and down the hierarchy, and horizontally across departments, can undermine the effort to focus on common goals."*
>
> **Mihaly Csikszentmihalyi**

I would not start from here

The new design should be compared with the current structure and ways of working to determine where – probably for sound historic reasons – imbalances have grown up that tend:

- to impede effectiveness, control and decision-making
- to slow the response to the changing market environment
- to add cost
- to divert managers' time and attention away from the main activity.

Action can then be instigated to move the business from the starting position – however imperfect – towards the new design, following a controlled programme to make the necessary changes as quickly and as smoothly as possible. Many fear causing disruption and instability during the transition, but, since the essence of the plan is to strengthen core and supporting activity and to slim less vital administrative functions, this should be avoidable.

5. Designing cost-efficient organisations

The design of an organisation affects the use of assets. In particular, removing internal management centres and layers has a dramatic affect on costs and operating efficiencies. In time, organic growth and geographical expansion tend to produce anomalies in reporting relationships and spans of control, especially when companies move into smaller countries or set up smaller operating units and replicate operating structures appropriate to larger ones. Simple ratios of staff to managers generally highlight these discrepancies.

5 Designing cost-efficient organisations

Layers and spans

The concepts of layer and span are fundamental to analysing structures that take the form of a managerial tree. Mapping the structure and counting its depth (layers) and width (spans) is a valuable exercise in understanding how a business is meant to work, the effort it is absorbing, and some of the problems that may challenge it. Even a brief study may throw up some obvious shortcomings in the configuration.

Optimising layers and spans – the 8 x 5 test

It is useful to benchmark managerial structures against an 'ideal' maximum span of eight and an 'ideal' of not more than five layers – usually referred to as the 8 x 5 test.

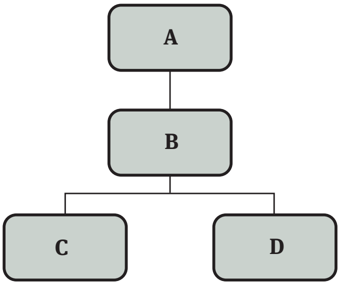
The 'ideal' maximum number of layers, five, is thus a number that has to be relative to the context, size and scope of the business. There are no strict rules. Judgement is required. In this regard also take into account levels, which are discussed later. Layers and levels are different concepts, even though they ought to cross-refer.

Structural shape – the dangers

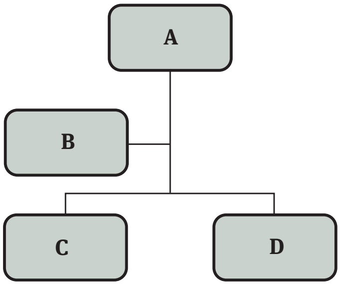
The importance of structural shape is often lost on senior managers who follow their own instincts in designing those structures they manage personally.

A common mistake is to assign one manager to each separate task or type of task, irrespective of the number of managerial jobs (nodes) this generates. Too many nodes will result in too deep a structure and narrow spans. For example, an accounts department of twenty people might give rise to eight managers in four layers, while a correctly shaped structure would be more likely to have four managers in two layers. One common feature of bad shape is one-to-one reporting of the type shown overleaf.

Wrong 3 layers



Right 2 layers



Worse, an unnecessary number of managers creates fertile conditions for an uncontrolled increase in the whole staff – a ballooning of the numbers employed – usually needlessly. So it is particularly important that spans should not be allowed to be too narrow or levels too numerous, because the proliferation that follows inflates the size and cost of the payroll.

Not that this is the only danger – for example, the job at B is almost certainly ill defined, and the accountability of A's job may be diluted as a result. It encourages other bad habits. B can be an effective barrier to communication and to the flow of information up and down the chain of command, and may block A's vision of the work being done, or not done, below B.

Cut out 'managerial' jobs that have no measurable output

Nearly all objective reviews of organisational structure reveal managerial jobs that could be eliminated. Some have indistinct targets and no real accountability. Others supervise few or no other people – and are better classified (and paid) as specialists. Think twice before creating new managers.

Effect of diversity of jobs

The optimum span may differ with the diversity of the subordinate jobs. This might vary at different depths in the structure. For example, lots of jobs can report to a chief executive, because each one will carry large discretion. Senior people need less managing than their juniors do.

But middle managers will find that managing diverse types of job places a limit on the span, perhaps to between four and eight. Middle managers need closer supervision than their senior colleagues do. But a junior manager can manage large numbers of non-managers performing jobs to the same or similar design. A call centre supervisor, for example, can manage well over twenty subordinates, because managing simpler, repetitive work takes proportionately less managerial time per person.

> *“Most discussions of decision-making assume that only senior executives make decisions or that only senior executives’ decisions matter. This is a dangerous mistake.”*
>
> **Peter Drucker**

De-layering and reducing the number of managers

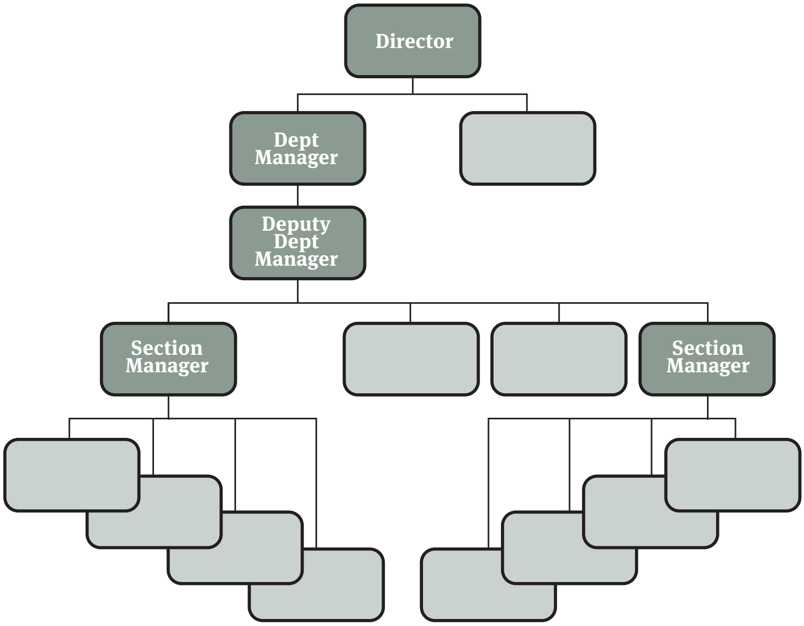
Generally, the wider the average span, the fewer managers and staff are needed for any given workload. Flat structures are best. The number of layers can easily proliferate in the same way as spans can do, often for the same reason, and with the same result. In fact, the narrower the span, the more layers are likely to be generated as a result. The staff thought to be necessary has to be fitted in somehow!

Flatter structures should result in a staff that is better motivated and controlled and in better performance from senior managers who are less likely to be out of touch with the quality of the work and the processes being operated. It is certain that the quality of communication throughout an organisation will deteriorate as its structure becomes deeper.

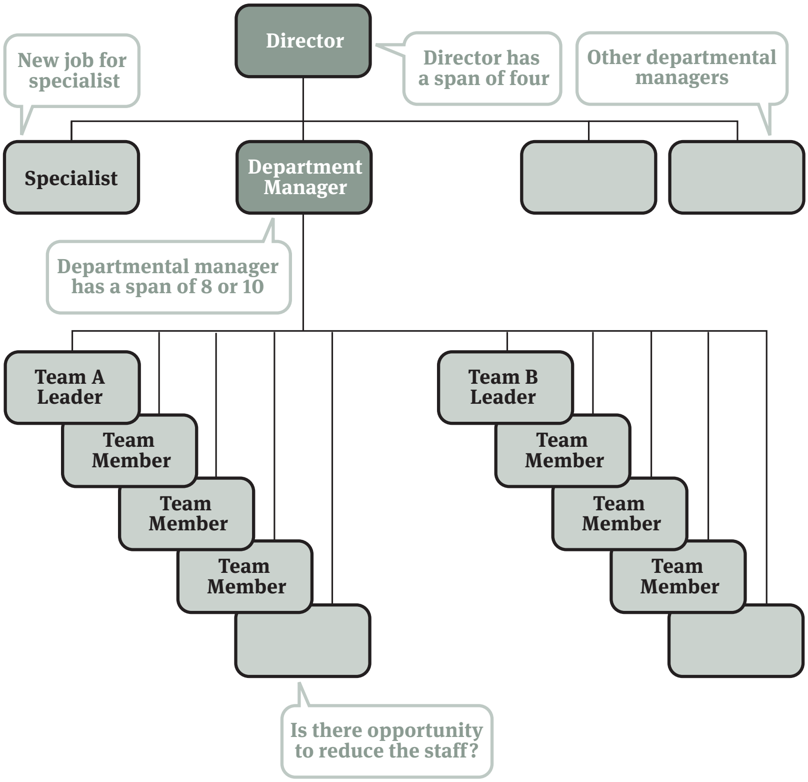
A manager should expect to spend at least two-thirds of his time interacting with the employees who report directly to him, so there should be enough of them to justify this – a broad enough span. If more than half of a manager’s time is spent on work that is distinctly different from that done by the staff who report to him, then the job may be using the skills of a senior specialist, not a manager.

So, first and foremost, managers should be good at managing people and should spend most of their time doing it. However, it is common for the most skilled specialist to be made head of department, irrespective of his lack talent for managing staff or operations generally. This commonly leads him/her to hand the task of managing the staff down to an assistant or deputy – the undesirable 'one-to-one' that creates the unnecessary extra layer.

Reviewing organisational structures



This structure almost certainly has too many layers and arguably too large a staff as a result. So it is possible to challenge it and to consider an opportunity to delayer by insisting on the correct design of jobs. It could be reworked as shown on the next page.


Director
Director has a span of four
Other departmental managers
New job for specialist
Specialist
Department Manager
Departmental manager has a span of 8 or 10
Team A Leader
Team Member
Team Member
Team Member
Team B Leader
Team Member
Team Member
Team Member
Is there opportunity to reduce the staff?

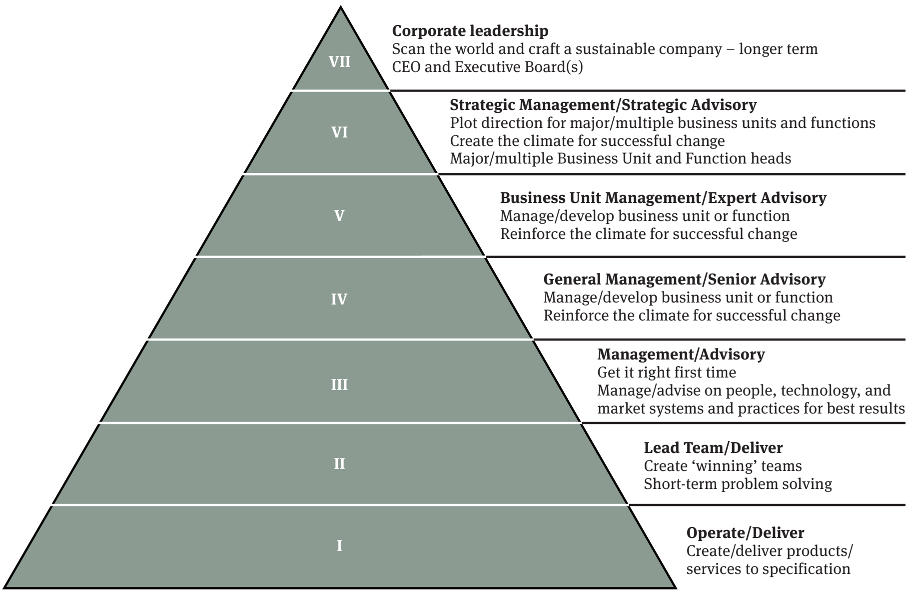
Levels of work

In a structure it is not necessary that jobs in the same layer (counting down from the top) have the same rank, that is to say the grade, or pay, or other indicators of seniority.

While the 8 x 5 benchmark is a useful check, a more systematic approach that can help control and optimise the number of layers is the levels of work method. It attempts to limit layers by creating a correspondence between each layer and a generically defined level or rank of job.

The ‘levels of work method’ developed by Jaques is based on his time span analysis. In this he classified managerial work into seven categories or levels according to the time that each type of job needed to achieve its aims. This was an indicator of the type of accountabilities associated with each layer and it is this that seeks to find a correspondence with the managerial responsibility and content in the job (the level in the model) and the layer the job is at in the structure.

Jaques’ model of seven levels of work



Using the levels of work method

The following steps can be taken to apply the levels of work principle to the task of radically reorganising a structure or creating one from scratch.

- Recognise the current problems: duplication, too many levels, too many layers, too much management (over-managed environment), excessive cost.
- Examine the characteristics of every managerial job.
- Define jobs by title, job code and function and map them to levels of work.
- Define required levels of work, noting that not all Jaques' levels are relevant to or required by all organisations.
- Consult the job grading structure and draft amendments, if necessary.
- Eliminate managerial jobs and capacity.
- Re-grade jobs/people.
- If necessary, create senior, non-managerial streams to accommodate the high-grade, non-managerial staff.
- Draft a structure chart with layers and spans.
- Note that there can be more than one layer within one level if a manager and his subordinate, both in that level, need such a line-reporting structure.

