Managing organisational design

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Produced and published by:

Collinson Grant
33 St James's Square
London
SW1Y 4JS

ISBN 978 0 9564337 5 6

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Printed in the United Kingdom using paper produced from sustainable sources.
Design, typesetting and production – Centrix Q2 Limited www.cq2.co.uk

Managing organisational design

Restructuring large businesses has been at the heart of Collinson Grant's activities since the early 1980s. We have helped to get better returns from assets, to increase operating results and to improve the competitiveness of companies in the United Kingdom, in mainland Europe and in the United States. Our work as management consultants focuses on costs, organisation and people. We use this simple framework to manage complex assignments – often with an international dimension – and to support managers on smaller, more focused projects. Supporting clients in responding to changed circumstances, in seizing opportunities and in strengthening their businesses is a constant feature of our work. The notes at the back summarise what we do.

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Contents

Introduction

This book is about the basics of good organisational structure. It is based on a belief that all businesses and institutions should default to the simplest design possible.

All too often, extreme concepts of organisation are promoted to popularise books on management. Recently published volumes have suggested that the structures of companies should have no boundaries, that they should be without a centre (bagel-shaped), or that there should be no top or bottom.

A well-known management guru, who surely should know better, wrote in a respected journal that 'management is a silly abstraction whose workings cannot be illustrated by charts that pretend to show who reports to whom'. He goes on to say that 'humans behave like bees and have an innate sense of what it is right to do, and if left alone will just do it.'

We choose to disagree with commentators who have their heads in the clouds. Have any of these authors, we wonder, interviewed the managers and the staff in an organisation where each colleague gives a different version of how a process is meant to work, about who owns its performance, and who in the department has authority to instruct whom? It is not unusual to come face to face with inconsistences of these sorts. We have found that it is all too common when the structural sinews of organisation are neglected for long periods.

Collinson Grant's work constantly demonstrates that clarity and robustness in the design of organisational structures, and of the jobs within them, is a source of strength where it exists, and a hazard to corporate health where it does not. All things in nature have structure, and none is more highly organised than the allocation of tasks in a hive. If only we were as good at it as the bees!

That true sage of management practice, Peter Drucker, first began to describe the rationale for certain generic forms of organisation back in the middle of the 20th century. Following his lead, it has since been possible for managers to think systematically and analytically about frameworks for the exercise of authority, how people are led, processes managed, and managers held to

account. Over time some general truths have emerged. Although common mistakes have been recognised, they continue to be repeated because many managers take so little interest in organisational design.

It is true that as organisations become increasingly complex it gets harder to be an effective manager. But structural dysfunction is a substantial contributor to most business catastrophes, usually with problems of transparency and robustness of accountability at its heart. In the banking and investment management industry in recent times, the formality of line reporting was largely abandoned. Accountability had been jettisoned in favour of individualised targets with rewards. Without much by way of a management process, bankers who were supposed to behave like bees managed to kick over the hive!

Those shooting star technology companies that keep outgrowing their formal structures may need brief periods of creative anarchy in which their worker bees do great things by just following their instincts. But is that really the case for long? The reality is that leaders like Steve Jobs and Bill Gates became successful visionaries partly because they had masterly authority over their organisations, setting firm boundaries and expectations, often to the point of being freakish about it. And we can be sure that finely tuned accountability for company time and money, for objectives, and compliance with organisational structure and process are not being ignored at the profit-conscious wonders of the age such as Amazon and Google.

Finally, at the outset of this little book let us suggest that all who tread here should heed two warnings. First, designing and changing organisational structure is more politically charged than any other undertaking in the world of business. It generates more resistance, runs up against more blockers, and gives rise to more perceived threats to the comfort of a greater number of people than any other type of change that can happen in an organisation. This fact underlines the importance of studying structure to get organisational design right.

Second, be aware that standards in organisational design are very low. Few managers do it well. Many never make a serious attempt to be objective, systematic or analytical. And any change is more often by drift rather than intent. Must do better!

1. Fundamental concepts

1 Fundamental concepts

1.1 A belief in simplicity

Making profit is the primary purpose of a business in the private sector. Therefore, how and where profit is to be managed and measured is a principal factor in organisational design. This leads to the underlying concept of the profit centre – a self-contained, relatively autonomous unit whose leader, whether a Chief Executive or a Depot Manager, has to achieve a budgeted net profit. Profit centres are fundamental building blocks of organisational design, clarifying where profit is measured, who is accountable for it, and who manages cost. They may encompass an entire enterprise or be one of many small units into which a business is subdivided.

Profit centres give the person in charge of each trading entity the authority to set prices and to direct marketing and selling activity. This simple approach encourages entrepreneurial behaviour and allows maximum responsiveness to local markets. It also positions decision making close to the customer and makes it easier to link managerial incentives directly to profit.

But what if they lead to the creation of a patchwork of fiercely independent territories which compete with each other to the detriment of the business as a whole? Other downside risks include: ineffective use of the company's total resources; minimal exploitation of economies of scale; poor and sometimes misguided direction; and minimal sharing of ideas and experience.

Deviations from the profit centre model are usually intended to mitigate one or more of these risks. The division into customer-facing and support functions, perhaps dubbed 'Commercial' and 'Operational', is only one example. A hybrid organisation, based on a matrix structure, is another.

At Collinson Grant we try constantly to keep our feet on the ground. We assume that managers and the staff in an established enterprise want to understand how the business works best, and that such study merits more than a passing thought.

We think successful businesses have managers who are clear about what they have to do and about the responsibilities of others; they know to whom everyone reports and who in turn reports to them; and these facts are widely communicated.

We feel comfortable with clarity about who has to make decisions and is then accountable for outcomes. We favour measuring the performance of individual managers and of the whole business and then connecting the two. We firmly believe that the structure of an enterprise greatly influences what it costs to run, and that the design of structure will affect everything that a business or institution attempts to do.

For us an organisational structure is a framework with a boundary. It must have a top and a bottom. There will be a central point at the top where ultimate authority lies, but it will delegate as scale and complexity require. We think that to believe differently is to deny the responsibility of the organisation's leadership for setting a pattern in which managers manage with economy of resources, efficiency of process and effectiveness of outcome.

"It is not necessary to change. Survival is not mandatory."

W Edwards Deming

1.2 The managerial structure

Section 2 of this book is about the fundamentals: configuring structure in the components of an organisation such as a department, using generic guidelines on a small scale. The concern here is with individuals, groups or functions in a single organisation. We refer to these as managerial structures even though some of the principles can be readily scaled up and applied to large, corporate models.

We emphasise the need to accommodate the staff and managers within a sound structural framework according to how many people there are, how they function and relate to each other to make processes work well, and how accountability is put in place. Particular concerns are layers of hierarchy and spans of control, of controlling costs by restricting the number of managers to what is strictly necessary, and of the relationships between operational and support staff.

The study and design of a managerial structure requires the application of some immutable principles, for which there are simple tools and techniques that help assess what is appropriate and shape the configuration accordingly.

1.3 The corporate structure

In Sections 3, 4 and 5 we discuss the design of structures at the level of the corporate enterprise. We begin by acknowledging the importance of the business model in influencing the structure given to business units and profit centres; and, in really large organisations, to divisions, sectors, territorial entities and groups of companies.

Ultimately a corporate structure has to work properly in terms of how it assigns responsibilities and accountabilities to the individual senior managers running each part of it. So the principles for designing managerial structures, discussed in Section 2, still apply. But our key considerations here focus much more on the functions and purposes of business units and less on individual job-holder accountability.

Design of the corporate structure is more crucial to the success of the enterprise than design of the managerial structure. It has a more direct impact on growth and how the business goes to market, organises supply and so on. It is, therefore, strongly influenced by business policy and strategy.

Tools and techniques are needed to design managerial structures to best practice standards, but designing corporate structure relies more on the practitioner's depth of business experience and well researched understandings of markets, products, core operations such as production and supply, and the generic organisational options that have, inevitably, to be considered. We deal with business model principles in Section 3, corporate structures and the centre in Sections 4 and 5, and more complex matrix variations in Section 6.

1.4 Control and lean principles

Structures need to be designed for more than clarity and logic. They also need properties that put managers in full control of their fields of responsibility and which, when certain design rules are applied, will tend to drive out unnecessary cost.

In Section 7 we suggest some guidance on how certain generic structures promote business controls. In Sections 8 and 9 we give examples of how certain techniques can be employed to apply lean principles in organisations.

1.5 Models of corporate devolution

In Sections 10, 11 and 12, we have selected three models to illustrate generic approaches to devolution in large organisations. These all support the principle of forcing decision making to the lowest competent level while allowing the organisation's centre to have transparency of operations and keep ultimate control.

2. Basic managerial structures

2 Basic managerial structures

2.1 Information and data requirements

The common form of managerial structure is the chart we know as the 'family tree'. It illustrates how the reporting structure is configured so we can see who reports to whom. From it we should get a clear account about the intended hierarchy of managers and the staff, and about the layers and spans in the organisation – the sinews of its structure.

But a chart is not the whole deal. It is the tip of an iceberg of other information and data that are needed to construct and validate the organisational chart, and to which access is needed if the chart is to be properly understood. Some of this information is needed to build a chart in the first place, and there are a lot of data with which charts ought to be annotated if the whole workings and profile of the organisation are to be fully described.

Some of the information and data needed for a chart to fully explain organisation include:

- members of staff by name and unique identifier (such as employee number)
- population headcounts and full-time equivalent (FTE) numbers related for each location, job and managerial node on the chart
- job titles
- job descriptions
- job grades (with a cross reference to the overall grade structure in force)
- lengths of service by individual, cross-referred to some analysis showing breakdowns and trends
- ages/dates of birth by individual, cross-referred to a similar analysis as that for lengths of service
- pay – with all its components, rates, earnings, including overtime and incentive structure, and the fully loaded cost by individual and with managerial node totals, cross-referenced to the pay structure in force and some analysis of breakdowns and trends
- equivalent hours of work with resource planning assumptions
- the employee status of individuals and groups by managerial node – full-time, part-time, term contract, et cetera.

Anyone drawing a chart from scratch should have researched much of this information. It can be used to populate the chart, colouring in the bare facts about numbers managed, and for other purposes such as assessing whether the resulting structure and population is fit for purpose to undertake the volume and type of work to be put through departmental processes.

A complete picture of the organisation will also include some details of:

- Key performance indicators (KPIs) for each managerial job
- layers and spans statistics – average spans and number of layers in each part of the organisation and overall, actual and target
- staff turnover and absenteeism
- history of changes (staff and managers' population growth, decline, last change made, et cetera).

The fitness for purpose of the organisational segment can finally be assessed.

2.2 Managers

What is a manager?

The job of manager is the single most important building block in any organisational structure. At its simplest a manager is any job into which at least one other person (a subordinate) reports. The concept is essentially about hierarchy, and how hierarchical authority is exercised over subordinates in the workplace.

This idea may sit a trifle uncomfortably with readers for whom modern employee empowerment and the 'worker bee' theory are attractive. Much is said these days about the time being past when people need to be managed in an old-fashioned sense. It is said that, instead, people merely need to know in which team they play and what skills they ought to contribute, with the consequence that there can be leadership and drive without managers.

This is wrong. We believe that most organisations need to make it known to whom authority has been given and therefore where accountability lies, and how the personal performance of managers and that of the process they are charged with are measured.

The managerial node – the position of a manager in the structure chart, is the point at which responsibility for their subordinates, and all their activity,

resides. Work done by subordinates is an extension of the manager's work. Poor work by subordinates is also poor work by managers, who need to recognise, mitigate and correct it. People want, need and must be led by managers with properly designed managerial remits which also define the remits of their subordinates.

No other system of working is sustainable, despite claims from some quarters that a hierarchical chain of command ought to be consigned to history and replaced by management structures where people do not sit at the top or the bottom but are said to inhabit inner and outer zones!

> *"Man cannot conceive of an organisation that some are not capable of subverting"*
>
> **Russell Ackoff**

Supervisors and team leaders

A supervisor is someone with all the powers and accountabilities of a manager but in a more junior capacity. Supervisors are often referred to as first line managers and, apart from their less senior standing, they have all the characteristics of any manager and a chart should treat them as such.

Team leader is a more problematic description since any sort of team can have a leader. The Chairman may be the leader of the Board, and the Chief Executive of the company at large. Nevertheless, it can be a conveniently specific term for someone who is not a manager or supervisor because they mainly do the same work as the people around them, but are also relied on to help organise the work within the relevant process. To us, a team leader is someone who does not have personal authority over the conduct and performance of individuals in their work group.

Typical team leader responsibilities are coaching, assisting, training, guiding or informing others in a team, setting an example for them to follow, or for acting as a communication or administrative channel linking the team and the first line manager. It is a position of responsibility but not of managerial accountability or power.

For example, in times past, a manufacturing operative on whom the foreman relied for support in organising work was known as a charge-hand. This person was responsible for the work but responsibility for the people remained with the foreman and was never delegated. A job-evaluated premium was usually paid but otherwise the terms and conditions were the same as those for the rest of the workforce.

Specialists

It is also best to distinguish managers – who always manage people, from those non-managerial staff (often quite senior) who do specialised work, including 'managing' things but not directing people. These are usually specialists or experts and are on the limb of a reporting line, outside the vertical chain of command.

Organisations have an unfortunate habit of appointing specialists to be line managers on the basis of their technical skills or length of service even if they have no skills in managing people. Worse, an extra layer may be created for a deputy, reporting one-on-one, who is instructed to manage the people in order to leave the specialist unencumbered by the manager's principal task of managing people!

It is best to resist this at all costs. Respected specialists with no leadership or people skills should be given a neutral title like 'executive' which is both accurate and carries no 'baggage.'

"...if any particular organisation isn't screwed up now, it used to be, or soon will be! That is the reality of organisational life."

Geoffrey M Bellman

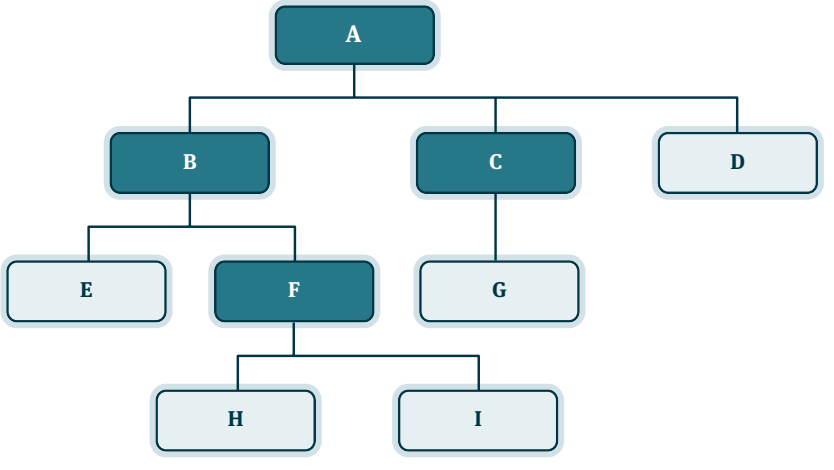
2.3 Layers and spans

Concept

The concepts of layer and span are fundamental in analysing any structure that has the form of a managerial tree. Quantifying structure by counting its depth (layers) and width (spans) is a valuable exercise in understanding

the resources it is absorbing and some of the problems that may challenge it. Even a brief study of any chart may throw up some obvious shortcomings in the configuration.

In the example below there are three layers of managers. A is at layer 1 being the head of the organisation. At layer 2 are B and C – A's direct reports – while F, who reports to B, is at layer three.



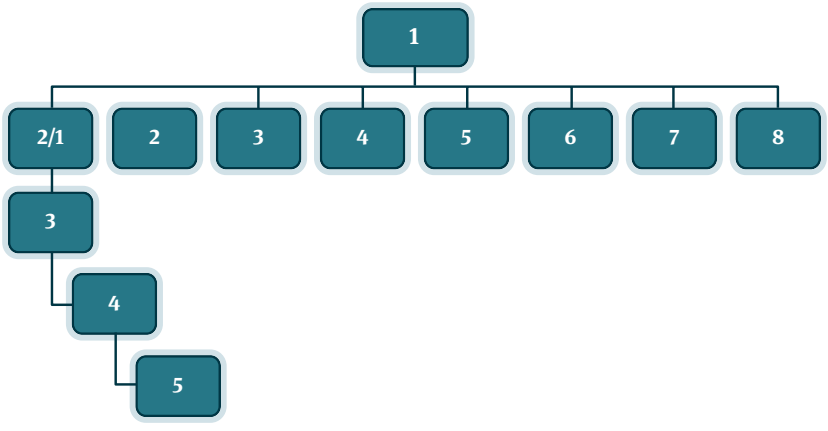
D, E, G, H and I are not managers because no one reports to them. In counting down vertically we should be clear whether our reference is to layers of managers or of all employees.

Manager A has a span of control of three; managers B and F have spans of control of two while C has just one. The five non-managers have no spans to manage. Each of the four managerial positions is a 'managerial node' within the whole structure.

Where the number of layers is small, structures are referred to as flat, and where they are great, they are deep. Where the number of nodes within a span is great, it is wide, or conversely narrow. Inevitably, these terms are relative.

Counting layers

The number of layers to be counted depends at which node the count starts – that is to say which manager is at layer 1.



For example the top node might be the group's Chief Executive Officer (CEO) (the most senior executive in a larger organisation), or a CEO of just one of its divisions, or the Chief Operating Officer (COO). In each case the scope shrinks – from the group to a division, to (merely) the COO's operating organisation.

Optimising layers and spans – the '8 x 5 test'

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

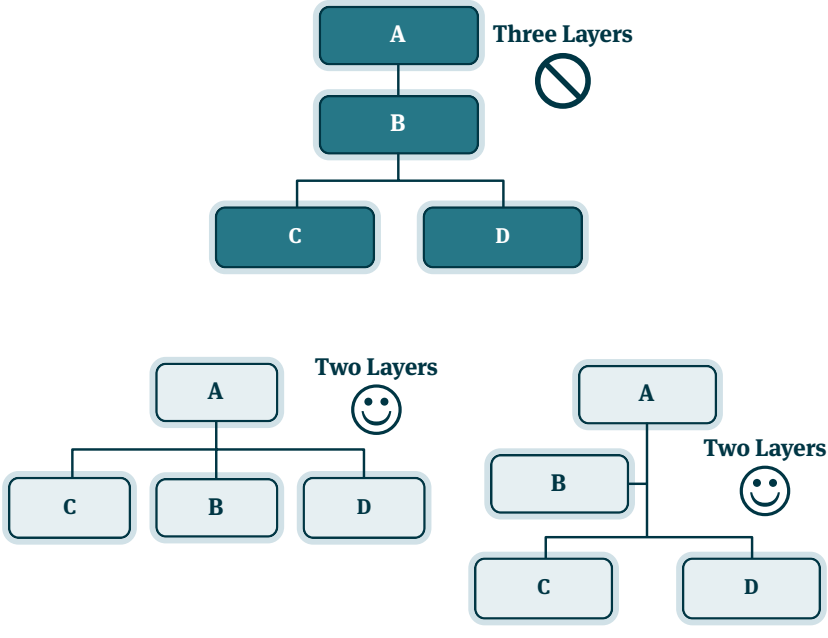
The ideal number of layers, five, is thus relative to the context – the size and scope of the organisational structure under review. There are no strict rules, and judgement is required. In this regard we may want to refer to the concept of levels discussed later on. Layers and levels are different but the latter is a useful tool in making judgements about the former.

Structural shape – the dangers

The importance of structural shape is often lost on company executives who follow their own, untutored logic in designing the structures they manage.

A common mistake is to assign one manager to each separate task, type of task, or activity irrespective of the number of managerial jobs (nodes) this generates. Too many nodes will result in too deep a structure and spans that are unnecessarily narrow. For example, an accounts department of twenty people might give rise to eight managers configured in four layers whilst

a correctly shaped structure would be more likely to have four managers and two managerial layers. One common feature of bad shape is one-to-one reporting of the type shown here.