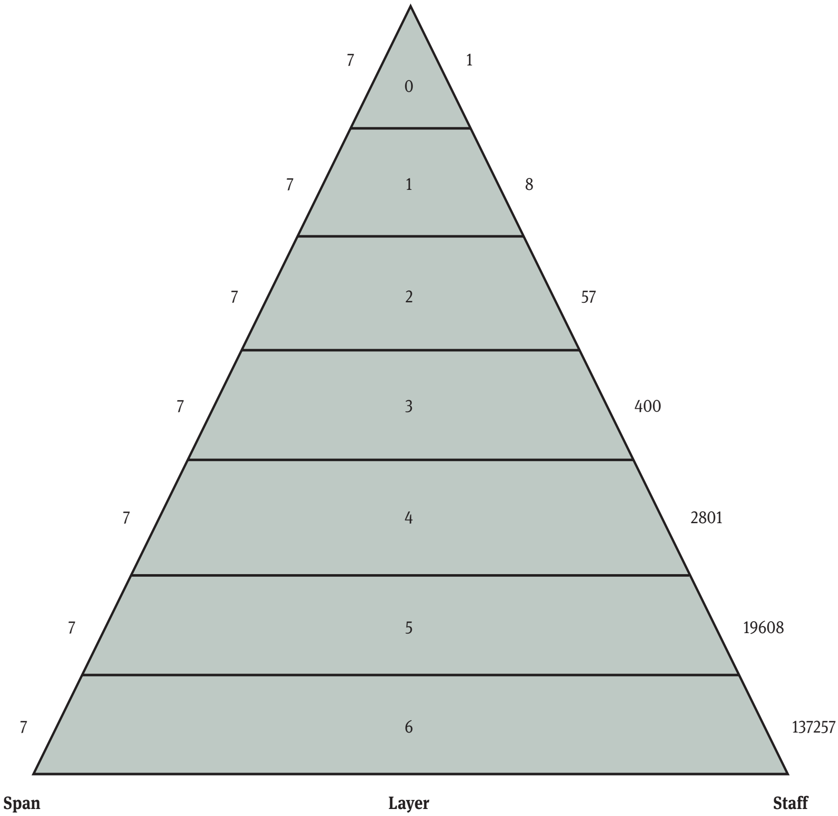
The exercise aims to achieve best fit and will therefore be iterative.

Levels and layers

If jobs are defined by Jaques' generic descriptors, and are first slotted into the model of levels before the number of layers is determined, the number of levels then 'occupied' can be allowed to influence the number of layers in the line and staff reporting structure. A level can contain more than one layer if the organisation of work or the managing of processes requires it, but should first default to a one level to one layer configuration before the necessity for two (rarely more) layers becomes apparent.

Likewise it is not necessary that every level contain a layer – not filling levels with jobs is a sure way of designing a lean structure, always provided that the managing of processes and the decision-making capacity of the organisation are not impaired.

It is the principle of levels that is important – you may substitute Jaques' definitions and create a model of your own, if you can build one that is consistent and clear and has a robust logic.



The grading structure may also offer potential as a framework for a levels model, but caution is needed, because many grade structures have even more steps than there are likely to be layers.

Nevertheless, it may be possible to construct a rationalised and downsized model based on grades, although Jaques' model should not lightly be set aside, and can always be tweaked, if appropriate. Theoretically, a pyramid of only six layers with an average span of seven is possible in an organisation of 137,000 people – big enough with plenty to spare for most organisations!

Functional relationship

It was common in the past to refer to 'line and staff' structures and, although less heard today, it remains the clearest terminology with which to refer to conventional structures set out as family trees. Some people were said to be in line jobs ('in the line') within the layered hierarchy through which is threaded the vertical chain of command. Others were said to be in a 'staff' relationship to line jobs because they work in what we now call the functional departments, and so had a more 'horizontal' juxtaposition or relationship to the rest of the organisation.

> *"Excellence in any department can be attained only by the labour of a lifetime; it is not to be purchased at a lesser price."*
>
> **Samuel Johnson**

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6. A different way of classifying indirect costs?

Modern enterprises need to decide which activities are vital to their success, and which others are then needed to support them. Activities are changing all the time as new technology and new competitors appear, so what mattered once may no longer merit investment now. Activities need to be classified by relevance to the demands of the market and customers to determine the balance required – a balance that has to shift constantly.

6 A different way of classifying indirect costs?

Understanding costs

Data on costs are the currency of management. They provide evidence for decisions and for improvements in performance. Managers need to be comfortable in analysing financial reports. But first they need to know how costs occur in the first place, how to classify them, how they behave in different circumstances, and how they can be controlled or eliminated.

Is the main classification of cost determined by the budget?

The budget is the most widely used mechanism for controlling costs. But it assumes a fairly steady state of business. Whereas demand is now more volatile. Specifications change quickly. New products replace older ones. Competitors spring up overnight – usually with much lower costs. So the budgets set up to contain cost now seem to retain them instead. To respond to uncertainty, organisations need to be flexible, and to find out how all costs add value to products or services.

To classify costs by the value they add is to see them from the customer's point of view. And that new perspective demands a different analysis. Do not ask which department people work in. Ask what they actually do. This allows costs to be classified in three broad categories:

Core – adding value to products and customers
Supporting – needed to maintain the organisation
Improving – required to change and improve the business.

Experience in many businesses suggests that:

- Core should be 70 to 80%
- Supporting should be 15 to 20%
- Improving should be 5 to 10%.

Direct and indirect costs – but which are core?

The old distinction between direct and indirect costs was simple. Direct costs added value to products during manufacture. Anything else was an overhead.

But the boundary between direct and indirect activity was never that simple. It is even less useful when more people provide services of one form or another (in the public and private sectors) than work in manufacturing.

Many indirect activities are just as vital as those defined as direct. Core activity – adding value to products and customers – is not confined to making things or serving customers. It can include crucial activities in sales, marketing and logistics too. Because a product once made (or purchased by a trader) has no value until it is sold and delivered to someone else. So core costs encompass not just direct costs but also the indirect costs vital to the value chain for that business.

In organisations that provide services rather than make things, the distinctions between direct and indirect activities may be even less clear. 'Front-line' is used to describe employees who deal directly with the public, but many other activities clearly satisfy the definition of 'core' in that they add value.

Which activities should be considered core within a particular trading environment will depend on:

- how critically they affect the performance of the business
- how they affect medium and long-term prospects
- their importance in the management of the organisation
- the time scale of their influence, be it immediate, medium-term, or to do with long-term development.

The spectrum of indirect costs therefore includes activities that are needed:

- to fulfil core tasks – crucial to day-to-day trading and service
- to support operations – to allow core tasks to be done effectively
- to develop and improve the business – meriting investment for the future
- to control and monitor performance – to guide managers on what needs attention

- to administer the business – routine tasks done efficiently by lean departments.

These are explained more fully in the subsequent sections.

> *"Almost all quality improvement comes via simplification of design, manufacturing... layout, processes, and procedures."*
>
> **Tom Peters**

Fulfilling core tasks

These are the activities that combine day-to-day to generate value – the competences without which that particular business cannot succeed.

In operations this typically includes production, but could also include front-line sales and order processing, some elements of marketing, logistics (warehousing, dispatch and transport) and even (in a trading environment or where vital components are bought in) purchasing and contract management. Procurement is growing in significance, not only to buy raw materials and traded goods economically but also to manage bought-in services, components and finished goods.

In general, core activities are those that are needed:

- to happen every day if customers are to be served satisfactorily
- to give customers a pleasant experience, so that they will return
- to occur consistently, as it would be costly if they stopped for any reason
- to contribute directly to the competitive advantage of the business
- to allow other critical activities to operate efficiently
- to provide a platform for continuing trading activities.

To decide which are core activities, start from the premise that all enterprises need to make a profit or, in the public sector, to provide defined services to a specified standard and within budget.

Senior managers need to work out which activities are essential for success and then how to make them effective and efficient. But, as technology advances and competition intensifies, it can be easy to miss an emerging requirement but include a redundant one. So the real needs now may be:

- to specify products and services precisely – what 'customers' are buying and how they perceive value
- to select and manage partners to supply products and services at the lowest transactional cost (the total cost includes quality, transport and administration, not just 'price')
- to manage the supply chain to meet customers' expectations for quality and timeliness
- to design, advertise, and promote the product or service and present it to potential customers. Marketing embraces design and sales
- to have as many sales channels as possible, of which a 'field' sales team might be the least important. Today activities range from internet sales to account management and change all the time
- to manage cash and to safeguard and minimise the assets employed in the business (credit control, stock management, investment decisions etc).

> *"We don't have as many managers as we should, but we would rather have too few than too many."*
>
> **Larry Page**

Supporting front-line operations

Behind the core lie the supporting activities that allow the front-line operations to work effectively. In 'operations' the importance of material control and handling, warehousing and maintenance has long been recognised. Service businesses (and others) rely absolutely on robust IT and communications. For web-based traders, IT systems are clearly a core competence. Good sales support (feeding leads to the front-line staff) is also a key element for many businesses, as is internet marketing.

The value of such close operational support should not be underestimated. If it is treated in a traditional way as part of 'overhead', the temptation is to view it as secondary – something to be minimised and cut whenever possible.

In reality there can often be a case for investing more in close supporting activities where they help:

- to reduce other costs. Good control of material and processes, for example, is vital to minimise waste and optimise effectiveness in a processing plant, but it is tempting to cut back once 'acceptable' operation is achieved. The potential for continuous improvement and refinement is then lost
- to create competitive advantage. Reliable, up-to-date IT systems are vital. Considerable investment must be made to maintain essential systems and develop new ones to keep ahead of competitors
- to offer support to front-line sales. Salespeople are only as good as the leads they are given. Good market research and analysis can enhance the productivity of a sales team. Effective support that cuts out fruitless visits but focuses on the best prospects can allow a smaller staff to generate higher sales.

Do not invest in a 'cheap' location – invest for effectiveness

A major business decided to do all its distribution throughout Europe from a single site on the outskirts of a 'low cost' Eastern European city. Initially, the heavy investment was a success. But that city has since flourished. Its infrastructure has become congested and it has become an expensive place to operate from. But the cost of relocating again would be prohibitive. And in any case, where would the company go? Wherever is 'cheap' now is not necessarily going to stay cheap. The success lay in the establishment of an efficient, comprehensive business model in which every element links effectively – not the specific location.

It is the links that matter. Having an effective web site to take orders is no use if the warehouse cannot keep up with demand. When internet trading took off, expectations soared, only to be dashed. Customers could not find out what had become of their orders. But word soon gets round. People soon homed in on the efficient operations and quit the incompetent ones.

Pinpoint and eliminate redundant activities quickly

You don't have to import a sophisticated analytical technique to pinpoint duplication, re-work and wasted effort. The local broom knows where the dirt is. So ask the staff and junior managers first. They are likely to come up just as quickly with valid proposals and ideas on how to apply them. And if you take heed now, they will be more likely to co-operate in the tougher decisions down the line.

Developing and improving the business

Senior managers need to exploit market opportunities, increase cost-effectiveness and beat the competitors. To make informed decisions about investment, they must have a clear grasp of the required competences, the market environment, relevant technologies, suppliers and competitors. And each of these is constantly evolving, so any plan must be kept under continuous review.

Flexible, responsive thinking

Agile companies adopt the same 'lean' approach to corporate planning as to front-line operations. They appraise investment, but do not seek to avoid all risk. Speed may be of the essence. Radical ideas should not be mired in laborious research and planning. What modern companies need at the top is flexible, rapid thinkers, informed but not paralysed by analysis, and not scared of risk.

Research and development

Leading companies expend huge budgets on primary research and developing products. As businesses mature, they need to find new and innovative products and services. This may be to replace older ones as patents expire (as in the drug industry); to meet consumers' demand for constant innovation; to stay abreast of technological sophistication; or even to keep in step with fashion.

In contrast, some companies prosper largely by following the leaders – by living off and copying the innovations made by others. Their strong suit is not pure R&D but their ability to respond flexibly and quickly to market opportunities.

Either path can be a route to success. But they need different skills. The key is to allocate enough – but not excessive – investment and effort to this work.

But what is enough? Non-technical managers find it difficult to understand what is involved in R&D and hence to argue against the increased expenditure for which engineers and scientists can make a very persuasive case. So they cross their fingers that it will pay off. Professor Bala Chakravarthy has argued that scientists and engineers should not be managed tightly but allowed 'slack' time in which creativity can blossom. But does it? Most research teams have one or two original thinkers supported by worthy but more mundane developers of their ideas.

With just a modicum of technical knowledge, it becomes possible to break research down into its component parts to analyse the effort required by different members of staff and its effectiveness, value and 'productivity'. Engineers usually hate this. They cling to the mythology of their 'black art'. So it is up to a senior manager to make a balanced appraisal of what really matters – what is core.

> *Group initiatives*
>
> Senior managers should aim constantly for continuous improvement and cultivate a culture to support and reinforce it. They should not be waiting for the Group to sponsor an initiative, or to give them an incentive. The best companies expect their managers to be self-winding.

Controlling and monitoring performance

Effective monitoring and control of performance are essential for any business. Managers need appropriate operational and financial data to be able to monitor progress against targets, to direct the business, to adjust priorities and effort as necessary and to intervene strongly when required. Overall financial results must also be collated and reported clearly to shareholders and others. But good control is best done lightly, in ways which do not stifle a business by consuming too much of managers' time and energy. There should be timely information on day-to-day activity and performance, information that is best garnered and disseminated locally to meet the specific needs of the unit. Too often extra demands are placed on a unit to report its results upwards through the hierarchy of the organisation.

The world does not stop because the full top-line report to the Chief Executive is delayed or incomplete one month. Yes, he or she will probably feel uncomfortable by not being in 'control', but it is remarkable how little difference it truly makes. News of any really serious problems will soon reach the top – usually faster through ad hoc channels than via the official reporting process. The formal report often only confirms and clarifies what is already known.

So, formal procedures, for reporting performance upwards, need to be kept lean and in proportion. Done badly and intrusively, they can badly distract unit managers and their team from their front-line duties in ways that add cost and impede the vital activities. Often the information that needs to be generated for a central 'template' of reports is quite different from what is recognised locally as being important. Formats and definitions also vary. So it may be inadequate just to send the local report to the centre: and it may be unnecessary to create separate and more complex analysis to meet the requirements (not necessarily the real needs) of 'head office'.

Consistent terminology

The task can be further complicated in multi layer organisations when different requirements are specified by each layer and the systems do not necessarily link up to allow seamless collation of all the necessary requirements. We have seen businesses where the financial manager of a low level business unit had to re-input reporting data into separate financial systems three times to meet the differing requirements and definitions used by the hierarchy of company, divisional and group reports. Even the language used can have different meaning. Does 'Turnover' mean external sales only or does it include internal sales? Is it net of tax or gross? So confusion can arise during reviews of the information because managers familiar with different definitions and terminology misunderstand what they are being shown. That can be particularly common in international businesses and in meetings between a parent company and managers from a new acquisition.

Often the measures are contradictory. Progress on one front can result in adverse movements in others. Short-term objectives compete with longer-term goals. So managers become confused about which are the priorities. Are they allowed to 'trade-off' poor performance in one aspect to make progress in another? Is it better to maximise sales or to minimise working capital? Often they are left to guess what will prove to be the 'flavour of the month' at the next review meeting.

> *“To think that the new economy is over is like somebody in London in 1830 saying the entire industrial revolution is over because some textile manufacturers in Manchester went broke.”*
>
> **Alvin Toffler**

Select relevant Key Performance Indicators

Senior managers who are truly in tune with the business are clear about priorities and give clear direction. They concentrate on the relatively few measures that matter, focusing on selected Key Performance Indicators (KPIs). Too often organisations are required to gather and report a plethora of financial and other measures, which are deemed to be essential to inform senior executives that all is well. But when asked what they understand from all these data and how they use them, they can seem somewhat vague. Most people home in on the few indicators or ratios that they understand and find meaningful and largely ignore the rest. So, why are they all necessary? Because the design of the reporting pack was left with financial analysts who love lots of data and take a delight in finding new ways to measure activity, just in case it reveals something useful, even if it is not truly of value to senior managers.

Similarly, far too much effort is devoted to the development and refinement of budgets. These assume a significance that greatly exceeds their value. Yes a baseline is needed to allow financial planning and as a starting point for routine reporting. But too often the budgeting exercise is used to examine fundamental problems in the business that should have been tackled long ago, and assumes a ‘political’ status that undermines its credibility, particularly when managers know that their next bonus will be linked to their performance compared with budget.

Rolling forecasts provide better insights than budgets

Regular reviews against routinely updated rolling forecasts are far more effective in monitoring and controlling performance, in highlighting trends and turning points and in instigating prompt corrective action. But they are rarely used. So, true appraisal of the trading environment and debate about who should take corrective action is delayed until the annual budget debate, which then assumes a magnitude out of all proportion. It becomes protracted, bureaucratic and cumbersome, which results in further delay in tackling problems. The budget process can also be so protracted that it has to be started long before the end of the current year and so becomes totally irrelevant before the New Year actually starts.

Reduce the effort on 'routine' reporting

Having too many people collecting and analysing data and preparing managerial reports wastes effort and adds cost. There is duplication, overlap and unnecessary variation in the activities at different layers of the organisation; people re-calculating and double-checking others' work; analysis being manipulated and represented in different ways to meet the particular preferences of senior managers, data being keyed several times into IT systems that do not link. The essence should be:

- to record all the necessary data once at the point where it is generated in as much detail as will ever be required (but to avoid collecting detail that will not be used)
- to adopt common definitions, accounting structures and language throughout the organisation. Make sure these are transparent and understood by all – especially new managers
- to agree on the KPIs that matter to the business. Keep the number as low as possible but augmented by a few specials for particular businesses
- to create a hierarchy of reports in which those used at the higher levels are largely direct extracts from lower-level management information – not documents and analyses that have to be created from scratch
- to minimise the number of layers at which and the times that the performance of the business is reviewed. Do not pick over the same problem at unit, company, divisional and group review meetings every month. Delegate responsibility to the appropriate managers and let them get on with it
- to use IT systems that link effectively, so that data are recorded once and once only, and can then be summarised as necessary

- to keep the annual budgeting exercise simple, quick and in proportion
  - use rolling forecasts to monitor performance, which can also act as the basis for the annual budget at the relevant point in the year
  - avoid multiple iterations of the budget
  - do not link incentives to the budget – reward year-on-year improvements and other specific targets
  - tackle problems in performance as they arise during the year. Do not wait for the next budget to resolve pressing concerns and instigate changes.

[KEEP IT SIMPLE]

7. Optimising the efficiency of overhead costs

Once the overall business model and organisational framework have been established, each piece of the jigsaw should be examined critically to determine whether it is as lean, effective and efficient as possible. Flexibility is also essential, so no cost should be fixed in the long run. Progress towards the desired model should be monitored regularly. There are a number of techniques for scrutinising specific functions and activities in the pursuit of cost-effectiveness.

7 Optimising the efficiency of overhead costs

Each part – large or small – must be cost-effective

Start by confirming what the business needs to do in order to operate efficiently and then put in place the right structures and organisation to achieve it. When this is done, each aspect of the framework of the business has to be examined to confirm that the specific processes, activities and tasks are efficient, being done by the right people and in the right place. Does each process or activity give value for money and is effort applied to meet the overall needs of the business, not just particular managers' preferences?

As noted, despite new technology, overheads have risen as a proportion of total costs. But this can be for good or bad reasons. Traditional concepts of indirect and direct costs no longer apply. Some indirect activity does contribute to the competitive strength of an enterprise, so might need to be enhanced, while excess cost elsewhere must be investigated and removed without delay.

There is no standard answer. Even within the same sector, two rivals might adopt completely different business models – one centralised and one largely devolved – that both work. The secret is that each model should be entirely consistent, each task done once only (locally or centrally), costs kept to the minimum, and strong controls and measures in place to monitor performance. That is the judgement that a good management team will exercise – to determine the right model to fit its environment and to decide on the staff each function and activity needs to operate successfully.

Fixed and variable

But the definition of costs in costing systems runs a risk. Managers may start to consider indirect costs as overheads and 'fixed'. Lots of accounting reports present them as such, which creates a mind-set about 'fixed costs'. People also associate the term 'overhead' with tangible, fixed assets such as buildings and plant, so reinforcing the impression that they are difficult to change. In practice, no cost need be fixed in the medium to long term. Indeed, many indirect costs are highly variable, so that it can be easier to reduce them quickly than to change 'direct' costs. All costs should be considered as variable as possible in order to increase the ability to respond quickly to changing market conditions and new opportunities.

This need has been recognised for many years in manufacturing. Managers learnt many years ago that major production facilities can be very inflexible and not at all variable. Yes, it can be possible to lay off some direct workers, but with them go skills that will be needed again when good times return. So it was notable that during the downturn in 2008/2009 that many companies chose to put skilled people onto short-time working rather than make them redundant in order to retain them for the future (and to avoid redundancy and subsequent recruitment costs). But this effectively turned a proportion of the workers' wages into a fixed cost – contrary to the view that labour costs can be variable.

And people are only a small part of direct costs in the modern world. Once investment is made in sophisticated IT systems, process plant, robotics and material handling equipment, the cost of running, maintaining and depreciating facilities becomes highly 'fixed', so that closing, relocating or scaling down the operation is too costly and too slow.

The scope for flexibility in indirect activities can be even greater. Some companies have reduced the 'fixed' element of their supporting, administrative and development costs to the minimum. But many have not. The opportunities clearly exist:

- to minimise the size of the corporate head office while putting administrative support into cheaper buildings with short leases in low-cost regions
- to consider releasing the office staff, most of whom have replaceable skills – particularly if you locate to regions with a good recruitment pool
- to adopt contracts of employment that oblige the staff to accept flexible working practices, including redeployment when necessary
- to maintain a permanent staff supplemented by people on short-term contracts to cover peaks (but there are also dangers in this – having too many 'temps')
- to out-source non-core activities – which could include logistics, some IT, payroll and even some marketing, technical and customer services (the equivalent of manufacturers outsourcing the manufacture components while retaining essential capabilities in design and specification) – while ensuring contracts retain flexibility.

Even when things are stable, the aim should be to increase the variability of all elements of the infrastructure of a business. The trap can be to seek short-term savings by, for example, entering an apparently attractive twenty-year lease or a lengthy facilities management contract which then locks you in to arrangements that are costly to shed. Flexibility often has a price – but it is well worth it.

> *"Create a definite plan for carrying out your desire and begin at once, whether you are ready or not, to put this plan into action."*
>
> **Napoleon Hill**

Techniques for examining the detail and removing costs

Where once the productivity of direct labour was a major influence on profitability, now managing the productivity of all indirect activity is just as critical. This requires a thorough understanding of what drives a business and creates cost. What are the inputs/outputs of activities that add value, and of their associated costs? When costs have to be cut, it is essential to analyse closely those needed and where they can be reduced without damaging the business.

There are a number of ways of assessing indirect costs to seek to understand whether they are enhancing competence, supporting activity effectively, or costing more than they are worth.

Activity-based costing

If well applied, activity-based costing should provide a rigorous mechanism for determining the activities that add value and which, consequently, should be designated as cost drivers. The most successful tend to use a relatively 'light' touch designed:

- to allocate indirect costs to direct activity in ways that are clear and well understood by all the managers in the unit
- to take adequate account of complexity as well as volume
- to use assumptions and relationships that the managers can see, debate and adjust easily as circumstances change
- to create an understanding of the true total cost of a product or service
- to allow specific costs still to be aggregated and scrutinised by line managers.

But sometimes the pursuit of 'accuracy' can lead to systems that are so complex that they lose touch with reality. The calculations become so complicated that they can only be done by sophisticated computer models and cease to be sufficiently transparent for line managers to understand and question. So the formulae in the system are set for long periods and, as circumstances change, become quite misleading. And if the system is only understood by a few analysts, routine updates are easily delayed, so the costs generated are quite simply wrong.

In a reporting system dominated by activity-based costing, indirect costs can tend to disappear from scrutiny. They are 'allocated' to activities and 'absorbed' by products in a way that implies that they do not need to be controlled separately. It becomes too easy to see the solution as being extra volume that can absorb the given amount of indirect cost – which is allowed to persist and even to grow. All costs need to be absorbed and charged to the products/services to which they relate – in contrast to marginal costing, which has its own horrendous danger – but equally all elements of cost need to be visible, closely scrutinised and open to challenge.

So activity-based costing must be used sensibly. When it is established in a balanced way, it provides a valuable defence against that other major trap – marginal costing – which takes no account of indirect costs, and can be one of the fastest ways of destroying a business.

Process activity analysis

Process activity analysis (PAA) is a powerful technique for reducing overheads. It starts from a rigorous appraisal of all the tasks that need to be done to allow the business model to work effectively. This initial analysis to determine the main processes, activities and tasks required usually reveals overlapping activities and processes and immediately starts to expose and challenge:

- assumptions about what needs to be done to run and develop the enterprise
- activities done out of habit (and comfort) rather than need
- aspects that truly support and promote business performance.

The subsequent detailed analysis of how people devote their time to the different processes, activities and tasks fully exposes the effort being allocated to work that yields low value to the business but that incurs high costs. PAA allows managers to make informed decisions when the scale of the changes required dictates that a more fundamental reorganisation and job losses are necessary. It is an essential tool for restructuring processes when cuts of more than 10% are required. Most importantly, PAA shows how costs can be reduced without diminishing the overall performance of the business.

PAA will produce a plan for reducing indirect, staff-based costs. The initiative should gain the commitment of the managers accountable for those costs. This becomes more likely when the urgency for reduction is communicated to senior managers, accepted by them at the outset, and sustained to the end of the exercise.

PAA tackles the problem directly. The benefits are threefold:

First, it is based on questioning – and gathering data from – the people in the organisation itself. In other words, the solution has the merit of being 'home grown'.
Secondly, the majority of the project team are from the business itself, which minimises the assertion that the organisation is being 'done over' by outsiders hired to cut out jobs. Nevertheless, the approach is robust and is led by experienced practitioners.
Thirdly, the process has an excellent record as the most penetrating and least damaging way of reducing the staff. Trades unions will reluctantly endorse the methodology, once they are persuaded that managers are determined to take action.