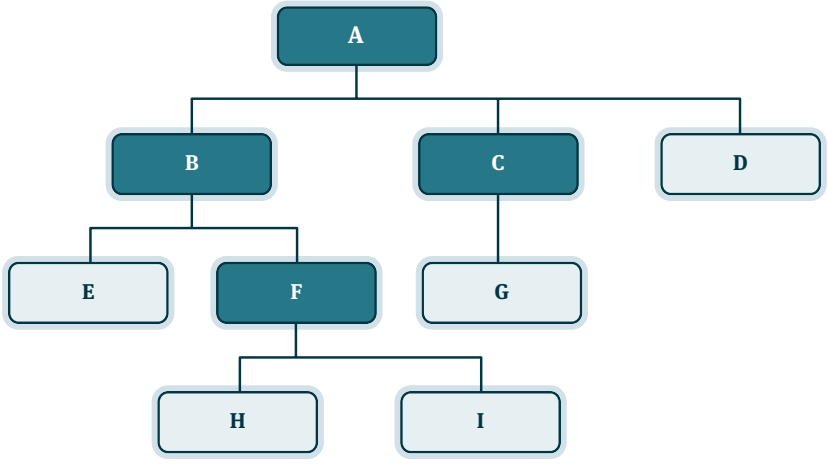
Worse, having unnecessary managers creates fertile conditions for the uncontrolled increase in the whole staff population. Managers tend to 'attract' members of staff to bolster the standing of their own jobs, sometimes building in more 'slack' for their own comfort or for 'emergencies.' The employed population can balloon needlessly and expensively.

So it is particularly important that spans should not be allowed to be too narrow or levels too numerous because the proliferation that follows drives up the size and cost of the payroll with no guarantee of adding any value.

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 also encourages other bad habits as B can be an effective barrier to proper oversight, communications and the flow of information up and down the chain of command, and may block A's vision of the work being done, or not being done, below B.

Calculating the average span

To counter the balloon effect, it is a useful test to quantify the average span. This is calculated from a ratio of the number of managerial nodes and the total population. In the example there are nine staff in total and four of those are managers (A, B, C and F), thus 9/4 computes as an average span of 2.25.



The 8 x 5 test suggests that eight is optimal so a figure as low as 2.25 must be sub-optimal by quite some distance.

Effect of diversity of jobs on width of span

In practice a span may need to differ according to how diverse the jobs are of the subordinates being managed. This usually varies at different depths in the structure. For example, the number of people reporting into a senior manager, such as a chief executive, is often greater because they are all well qualified in their different fields and require less managing from above than those lower in the structure.

But middle managers in charge of more junior managers and members of staff will find that the interventions they need to make in supervising subordinates limits the time they have available for each one, restricting further the number that they can manage.

Continuing down the organisation, where there are large numbers of non-managers performing jobs to the same or similar design (less diversity within the managed group) junior managers' spans can often be very wide indeed.

For example, a call centre supervisor can manage more than 20 subordinates, because managing simpler, repetitive work takes proportionately less managerial time per head.

Reducing the number of layers and managers

Flat structures are best because they reduce the number of layers. Generally, the wider the average span the fewer the total number of managers and members of staff will be needed for any given workload. The narrower the span, the more likely it is that layers will multiply.

Flatter structures are associated with better managed and motivated staff, better managerial performances, and senior managers who are less likely to be out of touch with the quality of the staff's work, and the processes they operate.

Flatter structures can also be an antidote to managerial remoteness. Common sense indicates that the quality of communication throughout the organisation will deteriorate as its structure becomes deeper. Goals are more easily shared when structures are flat.

"A manager will take six months to get to know his staff, but they will take only six days to get to know him."

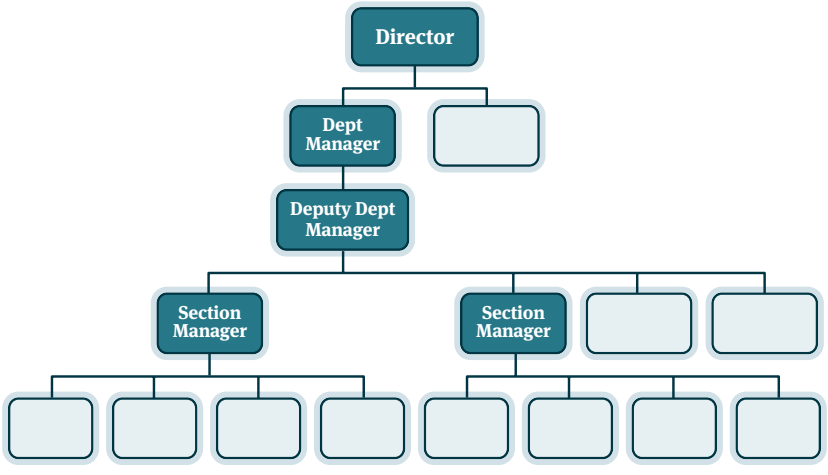
John Adair

Our research suggests that managers should expect to spend at least two-thirds of their time interacting with those directly reporting to them. Managers should have enough subordinates reporting to them and a broad enough span to justify this norm.

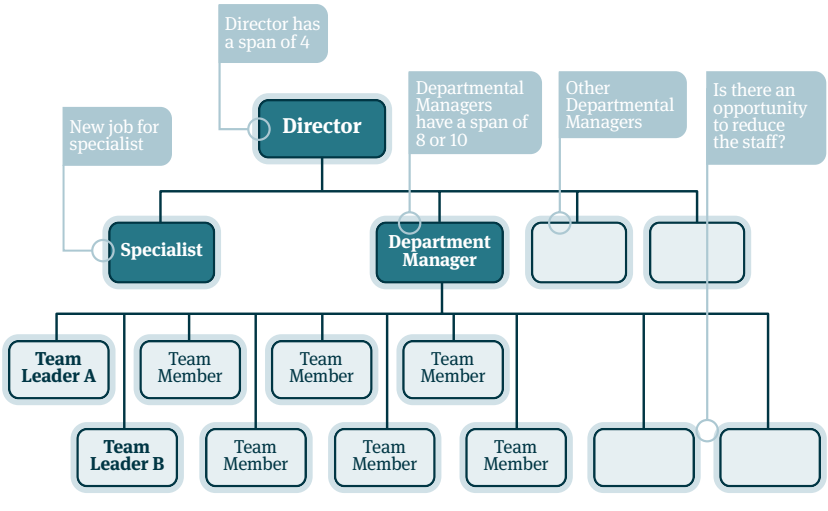
So, first and foremost, managers should be skilled at managing people and spend most of their time doing it. If more than half of a manager's time is spent on work that is distinctly different work from that done by subordinate staff, that manager may be using the skills of a senior specialist and managing things rather than people.

Unfortunately it is commonplace for the most skilled specialist to be promoted to head of department even though they may have little talent for managing staff, or for that matter managing operations generally. The result

of this is often that the task of managing the staff is delegated to an assistant or deputy to the manager, creating the undesirable 'one-to-one' and the unnecessary extra layer referred to earlier.



The structure illustrated above almost certainly has too many layers and, as a result, arguably too many staff. It is possible to challenge such a structure by seizing the opportunity to reduce the layers, justifying this by insisting on best practice in the design of some individual jobs. The structure could be redesigned as shown below.



Layers and grades – a warning

It is never wise to assume that jobs in the same layer (counting down from the top) need to be assigned to the same rank, grade, pay, or other indicator of seniority. This has become a bad habit in some organisations, particularly in the public sector. It has the effect of forcing a large increase in the number of layers, thus causing a population explosion with the attendant increases in cost. Some interest groups, not excluding managers themselves, can see this as an opportunity to increase the numbers employed. Of course, productivity dies.

"No institution can possibly survive if it needs geniuses or supermen to manage it. It must be organised in such a way as to be able to get along under a leadership composed of average human beings."

Peter Drucker

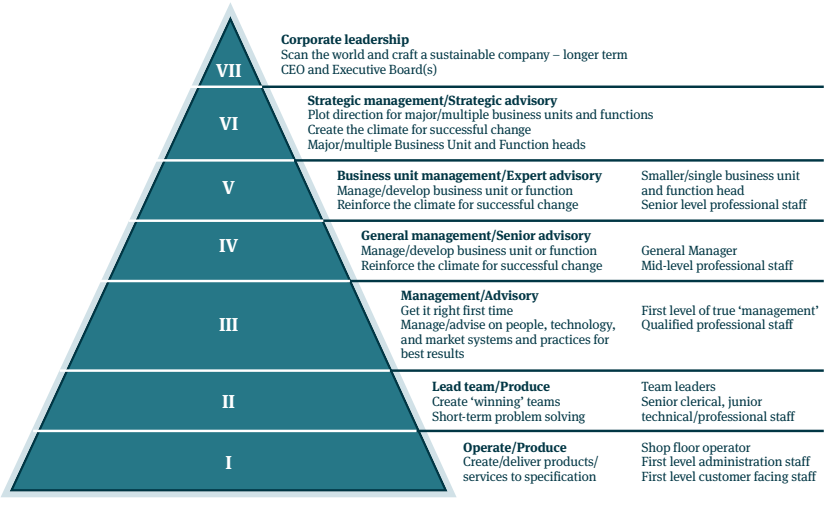
2.4 Levels of work

Jaques' model

Although the 8 x 5 benchmark is a useful check, there is another tool to help control and optimise the number of layers. The levels of work method is an attempt to limit the number of layers by forcing them to correspond to a generically defined level or rank of job type.

The concept was developed by Elliott Jaques, a Canadian organisational psychologist, and is based on time span analysis. He classifies managerial work into seven categories or levels based on the length of time which each type of job requires in order for it to achieve its aims and fulfil its purpose. In this way he creates associations between type of job, the weight of accountability and the organisational hierarchy.

Once a job is positioned at one of Jaques' levels, it is possible to fashion a correspondence with a layer in the structural chart.



Using the levels of work method to optimise the number of layers

This is the sequence of steps to apply the levels of work principle to the task of reorganising an existing structure, or to creating a structure from scratch:

1 Pinpoint current problems: duplication, too many levels, too many layers, too much management, excessive cost.
2 Examine the characteristics and requirements for every managerial job.
3 Define all jobs by title, job code and function, and map them to the appropriate levels of work.
4 Assign locally appropriate definitions to all the levels needed, noting that not all of Jaques' levels are relevant to or necessary for every organization.
5 Consult the job grade structure and amend it to reduce or, less likely, increase the number of grades if that makes sense.
6 Force a reduction in the number of managerial jobs if possible.
7 Complete the new scheme for job grades, layers, reporting structure and employee numbers.
8 If necessary, create senior non-managerial streams to accommodate high grade non-managerial staff.
9 Draw out and sense-check a new structure chart, auditing the number of layers and widths of spans and calculating the average spans.

One of Jaques' levels can accommodate more than one layer in an organisational structure if this is required to organise the work or manage processes. Start by defaulting to a model in which there is just one level to one layer before resorting to two (rarely more) layers.

In the same way, it is not necessary that every level should contain a layer. Not filling all levels with jobs is an effective way of designing a leaner structure, provided you can be sure that the management of processes or the decision-making capacity of the organisation is not impaired.

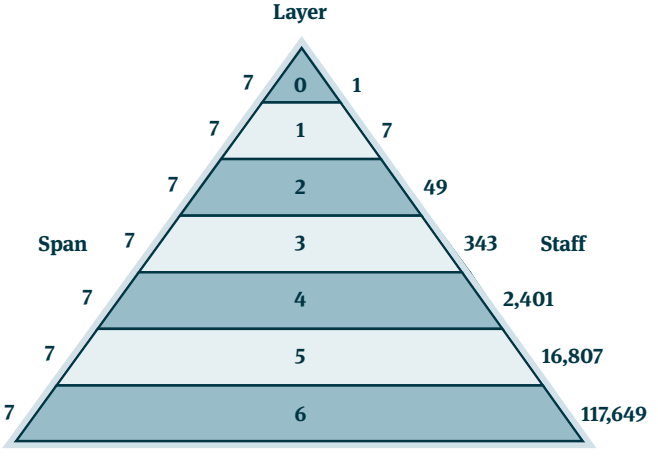
> *"If you want to change the culture, you will have to start by changing the organisation."*
>
> **Mary Douglas**

More on levels and layers

With levels, it is the principle that is important. The mechanics are secondary. The exercise is all about achieving 'best fit.' A series of iterative steps will almost always be needed to find the equilibrium.

It is not always necessary to stick with Jaques' time-span definitions. A custom model may work better, provided it is given a clear and robust logic that works in the specific context. That could be based on the local grade structure if the warnings given earlier are heeded. However, Jaques' model has a proven record and should not lightly be set aside.

Theoretically, a pyramid of only six layers with an average span of seven is possible in an organisation of more than 117,649 people – enough capacity for most organisations.



2.5 Job design

In this book we will not dwell long on this huge subject. From the perspective of organisational design, we are mainly concerned with jobs which derive from, and are directly relevant to, the processes for whose performance the employees and their manager are accountable. This sounds obvious. But often, much 'work' goes on that does little to fulfil a department's purposes.

To avoid too much unproductive work, arrange for the tasks and decisions embedded in jobs to be entirely functional and directed unerringly towards how outputs such as product or service effectiveness can be optimised. Only then should inputs be defined, such as time, skills, tools and materials; in other words, use the design process to create an effective test of whether value is being added.

The art and science of designing jobs is an effort to balance the behaviour and performance that managers want with the welfare of the jobholder. In relation to the latter, motivation starts with skilfully designed content and structure of jobs.

> *"Don't chase the latest management fads. The situation dictates which approach best accomplishes the team's mission."*
>
> **Colin Powell**

2.6 Line and function

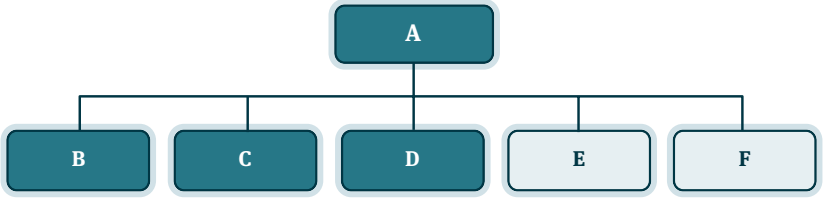
It was common in the past to refer to line and staff structures. Although the term is less heard today, it remains the clearest terminology with which to refer to the juxtapositions of conventional, 'family tree' charts.

On any chart some people are said to be in line jobs ('in the line') within the layered hierarchy through which is threaded the vertical chain of command. Others are said to be in a 'staff' relationship to line jobs because they work in what we now call the functional departments, and so have a more 'horizontal' relationship to the rest of the organisation. Specialist jobs mentioned earlier are also staff jobs.

These days there is much analysis of what is meant by 'functional' and 'line', the relationships they ought to have to each other, and the ratio between them or the balance they represent. So what is a function, and how does it relate to other parts of an organisation?

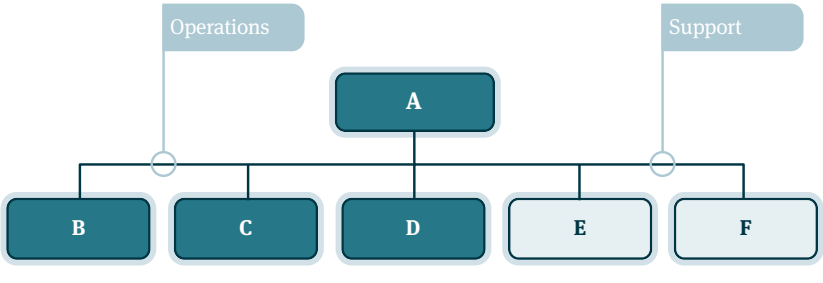
Operations and support

A job or the work it performs in any organisation is generally one of two main types – operational or in support of operations. The taxonomy works like this.



In the structure above, A is CEO or COO or General Manager of the organisation and B, C and D are the line reports for operational departments such as sales, manufacturing and engineering. These jobs manage activities which add value for customers through marketing, selling and delivering the products or services for which the organisation exists.

E and F are also direct line reports of A, but their jobs are functionally to manage activities that support B, C and D. Thus E could be the Chief Financial Officer and F the Head of Human Resources (HR). Information technology (IT) is another support function and others include legal, health, safety and environment (HSE), estates, and security.



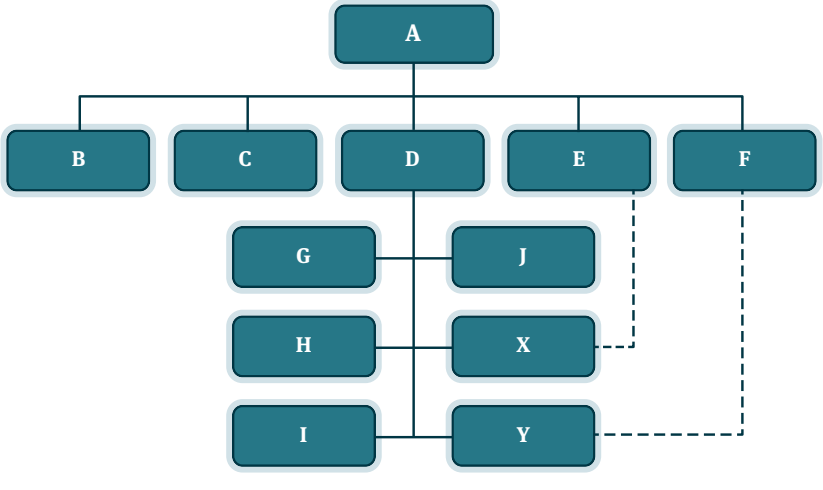
But some activities may be less easily classified into support or operation because context makes a difference. For example, distribution as an activity is usually operational if its performance is critical to adding value to the

customer in a direct way, but it may, in some organisations where that is not the case, be defined as 'merely' functional, particularly if its expense is a small proportion of total cost.

Whether engineering is or is not a support function also depends on context. It may merely support the organisation in a way that a maintenance department would, but if what the company sells includes the value added by engineering design, then it is almost certainly not a support function but an operation.

Functionally supportive relationships

The importance of the taxonomy here is to help decide how best to organise work, draw charts that best illustrate what we mean, and to aid understanding. In the chart sketched below, D is a divisional sales manager with three territorial sales teams led by G, H and I. D also has specialist support from J, an IT manager responsible for sales systems, X responsible for the HR support, and Y responsible for financial reporting and analysis. Day to day J, X and Y all report to D and the solid line drawn between each of them and D illustrates that.



But X and Y also have functional relationships with E and F, often called 'dotted line' relationships. This means that, although their day to day line reporting is to D, for certain aspects of their job they are responsible to E and F. This is usually illustrated on charts with a dotted line.

For Y, Finance Director F will probably provide direction on accounting rules and standards, reporting formats and timetables, budgeting, and other generic and recurring finance functions. F would have had a major influence in selecting Y for the job and would be the judge of Y's professional competence.

> *"The conventional definition of management is getting work done through people, but real management is developing people through work."*
>
> **Agha Hasan Abedi**

A point of interest is the degree to which X and Y are expected to follow the lead or requirements of their functional heads F and E where this may not be to the comfort of, or consistent with, the requirements of D. That questions the strength or weakness of the dotted line. The policy must be set by A and it must be made clear to D, E and F. D must also ensure that X and Y understand the boundaries and behaviours that define their jobs.

Note that J has, in this case, no functional head at the level of E and F so all IT policy is down to D, advised and supported by J. In the units run by B and C one would expect there to be the same or similar relationships paralleling those just described for D. But there are no rules that say the structure beneath D should be symmetrical. Indeed it is important that the design of each be configured according to their processes, scale and other features.

Functional governance – a variation on the 'dotted line'

Functional governance is a more robust variation of the support relationship. To the functional support already described, functional governance adds a duty on Y and X to use a broad discretion in reporting to F and E by exception. This process is commonly used to report actual or proposed departures by D from any common set of understandings on good practice set by F or E, and endorsed by A. The effect is to limit D's unilateral power to engineer opportunities for business policies and initiatives. By this means, D's decisions become subject to checks and balances from outside the division.