It is necessary to analyse the staff, not only department by department but also by processes and activities, asking 'What do people actually spend their time doing?' rather than 'Which department do they sit in?' As described earlier, costs should be in the three categories:

Core – adding value to products and customers
Supporting – needed to maintain the organisation
Improving – required to change and improve the business.

This approach, which focuses on processes, is far more revealing than the conventional, functional method.

Process activity analysis reveals:

- Where duplication exists – the same work being done, unnecessarily, in different parts of the organisation.
- A disproportionate use of effort – the total effort expended on processes categorised as supporting or improving may not be appropriate to their overall importance.
- Where responsibilities have been over-devolved – attempts to move processes and activities from a central department nearer to the front line may have gone too far. Obvious economies of scale may have been ignored.
- Where responsibilities have been too centralised – conversely, the opportunities to consolidate tasks in central services – possibly within a shared services centre – should be examined.
- Opportunities for outsourcing – transferring whole functions or processes to an external provider offers some advantages in cost and service, but does not necessarily increase flexibility.
- Opportunities for improving maintenance – tasks devoted to maintenance are often poorly controlled and excessive.
- Opportunities for cutting the cost of 'Specials' – non-standard tasks are likely to consume disproportionate effort. Why? Is it justified?

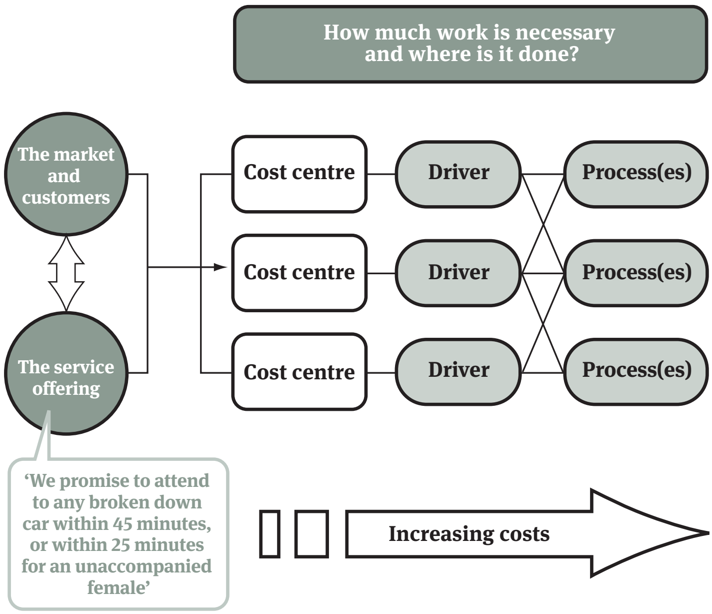
Decide quickly which products or services should be jettisoned

Is the organisation still doing things that it has already decided are unnecessary or unprofitable? Sales people can be reluctant to give up products that were once 'good sellers'. Managers sometimes ignore decisions to change agreed levels of service. Benefits only accrue when real change occurs. Make sure the system records this – deter regressive behaviour!

Analysis of work content

This approach allows managers to build up a cost model from first principles. It builds on the analysis of the key elements of the business model that should have been highlighted by the high-level evaluation described in Chapter 4. From that model the core and supporting activities should have been pinpointed and the requirement is then to determine how best they can be done.

This is an approach sometimes known as 'zero-based budgeting'. An accurate evaluation has to be made of what work needs to be done in a defined period: how this is broken down into different tasks; how long each task should take; what allowances should be built in for supervision, management, training, absence etc; what supporting functions are necessary (HR, finance, purchasing) and what their cost will be. A useful starting point is a map outlining how customers are served, what separate cost centres are involved, what the main costs are, and the main processes.



This provides a robust model to find out the best size and shape of the business and hence its cost. However, it relies heavily on managers describing precisely what work needs to be done and how much effort is necessary. There is a real risk that the very inefficiencies and duplication that should be revealed and cut out in order to reduce costs might be actually endorsed and fixed in the revised structure. This is particularly the case when the work is complex, with few repetitive transactions and no directly relevant comparators. Judgements tend to be made on subjective criteria rather than on objective reasoning.

A thorough analysis will define the cost centres, factors and processes. For example:

Cost centre	Factor	Process
Operations – optimum size of fleet of repair and recovery vehicles	Number of customers, typical travel patterns Age and reliability of customers' vehicles	Sales order Planning/scheduling
Personnel – pool of skilled mechanics	Technical complexity of customers' vehicles New technology introduced by vehicle manufacturers Availability of skilled mechanics	Personnel planning Training and continued development Recruitment methods, pay mechanisms
Operations – responding to customers' calls	Number of breakdowns and geographic coverage Timing – day/night	Call management processes Demand management Staff scheduling
Finance – credit control Collect cash from debtors Maintain a strong cash flow	Number of customers Number of cancellations Frequency of invoicing Average value of invoices Nature of debt	Credit rating Credit control Annual subscriptions Litigation Outsourced debt collection
Operations – maintenance Keeping recovery/ repair vehicles on the road	Size, age and variability of fleet Location of maintenance depots Availability and cost of spares Skills of maintenance staff	Maintenance planning Responsiveness of depots, Lean methods

The model of costs can be compared with the actual costs, but this does not necessarily reveal where and how savings should be made. The review should encompass processes, structure, procurement, overheads, technology and employment practices.

> *"There is hardly anything in the world that some man cannot make a little worse and sell a little cheaper, and the people who consider price only are this man's lawful prey."*
>
> **John Ruskin**

Lean

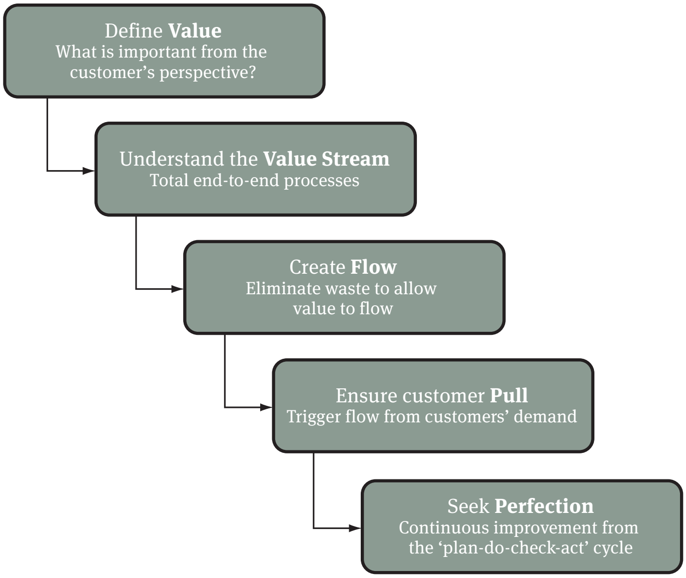
Lean thinking has developed rapidly in the last twenty years from its traditional roots in manufacturing, particularly in automotive production. It has been extended successfully to back-office, administrative functions, the health service and many other sectors. Tesco applies lean principles throughout its supply chain.

Adopting lean can cut costs, boost operating efficiency and inspire continuous improvement. Unlike most other improving activities, lean demands that the senior executives get involved, dedicate full-time effort and re-think ways of doing things. And, at the outset an 'Education' phase is essential to introduce lean ideas and demonstrate how they will improve performance.

A full transformation to lean has these characteristics:

- it is based on established and proven methods
- there is close engagement with employees (consultants/experts facilitate and coach, rather than lead)
- substantially better performance is achievable – much faster processing time, reduced waste, increased throughput and lower costs
- the initial focus on one set of activities (a value stream) can be scaled up later to embrace the whole organisation
- continuous improvement is an integral part of the programme.

Since the 1990s lean thinking has been distilled into five key principles:.



Value is always defined from the perspective of the customer. An activity that adds value is any operation that directly and positively changes the item or need in line with customers' demands. Employees at the outset must learn how to distinguish between operations that do and do not add value. This prompts a focus on waste and how to eliminate it:

An operation that 'adds value' is:

> "any activity in the value stream which directly and positively changes the state of the 'item' or 'need' in response to the customer's demand. That includes the handling of routine transactions and anything that supports the provision of service to the customer."

To make sustainable improvements, it is easier to try to eliminate the activities that do not add value than to try to make the activities that do add value run faster. In organisations that have not adopted lean, activities that do not add value typically account for more than 90% of flow time:

Waste is broken down into three types:

Overburden occurs when people or machines are pushed beyond their capacity or when excessive demands are placed on people or machines.

Unevenness occurs when the use of a person or a machine is irregular or inconsistent or when there are imbalances or fluctuations in the pace of production.

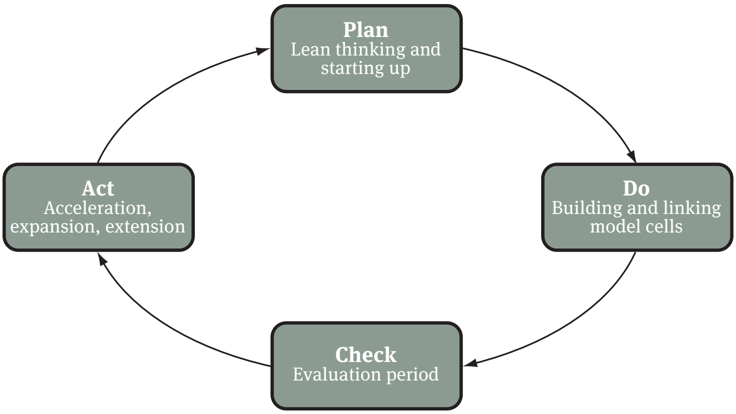
Operational waste occurs when activities take place that do not add value to the product or service, or when overburden and unevenness inevitably create different types of operational waste.

Eight categories of waste

- over-production – producing goods too soon, or when they have not been ordered
- inventory – all aspects of the business: buildings, services, unnecessary raw materials, work in progress, finished stocks etc
- transportation – any handling (unless you are being paid for it)
- overly complex processing – unnecessary processing, procedures or steps (work done that adds no value)
- waiting, hanging around or idle time – which adds no value to the product
- human injuries, mental and physical overburden
- re-working – of defective units that should have been right first time
- motion – the movement of equipment or people that adds no value to the product.

Although the concept of 'lean' developed in a manufacturing environment, the principles can be applied just as effectively to indirect activities, particularly the administration of routine transactions. Do not be put off by the terminology. All the categories of waste listed in the box above could equally apply to an indirect environment. Activities that support operations must also embrace its principles, if the whole organisation is to improve its cost-effectiveness. A drive to eliminate waste will only work if all functions, departments and activities link together effectively.

Once in place, a lean approach becomes self-enforcing and promotes continuous improvement, as shown here:



Optimising processes and capability

Effective processes, procedures and ways of working are essential if a business is to enable its people to achieve the cost-effectiveness demanded by the market environment. Yet too often skills and capabilities are squandered as people are allowed, required or even encouraged to work in ways that fall well short of their true capabilities.

Any enterprise should ideally employ people with the best mix of skills and experience to meet its needs. It should not pay people too much to do work for which they are over-qualified. But lots of organisations do. The PAA described earlier reveals the jobs being done by the wrong people.

- If a lot of people of limited training and ability apply weak processes badly, even more are needed to check their work. It would clearly be more effective to employ fewer but better people in the first place.
- Skilled employees often spend too long on jobs that subordinates could do. Salespeople, for example, may spend more time on administration than with customers.

Often these two traits are linked. Members of the sales team feel they have to sort out administrative problems because they do not trust the people and systems that are supposed to be helping them. This then becomes a vicious circle in which no-one takes the time and trouble to train the administrative staff and fix the procedures and systems – possibly because it actually suits the sales managers to do comfortable tasks round the office rather than have to be out and about dealing with awkward customers. So organisations end up larger and more costly than they need be, which in turn attracts more cost as additional managers demand secretarial and other (often underused) administrative support – and then bigger offices are needed to house the extra people.

It is easy to blame individuals, but to resolve these tendencies the starting point is usually an examination of the processes and ways of working. These need to be simplified and streamlined first, to allow responsibilities to be matched with skills. It often becomes apparent that it has not been competence or ability of the people that has been lacking, rather the weak procedures used by the organisation and the direction, training, guidance and empowerment given by the company and its managers.

> *"There is only one boss. The customer. And he can fire everybody in the company from the chairman on down, simply by spending his money somewhere else."*
>
> **Sam Walton**

Monitoring progress

Progress needs to be monitored against two dimensions:

- Internal: Are we improving, reducing cost and raising effectiveness against the starting position?
- External: Are we doing enough to retain and improve our competitive position?

It is easy to become inward-looking – to feel busy and satisfied by apparent progress against a plan or programme. But in the meantime the opposition will not be standing still. The market continues to evolve. Threatening new competitors will appear, bringing new ideas, new technology and fresh thinking to the sector. Steady progress might no longer be enough. A step-change is called for.

So measures must cover all aspects, which places demands on internal management accounting functions and also on sales, marketing and strategic analysis. All should be empowered to highlight emerging threats and concerns, with fast-track access to senior managers – not a lengthy chain of command that stifles early warnings.

Routine measurement should report on the effectiveness of:

- Processes: short-term success in making sales, meeting service requirements and controlling costs – direct, core and supporting, people, materials, and assets.
- Business goals: the medium–term progress against objectives, including the ability to make all activity and cost variable and flexible to meet changing requirements.
- External competitiveness: the long-term capability to respond to the external environment and competition, including the ability to make all costs and assets variable, so that it can adopt new technology and ways of working without constraints that could destroy it.

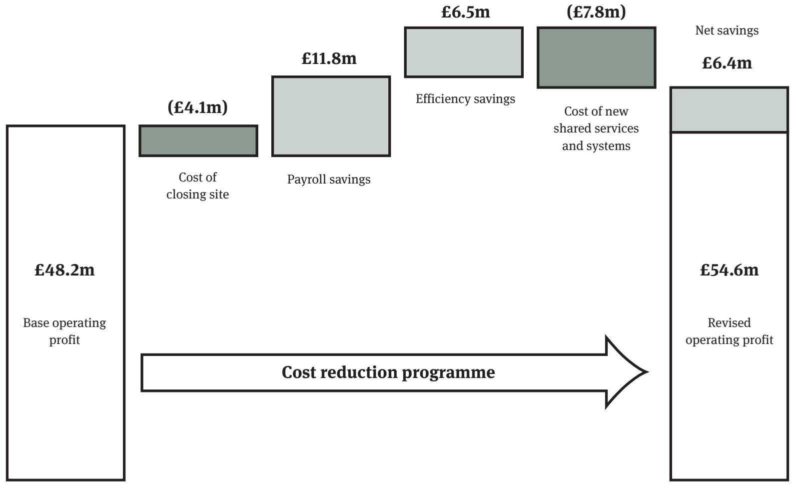
Managers may object to such close scrutiny and it can be difficult to establish hard measures for aspects such as 'competitiveness' without creating excess administrative cost. But relatively simple assessments using data gathered for other purposes might be all that is needed, provided that they are done honestly, without false optimism. But to that end they should be backed up by more robust examinations of the market environment from time to time.

Using a Performance Bridge to illustrate results

A Performance Bridge shows the movement from one set of numbers to another. It has several potential applications during a programme to reduce costs. The aim is to agree on a 'baseline' and then to explain and summarise movements, for example:

- by the savings achieved from different business units, markets, geographies, sites/plants, lines of business, etc
- by root cause – price, volume, gross margin, overhead cost reduction, etc
- by individual initiative within a programme of many separate projects.

Performance bridge: major projects



The Performance Bridge is a powerful means of holding the managers to account and ensuring that the investment in bringing about radical change is worthwhile. In conjunction with a project 'scorecard', it should be used with the normal period management accounts to explain the effect of other unforeseen variances and/or changes of tactics. Comparison of the Performance Bridge projected at the outset of an exercise with the final picture will show to what extent the initial plans have been translated into firm, measurable results.

8. Sharing services

Many organisations have made economies of scale and efficiency and saved cost by bringing together the handling of routine transactions into one shared service centre. But, as with contracting out, there are pitfalls. Not all organisations benefit. So check that the right conditions exist at the outset.

8 Sharing services

Shared service centres

Shared services generate real savings by reducing labour costs, applying consistent standards and focusing on value-adding activities. This is not about 'centralisation'. All parts of the business need to trust the SSC and be prepared to delegate the handling of the selected activities to the unit without trying to 'dabble' or 'interfere' in day-to-day routines. The SSC should take on tasks that allow it to exploit economies of scale and provide the critical mass necessary for the cost-effective use of improved systems. But, they can be remote from their own internal customers and not exposed to day-to-day problems in the field. And every new structure within a business creates its own raison d'être, tensions and rigidities – and attracts its own particular costs. There can be other pitfalls:

- consolidating functions in one place tends to diminish rather than improve the flexibility to reduce costs quickly in difficult times
- a 'centrist' approach can discourage innovation and stifle the essential initiative to respond promptly to change
- service level agreements are not infallible; performance has to be measured and managed robustly
- costs can escalate rapidly when new tasks are taken on board without a thorough review of how else they could be done.

The investment required to create truly common IT systems and ways of working can be underestimated. The transition can become protracted and expensive with duplicated effort required for training and setting up of activities at the new centre long before savings can be made elsewhere.

> *"The most efficient way to produce anything is to bring together under one management as many as possible of the activities needed to turn out the product."*
>
> **Peter Drucker**

Do the right conditions exist?

A well designed and run SSC that supports the business effectively can improve cost, service and operations. But not all businesses lend themselves to this approach. Before launching an expensive project or investment, check:

- Is there really a case for combining activities in an SSC?
- Are there high-volume, common, repetitive activities that will give economies of scale?
- Do activities have links to the front line that cannot or should not be broken?
- Who will still need to be retained in the field to handle local administration and queries? (In small units, the saving could be minimal.)
- Will combining make it easier or more difficult to automate?
- What investment is required?
- Are processes robust or do they need to be upgraded first?
- Could many of the savings be achieved by other/simpler means?
- How much disruption and cost will the transition cause?
- How long will the transition take, allowing for setting up and training?
- What risks could the business face from severe disruption?

The right circumstances do not always prevail

A construction company examined the case for creating an SSC to handle the routine transactions for several divisions. The aim was to take out the multiple teams of administrative people scattered throughout various business units.

However, analysis revealed that the group did not lend itself to this approach

- In several divisions, most 'sales invoices' were in fact quantity surveyors' submissions to clients, which had to be reviewed locally before being finalised.
- Similarly, payments were subject to local agreement, which remote credit control would have complicated and confused.
- Many purchases were specific to major projects: payments were linked to phased deliveries that had to be tracked and controlled on site.

- Even where some administration could be brought together, people were still needed in the local unit to deal with queries and exceptions. So savings in the local units would not fully offset the costs incurred at the SSC.
- The divisions used various computer systems that would have had to be rationalised and standardised (at considerable cost) before common ways of working could be adopted.

So the immediate creation of an SSC would have had a big cost and a minimal return. The better approach was to streamline activity in each Division and gradually to adopt new, standardised IT systems. The potential for an SSC covering some but not necessarily all the Divisions could then be re-evaluated.

Assess the business case rigorously

The example described above was a relatively extreme case. The characteristics of the business and the investment required did not provide a ready business case for creating an SSC. But organisations have gone ahead and invested to create an SSC without accurately assessing the costs and benefits.

In the right environment, savings in the region of 20% should be achieved by the introduction of shared services for transactional financial services and internal customer services such as payroll. In other cases the analysis might question the very need for the function at all – or at least its retention on a much smaller scale. In Personnel, for example, there is often scope for considerable cutting back. For other functions, training, legal services and property, the benefit will show in improved service.

Initial cost savings can be quickly eroded without rigorous control and clarity in accountability. To maximise effectiveness, managers should seek:

- to install accurate measurement of results and related rewards
- to analyse carefully the organisation's current costs and levels of service
- to define the core processes with adequate flowcharts and supporting narrative description

- to benchmark practices internally and with external companies
- to use metrics that are simple, tangible and acceptable to everyone
- to focus on ‘leading indicators’ to forecast results
- to establish processes for continuous review and improvement.

And, assess carefully the impact of proposed changes on the relationships with customers and agreed service levels.

Don’t proceed without a clear plan that demonstrates the return on investment (with a healthy contingency for the cost of IT).

So a service level agreement for the SSC must reflect all the requirements of the enterprise. But some important ones might be difficult to define and measure. A robust credit control department that minimises debtor days is not much use if it alienates all your customers so they stop buying. There has to be a balance between the hard measures and the softer needs of the organisation.

Do not underestimate the risks

In some high-profile cases, the risks were not understood or managed effectively. Some years ago, one of the UK’s largest engineering and design consultancies set up an SSC to handle, amongst other things, its sales ledger. The transition ran into severe problems. For a time the business was unable to invoice all its customers properly. The drastic consequences for cash flow placed what was normally a very successful corporation at risk of failing. It did recover, but its experience is a signal warning.

Outsourcing

Outsourcing and sub-contracting have become something of a panacea. ‘Our own business does not do it well, but there must be someone out there who can do it better!’ And that may be true. But it does not follow that – that is the best decision.

When an activity is ‘non-core,’ there may be a case for jettisoning it and asking another organisation to provide it via a robust contractual agreement. Well defined back-office tasks can be obvious candidates, but other supporting jobs might be suitable. Even outsourcing a more central process may offer real benefits. Other providers may be able to offer and maintain a crucial expertise and the lower labour costs that come from remote location. Many tasks, administrative and otherwise, have electronic inputs and outputs, so work can easily be ’exported’ from country to country.

But, not all outsourcing ventures by, for example, the large banks have been successful. In call centres, product information, local knowledge and even language have become big considerations. Services for directory enquiries are among several that are prone to cultural misunderstanding.

There has to be a clear distinction between a vital competence that must always be kept within the business and a less critical activity that could be handled by a third party. But the boundary is not always clear and could shift. Is it wise to allow even the most mundane of contacts with a customer to be handled by someone else? And do service level agreements that tend to measure mainly hard statistics about performance allow you sufficient confidence that transactions are being managed as you would wish? Even more than with an internal SSC, it is important to measure the softer aspects to confirm that the customer’s experience of the service is satisfactory.

The desire to concentrate on a specific market, product, or location ebbs and flows with the perceptions of opportunity, competition and risk. Given the time it takes to move from concentration to diversification (or back), the timing of the decision is the key to success.

Outsourcing is a decision that can take years to reverse – it’s strategic! When a business jettisons one of its core competences, it may become just a secondary competitor in a different market. While that may be the intention, it can have unexpected consequences that turn out to be irreversible.

Considerations for outsourcing

The decision whether to contract out part or all of an important activity poses some fundamental questions of strategy:

- How important is this expertise to our business?
- Can we outsource the non-critical elements of the activity but retain the core?
- Can we retain enough expertise to manage the new provider so that quality is not compromised?
- Will the provider be able to increase charges over time because we are locked-in to its services?
- What impact will this have on our marketing stance?
- Will we be able to serve our customers in the same way – and will they notice or care?
- What impact will this have on our responsiveness in the market and our ability to modify or customise products or services?
- What effects will that have on our relative and absolute margins?
- What will be the true annual savings per year, taking into account potential reductions in selling prices, increases in cost in the supply chain, rises in working capital, and loss of responsiveness?
- Is our proprietary technology, intellectual property or expertise at risk?
- Are we giving a third party access to information about our customer base and marketing plans that could be passed to a competitor?

9. The costs of employing people

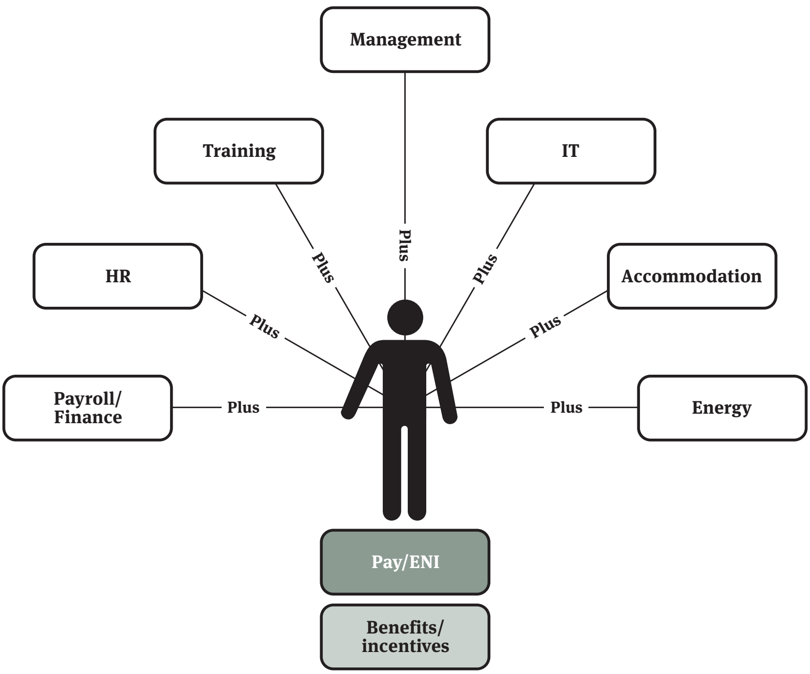
The costs of employing people are a big part of the total costs of nearly all organisations. But, of course, people are much harder to control than 'things'. Complex personal relationships, emotions and culture all stand in the way of 'objective' decision-making. So it is harder to control yet alone reduce these costs. But that is no excuse for avoiding them.

9 The costs of employing people

People cost money

People attract costs. In indirect functions, not only the people themselves but also the related activities to manage, nurture, accommodate, equip, pay and train them cost a lot more than is often recognised. And large organisations naturally grow larger – more activity spurs more support, more analysis, more reporting. It is an exceptional manager who willingly reduces the size of her/his empire before being forced to by economic circumstances.

So, a systematic review of the costs of employing people, how these are related and how they can be controlled better, is an essential part of any serious attempt to cut costs.



Employment practices

The way people are managed becomes inconsistent in time, and this is amplified when there are short-term campaigns to reduce costs quickly. Typically:

- a two-tier workforce might have been created, with differing terms and conditions, pay and benefits that sow the seeds of discord
- grading structures may be under strain and not reflect accountabilities
- a freeze on recruitment and promotion might have put pressure on some parts of the business
- salaries may be out of step with the market – encouraging some managers to apply temporary but expensive 'fixes'.