Thus the governance process (sometimes called the functional college) can subject D's decisions which, in the opinions of Y or X, need further review at the next level up the functional tree, and if necessary beyond, where matters can be discussed (one hopes dispassionately) between senior functional and operational managers.

Finance functions are the most vital of all the potential functional colleges because they control most of the information that an organisation produces and on which its decisions are based. But HR is also becoming more essential in this context because of the amount and range of compliance now required.

"I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."

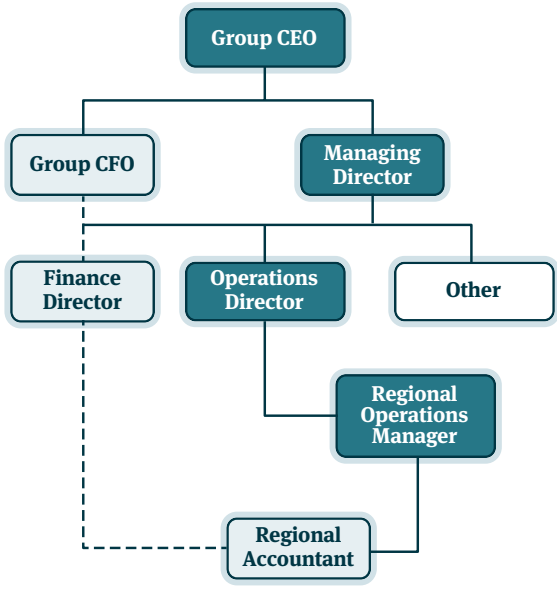
Warren Buffett

Needless to say, general managers, such as managing directors of operating subsidiaries, generally dislike functional colleges because covert decisions and actions cannot easily be kept from their own line. They are more likely to be relaxed about a more technical functional college such as IT.

The notion of functional governance is most useful where a general management position, such as the Managing Director of a company in a group (see the diagram opposite), has acquired a significant degree of autonomy from the group CEO. The Finance Director, who line reports to the Managing Director, is permitted an open line of reporting to the head of function, the group CFO. That then legitimately bypasses the Managing Director, releasing information and independent judgement by exception, thus curbing the Managing Director's decision making autonomy.

By the same token the Regional Accountant also has a direct line to the Finance Director. The three finance jobs inhabit the finance function college.

This organisational device allows a high degree of devolution day-to-day while at the same time operating a 'stop loss' or 'braking mechanism' to arrest rogue decisions made lower down the corporate structure.


Group CEO
Group CFO
Managing Director
Finance Director
Operations Director
Other
Regional Operations Manager
Regional Accountant

3. The business model

3 The business model

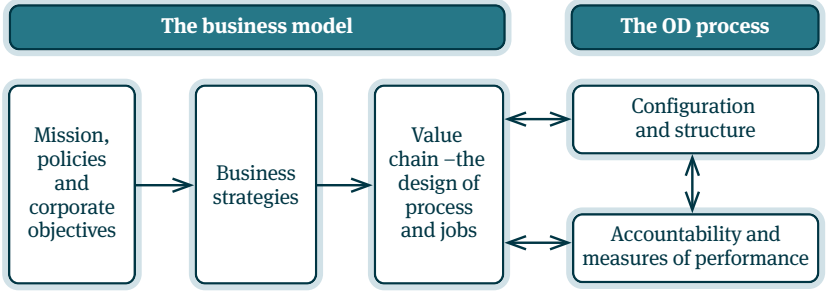
3.1 The starting point for corporate organisational design (OD)

The design of a new structure is not a single task that can be performed in a couple of hours. It involves a good deal more than sketching out a series of charts until it 'looks right'. Best practice entails a process with a sequence of steps. It requires proper research to achieve a thorough understanding of the business model in all its aspects, including all the key processes that add value and give competitive advantage to the enterprise. A quick and easy approach will be built on sand.

It is the business model which tells us how the company or institution earns its bread. However, all too often there is no shared understanding of how this works by those who labour at it. Even though all important decisions made by managers are or should be elements of it, the properties of the model itself may be articulated rarely or referred to only infrequently in discussions and decision making forums, even among the most senior managers.

In designing how an organisation should be structured and function we believe in the absolute necessity of using the model as the foundation stone. The model is the reason the business exists and a failure to take account of the breadth and depth of what the organisation is, and is trying to be, results in structures that are not fully fit for present or future purpose. The business model will be liberated by good organisational design which is rooted in that model.

The sequence of steps for researching the model of the business and the process of designing structure is illustrated below.

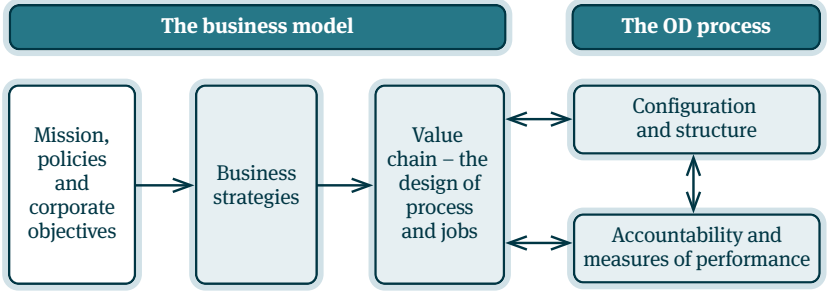


3.2 Mission, policies and aims

The business model is defined first by the policies that originate from the needs of stakeholders. These are owned collectively by the Board, not by its executives. They define longer term fundamentals of the business and may include statements of mission – what the organisation hopes to achieve or is there to do or an expression of its values. Policies should also acknowledge important aims such as the acceptable rate of return on shareholders' funds or targets for growth of sales or profit.

Policies are not immutable and will be reviewed or confirmed from time to time, perhaps even annually. But frequent changes of policy suggest a business not at ease with itself, even perhaps a headless chicken.

Typically, policies are about where to trade and what in, how to fund or resource the business, where to locate it, the direction in which to develop it, the questions of growth, acquisition, the place of research and development (R&D) and almost anything that sets the course of business operations for the medium or even the long term.



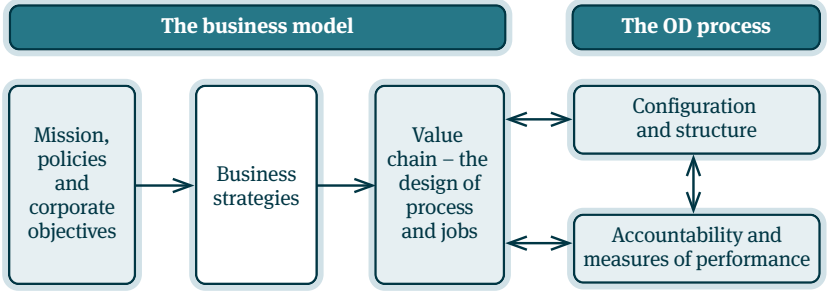
3.3 Strategy

Strategy is proposed by executives and ratified by the board. It must be a derivative of policy. Its purpose is to describe the means by which executives think policy can be realised and its priorities addressed. The board, for example, may prefer to maximise short-term margins rather than long-term business growth. It may wish to prioritise growth in new markets after recognising incipient decline in current ones. And, were there a policy to aim for, say, a 19% return on net assets, executives will determine which strategy will best achieve all these objectives.

Obvious examples of strategy formation are decisions about markets, channels, selling methods, products, pricing and terms of trading, supply chain, manufacture, quality and everything that underpins, in the private sector at least, the search for competitive advantage.

In the public sector the search for cost-effective ways to fulfil policies presents equally taxing strategic challenges, and represents equally important influences on organisational design. Not-for-profit organisations have equivalent outputs and benchmarks of success.

The distinction between policy and strategy can easily become blurred, particularly if the board consists mainly of executives, and even more so if executives are also the principal shareholders. And successful strategies may morph into policy. The essential point is that policy is about what to do (or try to do) and strategy is about how to do it.



3.4 Value chain - process and job design

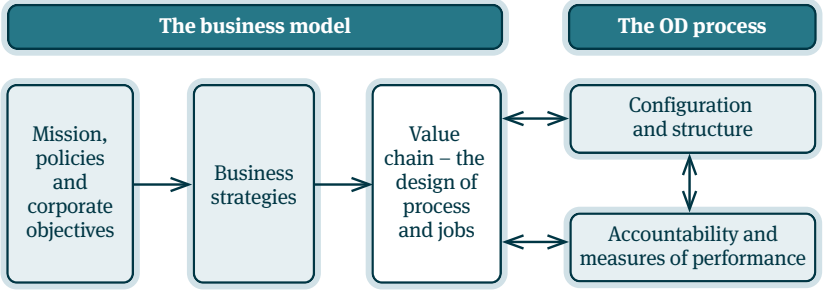
Processes and methodologies and the design of managerial and staff jobs are put in place because they are the practical means, tools and techniques used to implement business strategy. But there must be logic behind the sequence and configuration of processes. They are linked in what we usually think of as a value chain.

Although strategy creates the competitive advantage or the basic means of fulfilling objectives, processes actually add the value day by day. Strategy may be described in generalisations. Descriptions of processes need to get down to detail.

> *"When travelling on a journey, even if there are only three of you, make one a leader."*
>
> **Muhammad**

We can describe them by writing operating procedures, drawing flow charts, and by listing the content and responsibilities of individual jobs. Managerial jobs demand a formal design as much as the organisational structure itself. What actually needs to be written down might vary, but managers need to know enough about what is expected to be able to perform confidently. Others around them also need to know, so that they can work together effectively.

Process and job design together are the business model's largest and most detailed body of knowledge, and provide the foundation for designing structure.



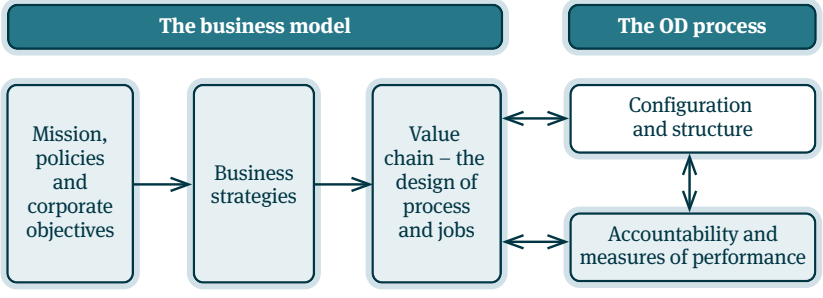
3.5 Configuration of structure

Our concern now becomes the structural dimension of design – how managers and staff report, and how they relate to each other within the framework that we configure and call structure. Managerial structures must be derived from the value chain, flowing logically from the physical, administrative, and managerial processes of the business. We segment the organisation, or chop it up into chunks like departments, which the logic of the value chain provides us with. Corporate structures go further and probably owe more to the policies and strategies of the model (rather than processes), and should be derived directly from those.

The job of top managers is to get the structure right and to maintain, modify and renew it. That of the middle and junior ranks of managers is to operate

faithfully to process and to structure. It is worth noting that operating to process does not necessarily imply a rigid and bureaucratic style of conduct. It simply means sticking to what the given job is and using common sense.

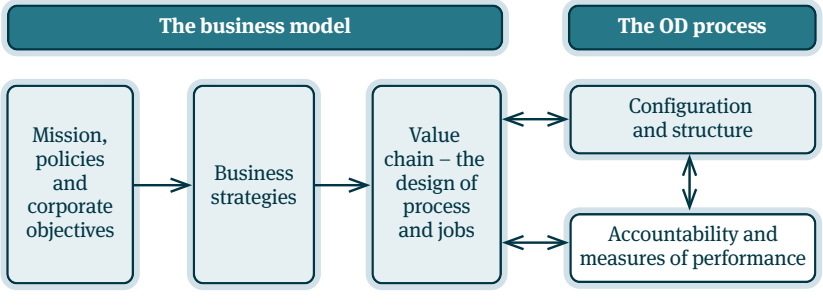
Design of structure should attempt to make, or to enable, managers to be effective by emphasis on economy, through optimising the numbers of managers and the number of their reporting staff, and on efficiency by optimising the depth of managerial layers and width of managerial spans. Section 2 describes the tools and techniques that can be used.



3.6 Accountability and measures of performance

Control is at the heart of any manager's job. And it remains true that, if managers are to be held to account, what is being managed by them must be measured appropriately using, for example, key performance indicators (KPIs).

So an organisational design requires that there be measures that quantify or qualify the performances of the processes being managed, and the corresponding individual performances of managers. If in any instance this proves not to be possible, it is the managerial job or the process being managed whose design might be searched for flaws.



3.7 Balance in all things

The aim of good design is to achieve a balanced and harmonious structure that will give the organisation a structure that is robust and flexible enough to help it achieve its potential.

The relationship between the business model and how the organisation should be put together may sound obvious. But our experience has been that companies are frequently keen to look for solutions to problems by changing the structure of the organisation without first asking if the problems originated in fundamentals such as strategy, or even in confused corporate objectives.

For example, a large retail organisation operating in many countries used franchises in some territories and in others operated its own stores. Following its acquisition by a group known for its leading global brand, it began to question how its retail operations should be organised in pursuit of improved performance. It was advised that no changes to organisational structure should be attempted until it had resolved matters at the heart of its business model.

"You can't build a strong corporation with a lot of committees and a board that has to be consulted every turn. You have to be able to make decisions on your own."

Rupert Murdoch

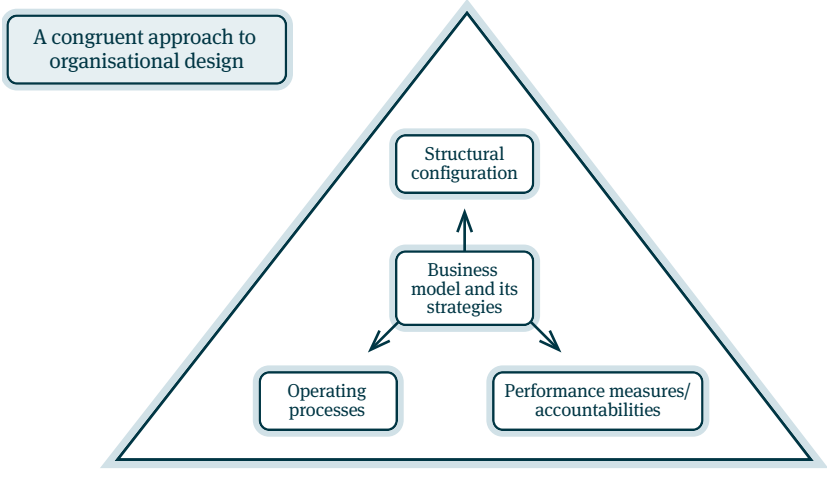
Some of the specific issues identified included whether the strategy of the business should be dictated by brand promotion or by expert retailing? Retailing strategy emphasises pragmatic local decisions using processes that aim to maximise margins in stores. Brand-led strategy requires a consistent global (or global region) approach to marketing that requires different types of management process that usually constrain how store managers, particularly franchisees, operate. Without a policy decision to govern which strategy should be followed, it is useless and dangerous to consider the issue of whether organisational design should favour the franchise or store ownership structures.

In fact it was also right to ask if the problem might be even deeper, requiring policy formation at the level of the acquirer group. Was it clear about what returns it needed from its investment and when? And what were, or are, its expectations from the acquisition?

It is common for organisations to change policies without reappraising strategy, to change strategy without recognising new requirements for processes or for the design of managers' jobs or changed resource requirements. Equally common are situations where policy and strategy are not even articulated or understood. In which case, processes cannot be underwritten by logic and in turn organisational design itself is merely the result of fragmented decisions arbitrarily taken.

> *"Management problems are not respecters of the company organisation, nor of the talents of the people appointed to solve them."*
>
> **Anthony Stafford Beer**

Structural configurations will either liberate or limit the effectiveness of the managerial process and affect the overall health of the organisation accordingly. How its structure is configured is a major influence on how it can and should work, and on how it is, and is intended to be, controlled by its managers.



The quality to be sought most in organisational design is that of balance – a balance between well-defined processes and lean, elegantly configured structures giving effective juxtapositions of managerial jobs. The harmonious concept is illustrated in the diagram on the previous page, remembering that process (how managers manage) is derived from the strategy and all the other properties of the business model.

4. Corporate structures

4 Corporate structures

4.1 Follow the business model

We come now to discuss the design of organisation at the macro level – how businesses and business units, as opposed to departments, are put together so that they work well.

As the previous section indicates, designing a corporate, organisational structure requires an intimate knowledge of the enterprise and every aspect of its business model. There should be a recognisable strategy covering the more common points of reference listed below and this should, through the design of its processes, influence the organisation's structural form.

- Markets, customer types and channels to market.
- Products – groups, range, pricing method and categories.
- Locations – geography and logistics.
- Production facilities for manufacturing (such as factories), or service organisation (such as franchising).
- Business support functions such as finance and HR departments.
- Supply chain sources and logistics (such as physical distribution, inventory management, sub-contract fulfilment, et cetera).
- Commercial strategy (such as pricing, contracts, et cetera).
- Inter-trading terms – trading within the wider corporate structure.
- Financial reporting and profit centres – how business unit performance is measured and at what points in the structure.
- Shared service centres, outsourced transactions and administration – purchases from within or from outside the wider organisation.

4.2 Integrated and devolved structures

Corporate structures fall broadly into two types – the integrated and the devolved. Both provide a macro view of organisation, and sometimes require complex organisational design at the level of the whole enterprise.

Any design that is devolved will introduce the idea of autonomy, putting a significantly higher degree of power and self-sufficiency directly into the hands of many managers. Accountability for profit itself is usually not far away.

A conventionally integrated company, on the other hand, is itself a single business unit and often a single profit centre, even if it is a very large entity. Some integrated organisations are monolithic, an example of which, the multi-dimensional matrix, is described at Section 6.4.

"The only things that evolve by themselves in an organisation are disorder, friction, and malperformance."

Peter Drucker

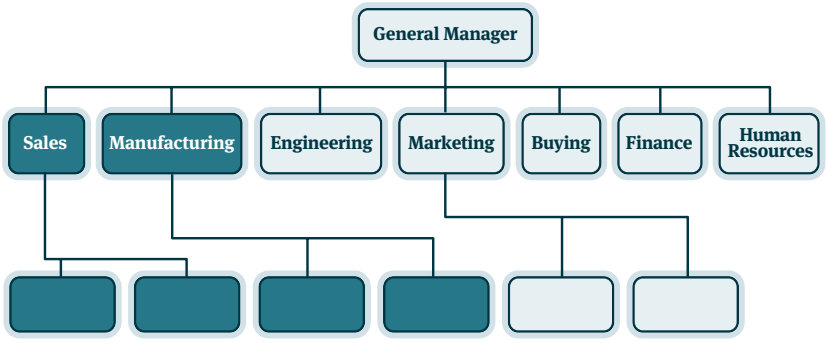
4.3 Integrated organisations

All companies default to a conventionally integrated structure until their size, or their internal or customer-facing complexity, pushes them in the direction of the more devolved features found in the profit centre and business unit types of structure.

In an integrated, centralised organisation the managers of operations and support functions all report to a point of control at the top of a unified hierarchy. Usually, this is the single position where accountability for profit is not shared with any other executive post.

Authority is delegated vertically into functional and operational silos, layer by layer within the hierarchy. Power is not dispersed laterally into profit centres or business units as in a devolved model. The entire organisation is the only true profit centre.

In integrated organisational models other notions of accountability have to be designed into the information system – those of profitability of product, market, channel, et cetera. Some managers will be held to account for these. But unilateral accountability is often difficult to isolate, and profitability is not as categorical a definition as profit. These complexities are met and dealt with in Section 6 on matrix structures.



The structure above is organised as a series of specific operational units (dark) alongside support departments (light). The operational units are normally parts of one uninterrupted value chain running end-to-end through the whole enterprise, giving it its integrated character. There is little or no organisational segmentation around geography, markets, customers, products, and so on. Sales, manufacturing and support functions are managed together, usually under a management team of departmental or functional heads and their chief executive.