So, as a business is restructured and a new operating model adopted, a complementary effort should be made to consolidate employment polices and practices. The total costs of employment should be affordable and manageable in an uncertain economic future.

Priorities for action

Many organisations allow long-standing anomalies and inconsistencies to develop that sit alongside – and often conflict with – the formal terms and conditions of employment. A programme of change is a chance to review and eliminate those that could impede new ways of working or that add cost unnecessarily. This review should cover:

- **Pay drift** – poor controls on pay inevitably lead to higher costs than were planned. 'One-off' and poorly defined benefits are always worth further examination.
- **Recruitment and selection** – in many companies, poorly co-ordinated recruitment processes lead to duplication and higher costs. In tight labour markets, managers seriously underestimate the costs of finding recruits. So allocate those costs properly.
- **Replacement of leavers** – a decision to replace an employee who leaves should only be made after a critical appraisal has been made.
- **Unproductive time** – how much time is being spent on meetings, travel, managing e-mail, social events and other activities of questionable benefit? The rationale must be challenged.

- **Use of temporary and contract workers** – many firms run with lots of agency workers, but fail to find out their costs or to manage their performance. What employment rights do contract workers have? Why have managers pursued this policy?
- **Overtime (paid or unpaid)** – too much or too little use of overtime indicates that people have been poorly apportioned to tasks. There should always be slightly more work than people to do it. Challenge all requests for overtime and only authorise work that is crucial.
- **Managerial time** – a comparison of how managers in different parts of the firm use their time can be revealing. Signs that they spend a lot of time on the same tasks as subordinates should be examined.

Reward

Schemes for the pay and benefits of all employees should add value and should focus on the bottom line. Pay should be designed to reduce costs and get better returns from the investment in people.

Some employees rightly command salaries above the norm. Excellent contributions deserve exceptional pay. A sophisticated scheme for reward accommodates such circumstances, while retaining its purpose of achieving value for money.

Margins not volumes should be the focus of directors and managers. All initiatives on pay and employment benefits should target costs. Managers should set an agenda:

- to strive continuously to cut cost and boost productivity
- to recover the costs of pay increases as a matter of routine
- to measure progress continuously and openly
- to improve margins by using people more cost-effectively.

As a minimum, holding costs is an imperative in any change to systems for reward. Pay systems should be simple and easily understood, provide clear targets and encourage ingenuity and enterprise. Sustained success results from:

- concentrating on a small number of goals
- setting stretching targets
- offering powerful incentives for excellent performance.

Managing pay in recession

- Remove costs faster than the decline in volumes
- Communicate the principles to everyone

Unit conversion costs must not increase

- Concentrate on recovering annual pay increases as a matter of routine
- Develop a pride in the job and winning
- Use a procedure: all leavers should only be replaced after critical defence
- Reduce the absolute employed head count
- Link expenditure plans to trends in unit costs

Other employment benefits

Because of changing tax regimes 'fringe benefits' are no longer as attractive as they once were. For example, many employees are now better off with a car allowance (taxable) than with a leased car. The costs for the employer are also much easier to control. But if this change has not yet been made, it should be seriously considered.

Usually the most expensive benefit is a pension, which has to be offered in some form to all employees. Many organisations have closed their defined benefit schemes to offer a much less risky and simpler defined contribution pension. Any change to dilute pension arrangements will be deeply resented by the staff (particularly by people with long service) and must be handled carefully.

But it is worth reflecting that its prime value is often to lock people in and retain them. In a period of change, that might not be the main aim. New starters are also less bothered by what has gone before. Bright young people with the new skills, which you might need for the future, will join you accepting what is on offer now. They will tend to take a much shorter view. For them the pension is not the strongest motivator. If you are entering a phase of much greater flexibility, then a more fluid workforce, motivated by immediate reward and recognition, might be best.

Terms and conditions

As market conditions change, organisations have to respond rapidly. But one thing that can constrain their ability to improve productivity and reduce costs is terms and conditions of employment. So any serious attempt to achieve savings needs to review how they might be changed for the better:

- to remove demarcation barriers and allow jobs to be linked and combined
- to encourage workers to transfer to other jobs rather than claim redundancy when one post vanishes
- to promote re-training to meet the demand for new skills
- to allow for the introduction of new technology
- to adjust working hours to match the needs of customers
- to allow the staff to be relocated when the need arises.

Most of these changes will be covered by formal terms and conditions and can only be altered by mutual agreement. Employees and their representatives, if appropriate, have to be consulted. All this takes time, sensitivity and patience. This is not an excuse for not trying. The objective should be consistency, simplicity and flexibility. However, it is only part of the picture. Achieving a well motivated, skilled and responsive workforce – a highly desirable outcome – takes considerably more effort than just changing employment contracts.

Bonuses and incentives

Bonuses should, by definition, not be part of continuing earnings. They should be at risk. But all too often big bonuses are paid for no more than 'normal' performance, and even for results that are well below par, which is when the company can least afford them. The bonuses paid in 2008-09 by banks collapsing under toxic debt beggared belief.

Such schemes, and the attitudes that give rise to them, are difficult to change. They offer no incentive to stretch performance, to curtail unnecessary expense or to minimise comforting arrangements. Yet that is what is needed when a re-balancing of indirect costs and priorities is required. There should be powerful incentives to work for the greater good, particularly for those whose departments will have to make sacrifices. That is painful for any manager and does call for some reward.

The best incentives:

(i) pinpoint four or five ratios that are crucial to the performance of the business in the forthcoming financial year and within the control of the director/senior manager
(ii) include specific departmental targets, so that the relevant senior managers support the overall objectives, even if their department has to take pain
(iii) reward the collective performance of a team when appropriate – not just one 'lucky' person
(iv) offer a worthwhile reward for the achievement of stretching targets – say 25% of salary
(v) pay nothing if any target is missed
(vi) pay much more for better-than-targeted performance, up to a cap
(vii) change from year to year, to remain relevant to the needs of the business
(viii) are accompanied by day-to-day recognition and longer-term prospects – often the strongest motivators.

Incentives only work as applied. No bonus is contractual. No result is definitive.

Matching the staff to demand

Costs increase when some people are not fully utilised and others are over-stretched. Good management reporting should reveal this quickly – although even better are good line managers who know precisely what is going on in their 'patch'. An efficient organisation should have the means to move people promptly to where demand is on the up and to maintain adequate cover where there is a lull.

In the most successful businesses, this process is readily accepted. Managers know that it might be right for a department to shrink gradually. Junior employees accept that they might be asked to work elsewhere and acquire new skills regularly. Indeed, they welcome it and enjoy the fresh challenge, recognising that flexibility and progressive re-training enhance job security rather than damage it.

But workforces without that flexibility almost inevitably breed problems for the future. So when a crisis does occur, managers have to make a big change quickly, which is inherently more painful and disruptive. Unnecessary redundancies and poor utilisation of people may well be the result.

> *"Executives owe it to the organization and to their fellow workers not to tolerate non-performing individuals in important jobs."*
>
> **Peter Drucker**

Managing redundancy

Redundancies should be handled fairly. This fulfils legal requirements and moral commitments to loyal employees. It helps to protect a reputation as a caring employer. And it sends a signal to the survivors – on whom the business now relies heavily – that everything is being done to help the redundant employees through a difficult time. This is most important. Insensitivity can colour the views even of people not directly affected by it.

Achieving a reduction in the payroll by declaring redundancies may be necessary, but it can be expensive if not handled properly. There are rules on the conduct of consultation. Care needs to be taken with every individual. Sometimes companies fail to remember redundancy agreements negotiated with a trade union (possibly years ago). Some employees may have special terms and conditions inherited from a TUPE transfer. If protocols are not observed, employees may later claim unfair dismissal at the employment tribunal – and there will be a cost in defending these cases, even if they are won.

When savings have to be made, it is tempting to seek to minimise redundancy costs. Excessive largesse can be avoided, but it pays to strike a balance. To give people a little more than the minimum and to treat those with long service fairly can help the medicine go down. It makes agreement during consultation easier to reach, persuades the leavers to hand over their duties responsibly, and reassures those staying on. It all contributes to making the changes less disruptive to day-to-day operations and therefore less expensive in the long run.

10. Communication and culture

Overhead structures in many businesses are closely linked to the culture and attitudes of the organisation, particularly when it has been run in a particular way for several years. Decisions about priorities that led to the current style of operation might have been made many years ago by a previous chief executive, but the resulting approach to business will have been adopted by the vast majority of employees, who will see it as 'the norm' – however wasteful and misdirected it may now seem to be. So a great effort is needed to communicate why change is necessary and what is now required to gain support for it and improve the culture.

10 Communication and culture

Establishing a compelling argument

To improve working practices and to reduce costs, a clear, compelling business case must be made and proven. It should marshal quantitative and qualitative arguments to generate a sense of urgency in senior managers and all members of staff. The new objectives that result will support the development of a fresh vision and plan for the organisation. Senior managers are most committed to ambitious programmes of change for which they have analysed and defined the need – so that they feel part of the new regime.

But the support of more junior members of staff is also needed. Without it, the scope for disruption and resistance is great. Yet for them, the need for the changes may be more difficult to grasp. It might seem obvious to some that things cannot continue as before, but for those who have only known the old ways of working and are probably quite comfortable with – even proud of – them, the inherent criticism will seem unfair and unreasonable. So time must be taken to communicate carefully and thoroughly what is happening and – most importantly – why. And it should be done in a way that criticises the managers and staff as little as possible. Many of them will be blameless.

Communication must be led from the top

Good communication is a core competence for all businesses. Senior managers often quake at the demands it seems to make on their time. So they hide behind a communications 'machine', which soon grows out of proportion and loses touch with the real concerns of the managers and staff. But a consistent, targeted approach, well applied, need not demand excessive time or effort.

Before any major change begins, and while it is in progress, good communication is essential. A rigorous review of indirect activity that radically switches people from non-core to core activities will also transform the culture and how everyone sees priorities. So employees need to understand why the changes are necessary and where the business is going. This will demand a clear explanation of the plan, sensitively targeted and careful timed. All those affected by the changes, inside or outside the business, must receive consistent information that reinforces confidence in the future.

Personal responsibility for communication should lie with the chief executive, or at the very least with a senior colleague who shares the vision. Sufficient people need to be allocated. The time spent talking to the parent company, external analysts or investors should be balanced against the more important time devoted to managers and employees in the business and to customers and suppliers, particularly if the impact is visible to the outside world.

A new sense of authority needs to be promoted. This can be helped by putting in place:

- vital messages for the immediate period of change, to create the correct impression
- mechanisms for briefing employees on immediate changes and longer-term goals
- arrangements for dealing with the media in order to provide a consistent theme through authorised sources. Local newspapers can be remarkably quick to pick up the wrong story
- plans for creating and sustaining a momentum for change, with regular briefings on the progress of the programme.

Communication and consultation

Communication should be two-way. It is vital to elicit opinions and to listen to employees' fears and concerns. But it is useless to foist information on an audience that has switched off. So, if cost-cutting is planned, communication must be planned too.

How are the employees reacting to change and the new regime? Managers need to know! They can find out by 'walking the walk', sometimes supplemented by surveys, focus groups and structured and semi-structured interviews. Thus informed, they can adapt the programme to enhance its prospects of success.

Communication is a sophisticated process. Its planning must match its execution. The key messages should be in line with the published strategy, consistent, honest, and reiterated. It is vital to set up and manage communication between different change teams, as well as with programme managers and employees.

Checklist for managing communication

- Confirm personal responsibility for communication
- Convey consistent, simple, accurate and timely messages
- Meet managers quickly
- Ensure that a 'business as usual' message is heard and understood
- Communicate effectively with employees and meet as many as possible
- Conduct a survey of employees' opinions
- Consider organising a management conference
- Counter false rumours quickly and effectively
- Obtain candid comment on the form and content of communications and respond accordingly
- Use formal and informal channels.

Bridging the cultural gap

Whenever initiatives to cut costs involve major restructuring, outsourcing, mergers of departments (or sister companies) or working more closely with other organisations, 'cultural' differences will emerge. Different ways of working and managing in each organisation will be set in stark relief.

The first step is to acknowledge the cultural differences. The second is to decide how to bridge them. There are myriad ways that managers from different companies and countries can discuss the problem and try to agree on the way forward and to motivate their people to act. But, of course, they will be starting from different points. And the disparate terms and conditions of employment and working practices will confuse the situation too.

The objective of analysing and understanding cultural differences is to prevent the acquired behaviour from impeding the desired action. This is normally easier than altering beliefs and values. Establishing trust means bringing people together early and often. If the scale of change demands it, there is a lot to be said for an early management conference to start this process. It should be reinforced by the creation of teams to lead varying aspects of change.

The fear of the unknown is most disruptive. To counter this:

Reduce anxiety – be open about the reasons for the proposed changes and the likelihood of job losses. Challenge false rumours.

Provide information rapidly – keep your promises to inform people regularly, even when information is limited.

Minimise managerial power plays – managers come under close scrutiny during periods of change. Their behaviour can send out the wrong signals to the unsettled staff.

Focus action on the future – concentrate people's energy on projects and on the new market position of the business rather than on personal grouses.

Highlight early progress – describe how early initiatives have worked and will help.

Managers must work hard to build trust, must spend sufficient time on developing the processes for achieving change, and should focus on what needs to be done. They need to be aware of their own feelings as well as alive to the behaviour of others.

"My main job was developing talent. I was a gardener providing water and other nourishment to our top 750 people. Of course, I had to pull out some weeds, too."

Jack Welch

Understanding different cultures

An ability to recognise quickly and precisely the influences and forces at work, and to respond to them, greatly enhance the chances of effective progress. Whatever the theoretical profile of the organisation, the practical requirement is to attract support and overcome resistance to change. But how much resistance is there? How great is the desire to do things differently and better? Usually, where reform is most needed, the latent desire for change can be stronger than it seems. It simply has to be brought to the surface.

Imposing change on a foreign business will engender particular uncertainty among employees not comfortable with the approach of an overseas parent, particularly in countries where the local ethos is to provide a softer social cushion than has become the norm in the UK and USA. Employees will be concerned for their livelihoods and in some countries can resort to ways of opposing change and cuts rarely seen in the UK today. It will be all too easy to blame them for their resistance and for them to blame other people – particularly those from the other company or country – if things go wrong, as some inevitably do. Programmes of change must be sensitive to this and employ tactics that reduce resistance and the threat of disruption by explaining fully and honestly the reasons for the proposed changes, the limits of the action planned, and the help and compensation being provided to those adversely affected.

Wide differences can prevail even between apparently similar subsidiaries, business units and factories within the same group. In some groups of companies there are business units – particularly those that trade within competitive markets – that are run tightly with an established ethos of minimising waste. By contrast, within the same group, there can be others which for many years have been successful but have faced a benign commercial environment. This has allowed managers to relax their attitudes and disciplines, so that the good housekeeping attitudes needed to minimise inessential cost have been lost. A change of direction or the appearance of sharply tougher trading conditions that demand tighter discipline and control can be very painful for members of staff who have grown accustomed to relative 'comfort.' So a new senior manager sent in to change the approach and cut out excess cost will encounter a culture that simply does not understand and will initially struggle to adjust to the much tougher requirements of the new regime. There is bound to be resistance. The skill will be in quickly removing the cultural obstacles to change without creating fear and panic that will only make things worse.

People, communication and financial performance

Collinson Grant conducted a survey in partnership with a trade magazine and the Corporate Communications Unit of one of its major clients. This gave valuable data about the importance of communication in major restructuring exercises. Although there is evidence that responsibility for communication was at a senior level, it was disturbing that shareholders, financial institutions and suppliers were often not rated as important groups in planning communication. Employees and managers were given the highest priority, but only about a quarter of the sample of almost 200 companies had undertaken some prior research into the possible effects of restructuring on employee relations. The companies in this group encountered more problems than others in achieving change but ultimately were more successful in gaining the commitment of employees. Other facts to emerge were:

- 68% of respondents had a detailed plan for communication before the restructuring
- 51% changed their methods of communication during restructuring
- only a small minority trained managers and supervisors in techniques of communication
- about 50% thought that communication specialists had a useful part to play in restructuring
- the use of e-mail and intranets was no guarantee of effective or rapid dissemination of information
- false rumours had created problems in 70% of the cases reported – causing elements of the plan for implementation to be rescheduled.

The research provided many examples of bad practice and a few of good. In the former group was this anonymous gem contained in a Christmas message from a new CEO:

‘Restructuring is going well. Don’t worry about the redundancies we’ll let you know after Christmas. Merry Christmas and a happy and prosperous New Year to you and your family!’

11. Short-term actions

Managers are sometimes required to take urgent, radical action to review and cut 'overheads' because of particular business circumstances. The requirement is often to act quickly, boldly and dispassionately to challenge and reduce all elements of costs – not just the easy ones. Immediate, strong action also helps to transform the culture of a business and to prepare the organisation for more considered but probably more substantive change later on.

11 Short-term actions

Exercising managerial will

Regardless of more considered efforts to reduce costs, there are circumstances when immediate action is required to rein in excessive expenditure quickly. Trading conditions may have slumped in an unpredicted way, a major contract been lost or some external funding withdrawn early. Sometimes it will be as the result of a change in ownership or when a new executive arrives. Whatever the reason, prompt action is necessary to bring down costs and to send a signal to the staff that a new regime is in place.

The usual 'suspects' may well yield the best and quickest results. But the employees themselves are also a useful source of ideas for cutting out waste and reducing cost.

Don't delay

Proper long-term control and management of supporting and development costs require full understanding of the dynamics and requirements of the enterprise and its operating model. This examination, if rigorously done, can lead to quite fundamental changes. But that takes time, so the temptation is often to seek to delay action until a complete analysis can be assembled.

People quickly gain the impression that nothing much is going to happen after all and settle back into their comfort zone – from which they then seek to resist and block change when it eventually is suggested. And early action that tackles the obvious rarely conflicts with the more fundamental changes that eventually emerge from a more thoughtful appraisal of business needs. Indeed, immediate challenges to custom and practice are often valuable in exposing more endemic problems.

So start to act immediately to tackle the obvious ills that soon become apparent to anyone arriving new to an organisation or 'wakening up' in a crisis and recognising the demands of the new situation. Yes a full, planned review will be needed, but any executive given the opportunity should start by asking: 'What can I do on day one to start to save the pennies and accumulate the pounds?' Often it is surprising how much can be done quickly and easily, particularly in an environment where things have been relatively undisturbed for many years.

Make an early impact by meeting major suppliers and setting targets for increased value

Few managers approach purchasing negotiations as rigorously as they should – cosy relationships with suppliers become entrenched. Determine the points of 'leverage' and a credible strategy based on the options for switching, the number of suppliers and targets for reducing price.

Checklist for starters

Target	Action
People costs	
Recruitment	Block all current recruitment Make an objective assessment of each new vacancy Stop advertising and use of agencies
Pay	Introduce pay freeze at all grades
Performance	Take decisive action on consistent underperformers – remove from payroll at earliest opportunity Review/abandon current appraisal system (almost certainly leads to pay drift)
Temporary/ agency workers	Review justification and reduce where possible
Overtime	Stop overtime and insist on a costed case for its re-introduction
Travel and expenses	Review policy and justification for travel Apply rules on expenses firmly
Early retirement	Offer fair (not over-generous) terms to those who can be spared
Sickness/ absenteeism	Review controls, insist managers apply them
Meetings	Insist that managers review the need for meetings and their usefulness Instil discipline in their conduct and timing

Procurement	
Non core purchasing	Delay or defer inessential items Reinstate or introduce controls on purchase orders Ask suppliers for immediate better prices and terms
Materials	Check up on wastage, obsolescence and storage Tighten up forecasting and ordering procedures Negotiate improved terms with suppliers Review 'cosy' relationships with long-term suppliers and insist that managers find alternatives
Premises	
Accommodation	Find under-used space and get managers to reorganise fast Check leases and the opportunities for vacating or sub-letting spare accommodation Remove filing cabinets, reduce paper, store electronically
Warehousing etc	Do an immediate audit of how much space is available and how much is used. Act on the results to eliminate spare capacity at the earliest opportunity
Energy	Check how recently contracts with suppliers have been reviewed and the options for better prices Turn down thermostats and appoint somebody to monitor energy consumption
Other priorities	
General overheads	Examine, line by line, other cost centres, spotting trends and immediate actions
Working capital	Delay payment of suppliers – but act carefully
Capital projects	Review 'committed' and planned capital investment
Transport	Improve utilisation of fleet vehicles, reduce and/or eliminate
Affiliations and associations	How many annual fees and subscriptions are paid to organisations that add no real value?

People will grumble, but faced with reality they would rather lose some marginal perks than see jobs go. Review training plans – not to curtail training but to make sure that it serves a real purpose for the company. Question the 'miscellaneous' and 'other' categories in the accounts. It can be remarkable what they conceal.

What can be stopped or curtailed?

Departmental managers should be challenged to consider which activities can be stopped – temporarily at least. Is all the financial, sales and marketing analysis routinely done really necessary? Could the management reporting pack be simplified and slimmed? Could some of the analysis and reporting be done quarterly rather than monthly without a great loss of control? Where is there duplication and overlap? How much risk would there be in reducing the double-checking that undoubtedly will be found in any business? This does not imply a comprehensive process review or re-engineering exercise (that might come later) but rather a rapid and immediate challenge to the whole management team to do some simple good housekeeping.

Large meetings impede effectiveness

A German scientist named Ringelmann asked workers to pull as hard as they could on a rope attached to a meter that measured their efforts. Subjects worked alone and in groups of two, three and eight.

While the total force on the rope increased as the size of the group rose, the amount of effort by each person dropped. One person alone exerted an average of 63kg of force; this dropped to about 53kg in groups of three and to about 31kg in groups of eight. The greater the number of people, the less effort each one expended.

Similarly, the impact or effect directed towards a group by an outside force (such as a manager) is divided among its members, so the more people in the group the less the impact on each. Because they are working with others, the members of the group feel that the others will take up any slack resulting from reduced effort on their own parts. The group will cover while they take a breather and relax for a while. And since all members tend to respond in this fashion, average output per person drops sharply.

So people do not perform at their best in meetings – particularly large, lengthy ones, when only some of the topics are of interest to each person. The excuse is often that all need to know 'what is going on'. But that can be achieved by other, less time-consuming, forms of communication. The best meetings are kept small (ideally one-to-one), short and to the point.

There should be no 'fixed' costs

The challenge again will be the ingrained attitude that offices and other premises are 'fixed'. And that might be true in the short term, especially where there are several years to run on the various leases. There will also be a fear that any precipitate action to close sites or relocate activities might prove, on more comprehensive appraisal of the business, to have been a false move. So the temptation is to accept the status quo for the time being at least.

But failing to examine the scope to cut the space occupied only reinforces the 'fixed' nature of these costs. If there are going to be problems vacating property, getting out of medium-term leases or relocating activity, the sooner action is taken the better. The aim must be to turn 'fixed' elements of the cost structure into variable ones as quickly as possible.

This applies to more than property. As well as finding quick savings, the aim of an initial review should be to create a platform for the next, more detailed phase of work to examine the business model. And that will almost certainly result in more change. To facilitate that, every effort should be made to make the cost base of the business more variable. Reduce the size of in-house transport fleets, for example, and consider contracting out distribution. Also consider out-sourcing catering and facilities management and administrative tasks such as payroll. This might not give immediate savings, but the beauty is that these activities become much more variable. You will no longer be constrained by 'fixed' costs.

Allow a challenge – but with strict limits

Departmental managers should be allowed a limited right of appeal before confirming short-term cuts, either across the board or in specific departments.

When recruitment is frozen, for example, it will often prove possible to cope without filling many of the outstanding vacancies for a short period at least. But there will be a handful of posts that do truly need to be filled. The skill will be in assessing which these are. It will not be in the department of the manager who shouts loudest. He or she will always have made sure in the past to be well (and probably over-) staffed. Rather it might be in a quiet but vital corner of the organisation where real pressure exists. So make sure that such situations are highlighted and resolved. For a new senior manager, this is also a useful way of pinpointing and understanding the pressure points in the business that need longer-term consideration.

Nature abhors a vacuum – so it gets filled

Some successful senior executives have a rule:

> 'Never build an extra warehouse – people will only fill it with slow-moving stock – and never take on extra office space – it only encourages recruitment of unneeded staff. Make managers clear out the redundant stock from warehouses and trim departments which have surplus staff to make space for growth if they really need it.'

Managing risk

If challenges are listened to and some selective adjustments made to the proposed savings, major damage should be avoided. But even then the temptation for a business in trouble is to cut some supporting activities too much. Some economies will easily be absorbed, particularly where – as above – a company has been allowed slack so that even the most critical activities have become fat. But cutting too deeply can affect capability in ways that might not be apparent immediately. There is often enough momentum to keep thing going for several weeks – good practices on the shop floor or a pool of sales leads still to be pursued. But the gaps will soon start to show. When it becomes apparent that loss of control is resulting in poor productivity and high wastage, or sales successes are reducing because of inadequate support, then prompt corrective action is essential. Managers need to recognise the danger signs when they do appear and to be quick to admit their mistakes (and there will always be some). It is far better, and in the long run much less damaging, to reverse an over-ambitious saving promptly than to continue to allow the damage to persist and increase.

So not all the savings will be sustained, which is not ideal, but brave managers, who act strongly but are ready to pull back when necessary, are far more successful than those who are paralysed by fear and err on the side of caution. When corrective action is necessary, it has to be decisive. Cuts save money and buy time for a more balanced assessment. Excessive reductions quickly become apparent and support can usually be provided promptly enough to avoid long-term damage.

> *“The way to get things done is not to mind who gets the credit for doing them.”*
>
> **Benjamin Jowett**

Managing people

Even if you communicate well and explain what is going on, early action will almost certainly cause pain. People will resent giving up some of their protected and comfortable working practices. Others will lose their jobs. This will not be popular immediately, but is far better than having to take more drastic action later if you delay. Often the more sensible members of staff welcome firm control of wasteful practices (and colleagues) that have long irritated them.