This integrated structure places limits on the degree to which managers can make independent decisions. They must make only those relevant to their function, since all departments need to plan and act in concert with a single end in view. The mechanism for this is the integrated budget. The chief executive or an equivalent is alone responsible for the overall budget and accountable for the realisation of profit.

But monolithic examples of integrated structures are often inherently unhealthy in their design. In larger companies this can include behaviours by top ranking executives which have not been seen since the days of medieval baronies.

As an example, a great engineering organisation once had a structure in which the chief executive's main role was as peacemaker between functions that behaved more like hostile factions. The heads of two product groups competed for resource from other functions formed around procurement, manufacturing and engineering, each of which regarded themselves as profit centres even though they sat on the same value chain, just as they would have done in any other integrated organisation. Fortunately, a change of leadership resulted in a change of business model that enabled

the structure to morph naturally into a highly successful devolved model. Managerial dysfunction and flawed structural design often go hand in hand. Usually, the solution also calls into question the business model.

> *“Leaders create an environment in which everyone has the opportunity to do work which matches his potential capability and for which an equitable differential reward is provided.”*
>
> **Elliott Jaques**

The question remains: why would an organisation not want to adopt a devolved, business unit structure? The answer is that there are examples of healthy integrated structures both large and small. Integrated structures are often less expensive to run. Devolved structures may encourage duplication of tasks, processes and functions as they become replicated in many places. This can ramp up cost and create a need for administrative overlays to maintain control, compliance or transparency.

Then again, an organisation that is without much diversity of product or market is quite likely to have no need to devolve responsibilities to a greater number of managerial positions. Increasing their number itself increases complexity and problems of communication and flexibility unless there is a true need for devolution.

4.4 Devolved structures

Complexity and scale

As a generalisation, devolved structures offer more help in managing complexity than the integrated model. The need to segment organisations in order to firmly fix accountability, to encourage a self-reliant and enterprising team of senior managers, and to control a multi-faceted strategy brings with it challenges which sooner or later force organisations to devolve their structures to some degree.

In his classic book, The Practice of Management, Peter Drucker describes how corporations evolved in the first half of the 20th century. He noted that as soon as companies began to grow they needed to grapple with the

necessity of devolution. He observed how over time, they were forced by circumstance to change from the integrated form to another, which he called the federal.

The terms federal and decentralised are no longer common currency in organisational design, having largely been replaced by 'devolved.' But the idea and application behind all these words is the way in which the governance and structure of all larger corporations would have started to evolve at some time in their histories.

Devolution was once considered innovative. Before it joined the devolution revolution, the Ford Motor Company grew as a fully integrated, functional monolith. Control went directly up a single hierarchy towards one man, notwithstanding the huge scale of Ford. In contrast, General Motors began to create subsidiary managerial platforms in which power, with accountability for local results, was pushed outwards and downwards throughout the organisation in a way we recognise as devolved.

For the first time, the results achieved by specific units of the wider corporation could be ring-fenced. Results could be reported and differentiated according to the products being made, or by a level in the supply chain, such as a parts manufacturer, or by a geographical market. It was soon appreciated that this empowered managers, induced better performance from them, and became a powerful enabler of growth. Ford, General Electric and all the other giants of mass manufacturing followed suit, creating the birth of consumerism so eloquently described by Drucker.

> *"The speed of the boss is the speed of the team."*
>
> **Lee Iacocca**

When to devolve

Today the choice is usually not whether to devolve in the federal mode, but at what point on the path of growth and complexity it should be done. And when it is being done, what logic or principle should be followed. Complexity, as well as size, matters in organisational design although the two are often bound together as a single challenge.

Today, businesses seem to become more complex earlier and earlier in their development. This may have something to do with technologies opening more channels through which customers can be reached, and globalisation and international development opening up many markets simultaneously. It is also easier to manage longer and more fragmented supply chains by offshoring and outsourcing. Today it is much more likely that managers will be comfortable with this 'change is normal' approach to life.

Size may be the final determining factor. A manager cannot lead if his or her reach is so extended that control is loosened and effectiveness reduced. The point at which this becomes a game-changer on structure varies greatly within the industrial spectrum.

From these examples it is clear that devolution into business units follows, first and foremost, the logic provided by the organisation's external interfaces for both sales and supply. Accordingly, we shall now focus on the principles upon which effective devolution rests, and in Section 6 on the form of devolution known as the matrix.

Autonomy

The distinguishing characteristic of a devolved unit of organisation is the decision-making autonomy it hands over to its managers. All business unit managers have some degree of autonomous authority, a measure of freedom to decide and act without referral upwards. Typically this freedom may allow discretion on levels of expenditure, on allocation of resources, even the development and pursuit of strategies.

In an echo of Jaques' concept of 'time-span of discretion,' there is a close connection between the degree of autonomy and the interval of time between which a business unit manager is called to account. This suggests that time is a factor in defining autonomy as well as in measuring accountability.

In practice, the degree of autonomy residing in organisational structures varies widely. For example, at an extreme end of the spectrum a group of companies might use the principle to invest broad discretionary power in a business unit manager by providing only its capital, its mission and an expectation of trend in profit performance or growth, reviewed after, say, three years. The rest is up to the executive officer in command.

However that would be too loose a mandate for most main boards to swallow. They would be uncomfortable about losing so much control; and are likely to be more prescriptive, requiring at least annual or perhaps quarterly reporting with possible challenges and interventions, monthly profit and loss reporting to budget, and caps on capital expenditure and rafts of business case justifications for initiatives and innovations. Banks and investors may also limit autonomy by imposing regimes of financial governance such as covenants.

It is part of the task of a designer or auditor of organisational design to measure the degree of autonomy a manager of a devolved unit has been granted. Pinning this down helps define a key attribute of structure which should make an appearance somewhere in the description of the business model. An appropriate degree of autonomy is one that sits comfortably with:

- the mission and objectives associated with the business model
- the risk assessments done on the relevant strategies
- the overall scale and complexity of the enterprise.

> *"Dreams have their place in managerial activity, but they need to be kept severely under control."*
>
> **Lord Weinstock**

Power of devolution

Essentially, autonomy describes and measures how a corporate organisation embraces the principle of devolution – a letting go of power formally recognised through the design of organisational structure.

The power of devolution lies in giving practical effect to a principle which can have a huge impact on the performance of managers. It is to push any given degree of managerial accountability down to the lowest competent level in the organisation. In a large well known group of companies that level is defined not by whether the individual job holder is up to the task (that is a given because of excellent selection processes) but by a search for what appropriate accountability can be embedded in each job in the hierarchy.

There is no suggestion that this ought to determine the number of levels or layers appropriate to an organisation's structure. But there would be a tangible connection between any Jaques-type 'level of work' definition and the level or layer to which decisions and accountability for results are devolved. Devolved organisations, of course, spread accountability widely.

4.5 Profit centres

Creating profit centres

Profit centres are archetypal business units where the devolved principle is demonstrably clear, and autonomous accountability easily measurable. So it is common for enterprises to choose to configure their organisation around this idea. It can be an easy, almost compelling hypothesis to test at an early stage of a restructuring project. Recognising and locating the profit centres from revenue streams can be the key design task from which much else follows.

Profit centres, like all business units, often become a key feature of the business model and, in some cases, are even enshrined in the corporate policy or strategy. Once put in place they make performance and the origin of profit more transparent. Profit centres can vary in size from the building blocks of very large corporations to simple product or customer segments of a business that has outgrown its former integrated structure.

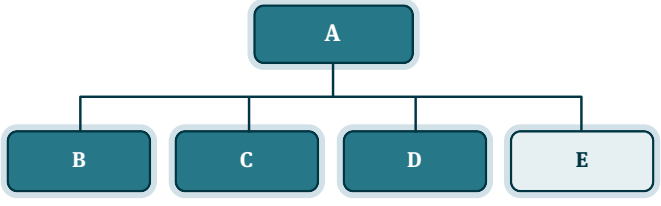
A profit centre must have most of the following characteristics:

- control over the origin of its revenue – by market, channel, territory, product group or any equivalent measure
- control over the managerial and structural entity to which the revenue is credited – a whole company or a division or discrete unit of it
- a discrete body of cost that can be more or less realistically associated with the corresponding revenue
- the difference between the revenue and the costs being the centre's profit or contribution to overhead and profit
- the ability to measure all of the above, together with an adequate system of financial and operational information that supports decision making and performance measurement
- a recognisably discrete body of resources – managers, the staff, assets, tools, et cetera, and the ownership of processes
- a sub-set of the business model and the corporate policy and strategy to go with it.

The organisational principle being followed is that the work, enterprise and resources that a profit centre will liberate can be hard-wired into its culture and system of performance reporting, thereby creating managerial accountability at its most direct, measurable and transparent.

Measuring profit centres

Specifically, a profit centre is a unit of an organisation whose manager has accountability for the revenues attributable to it and the corresponding costs. In a corporate structure shown below where B, C and D are profit centres within company A, all of A's revenue is being generated by the managers of B, C and D, before it is consolidated in A's profit and loss (P&L) account. There is a range of corporate functions bearing the usual variety of overhead costs at E.



There are costs directly attributable to B, C and D, so that a bottom line of 'profit' can be determined for each of them. This may include direct costs alone (generating a bottom line we can call gross margin), or also include some operating costs not directly incurred by individual products but indirectly incurred – such as their cost of distribution (generating a net gross margin or contribution).

The cost of sales, conventionally made up of variable costs, is the obvious first charge against the revenue of a profit centre. It becomes more complex when we have to decide which semi-variable and fixed costs to charge against the revenue of the profit centre. It is perhaps obvious that the profit centre payroll and the people managed in the profit centre have to be co-terminus.

Within profit centres B, C and D, there may be overheads that bear no relation to the profit centre's products, outputs or revenues. But they might be an appropriately apportioned or allocated charge against the profit centre.

Some overhead costs may simply be shared between profit centres, including some that occur at the corporate centre far from the authority of the profit centre manager. A view must be taken whether to allocate or apportion these

back to the profit centres. The pros and cons of this could be debated at length and there is no absolutely right or wrong methodology.

Fortunately, for the purposes of organisational design we need not be too dogmatic about what costs to include. It is more important to have a thoroughgoing awareness of what is or is not included, and above all to ensure consistency across all the profit centres in any organisation.

The relative performances of B, C and D are easy to calculate at gross margin but at gross profit and net profit, the results are affected by the treatment of shared cost. There is, for example, a case for charging the cost of E direct to P&L.

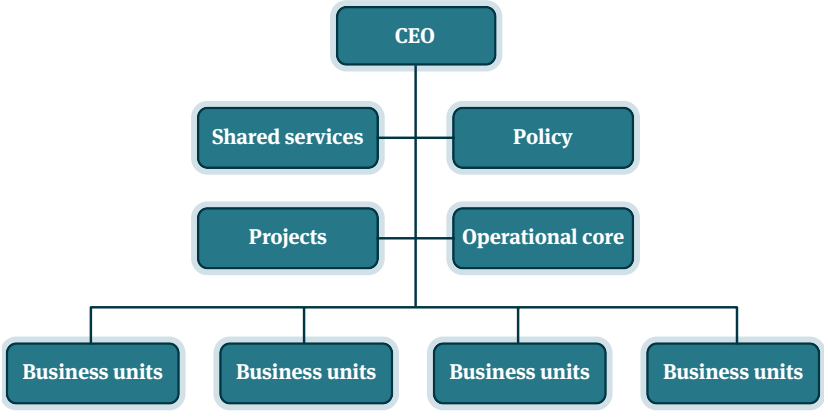
	B	C	D	A
Revenue	100	120	80	300
Cost of sales	80	90	60	230
Gross margin (GM)	20	30	20	70
Profit centre costs	5	5	5	15
Gross profit (GP)	15	25	15	55
Share of E's overhead cost	4	5	3	12
Contribution: B+C+D = A	11	20	12	43

Typically, profit centre managers ought to have authority over the main influences on profit – prices and sales volumes – and the main costs. These are the discretionary elements of a trading strategy which must operate within the company's policies on markets, capital, financial returns (return on sales and/or return on capital employed) and matters of corporate compliance.

4.6 Support functions

The scale of the profit centre in relation to its parent organisation often makes a difference to the entrepreneurial latitude allowed to the profit centre manager, and the rigidity of the requirement to comply with directives from the centre. Some core or operational functions such as sales, supply chain, and manufacture or distribution enable the profit centre business model to operate. Other functions such as finance and HR support these activities and thus provide the internal engine that allows the organisation itself to function. These fixed or semi-variable overheads may or may not be profit centre functions.

Support functions fall into four types, two weak and advisory, the other two stronger and more authoritative.



Shared service support

The simplest of the four types of support are the transactional and generic services common in most organisations – financial accounting, HR, IT, legal services, estates, HSE and so on. Conventionally, they were departmentalised but are increasingly given quasi-autonomous status as 'shared service' units.

They normally report into the organisational centre and support the entire enterprise, but they can be wholly or partly positioned within operating functions or business units, which is to say they are devolved. Sometimes they exist both centrally and in a devolved part of the structure. However, too much unnecessary duplication of the same or similar processes at the centre is a common and expensive mistake.

Project or coordinating units

These usually consist of multi-disciplinary teams set up to pull together core operating, functional work on specific projects, usually in support of initiatives or innovation related to introducing new technology, products, markets or assets. Such units are frequently temporary and their outputs are advisory rather than authoritative.

Policy units

Support also comes in the form of functions that dispense governance and policy. In very large companies these may be head office organisations like finance, HR, corporate communications and legal. They can be positioned in the person or office of the most senior executives in the organisation. They are powerful, but the power is often confined to professional, technical and behavioural standards for processes and managers, rather than to operational and executive management. In large organisations they sometimes have powers to instruct or recommend the horizontal integration of functions performed in devolved business units. An example of this would be where a policy function mandated the coordination of sourcing supplies for several brands or products.

> *"In time, every post tends to be occupied by an employee who is incompetent to carry out his duties. Work is accomplished by those employees who have not yet reached their level of incompetence."*
>
> **Lawrence J Peter**

Quasi-core functions

A fourth type is less administrative in character and more direct and influential in supporting executive operations. Examples include quality assurance, engineering, logistics and even marketing. The classifying of these as support can be debatable; the processes used in carrying them out need careful study to decide if they add value directly or simply support the functions that do. So they will either occupy a place in the structure at the corporate or business unit centre, or as a mainstream operating function.

5. The corporate centre

5 The corporate centre

5.1 Corporate parenting

If policy, mission or objectives have been clearly articulated, the role of the corporate parent in owning profit centres, companies, divisions, and other devolved entities that have been given degrees of autonomy, ought to be obvious. There should be more than a hint as to why devolution is the policy, and what purposes the devolved business unit structure is meant to serve.

This is best practice because a corporation, as it grows, often finds it increasingly difficult to demonstrate the value added by the centre. It is sometimes alleged that organisational centres (head offices) destroy rather than create value, and that if the corporation is a group of companies it may be worth less than the sum of its parts. Thus it may come under pressure to justify its existence, or at any rate its size, by demonstrating to investors that the centre is a powerhouse of governance and policy that forces financial performance and is astute strategically.

To avoid this trap, the design and composition of the centre should, ideally, be put through the same investigation and tests on structure as any of its constituent businesses or business units.

There can be great reluctance to do this. The central organisation owns its own autonomy, and usually chooses to avoid the stress brought on by any challenge to its form or performance. However, avoiding the issue altogether invites conclusions about 'them' at the centre and 'us' in the working businesses which may reverberate unhealthily.

Collinson Grant has worked with a number of organisations to define the function of the corporate centre and to reshape the relationship with operating divisions. In these examples, the centre can be seen as:

- a dispassionate investor/shareholder – offering minimal strategy and few managers or operational capabilities, but simply demanding a return on its investment and compliance with a number of audit requirements

- a parent of a number of loosely integrated and 'lightly' managed business units – applying a fundamental strategic direction, allocating support, and providing common 'governance' processes and controls, but leaving many important and all operational decisions to local, accountable managers
- a parent of tightly managed business units – applying numerous controls and making sufficient interventions to give local managers a well-defined set of guidelines within which to operate.

When managers take the first view – that the group or 'PLC' is an investor – they rarely intend that as a criticism. Rather, it reflects a desirable state of affairs. They can run their operating units as completely independent businesses, with their own cultures and identities, and have the autonomy and freedom to develop them as they see fit.

However, when managers take the third view – that their operating units are tightly controlled – they often do intend that as a criticism. They reckon they have too little discretion in forging their own destinies. This view could be shaped by a range of factors: the history of the business within and outside the group; the personal relationship with the relevant people at group; the extent to which the activities of one operating unit are tied up with those of others; or a perception of unnecessary intervention from the centre.

There is generally a recognition that large and diverse groups do need to set some common disciplines and controls in evaluating the risks of projects or acquisitions. 'Codes of practice' can also be extended into 'soft' areas of managerial practice and behaviour. Such a mechanism balances purely financial measures of performance. And compliance (or otherwise) with the standards gives group another indicator of the health of each of its operating businesses.

5.2 Structure and operations of the centre

A major challenge for any ambitious business is to ensure that it is sufficiently robust to support growth and then sustain performance. This naturally encompasses the function of the centre. Pertinent questions are:

- Would the development of the function and responsibilities of the centre help to improve control? Or would it simply add bureaucracy?

- Does the group rely too heavily on the personal intervention and commitment of a few vital managers, stretching them to the limit?
- Does a 'hands off' approach work for established operating units? Would it be suitable or grossly inadequate for newly acquired or fledgling businesses?
- How effective are the structure and the supporting systems and processes at recognising and responding to early warning signals?
- Are the basic assumptions – particularly about the competences needed and the market focus – apt?
- Is the configuration of operating units appropriate? Could they be redefined and reduced in number to create discrete strategic business units, each with a unique service capability and/or market focus?

5.3 A model for the function of the group centre

What elements of strategy, policy, standards, processes and systems should be imposed from the centre? How should they be put into operation? How should their effectiveness be measured? A framework to express this is shown in the table below.

Functional strategy/process		**Strategy and policy – led by**	
		Centre	Local operating company
■ Operational execution ■ Led by	Centre		
	Local operating company		

As a starting point for illustration, the HR strategy and the core processes that support it could be mapped into this framework. An assessment of what needs to go where would have to consider:

- the risks and implications of diversity versus commonality
- the nature of the competences required
- where specific capabilities should sit within the overall organisation.

This approach can be applied to any of the functions and processes within a business. In aggregate, it would define and size the centre relative to the organisation as a whole.

6. Matrix structures

6 Matrix structures

6.1 Three degrees of complexity

The matrix has evolved as a solution to accommodating accountabilities within complex devolved structures. It was originally popularised by the white goods industry in the United States about forty years ago. Initial enthusiasm for it had, after a decade of application, given way to more mixed opinions. But it was the first conscious attempt to define a way of dealing with corporate organisational challenges at their most complex – situations where authority over people is split because managers or employees report and are accountable to two or more managers. They may be required to take instruction from, and therefore to have performance judged by, two bosses (sometimes more) residing in different parts of the organisation.

Behind this is the problem that as organisations become larger, spread their activities over more markets, products, and sources of supply, they respond by becoming increasingly devolved but laterally wired together. As this feature develops, it becomes harder to govern any one activity from just a single point of management. Structurally, the matrix is neither wholly devolved nor wholly integrated.

"The key to being a good manager is keeping the people who hate me away from those who are still undecided."

Casey Stengel

The big question that haunts all matrix organisations is whether conflicting instructions will descend on managers from different directions. If those instructions are about different aspects of their work and responsibilities, they may be mutually compatible. If they are about the same aspects, they may conflict as one authority within the structure struggles to impose itself on the other without a clear-cut right to do so.

Organisations usually face this crunch when they become sufficiently large and devolved that they sell multiple products in multiple markets (particularly in different countries) and/or through different channels and/or fed by alternative sources of supply.

The matrix structure has many variants and exists on a continuum in which it becomes weaker or stronger towards the extremes. However examination is helped if we can recognise three main categories. The first we can call the loose (or weak) matrix because it is the least organisationally challenging. The second we can call the strong matrix. Finally, there is the classic matrix, an application of structural design where complexity is at its greatest.