Quick savings can yield surprising results

A rapid but thorough search for quick savings can yield quite impressive results. We know of one austerity programme that was launched to save a company in trouble which eventually ran to over 4,000 lines of specific savings and generated several millions of pounds. The company was turned round and members of staff who initially complained were grateful in the end that their jobs were saved.

Some remarkably large neglected opportunities almost always surface in the immediate scrutiny of the cost base. This can include the potential to sell or sub-let unused property, to stop maintaining and to dispose of surplus vehicles and other assets, or to release members of staff who fulfil jobs for which the need has disappeared or who have been held unrealistically in a pool for ‘redeployment’.

In the long run, control must be applied selectively to concentrate effort where it is needed. But we have often found that in the worst of circumstances, where control has been weak for some time, it is actually quite reasonable to apply the dreaded 5-10% top slice to all functions in the business, because there is simply so much slack everywhere that everyone can absorb it without drastic damage. This might seem crude and dangerous, but provided that it is done with sufficient care and regard for the implications for service and core competences, it can be effective in difficult times.

Good housekeeping

The initial, fairly crude, actions to tackle the cost structure of the business are only the start. Clearly they need to be followed up by a deeper, more thoughtful appraisal of the business model. But that will take time – time which should have been gained by the immediate savings that have been found. So reinforce early success with sustained pressure. Set up a process by which the business constantly challenges itself to make sure that bad habits do not return. It is all too easy for control to slip once the immediate crisis has passed. But that does not mean relying on cursory review as part of the annual budget process. Good housekeeping has to become part of everyday life and a natural instinct for all managers.

> **Better procurement offers good opportunities to reduce costs and increase margins**
>
> Managers fail to review the specifications of products regularly enough to determine whether costs reflect the value that customers receive or match the competitors' costs. By concentrating attention on procurement, companies should reduce the overall cost of purchases by 10 to 15 per cent. Managers should adopt a systematic approach to purchasing: aggressively controlling product specifications and using less expensive materials where possible.

12. Programme management

The ability to manage costs ought to be instinctive for a good senior manager – but this is not always the case. Setting up a formal framework to achieve agreed objectives is a good idea. It confirms accountability, sets targets, allocates effort and defines timescales. Good planning does not guarantee success, but it certainly shortens the odds.

12 Programme management

Planning, action and control

Any project to reduce the costs of an organisation must be planned and executed as carefully as any other important initiative. There should be clear managerial accountability and objectives, adequate staffing and robust controls. It is no good having a target to 'remove 15% of indirect costs' if there has been no accurate measure of these costs historically. So establishing a clear starting point is essential, with agreed criteria on the scope of the exercise and the means of measuring progress. This will provide confidence at the outset that the effort involved will be worth it.

Once a decision to reduce costs substantially has been made, some actions can be taken straight away. But arbitrary 'slash and burn' will always create as many problems as it solves. It may take five to six weeks to investigate carefully which parts of the business deserve attention, and two or three more weeks to draw up plans for action. This is the best way to get managers and other members of staff to endorse the objectives. Action can follow immediately – but on the larger projects it may take several months before results come through.

> *"In the future, instead of striving to be right at a high cost, it will be more appropriate to be flexible and plural at a lower cost. If you cannot accurately predict the future, then you must flexibly be prepared to deal with various possible futures."*
>
> **Edward de Bono**

Elements of good programme management – in summary:

Accountability	Any serious attempt to reduce costs must be overseen by a director and, if that person is not involved on a day-to-day basis, responsibility devolved to specified senior managers. In larger programmes there is likely to be a project board or committee to oversee progress.
Planning	Good outcomes follow from good planning. There should be a clear description of the scope (extent) of the programme, the main activities, the objectives for each one and the expected timing.
People	Little will be achieved unless enough people have been allocated. Some managers and staff may need to be directed to work on projects full-time, others will contribute as and when required. Their managers must agree to their temporary secondments.
Incentives	Incentives for managers to achieve specific results can form an important part of a well-designed programme.
Support	Some initiatives to reduce costs are supported by external consultants, who must be carefully managed. Their terms of reference should include a clear explanation of how the return on the investment will be achieved. Their support should be in phases and there should be a clear description of how they will work with the company's own staff.
Measurement	Results can only be verified and progress sustained if there is a reliable and accepted methodology for measuring how costs are being reduced. Many companies start without knowing exactly what the present organisation costs (or exactly how it is defined). An accurate allocation of staff to cost centres will often reveal that costs are higher than expected (especially when temporary or contract personnel are added in).
Momentum	Sustain the pace and direction of the programme by achieving consensus from senior managers and telling them regularly about progress. Keep targets realistic and update them when necessary.

Risks	Good programme management includes an assessment of the potential risks arising from each main activity. There are many that could arise, for example: – detrimental effects on customers – obviously a high priority – impact on operations – how organisational change will affect output in the short term – a temporary increase in working capital as changes in processes take time to improve performance – decreased operating efficiency as morale dips when colleagues are made redundant or other ‘unpopular’ changes are introduced – the ‘unexpected’ – an unforeseen consequence of organisational change which has to be corrected quickly.
Communication	A carefully constructed plan for communication is an integral part of every programme of change. Too often programme managers forget that communication should be a two-way process. It is vital to elicit employees’ opinions and listen to their fears and concerns, rather than foist information on what might be an unreceptive audience.
Reporting	The programme plan should describe the arrangements for reporting progress regularly. Timescales should not be allowed to slip. Reporting should be used to hold managers to account.
Sustainability	Some programmes to cut costs start to unravel almost as soon as they have been run. Disciplines relax, managers go back to their former behaviour and working practices revert to their previous inefficient ways. So there should be a sustained emphasis on ensuring that change is properly bedded down, that employees have been properly trained in new ways of working and that adequate investment has been made where necessary.
Publicity	The results of cost-saving initiatives are not always evident to everyone in the business. So demonstrate the value of more efficient ways of work to employees and other interested parties.

Lean

A Lean 'transformation' is one way of combining cost-saving initiatives in an overall programme with a good chance of sustainability. There is close engagement with employees and an education phase, which helps the staff to understand how new working practices will improve efficiency, reduce wastage and speed up flow – and most of all benefit the customer. A systematic approach will plan savings carefully and keep employees motivated to make more.

So Lean projects increase the prospect that benefits will be sustained and indeed improved upon as time goes on. However, continued vigilance is required. Because Lean can be so successful in the early stages, there can sometimes be a tendency to assume that no more improvement is possible. Senior managers decide that sufficient benefits have been made and the programme slips off their agenda. This is when problems reoccur and the gains made from earlier investments start to fall by the wayside.

Measurement

Progress must be measured. Without clear and rigorous metrics, there can be no certainty that anything is actually being achieved. It is all too easy to 'squeeze the balloon' only for the costs to bulge out somewhere else. So put in place some simple controls, using as much as possible the established reporting system and performance measures – the last thing you should do is add cost and complexity while trying to make economies. But make sure you understand the measures in use and the baseline costs at the outset. It is very easy – particularly if you are new to a business – to be misled by statistics that appear to show the improvement that is wanted but which omit key elements that are going the opposite way. Check, whether figures for numbers of employees are for the number of posts in the organisation or for actual people. How are vacancies being treated? Are people being transferred from budgets under scrutiny to others where there is slack? All sorts of games can be played by managers seeking to protect their empires and colleagues.

13. Summary

13 Summary

Indirect costs and the activities that they support are an indispensable element of any enterprise. There will always be occasions when there is an urgent imperative to reduce costs quickly without much thought for the longer-term consequences – the dreaded 'cuts and more cuts' syndrome.

What we have attempted here is to describe more fully the structure of costs, their inter-relation and the options available to improve efficiency and achieve better performance. Mostly, and correctly, managers behave instinctively, knowing where costs are too high, sloppiness has set in and action is long overdue. But an overall framework that links organisational capability to strategy and produces a streamlined organisation should be helpful. It allows a properly planned approach to go ahead at the right time while keeping options open for more urgent action when the circumstances demand.

Successful managers create a sustained pressure to review and control costs. The techniques outlined here are an essential part of their day-to-day armoury – but are by no means mutually exclusive or exhaustive. We have used all these approaches to reduce costs for clients in many different types of business and in the public sector. The most successful programmes are those in which a permanent managerial culture is created to assume responsibility for costs and their causes. In a world where markets are rapidly becoming more homogeneous and products and services more difficult to distinguish, cost is assuming a more and more important position as a true differentiator between competitors.

Good luck!

14. Notes on quotations

14 Notes on quotations

We have often included relevant quotations in our publications – readers seem to enjoy them. But sometimes their origin is not entirely clear, so here are some brief introductions.

Page reference	'Famous person'
2	**Marcus Porcius Cato** (234-149 BC), known as Cato the Elder and Cato the Censor, was a Roman soldier, statesman, orator, and author. His stern morality in office as well as in his private life became proverbial.
8, 17	**Scott Adams** (born June 8, 1957) is the creator of the Dilbert comic strip and the author of several business commentaries, social satires, and experimental philosophy books. Much of his interest in the food business comes from the fact that he is a vegetarian.
11, 28	Psychologist and educator **Mihaly Csikszentmihalyi** (born 1934) gained recognition for his investigations into the nature of happiness and creativity. He is best known for the concept of 'flow' – the state of 'being completely involved in an activity for its own sake'. – *The ego falls away. Time flies. Every action, movement, and thought follows inevitably from the previous one, like playing jazz. Your whole being is involved, and you're using your skills to the utmost.*
25	**Barbara Ehrenreich** (born 1941) is a social critic and essayist. Her book *Nickel and Dimed* (2002) was a national bestseller in the United States. She is a prolific journalist who peppers her writing with a sardonic sense of humour.
35,77 and 91	**Peter Drucker** (1909–2005) was known as the father of modern management. A prolific writer, business consultant and lecturer, he introduced many management concepts that have been embraced by corporations around the world.
41	**Samuel Johnson** (1709-1784) oft-quoted biographer, poet and lexicographer wrote *A Dictionary of the English Language* (1755). In his time it was the most comprehensive

English language dictionary ever compiled and remained the standard reference for over a century. The first edition included thousands of quotations from such authors as John Dryden, William Shakespeare and John Milton to illustrate the use of the over 42,000 words it contained.

47 **Tom Peters** (born 1942) is a management guru of the late 1970s to the present. His first big book *In Search of Excellence* is focused on devolving power to the lowest person possible in an organization to empower them to solve the most problems possible. His view was that the previous outlook of a centralized authoritative structure of business governance was imperfect because it required business leaders to know too much and overburdened them with needless trivia.

48 **Larry Page** was Google's founding CEO and grew the company to more than 200 employees and profitability before moving into his role as President of Products in April 2001. He continues to share responsibility for Google's day-to-day operations with Eric Schmidt and Sergey Brin.

53 **Alvin Toffler** (born 1928) is an American writer and futurist, known for his works on the digital revolution, communications revolution, corporate revolution and technological singularity. His early work focused on technology and its impact (through effects like information overload). Then he moved to examining the reaction of and changes in society and more recently wrote about the increasing power of 21st century military hardware, weapons and technology proliferation, and capitalism.

61 **Napoleon Hill** was born into poverty in 1883 in a small one-room cabin in Virginia USA. He began writing as a journalist for a small town newspaper and worked his way through law school. He became a respected attorney and a best-selling motivational writer. His works stands as a monument to individual achievement and modern motivation.

67 The English critic and social theorist **John Ruskin** (1819-1900) more than any other man shaped the aesthetic values and tastes of Victorian England. His writings combine enormous sensitivity and human compassion with a burning zeal for moral value.

71	**Samuel Moore Walton** was just the founder of Wal-Mart, the largest retailer in the world. He knew about costs!
67	**John F Welch Jnr**, a native of Salem, Massachusetts, served as Chairman and Chief Executive Officer of General Electric from 1981-2001. During his 20 years of leadership, Welch increased the value of the company from $13 billion to several hundred billion. His best-selling autobiography was called *Jack: Straight from the Gut*.
109	The English educator and Greek scholar **Benjamin Jowett** (1817–1893) is famous for translating the dialogues of Plato and for his academic reforms at Oxford University. Apart from ancient philosophy he had many other interests, lectured on political economy, promoted the entry of poorer students to Oxford and helped to reform the Indian civil service.
113	**Dr. Edward de Bono** is regarded as one of the world's leading authorities in creative and conceptual thinking, and the direct teaching of thinking as a skill. He has published 60 books and is translated in 35 languages. Edward de Bono was born in Malta and was a Rhodes Scholar at Oxford, where he earned his MD and two PhDs. He has held faculty appointments at the Universities of Oxford, Cambridge, London and Harvard. He is the originator of the term "Lateral Thinking"

Note: These snippets have been unashamedly culled from the internet (but not Wikipedia!) so we do not absolutely guarantee their accuracy. And, as Alvin Toffler famously said:

> "Anyone nit-picking enough to write a letter of correction to an editor doubtless deserves the error that provoked it."

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Costs	**People**	**Organisation**
Productivity	**Performance**	**Restructuring**
United Kingdom	**Mainland Europe**	**United States of America**

Complexity, Direct costs, Employee relations, Employment law, Implementing change, Integrating organisations, Lean, Managerial controls, Organisational design, Overheads, Performance management, Pricing, Process improvement, Procurement, Reward, Supply chain, Transitional management, Value chain analysis, Workforce planning

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