6.2 Loose matrix structures

The loose principle

The box diagram below illustrates the principle of loose matrices where problems of conflict are usually avoided because each authority exercises it in a different sphere of responsibility for process. This can be illustrated as follows.

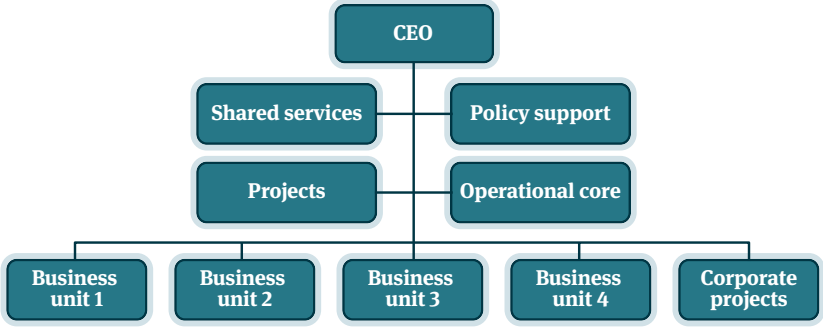
	Executive			
Functional	**A**	**B**	**C**	**D**
1				
2				
3				

We call the managers on the A, B, C, and D axis executive and those on the 1, 2, and 3 axis functional. Functional managers control the training, skills, standards and HR aspects of work within spheres such as engineering, design, product and marketing centres of expertise, finance, and support functions generally.

Executive responsibilities are for project or operational activity and therefore have an executive character. Executive managers may second or adopt managers and staff who are based in the functional departments which are their 'professional home' (such as finance or HR) and redeploy them to the executive tasks for which they, as executives, are responsible. The executive or operations departments, such as production, sales or projects, may be organised as devolved business units based on geography, markets, type of customer, types of product or operational execution.

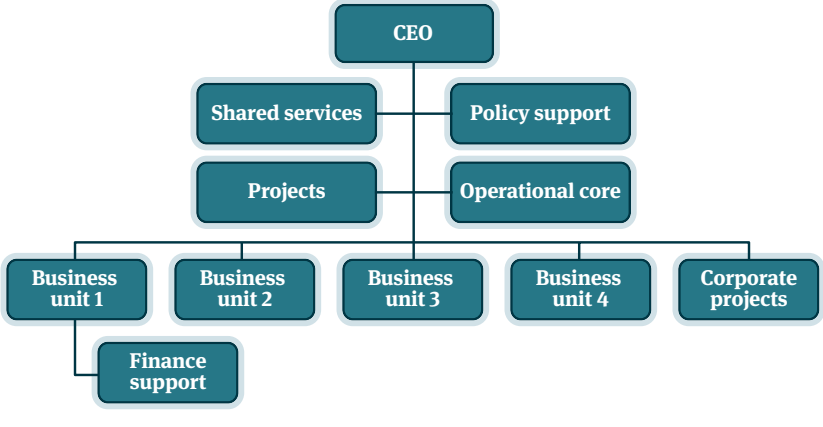
The people positioned like this (in the cells of the matrix) look to the executive manager for day-to-day operational direction and to the functional manager for methods, standards, and other matters of compliance. Managers on both axes have formal authority within a defined line and staff structure, the key point being that in this weak matrix their powers do not conflict because they are each managing different aspects of the employee's work and performance.

The diagram indicates four types of function we can associate with a weak matrix:



Policy support function matrix

This construct was discussed at length in Section 2 where we drew a dotted line between a finance support executive, such as a management accountant, devolved to a business unit and a functional boss, such as a finance director, who lives in policy support usually found at the level of the company or unit board.



This type of loose or weak matrix works easily and is often a brilliantly effective way of strengthening the capability of business units by devolving to business operations the skills which have been honed in the specialist functions under the functional head. This can all be achieved without the functional head giving up control over the quality, standards, methods and compliance of which it is the originator and guardian. On charts of departmental organisations we saw this illustrated by a dotted line.

In the case of the finance function, these are the accounting practices, reporting timetables, career paths, et cetera, where compliance with a centralised view of life is accepted as normal. The requirements of the executive manager on the other hand are likely to be the day-to-day execution of the operational work which, in the case of the finance executive, might include management accounting analyses, financial and commercial research, the gathering of data and period reporting.

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

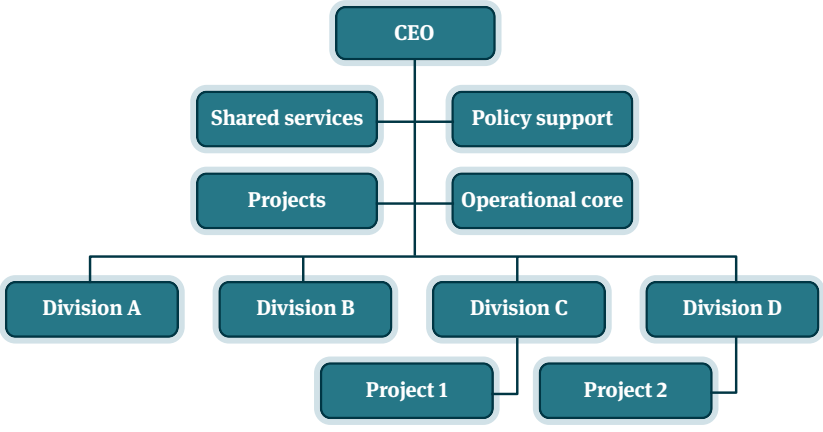
Project function matrix

This construct can be organised in two ways. Individuals, teams and managers may be based in a central project support pool and be assigned to projects based in business units or corporately; or individuals can be drafted from business units into project teams.

For the duration of the project, the day-to-day reporting line is to the head of the business unit or corporate project leader, whichever is appropriate in the context. Projects may be long or short and be continually or periodically regenerated.

There will be a line of reporting (call it dotted) to the head of the central professional resource located in Projects, such as a Chief Engineer, Chief Research Scientist or Chief Designer. Career and professional matters remain the province of the professional 'father' in Projects.

A benefit of the matrix structure is that people having similar sets of skills are pooled together, giving them a sense of being at home professionally and promoting the collegiate environment so important in getting professional skills to flourish. At the same time, the diversity of experience acquired in project-type secondments promotes experience exchange within the professional group.



Project support matrices in some organisations may simply be a way of organising off-line projects. For others it may be central to the business model when, for example, very large amounts of value are added by research, design, and development or when the essence of the business is to perform projects or contracts for customers. In such cases the resource allocation process is always operated from the professional centre. This can sometimes become the subject of conflict where resources are scarce for specialist skills, experience or talent. Generally however, the solution works very well and for larger companies that struggle with using project resources flexibly across many contracts, no better solution is likely to be at hand.

Shared services support matrix

Shared service units, the most common of which are the accounting and human resources functions, can perform the transactional services supporting an organisation's business units more economically, efficiently and effectively than when each discretely manages its own. But this is a very weak form of matrix. Although the head of the service has two bosses, one of them, the business unit head, is really more like an internal customer, and their relationship, typically, is governed by service level agreements.

Some shared service units combine with, or are an element within, a policy support function (see page 61) in that their scope may extend beyond the transactional and into advisory support and surveillance of compliance.

Core functions support matrix

In devolved structures, business units may be given a focus on customer-facing activities like selling, marketing, and country management, to the exclusion of other core activities like manufacture, supply or logistics. Those could, like the customer-facing activities, be devolved. Instead, these processes are organised as a unified central resource. In this type of structure, they are cast in the role of functions supporting business units.

This matrix structure is usually very loose. Nevertheless conflict may arise if managers in, say, logistics find themselves sandwiched between policy support directives with which they should comply (for example, a prohibition on the expensive use of air freight) and the requirements placed on them by business units using their weight by behaving as internal customers (and who might insist on an air freight delivery).

"Every company has two organisational structures: the formal one is written on the charts; the other is the everyday relationship of the men and women in the organisation."

Harold S Geneen

6.3 Strong matrix structures

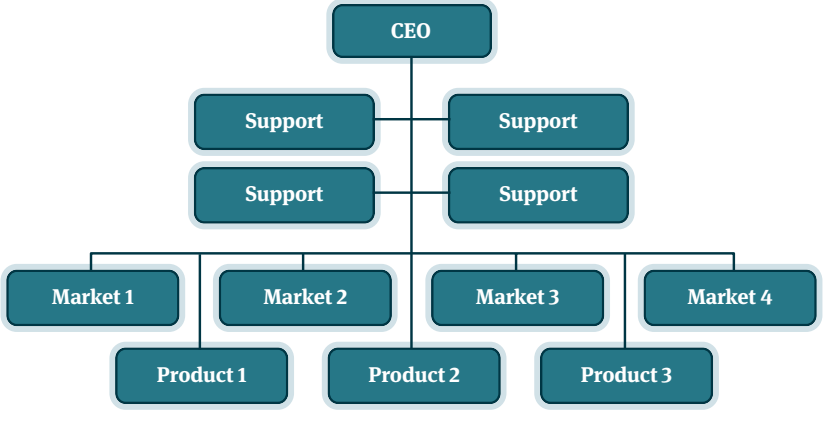
Matrix structures for support functions and projects are usually straightforward to organise when the weak matrix structure is used. Then, although managers and staff may have two bosses, the lines of authority can be easily defined. Generally behaviour is intrinsically weighted in favour of compliance with a minimum of conflict.

None of the above applies to the various forms of strong matrix where one authority directly and uncomfortably overlays another. Here power and political issues can be daily challenges. Conflict may be inherent and it becomes more difficult to draft charts illustrating how the organisation

works. The strong matrix becomes not so much a solution as a compromise, springing from a recognition that there is no better alternative.

The most common case is the problem of needing to organise managerial activity by both product and market, and to hold the managers of both equally to account. It is at its most acute where markets are associated with countries that need dedicated (often resident) managers; where there are markets associated with sales channels that require specialists; or there are products with multiple branded lines.

Before the best compromise structure has been put in place, the problem may appear to look like this:

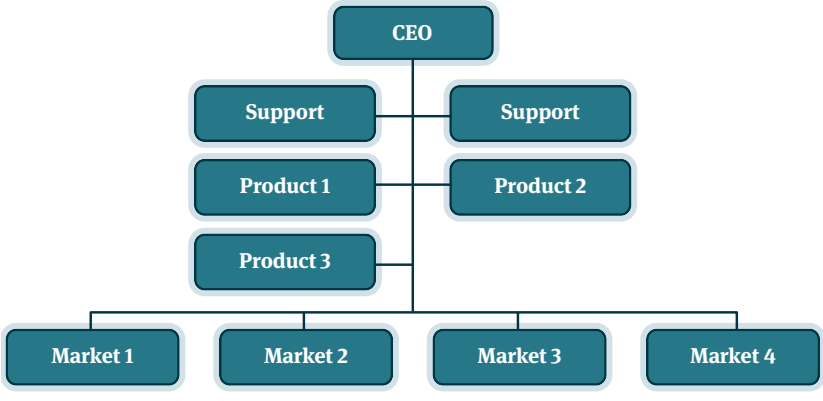


Selling more than one product through more than one customer into more than one country is an organisational problem that almost certainly cannot be resolved by structural means alone. Nevertheless, an attempt must be made to construct a balance of power between managers of product operations (supply, manufacture, commercial, sales and marketing) and managers of market operations (in-country, in-house, in-territory, and via channel).

Loose/tight matrix

It may be acceptable to recognise that responsibility for the product is subordinate to that for the market. The managers of the market may be given a strong remit to determine, by acceptance or veto, the properties of the product, its price structure, its methods of distribution, et cetera.

In effect, the product managers become a support function as shown below, where activity is mainly being driven by the market managers. However, each market manager may see the requirements of each market as different. This may create difficulty and expense for product managers who, in theory, could be producing a different version of each of three products for each of four markets, making twelve variations in all.

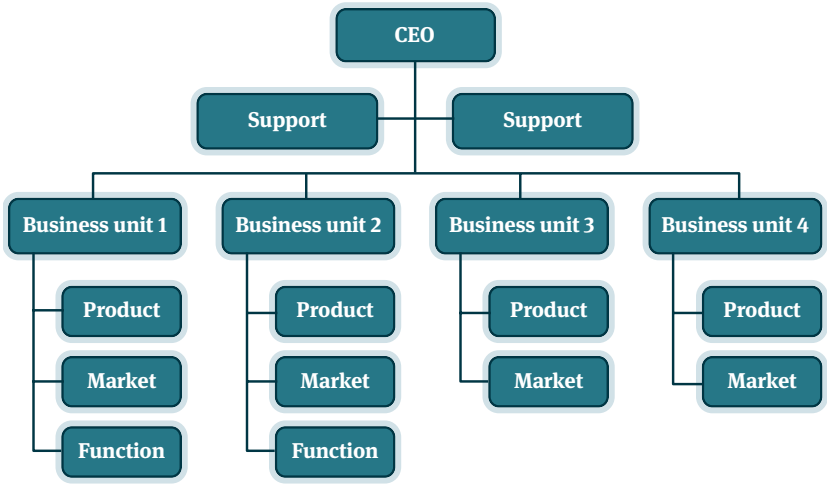


This can be mitigated by a variant of the structure above, illustrated in the next diagram opposite. It creates a role for an additional senior manager to pull together the management of all markets. This post would be filled by, for example, a group or global sales or marketing manager, or chief operating officer. This solution gives some stability to the relationship between product managers and market managers, and will help to organise a more rational strategy for products than might otherwise be the case.

The business unit matrix

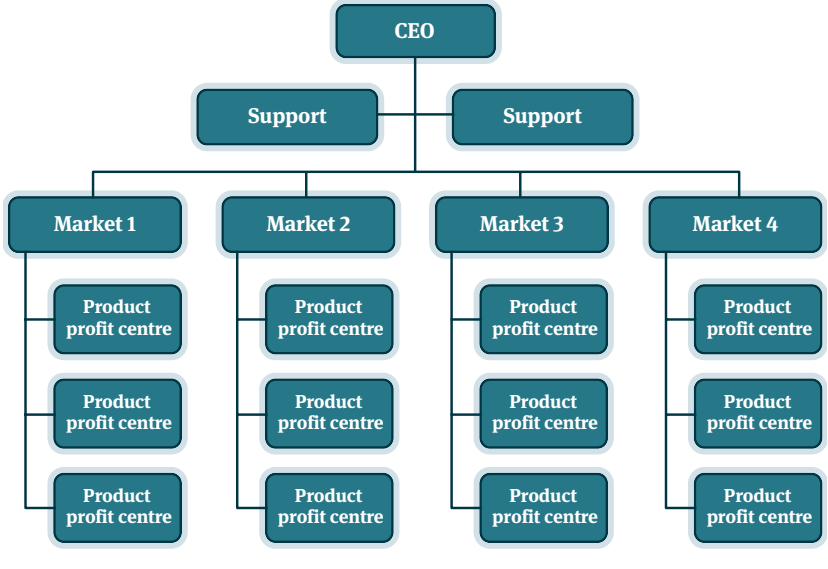
The loose/tight structure may not be ideal if it would underplay the legitimate contribution of product specialists with their intimate knowledge of the properties and potential of their products. It may take a manager who can be more dispassionate about how a product should be presented and taken to market.

So, in the variation illustrated above, business units are formed to cover the multiple products and markets. But this is at the expense of fragmenting the managerial task over the four markets. This may be destabilising if the markets overlap and the same customers inhabit two or more markets. It also creates an extra layer of management cost.



A more rational structure would show the above situation in a variation illustrated below. But its feasibility might depend on whether the organisation can report profit centre numbers with enough information about costs and revenues.

Neither this nor many of the other matrix structures can be efficiently managed and controlled without systems for accurate period reporting and performance measurement of both process and management.



> *"In any great organisation it is far, far safer to be wrong with the majority than to be right alone."*
>
> **John Kenneth Galbraith**

6.4 The classic matrix

Product and market matrix

All the examples of matrix structures so far, both of the loose or weak type, and the strong, have been designed to mitigate the potential for conflict that can arise when people have two bosses – an organisational structure where they have more than one line of direct reporting.

The classic matrix meets head on the challenge which this presents. In doing so, like any dog with two masters, the manager or staff member in this position yields less to authority and more to their own sense of judgement and, hopefully, of responsibility. Clear line reporting breaks down.

	Product business unit 1	**Product business unit 2**	**Product business unit 3**
Market division 1	Market/product profit centre manager	Market/product profit centre manager	Market/product profit centre manager
Market division 2	Market/product profit centre manager	Market/product profit centre manager	
Market division 3	Market/product profit centre manager	Market/product profit centre manager	Market/product profit centre manager
Market division 4	Market/product profit centre manager		

In the illustration the market/product profit centre managers shown in each cell are in this position. They are accountable for the sales revenue and the margin yielded from each product by each market in the matrix. Note that in the example it cannot be assumed that all markets sell all products. Note also that an individual salesperson or manager may be responsible

for the activity and results of more than one product (cell in the matrix) in any market. In the chart, the nine cells might be covered by, say, four profit centre managers.

The essence of this structure is that accountability has passed to the managers of the profit centres who report to their market and product bosses with a greater degree of operational discretion than in any of the other structures we have considered. Their lines of accountability to both bosses are put more into question and they have a stronger hand to play than in the other forms of matrix outlined earlier.

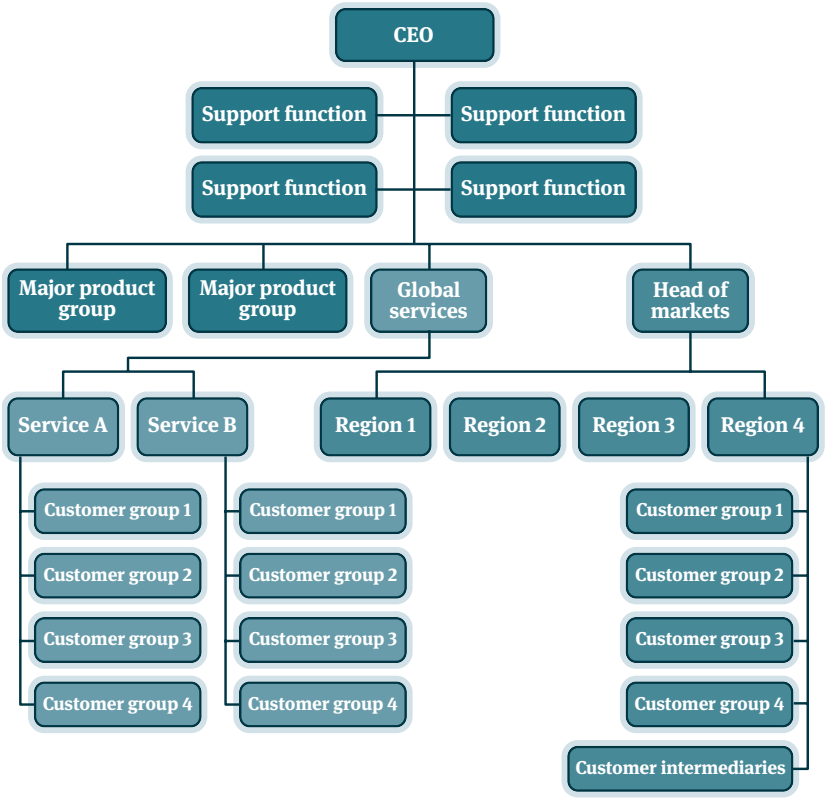
For here it is the matrix itself that sets the behaviours. Control and accountability upward through the organisation is sacrificed to an enlarged degree of devolution. And, by way of a footnote, the ability to draw a conventional line and staff chart for this classic matrix structure has reached the limits of possibility.

There are many variants on this theme when it comes to the detail of who takes responsibility for decisions which include prices, products, range, promotional initiatives (their devising, tuning and implementation), channels and selling methods, and much more. There is no single preferred approach to putting a structural framework around these. The least to be hoped for is that the three parties always involved in the classic matrix work harmoniously and to the same agenda. At best a strong and bright talent, preferably without excessive ego, emerges in one of the positions in the matrix, and is supported by the other two. Here behaviour rather than structure brings success or failure.

The multi-dimensional matrix

In large, multi-market, multi-product, global organisations there are yet more possibilities for added complexity. The chart below is an organisational diagram of a well-known global company that seeks to organise by:

- support function – finance, HR, legal, et cetera
- two major groupings of product and two major types of service
- four types of customers defined by industry
- four global regional markets
- four types of customers within multiple countries
- groups of marketing intermediaries defined by channel.



The product and services dimension on the left hand side operates in a less heavyweight, more background mode than the market dimension on the right, which is strongly focused on customers.

All the labelled boxes are managed by an individual senior executive with conventional line and staff reporting above and below. Clearly, completely discrete accountability for revenues, margins, costs and profit is impossible. And strategies for products and markets cannot be the province of any single executive. Line reporting overlays of product, market, channel, et cetera, are necessary and critically important in understanding trading events and performance throughout the business.

The role of the CEO becomes more crucial by several orders of magnitude in larger companies with these complexities. It is a paradox that such organisations may need to fall back from more and more devolution towards a greater degree of centralisation just to hold products and markets together

in a coordinated way. The CEO may talk about executive performance to a conference of executives rather than to individuals in turn.

However, the logic of this business model is that the monolithic structure brings a competitive advantage of its own. The matrix transforms from a devolved structure into an integrated one, squaring the circle and bringing us back to the integrated model we first examined.

> *"The secret of all victory lies in the organisation of the non-obvious."*
>
> **Marcus Aurelius**

Far from being undesirable, with maximum devolution seen as the ideal, this monolithic matrix may become the best option in preventing the empire succumbing to disintegration and sprawl. The history and size of the global empire, in this case, has created a business model whose competitive advantage is its scale and hegemony.

In this organisational environment, solutions to accountability and control may involve introducing structural features such as multi-disciplinary committees led by the chief executive; or a chief operating officer, positioned at the node where policy is set, who can review strategy and process with precision and regularity. This is also the 'land of the project' where most competitive initiatives are conceived, planned and implemented by multi-disciplinary teams of executives seconded from around the organisation.

6.5 The matrix environment

To adopt or not to adopt a matrix structure

The matrix design problem is at its most acute in deciding who should have accountability for taking products to market. As we have seen in the strong and the classic matrix models, managers with territorial responsibility (say regional or country managers) and managers with product responsibility compete for influence over the same piece of business. Although responsibilities for roles and tasks can be differentiated and the exercise of authority coordinated, it is in measurement and the fulfilling of accountability, the 'who got the sale' issue, where most difficulties tend to lie.

But matrix structures are often also employed when there is no particular structural solution being sought. Some CEOs seem strangely drawn to them for reasons that have nothing to do with necessity but more because they seek to avoid conflict with subordinates in handing out jobs. They tend to be indecisive about whom best to hold to account for results and the matrix structure fudges this problem nicely. The structure is adopted by choice, as a convenience, not because the context requires it.

However to put a more positive spin on this, matrix structures are rightly associated with that style of management which likes to emphasise cooperative values, teamwork and harmony, and collective accountability. Nevertheless, we are not fans of the matrix, and to unnecessarily embrace a complex structure when it has the effect of complicating measurement and accountability cannot be recommended. If certain behaviours are thought desirable (like teamwork and cooperation) it is better to induce them through training and incentives, or by the way in which people are managed.

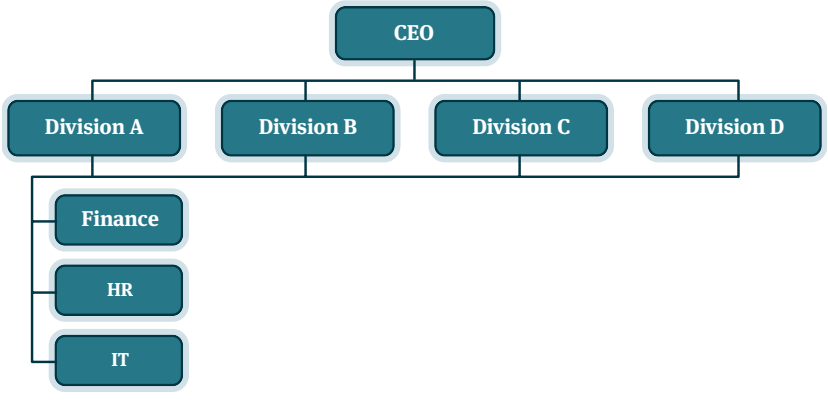
The faux matrix

It is common for managers to refer to a structure as a matrix when it is actually nothing of the kind, but merely drafted to appear so. Not all charts drawn in the shape of a matrix operate as one in managerial terms. The process of managing, and the line reporting structure may, in practice, be one which is quite conventional and owes nothing to a matrix except how it has been represented on paper.

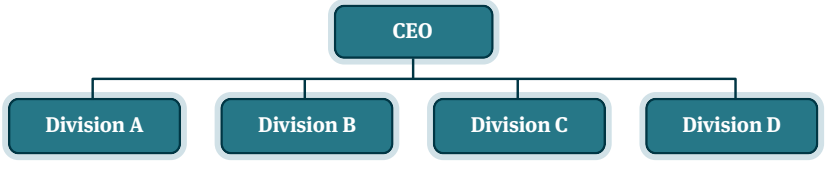
To distinguish between a real and faux matrix it is necessary to focus attention on how the process is actually performed or would be best performed – in terms of who does, or should do, what and how. In Section 3 we suggested that when creating a design, the first task is to study processes and the jobs they require before going on to define accountability and how it is best measured. The organisational structure can be designed around them.

Note that decision taking is a real process. Decisions, like the processes in which they are embedded, need owners (those responsible for taking them). Once the processes for making decisions are recognised, accountability for them will lead towards the right organisational structure, metrics and KPIs which will (if there is balance in the organisational structure) confirm it.

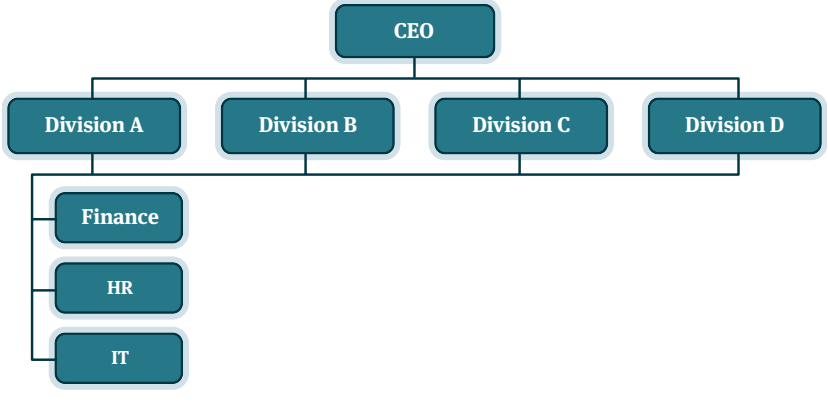
In drawing the structure, give proper weight to all these points. For example, the chart below appears to be a drawing of a matrix.



But it is probably not telling us anything other than the chart below, which is the straightforward story of an organisation of four business unit divisions and three of the usual centralised support functions.

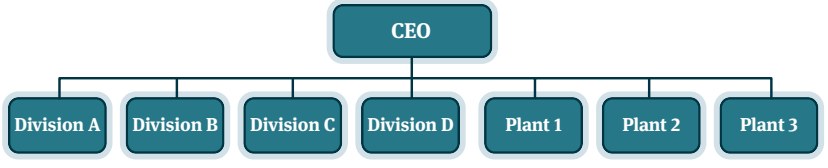


In practice there is unlikely to be a process in which the heads of the three functions line report to any, let alone all, of the divisional business unit heads as the matrix version of the chart appears to suggest.



Again, if there are three production plants each supplying some or all of the four trading divisions (chart below) then the relationship may be one in which each plant manager reports to four divisional heads who instruct their subordinates about requirements for supply. But it is more likely that the divisions act simply as internal customers and the plant managers line report to the CEO, even though the chart is not drawn that way.

The correct way to draw the most likely relationship is shown below so that the line reporting is clear and layers and spans are made transparent.



Drawing matrix diagrams like that below is fine. It indicates usefully which plants supply which divisions – an aspect of the organisational story. But this is an organisational explanation, an annotation of the true organisational chart that will or should properly show line and staff reporting.

	Division A	Division B	Division C	Division D
Plant 1				
Plant 2				
Plant 3				

The grid diagram below probably also tells the truth about the operating relationships where PM is a product manager. But this is not a line and staff chart, merely an explanatory memorandum in support of a process description.

	Sales and Marketing 1	Sales and Marketing 2	Sales and Marketing 3
Engineering	PM	PM	PM
Manufacturing	PM	PM	PM
Commercial	PM	PM	PM

7. Control and structure

7 Control and structure

7.1 The property of control

Control needs to be an intrinsic element of organisational structure. A structure is only in balance and fit for purpose when it is anchoring the controls that sustain every healthy business. This is largely achieved by clear accountabilities and well designed, transparent business reporting. These themes have already been discussed but even so are worth a final look.

The essence of control is accountability. This is present when a structure has in its chart, or within its narrative description:

- clarity on who reports to whom, for every managerial node in the structure
- clarity on which managers own (are accountable for) which processes
- measures of process economy, efficiency and effectiveness which use data on financial and resource inputs, the ratios for transformation of inputs into outputs, and the outcomes achieved against expectation or target
- KPIs (key performance indicators) to measure the fulfilment of accountabilities. KPIs can be stand-alone salient figures, but more frequently are expressed as ratios or the relationships between two or more bits of data owned by a manager (such as 'average units produced per hour')
- a logical hierarchy of measures that cross refer to, help quantify, or reconcile with the financial reporting of the business, and are free from ambiguity.

7.2 Accountability and responsibility

Because both of these terms have resonance in designing managerial structures, it is useful to avoid using them interchangeably. Responsibility is a general term that relates to a job holder's duties in an operational or functional field of activity – the scoping of the job. Thus one can be held responsible for health and safety, for the credit control department, for eight people, or for teamwork.

Accountability introduces the concept of accounting for performance and results – measurement, appraisal, and judgement about degrees of quantity and quality for all the things for which there is responsibility.

Thus a manager with responsibility for health and safety might hold accountability for there being no accidents. The manager responsible for credit control could be accountable for limiting debtors over sixty days to 2% of the total. Typically, accountability is associated with the KPIs of the department or, for the financial results, against the budget for the division.

It is not possible to describe a job definitively without adequate reference to both of these terms, but best practice has it that without accountability, control of business management will be weak.

In a well-designed structure, accountability and measurement will be clear. They will be robustly supported by forms of management accounting, particularly those that unitise costs and margins, use standards for both of these, and then employ them as the foundation of the system of budgetary control. A structure cannot reach its optimum design unless underpinned by these properties. For this reason business reporting is a key component of organisational design.

"Reduce the layers of management. They put distance between the top of an organisation and the customers."

Donald Rumsfeld

7.3 Business reporting

The design of the monthly management information pack and its associated analyses are rarely thought of as an aspect of designing organisational structures. We take the opposite view. Organisational structure ought not to be reviewed without including detailed reference to the financial and operational numbers that quantify the scale and shape of an organisation, and point to how it is to be controlled.

The numbers for which managers are held to account are an essential element in defining jobs and placing them in context among all the others in the organisational hierarchy. Whether we are measuring sales turnover, payroll cost, supply chain, inventory values or whatever, the more senior the job the more money is at stake.

So, the most important principle to be observed is that of ensuring the best possible congruency between the structure of organisation and the design of business reports. No managerial node should be outside the scope of business reporting, and most if not all should be recognisable from a cross reference to the business reporting suite.

It ought to be possible to make a good fist at drawing a structural chart from a sufficiently detailed set of management accounts, and conversely, to base the design of a reporting suite by working back from a chart.

8. Shared services and outsourcing

8 Shared services and outsourcing

Cost can be saved by bringing routine transactions into one 'shared service centre' offering economies of scale and efficiency. But there are pitfalls. Not all organisations benefit. Checks should be made to determine whether the right conditions exist at the outset. Similarly, outsourcing can be advantageous, but also carries certain dangers.

8.1 Shared service centres

Shared services generate real savings by reducing costs, applying consistent standards and focusing on value-adding activities. This is not about 'centralisation'. All parts of the business need to trust the shared service centre (SSC) and 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 implementation of improved systems. But it can be remote from its internal customers and not exposed to day-to-day problems in the field. And every new structure within a business creates its own reason for being, tensions and rigidities – and attracts its own particular costs. There can be other pitfalls:

- consolidating effort 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. Duplicate people and equipment may be required for training and activities at the new centre long before savings can be made elsewhere.

8.2 Do the right conditions exist?

A well designed and run SSC that supports the business effectively can benefit cost, service and operations. But not all businesses lend themselves to this approach and some questions need to be answered before an expensive project or investment is launched:

- 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?
- What personnel will still need to be retained in busines units (BUs) 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 the 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?

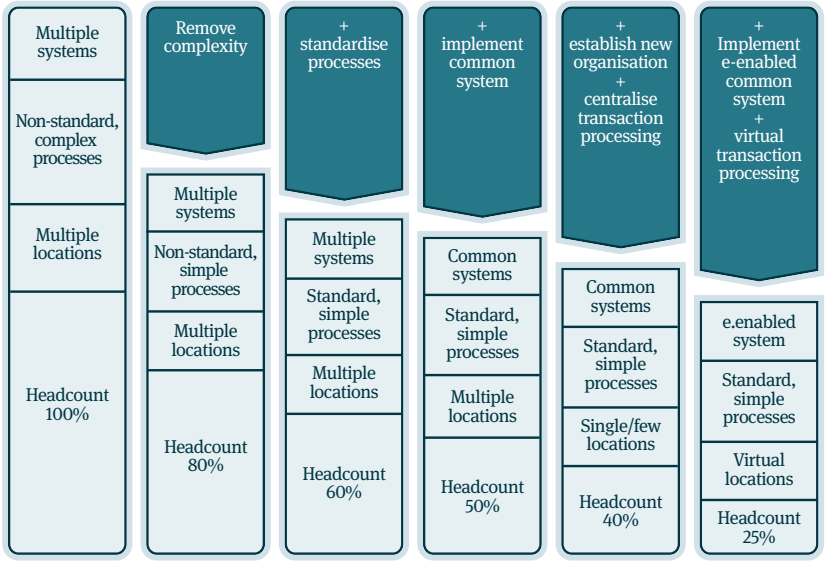
Assess the business case rigorously

The characteristics of the business and the investment required do not always provide a ready business case for creating an SSC. The nature of the transactions does not always make it easy for a remote team to handle them – particularly where local links to the customer are important to avoid disputes. And a common failing is to underestimate how many employees have to be retained by local units to handle queries and other administration when some duties are taken over by an SSC. There are cases where organisations go ahead and invest to create an SSC without accurately assessing the costs and benefits, only to discover that the expected savings cannot actually be achieved.

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 services such as payroll. In other cases the analysis might question the very need for the function at all – or at least suggest that it need only be retained on a much smaller scale. In HR, for example, there is often scope

for considerable cutting back. For other functions such as training, legal services and property, the benefit will show in improved service.

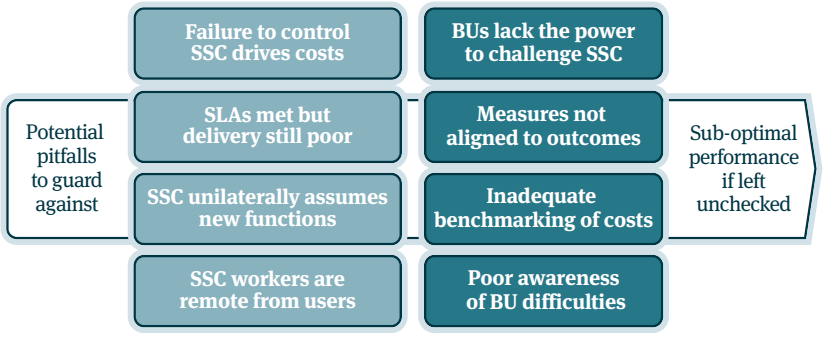
Shared service centre: evolution and maturity
SSCs allow an evolutionary approach to raising performance and reducing costs



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 services
- to define the core processes with adequate flowcharts and supporting narrative
- to benchmark practices internally and against other companies
- to use measures that are simple, tangible and acceptable to everyone
- to focus on 'leading indicators' of business drivers to forecast results
- to establish processes for continuous review and improvement.

It is also vital to assess carefully the impact of proposed changes on the relationships with customers and agreed service levels. Do not proceed without a clear plan that demonstrates the return on investment (with a healthy contingency for the cost of IT).



So the design of an overall service level agreement (SLA) for the SSC must reflect all the requirements of the enterprise. Some of the most important might be quite difficult to define and measure. There is no value in having a robust credit control department that minimises the debtor days, 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

There have been some very high profile cases in which the risks to the business were not understood or managed effectively. Some years ago, one of the UK's largest engineering and design consultancies set up a shared service centre to handle, among other things, its sales ledger. The transition encountered severe problems and for a time the business was unable to invoice all of its customers properly. The consequences for cash flow were so drastic that what was normally a very successful corporation was at risk of failing. Thankfully it recovered quite quickly, but its experience is a warning for all.

8.3 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 outsourcing is the best solution.

When an activity is 'non-core' there may be a case for considering jettisoning it completely and asking another organisation to provide that service under the terms of a robust contractual agreement. Well defined back-office tasks can be obvious candidates, but other support jobs might be suitable. Even outsourcing a more central process may offer real benefits. Other providers may be able to offer and maintain a critical mass in 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 large banks, for example, have been successful. In call centres, product information, local knowledge and even language have become major considerations. Services for directory enquiries and train timetables are among several that have been prone to cultural misunderstanding.

There has to be an absolute distinction between the essential competences that must always be kept within the business and the less critical activities 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 shared service centre, 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 geographic area 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 vital 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 player competing in a different market. While that may be the intention, it can have unexpected consequences that turn out to be irreversible.

9. How lean structures keep down cost

9 How lean structures keep down cost

9.1 Good design is naturally lean

By adhering to the guidelines on good design described in this book the structures created will tend towards being leaner than if a more instinctive and unsystematic approach is taken. The following are examples drawn from earlier in this book:

- Minimise layers and make structures as flat as possible.
- Optimise spans and apply the 8 x 5 test.
- Avoid one-to-one line reporting.
- Distinguish between operational managers and specialists who may be important but are not true managers (because they do not or should not have subordinates).
- Consciously seek to limit the number of managers.
- Look for misshapen, inelegant, unbalanced and overblown structures that suggest it would be possible to have fewer layers.
- Cross-reference layers and grades but do not allow grades or levels to determine the number of layers.
- Take job design seriously and, if the business is large enough, use a design specialist to combine multiple tasks within discrete jobs and thus minimise hidden unproductive capacity.
- Achieve the best balance between functional support jobs and operational jobs, avoiding duplication and considering shared services.
- Challenge the need for functional overhead everywhere, including the corporate centre.
- Check that strategy is derived from a fully articulated business policy so that both give rise only to effective processes.
- Base organisational structure on processes of proven relevance to the business model (that they add value).
- Check that accountability can be measured at every managerial node.
- Check for congruence between the structures of organisation and management's financial and operational reports.
- Employ matrix structures only when they accurately reflect how the organisation has to work.

9.2 Mapping the functional alignment of the population

One of the techniques for examining the leanness of a structure is to locate and quantify population by its functions and professional taxonomies throughout the indirect staff of an organisation, which will typically account for at least 60% of the total headcount even in manufacturing companies. The larger and more complex their structures, the more they tend towards matrix characteristics and have multiple levels of devolved management, the more they are likely to conceal the real number and locations of occupations of the same type.

For example, in some organisations jobs in finance, HR, logistics, engineering, and other generic occupations can be found scattered across a wide range of territorial or business unit locations. And resource groups such as secretaries and clerical support grow and take root in an unplanned and unjustified way. There is a simple analytical technique that can drill down into the organisational data and map, quantify and profile these groups or functions. Other generic types of jobs such as direct and indirect blue collar production, the head office staff and so on, can all be included to give a comprehensive view of the type illustrated in the following table.

The data above is taken from an actual case and shows, for example, that in this integrated group employing just over 3,000, nearly 5% have financial jobs that are threaded through just about every division. In fact all the customer-facing divisions carry out their own invoicing, a feature never previously noticed let alone questioned by senior finance managers at head office because they never thought of it as relevant to their own function. The view given by the chart data suggests another option.

Because conventional business reporting rarely provides any analysis from this perspective, when such data is exposed for the first time it can reveal a worrying profile of jobs scattered randomly without process logic or functional theme. This can be the key to opportunities for making the organisation leaner by realigning the structure so that the same or similar jobs are given more effective managerial cover and perhaps assembled into more robustly designed and effective processes.

Function	Group HQ	Customer-facing divisions (CFDs)						Operations				Total	%
	Head Office	Service Division	Export Division	Customer Division	Energy Division	Industrial Division	CFD total	Manufact'g Division	Group Purchasing	Group R&D	Operations total	Group total	Functional profile
Finance	**32**	4	16	12	17	49	**98**	12	7		**19**	**149**	**4.9**
HR	**59**	3	7	3	8	24	**45**	20	19	4	**43**	**147**	**4.9**
IT	**7**	3	4		2	13	**21**	2	1		**3**	**31**	**1.0**
Facilities Management			3			3	**6**	3	2		**5**	**11**	**0.4**
HSE		2	1	2	1	3	**9**	1			**1**	**10**	**0.3**
Legal	**5**		1				**1**				**0**	**6**	**0.2**
Communications	**7**		12	5	1	4	**22**	3	1		**4**	**33**	**1.1**
Support function sub-totals	**110**	**12**	**44**	**22**	**29**	**95**	**202**	**41**	**30**	**4**	**75**	**387**	**12.8**
Executive Directors	**6**											**6**	**0.2**
Secretarial/Clerical	**50**	20	31	9	45	63	**168**	24	14	4	**42**	**260**	**8.6**
Project Managers	**6**	2	27	16	1	28	**74**	10	5		**15**	**95**	**3.1**
Business Managers		3	38	12	3	36	**92**	19	12	3	**34**	**126**	
Business Improvement	**1**	4	5	2		10	**21**	5	3	2	**10**	**32**	**1.1**
Resource group sub-totals	**63**	**29**	**101**	**39**	**49**	**137**	**355**	**58**	**34**	**9**	**101**	**519**	**17.2**
Logistics	**1**	10	73	13	12	20	**128**	118	54		**172**	**301**	**10.0**
Purchasing	**9**	11	14		15	44	**84**	96	56		**152**	**245**	**8.1**
Commercial	**1**		14	1	1	8	**24**				**0**	**25**	**0.8**
Quality	**2**		15	8	2	15	**40**	10	5		**15**	**57**	**1.9**
Customer Services		2	14		1	15	**32**				**0**	**32**	**1.1**
Sales	**2**		2			11	**13**				**0**	**15**	**0.5**
Corporate & Business Development	**7**		3			4	**7**	3	2		**5**	**19**	**0.6**
Aftermarket			9	2		0	**11**				**0**	**11**	**0.4**
Marketing			5			2	**7**				**0**	**7**	**0.2**
Engineering	**0**	5	39	13	13	52	**122**	30	21	22	**73**	**195**	**6.4**
Operating function sub-totals	**22**	**28**	**188**	**37**	**44**	**171**	**468**	**257**	**138**	**22**	**417**	**907**	**30.0**
Indirect staff totals	**195**	**69**	**333**	**98**	**122**	**403**	**1025**	**356**	**202**	**35**	**593**	**1813**	**60.0**
Direct employees (blue collar)		36	75	24	52	128	**315**	841	15	40	**896**	**1211**	**40.0**
Total group employment	**195**	**105**	**408**	**122**	**174**	**531**	**1340**	**1197**	**214**	**75**	**1489**	**3024**	**100.0**

We found in another, even larger devolved organisation, the group human resources director had no ownership of several hundred HR professionals scattered about the whole enterprise, and was ignorant of the total number. Given that each level in the hierarchy of HR managers had no interest in reducing their own resources, it was entirely fair to conclude that the HR overhead was not subject to any control over total headcount or cost. The same was true for most other functions and resource groups. Functional alignment even of core operating activities revealed some surprises, and scope for challenging the way things were.

This analysis paints a picture of where each type of employee is located, how many there are relative to other groups, and how rich or poor the various managed units are in their different types of staff. In addition, the size of the organisational centre and what it consists of is also made plain.

Any assessment of the facts revealed by functional analysis has to be based on judgments. But anomalies, inconsistencies and even previously unnoticed and possibly scandalous offences against common sense will come to light. The technique can produce uncomfortable but valuable reading that, with the right action, can reduce cost when the design of an organisational structure is redrawn.

A case study in making an organisation leaner by using functional alignment as a tool of analysis

After a lean project in the company whose functionally aligned population is illustrated above, the case for structural change in each function was examined. After looking at the possibilities for improved processes, including introducing shared services, the following restructuring plan was developed.

Function	Head Office	Prof'l & advisory	Trans-actional	Services Division	Export Division	Customer Division	Energy Division	Industrial Division	CFD Total	Manufact'g Division	Group Purchasing	Group R&D	Operations Total	Group Total	Notes
Finance	**20**	12	32	3	5	5	8	18	**39**	7			**7**	**110**	Management accounting only in divisions
HR		17	70					5	**5**	15			**15**	**107**	HR concentrated in SSC
IT		10	25					7	**7**	5			**5**	**47**	Increase in IT resource to support SSC
Facilities Management		2	7							2			**2**	**11**	Some outsourcing
HSE		1	6							2			**2**	**9**	
Legal	**1**	5												**6**	Take out of GHQ into SSC
Communications	**1**	2	6		2	2			**4**					**13**	Centralise for better uniformity and consistency
Support function sub-totals	**22**	**49**	**146**	**3**	**7**	**7**	**8**	**30**	**55**	**31**			**31**	**303**	22% reduction in support functions
Executive Directors	**6**													**6**	
Secretarial/Clerical	**6**	3	25	10	15	6	30	50	**111**	26		1	**27**	**172**	Secretarial blitzed
Project Managers		1		2	27	16	1	28	**74**	15			**15**	**90**	
Business Managers				2	38	12	3	36	**92**	31		3	**34**	**126**	Left intact during organisational change
Business Improvement		1	25							5			**5**	**31**	
Resource group sub-totals	**12**	**5**	**50**	**15**	**80**	**34**	**34**	**114**	**277**	**77**		**4**	**81**	**425**	18% reduction in resource groups
Logistics		1	49		50			15	**65**	90			**90**	**205**	New SSC department adopts better processes
Purchasing		15	55					40	**40**	81			**81**	**191**	New SSC department adopts better processes
Commercial	**2**				14	1	1	8	**24**					**26**	
Quality	**2**	2			15	8	2	15	**40**	12			**12**	**56**	
Customer Services				2	14	10	1	10	**37**					**37**	Case to strengthen accepted
Sales				2	2	2	2	9	**17**					**17**	Case to strengthen accepted
Corporate & Bus Development		7												**7**	Deemed only a corporate function
Aftermarket					9	2			**11**					**11**	May be strengthened later
Marketing					5			2	**7**					**7**	
Engineering				5	39	13	13	52	**122**	42		22	**64**	**186**	Retain scarce skills as a policy
Operating function sub-totals	**4**	**25**	**104**	**9**	**148**	**36**	**19**	**151**	**363**	**225**		**22**	**247**	**743**	23% reduction in operating functions
Indirect staff totals	**38**	**79**	**300**	**27**	**235**	**77**	**61**	**295**	**695**	**333**		**26**	**259**	**1471**	20% reduction in indirect staff
Direct employees (blue collar)				36	75	24	52	128	**315**	841		40	**881**	**1196**	Virtually no change as directs out of scope
Total group employment	**38**	**79**	**300**	**63**	**310**	**101**	**113**	**423**	**1010**	**1174**		**66**	**1240**	**2667**	

↑ Lean GHQ focused on governance

↑ Two-level shared service centre

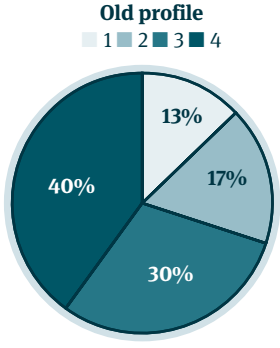
↑ Sector businesses' overheads reduced and moved to SSC

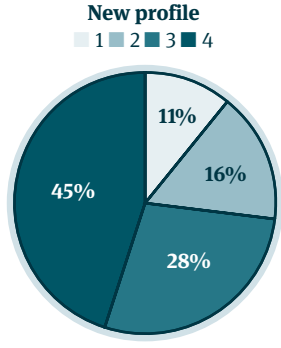
↑ Group Purchasing eliminated

↑ R&D overhead embedded in Manufacturing Division

The effect of its implementation is illustrated in the two charts below. The measured changes between the base deployment and number of people and that projected was as follows.

	Total	Total	Saving	Saving	Profile	Profile
Function	Old population	New population	no. increase/ decrease	% increase/ decrease	Old %	New %
Finance	149	110	(39)	(26)	4.9	4.1
Human Resources	147	107	(40)	(27)	4.9	4.0
IT	31	47	16	52	1.0	1.8
Facilities Management	11	11			0.4	0.4
HSE	10	9	(1)	(10)	0.3	0.3
Legal	6	6			0.2	0.2
Communications	33	13	(20)	(61)	1.1	0.5
Support function sub-totals	**387**	**303**	**(84)**	**(22)**	**12.8**	**11.4**
Executive Directors	6	6			0.2	0.2
Secretarial/Clerical	260	172	(88)	(34)	8.6	6.5
Project Managers	95	90	(5)	(5)	3.1	3.4
Business Managers	126	126			4.2	4.7
Business Improvement	32	31	(1)	(3)	1.1	1.2
Resource group sub-totals	**519**	**425**	**94**	**42**	**17.2**	**16.0**
Logistics	301	205	(96)	(32)	10.0	7.7
Purchasing	245	191	(54)	(22)	8.1	7.2
Commercial	25	26	1	4	0.8	1.0
Quality	57	56	(1)	(2)	1.9	2.1
Customer Services	32	37	5	16	1.1	1.4
Sales	15	17	2	13	1.5	0.6
Corporate and Business Development	19	7	(12)	(63)	0.6	0.3
Aftermarket	11	11			0.4	0.4
Marketing	7	7			0.2	0.3
Engineering	195	186	(9)	(5)	6.5	7.0
Operating function sub-totals	**907**	**743**	**(164)**	**(18)**	**30.1**	**27.9**
Indirect staff totals	**1807**	**1465**	**(342)**	**(19)**	**59.9**	**55.1**
Direct employees (blue collar)	1211	1196	(15)	(1)	40.1	44.9
Total group employment	**3018**	**2661**	**(357)**	**(12)**	**100.0**	**100.0**





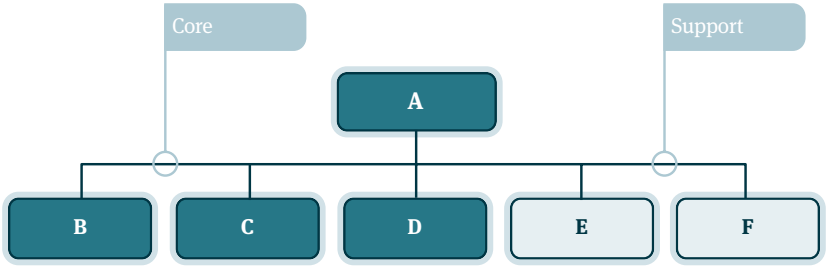
The proportion of indirect staff – 2, 3, and 4 in the pie charts – fell from 60% of the whole to 55%, and there was an enormous change in the proportion of indirect overhead. Overall the effect was as follows:

	Old structure	New structure	Change
Sales	£50m	£50m	nil
Sales per employee	£16.6K	£18.8K	+13%
Employees	3018	2661	-11.8%
Indirect staff	60%	55%	-5%
Profit	£2.2K x 2661 employees = £8.5m		+17.1%

Even on unchanged turnover, the effect of fitting the organisation to a new structural disposition was dramatic.

9.3 Core and Support

Another useful analytical tool of organisation is to apply the taxonomy of Core, Improvement and Support (CIS) to the numbers in employment and their cost. This can lead to similar results as functional alignment, and the two tools can easily be applied in the same lean project.

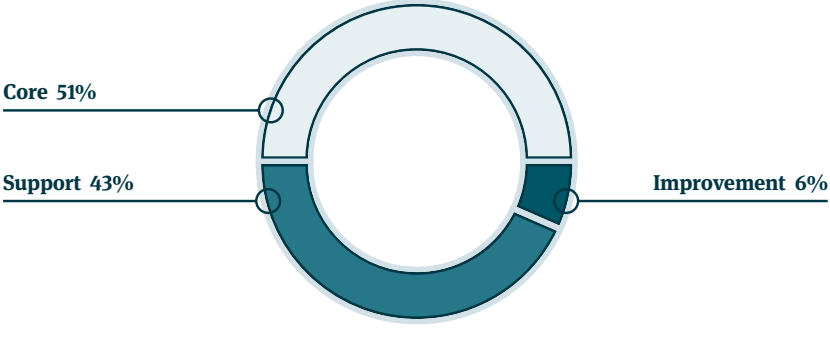


The nomenclature used earlier in this book – Operations and Support are synonymous with Core and Support – is normally applied to an analysis of the total cost of employing people.

In general, Core operations add value to what is supplied to, and paid for by, customers. This may also be loosely associated with the direct, often variable, cost of personnel.

Support functions default to being the fixed or semi-variable, indirect or overhead cost of people. 'Improvement', a sub-set of Support, is functional support activity associated with planned change, the maintenance of, or improvement to, quality.

The CIS model looks towards an idealised balance between these three categories of resource. All can be quantified by measuring time spent on specific activities defined as one of the three categories. The balance of employees' time spent between Core operations, Improvement activity and functional Support can be measured using the Collinson Grant methodology known as Process Activity Analysis (PAA).



The ideal proportions are usually thought to be in the region of 75% (Core), 5% (Improvement), and 20% (Support), although many organisations struggle to achieve this because they find it difficult to manage overhead. The result of the analysis provides a strong indication of where resourcing priorities lie, and whether a change in the population's structure is desirable. Even more important than reducing the Support cost is to spot and resist an adverse trend towards an ever larger Support population relative to the Core.

9.4 Duplication

The biggest scope for organisational change to produce a leaner structure can often be found by identifying where work of the same or similar sort is being done in more than one place. This gives sharp pointers to units that can be eliminated, or combined and reduced.

Functional alignment and CIS often provide pointers towards scope for change, but careful study of organisational charts illustrating structural juxtapositions, narratives on job design, and almost any other data on population profiles can reveal opportunities for amalgamation and consolidation, merger, elimination, and reduction of activity and population generally.

10. The inter-trading organisational model

10 The inter-trading organisational model

10.1 The inter-trading challenge

When there is inter-trading of goods or services between the subsidiary companies or profit centre business units of a common parent organisation, managers in the subordinate businesses and in the common parent may both need to answer a series of questions:

- What are the best organisational corporate structures and configurations for maximising the parent organisation's profit?
- How would that affect profit and loss reporting, and how would the financial returns of each of the inter-trading businesses be measured objectively?
- What principles should be adopted and transactional methods used to report inter-trading business?
- How can commercial and planning disputes between inter-traders be avoided?
- How should inter-trading prices and terms be set?
- What information systems and support for decisions are needed to understand and control inter-trading transactions?

All of these questions are central to the corporate business model (see Section 3). We have already stressed the importance of choosing an organisational design that supports a trading strategy rather than allowing inter-trading to develop by custom and practice and thereby possibly distorting profit. In short the answers to the questions should determine how the structure reflects the value chain, the trading strategy and the general model. Nevertheless, designing and managing an organisation that inter-trades raises significant challenges in which we have taken more than a passing interest.

"The problem with managing either a business or a prison by periodic rather than continuous inspection is that the 'variables' are likely to be seriously out of control before the discrepancy is noted."

Anthony Stafford Beer

10.2 The inter-trading business model

Inter-trading becomes necessary when the value chain of a company's products or services passes through two or more of its subordinate units, both accountable for profit and loss. This makes the profit centres into buyers and sellers of partly finished goods within an enclosed trading universe, system of exchange or value chain. Despite being locked together in common ownership, each needs to price and pay for goods and services within conventional systems of accounting, so that each can make margin on the transaction and report profit. So, how to do it?

Taking a simple example, an oil company has four subsidiaries: to conduct exploration; to pump oil from its wells; to refine the product; and to market the oil. All have accountability for their own profit and loss. Each business has to quantify the increments in value that occur inside the profit centre as products move through successive stages of the parent organisation's chain of value. The results they report will depend, to some degree, on how the terms for inter-trading are designed, essentially the price of the trade.

"Rank is a great beautifier."

Edward Bulwer-Lytton

Inter-trading prices are used to assign value to the product as the first business trades with the second (and in a long chain such as oil) the second with the third and so on. In a fully managed system of inter-trading, these prices would be fixed by a method determined or approved by the parent company. For reasons that will become clear, it is barely an option for the prices to default to a free market price as would be the case between unrelated willing buyers and sellers not under common ownership.

Business models that rely on inter-trading can be qualified in four ways:

- transactions take place between sibling organisations under the authority of a single parent or common owner
- the parent organisation is minded to oblige the subsidiary businesses to sell some or all of their goods and services to each other – it mandates the inter-trade

- the sibling organisations add value to the products or services traded between them, causing them to share the same value chain
- the sibling organisations are accountable for, and report through, their own, separate, profit and loss statements – they are discrete profit centres.

Normally all four conditions are present when businesses inter-trade.

10.3 Resource allocation and the value chain

In conventional capitalism, resources are allocated in response to supply and demand, and to cost and price. Prices tend to find their own level when they are struck: when willing buyers and willing sellers act on the relative strengths of supply and demand. This is so fundamental to industry and commerce as we know it that it is easy to forget that other options for setting prices may be needed in some circumstances.

In an inter-trading regime, the business model dictates that value will be a function of policy, not of free market economics. Though it cannot be based on subjective need, inter-trading is nevertheless a process that requires regulation and intervention. Units bound together by common ownership and a common value chain cannot create price as the free market does.

In these circumstances, the utmost care is needed to obtain a true and fair view of the reality behind how incremental value is measured and added into profit.

The concept of the value chain helps to point up the stages through which goods or services pass as value is added by each profit centre in the chain. Each value chain has a unique configuration shaped by the processes and the positions they hold in the sequence of links. Value chains vary in length (number of business units in the chain) and size (value added) of the links.

Value chains may be designed deliberately to adopt an effective organisation, or may be a simple evolution. It is best if an evolved configuration and methodology for valuing outputs are replaced by a design that fairly and logically determines where profit and margin should be taken.

Although financial accountants have various ways of dealing with inter-trading bookkeeping, the information of interest to managers is what supports such decisions as, in the example of the oil company:

- How profitable is drilling?
- What are the margins on refining?
- What is the return on capital employed in marketing end products through retail filling stations?

The answers are valuable, not because they will be right or wrong, but because they will, potentially, inform logical, profit-seeking decisions on investment, cost control, volumes and so on.

In addition, decision-supporting information must help the company:

- to retain control over its business model, particularly when inter-trading assumes some complexity, and there is danger that transparency may be lost
- to set transfer prices so that it can take profit in the amount and at the point in the value chain that best serve the company's interests
- to promote efficiency and effectiveness in managing the processes in all the company's inter-trading business units.

10.4 Making inter-trading work

Inter-trading may be at the heart of a business model or peripheral to it. Which of these depends on what proportion of revenue or cost is represented by the value of inter-trading transfers. Anything above, say, 5% could materially influence the reported financial results of the inter-trading parties. So about this point there begins to be a need for a considered policy on inter-trading, and a regular system that reports and accounts for inter-trading transactions. Of these, the most important is the inter-trading price itself.

The common parent of inter-trading businesses must exercise authority to fix the method by which the inter-trading price is set: its sibling business units are impotent to do so. The business model that binds them into mutual trade removes their option to negotiate and agree on a market price that reflects the strengths of their respective positions. And because the goods and services that they are directed to trade are in the same value chain, the supplier is obliged to plan capacity and to offer uninterrupted supply of a quantity exactly equal to the user's expressed demand.

This business model has the effect of imprisoning both parties in artificially weak positions because they are prevented from negotiating freely or to any real purpose. Neither is owner of the business model. Each party's cards are known to the other in a way not usual in conventional, third-party deals.

It may be that an inter-trading price that would suit both parties, and that recognises some mutual 'goodwill', might resolve the problem of setting an agreed price. However, that could not be relied on. Goodwill can be in short supply in 'corporate families' as in others. Sibling organisations, abandoned by the common owner to 'slog it out' through bullying or bluff and counter bluff, have sometimes resorted to expensive internecine strife; or to cartel-type agreements to cover up inefficiencies that act against the interests of their common owner.

More importantly, a transfer price that suited both parties might not report profit in the way that suited the other important party, the common owner of both businesses, which must understand and correctly record the wealth creation taking place in the value chain under its ownership. It must know how its wealth is created; where its profits come from; and how effective its business model is.

> *"Management is efficiency in climbing the ladder of success; leadership determines whether the ladder is leaning against the right wall."*
>
> **Stephen Covey**

There are a number of ways for the owner of the business to set inter-trading prices. But to set them with confidence, it is even more necessary than usual to know the costs. A known relationship with cost supports the decisions managers will have to make. For example, is the inter-trading price to be more than, the same as, or less than the understood cost? And if more than cost, how much more?

Usually costs are researched from internal data in order to test the margin available at a given price. This will be followed by a series of commercial judgements and financial plans, after which sales and marketing activity can take place. A lot will depend on whether the same or similar goods are inter-traded and sold in the open market concurrently.

Many inter-trading prices are set to a cost-plus formula of a type common in the public sector, or in the private sector when a contract is expected to run for a similarly long and uncertain period. An example might be a groundworks contractor in a construction business which is a sibling to the design and build business in the same group. In other cases cost plus means, say, £1 each plus 15% to give a 15% return on sales, or £1 each plus 20p to yield a 15% return on capital employed, calculated from the company's budget.

The policy applied to setting inter-trading prices might properly be influenced by the lower commercial risk that is associated with inter-trading. Conventional calculations of return assume that high risk of the loss of capital, or of an under-utilisation of capacity because of unstable demand, justify an aspiration to commensurately high returns. Inter-trade is not exposed on these fronts.

10.1 Transfer costing

Banking profit early in the value chain

Where output passes through several subsidiaries before being sold to an external customer, the owner of the business model can choose to turn cost into profit and loss by adding most margin in one or more profit centres that come early in the value chain. Margins and profit in the first profit centre are then fatter than those budgeted or realised from the second or from others further down the chain.

Adding margin early defines the business model. It is justified as an effective means of squeezing the last drop of profit out of increasingly challenging inter-trading prices on subsequent trades, particularly at the last one to a third-party customer. These low inter-trading prices and relatively high targets for margin and profit can be the instrument for forcing cost out.

Sometimes the strategy is articulated in the claim that it 'prevents sales teams from giving away margins' to external customers. That is to say, when salesmen have no margin to give away, they cannot be seduced by customers into agreeing to low tariffs or spot prices, 'low ball tenders', or other stratagems to shift volume or achieve total revenue targets in hard markets.

In extreme cases, any potential margin from the open market may already have been exhausted before the last amount of value has been added. The problem that this may present is that the margin to the external customer becomes harder to know, and the customer's motivation for buying harder to interpret. This is particularly so if the value chain is long and the relationship between sibling parties at the high and low ends of the chain is remote. The control over the profitability of products may not be centred in a recognisable place. Furthermore, the sales personnel and profit-responsible managers who are selling to 'real' customers may become demoralised when little or no profit can be made and attributed to them. This can adversely affect the sales and marketing effort.

Another concern is that the high margin yields won early in the passage of the product down the value chain may lead to complacency in managers there, disguising inefficiencies which, if they could be seen for what they are and tackled, would create higher profits for the parent.

Taking margin at the external point of sale

The opposite strategy is also commonplace. Little (sometimes no) margin is embedded in inter-trading prices. All or most is reserved for the final, external sale. The logic of this is that the only real margin is that realised from prices in a free and open market. To know and report this, and to base all analysis of the profitability of products on it, is to achieve the truest measure of profitability.

There can then be a focus on getting the maximum sales effort in one place. To avoid the 'low balling' problem, it is usual to apply controls on the sale prices, if necessary to a design approved by the owner of the business model, and possibly even under its direct authority.

It is common for companies to suffer systemic bidding failure if sibling businesses need to collaborate to win bids. Each business often blames the other for destroying competitiveness, usually with allegations of greed aimed at those early in the chain. This problem is usually solved by instituting a 'group' procedure for approving tenders in which there is an oversight at the level of group (parent organisation) of any bid price or tariff to which two or more profit centre business units are contributing.

Equitable returns

As value is inter-traded between the businesses they own, some parent companies consider that each subsidiary that adds value should be allowed to earn a fair return on the capital used or the revenue generated. The return that is then targeted is a calculation reflected in the approved inter-trading prices.

There are always as many views about what represents a fair return as there are parties with an interest in it, even after any agreement on the best type of return to be targeted, whether it be on sales, capital employed, net assets or fixed cost.

And there are further challenges to be faced when, for example, a 'fair' figure of, say 5% on sales, is thought to be a fair average but it is felt 'more fair' – or more challenging – for some of the relevant business units than for others. The technology, innovation, or quality required might not necessarily be paralleled by the costs of production. Some business units in the chain may think it fairer to be asked to add value at 5% ROS, while others would be happier with, say, 10%. All such judgements can feel subjective.

This problem is compounded if reasonable returns are agreed on but the sibling organisation that sells to the external customer is having trouble hitting its targeted return because the market has stopped paying the prices necessary for it to do so. In that scenario, those subsidiaries which are only inter-trading will win out even though they may have the most scope for reducing costs. The sibling business which is the final adder of value and has the vital task of selling is overexposed to failure. This is not a recipe for harmony up and down the value chain.

If the value chain is short, a fast and flexible response to external market problems may be possible. If the value chain is long, that may, because of the number of links in it, be more difficult. The difficulty may be affected by the extent to which players in the value chain have an investment in it. Is the product line central to their sales effort or merely peripheral? If they have large external markets for the partly processed product, or for unrelated products, transfer prices are less crucial to financial outcomes and easier to set without fuss. The parent organisation remains the natural arbiter in all of this.

What should be avoided is an arbitrary agreement for a percentage return – a sort of 'ex gratia gift of margin or profit'. In a case in point, a manufacturer used a sibling organisation as a depot for low-cost stocking before onward transit to a third sibling for final manufacture and external sale. In an informal arrangement, the depot service was 'awarded' a nominal 5% of the value of goods crossing its threshold, thereby ill-advisedly distorting the measurement of relationships between costs and revenue.

Synthetic market valuation

It is not unusual for a product to be sold in the open market and also transferred downstream to a sibling business for further processing before sale. In such cases the open market price provides a sound basis for setting the inter-trading price.

Even if the inter-trading sibling company does not sell externally, it may still be possible to research price equivalents when there is a third party organisation that does. The inter-trading value can then be synthesised from market research.

The problem with this attractive option is that open market prices may vary with location, product, customer, rebates earned, or otherwise. Nevertheless a realistic price can often be synthesised. Data are simply projected or extrapolated (incorporating 'what ifs' and 'if onlys') to arrive at convincing inter-trading prices.

10.2 International inter-trading

As we have seen, inter-trading takes place exclusively between separate business units that are accountable for profit and loss where they exist within a single parent company or group. But these parts of the group, though linked by the same value chain, may be located in more than one country. In one respect, the management accounting for profit and loss in each domain can just ignore this. The effect of currency movements can, of course, be shown as a variance. Exposure can be excluded from or included in the inter-trading price according to the use to which information on, say, margin is to be put. Thus the system of accounting for profit in one place or another, in order to measure added value consistently, can be entrusted entirely to the finance department.

A greater challenge, however, may be the need to employ different transfer prices to fix profit in each country by a method, or at an amount, that satisfies different tax regimes. Some tax authorities are said to be suspicious of any parallel transfer prices used for management information or cost accounting. They may spot that these, were they applied to tax, would improve its yield. So it may be prudent to keep well away from the official audit trail any transfer prices that are primarily used as internal measures and controls over performance.

10.3 Terms of inter-trading

Formal terms of trading such as credit given or taken, conditions of sale, warranty and so forth are sometimes necessary, sometimes not. Sibling companies may comply with a consistently applied group practice in these matters or may not. They may be self-accounting or served by a shared service centre. The inter-trading parties may not only be separate profit and loss accounting centres but have separate banking arrangements and their own KPIs and budgets controlling cash flow. Terms of trading will therefore cover transactions for which invoices will be rendered against terms for credit given and taken, perhaps even with penalties for non-compliance with the agreement or contract.

Terms of trading also need to have provision for how inter-trading prices can be changed and, particularly, how and when adjustment may be made for cost inflation, such as in the cost of commodities. Getting a price increase (or resisting it) in a transfer costing relationship can be one of the more frustrating and time-consuming tasks undertaken by a business executive. None of this matters too much, provided that there are rules in place for behaviour and process.

When things go wrong, for example if inter-traded goods or services are alleged to be unsatisfactory, it is usual to have ready a code of practice that determines the provision for restitution, if any. It is important to have put in place a robust process to handle this well before it is actually needed. As with the inter-trading price itself, buyers and sellers are bound together by the ultimate owner of the business to whom both belong.

Neither can walk away, even though the dissatisfaction might in other circumstances make this a natural course of action. With inter-trading, agreement on restitution in the wake of a complaint can be especially

difficult to reach, while recourse to law is impracticable and unlikely, even though this has been known in cases where the parent was weak and there was a policy vacuum.

A longer list of things that can go wrong, and for which some prior agreement on corrective action or compensation may be needed, includes:

- providing sub-standard quality, or failing to meet specification, and any associated costs of returning or disposing of the goods
- poor performance on delivery, possibly leading to consequential loss of performance in downstream processes, including the costs of overtime required to make up for delays and the penalties imposed by external customers
- unscheduled deliveries causing unplanned stocking, with the associated costs, which may include writing off the value of work-in-progress
- costs associated with cancelled orders, for whatever reason or cause attributed.

There may be other problems to be covered that are specific to the inter-trading context. These need to be anticipated before actual conflict arises, bearing in mind that settling these or any problems between inter-trading parties is more difficult than in conventional customer/supplier relationships.

Hazards of this sort are present in all inter-trading arrangements. The parent company ought to devise, or agree and authorise, some principles that provide a consistent line in restitution. It might be that the answer to some problems is not to be found in restitution at all. Not all parent organisations would, for example, wish time and money to be used pursuing disputes, and sending money backwards as well as forwards down the value chain. For example, inter-trading suppliers' performance can be monitored, and action taken by the parent to resolve cases of under-performance through managerial rather than financial solutions.

Subsidiary company and divisional accounts usually include inter-trading revenues and costs as an essential part of the published management accounts. Consolidated group accounts, however, will invariably treat inter-trading revenue transactions as eliminations, avoiding double-counting their income.

> *"When any organisational entity expands beyond 21 members, the real power will be in some smaller body."*
>
> **Cyril Northcote Parkinson**

10.4 Strategy and structure

In a business with a conventional, unitary organisational structure, all value-adding activity, by definition, takes place within the single profit centre for which its chief executive and managerial team take responsibility. There is, of course, a value chain, but it will pass through the departmental and functional areas that make up the structure. Such a model offers no inter-trading challenges.

But that structure, a single profit centre, can be changed without the need for new, incorporated subsidiaries. Profit centres can be created notwithstanding and might be justified on the grounds that they make it easier to measure managers' performance and accountabilities, and to exercise control. Each profit centre may be a self-contained, independently managed division of the larger business. This may enable the parent company:

- to place a limit on managerial spans or unit size
- to distinguish particular activities or skills in order to sharpen focus
- to recognise the effects of location, site, sunk and new investment, and so on.

The centre, the common owner or parent, will have particular regard for the importance of attributing profit to, controlling the cost of, and pursuing sales from the devolved platform it has created. Whether its devolved units are incorporated operating subsidiaries or not, they become inter-trading siblings and subject therefore to the need to comply with some system or rules on price, terms, behaviour and so on.

Entities created by devolving a business into profit centres may seek the benefits of synergy in adding more value together than would be possible for each alone. This possibility may be discovered by serendipity, or may be deliberately conceived at the corporate centre. In this context the synergy is almost always associated with an over-riding objective owned by the group parent or common owner rather than by the individual inter-trading units.

The oil company is a good example of this. Its vertically integrated configuration is its main competitive advantage over organisations that have more fragmented or looser structures. The synergy that comes with inter-trading helps to exploit to maximum effect the profit to be made from the scarce raw material. Keeping control of every point along the value chain maximises the profit to be wrung out of ownership. Only inter-trading can achieve this. Furthermore, this business model creates barriers to market entry by competitors.

The use of a vertically integrated model, with multiple business units strung along the value chain, does not prevent those units from trading their outputs with third parties. A vital decision for those managing the whole organisation is how much to release into the market at each intermediate point and how much to retain until the process at the end of the chain – retail sales – is complete.

As we know, large quantities of crude oil end up as petrochemical products because supply and demand and pricing are used to optimise profit. Making sales at multiple points along the chain generates cash flow for the investment that sustains the chain. This decision also faces the company discussed in the next section.

10.5 Reviewing the value chain

It is just as important to analyse and understand the inter-trading data of a business as its conventional external transactions. However, this is often ignored. There is a tendency to assume that inter-trading and intra-group sales are a lower 'grade' of sale for which the only reporting necessity is a figure needed for group eliminations. But more analysis is safer. The impact of the inter-trading configuration on the business model ought to be clear and the value chain mapped and fully understood.

In the real example shown below, the parent company operates six incorporated manufacturing profit centres, (DON, WQ, BAC, SSS, BTS and PTB). Each one is based on different processes, operating for historic reasons on different sites. Each reports to the parent through its own profit and loss account. All the businesses make external sales as well as inter-trading with peer profit centres supplying downstream processes. The profit centres also inter-trade with three other home and overseas divisions engaged in distribution (CUK, CFE and BNZ).

The data on sales, margin and margin percentage in the following three tables were collected by special analysis from the accounting record. The data in the first table were used to create the value chain map shown opposite.

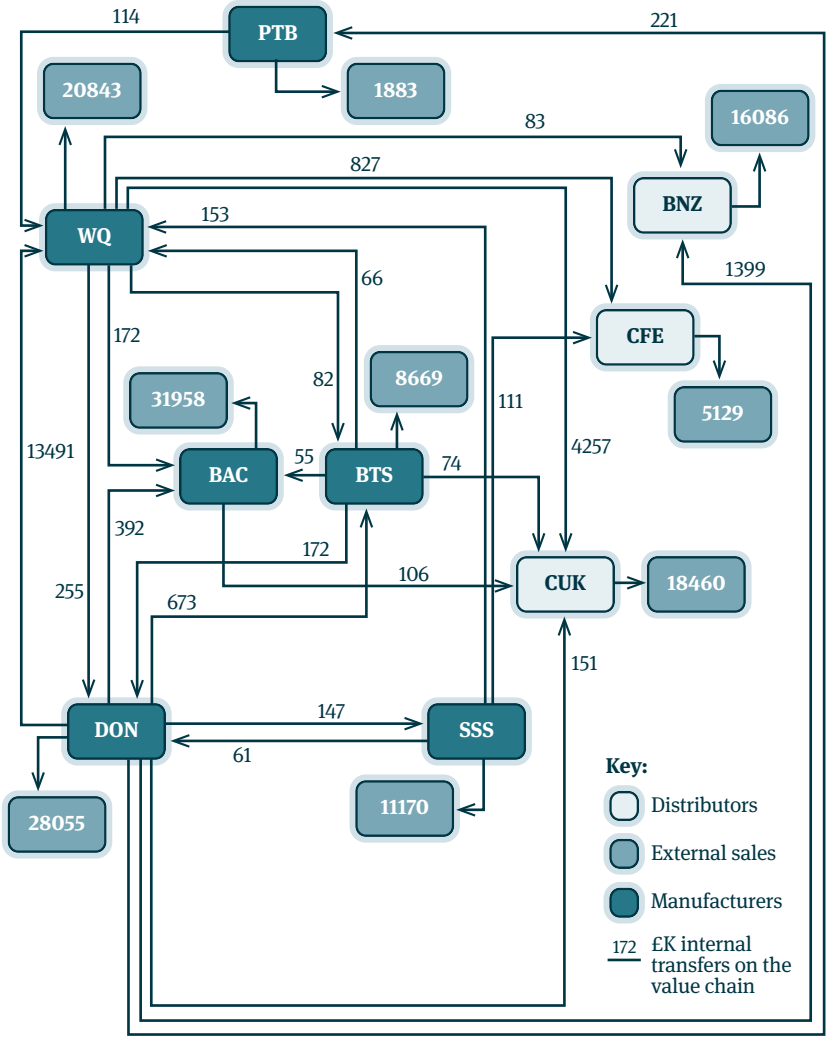
Sales inter-trade value							
£K	S&J Group inter-trade sales (extract only)					External sales total	Inter-trade %
Sales by/to	DON	SSS	PTB	WQ	CUK		
DON		147	221	13491	151	28055	33
SSS	61			153		11170	1
PTB				114	106	31958	1
WQ	255				4,257	20843	18
CUK						18460	–

Margin inter-trade value						
£K	S&J Group inter-trade margins					External margin total
Sales by/to	DON	SSS	PTB	WQ	CUK	
DON		59	99	6476	38	15150
SSS	37			77		3798
PTB				89	58	17577
WQ	122				1831	14590
CUK						4615

Margin inter-trade %							
%	S&J Group inter-trade margin %					External sales %	Inter-trade %
Sales by/to	DON	SSS	PTB	WQ	CUK		
DON		40	45	48	25	54	48
SSS	61			50		34	53
PTB				78	55	55	67
WQ	48				43	70	46
CUK						25	–

The map shows a value chain of 23 inter-trading flows between nine profit centres. In some flows, such as DON and WQ, inter-trading transactions take place in both directions, making a complex picture, imperfectly understood by managers.

Flows on the internal value chain >£50K



Equivalent maps were also drawn for margin and margin percentage. Others can be drawn for different product types, and for volume and added value.

The data in the third table show margin percentages achieved by the sellers on peer-to-peer inter-trading, and the weighted average margin percentages for all the inter-trades. No consistent pattern of margin percentage can be discerned in the inter-trades. So the coherent regime for pricing that one would have hoped for is lacking.

The conclusion to be drawn is that the profit centres inter-trade without the strategic direction from the centre that would give a defining characteristic to the business model. The profit and loss accounts of the divisions lack some meaning because the inter-trading revenue is calculated from unstructured prices, yielding percentage margins from which no business information or standard for control may usefully be derived.

The full consequences of such an absence of analysis, and loss of control, can result in misinformation on a wider canvas. First, there is the apparent inability to understand the significance of profit and loss and its elements: cost, margin, and average selling price.

Second, it is not clear how the internal value chain can best be configured and optimised or, therefore, how the company's business model should best function to promote its efficiency and effectiveness. These are just some of the questions that could be asked:

- Are all the subsidiary profit centres necessary?
- Is there a case for rationalising the managerial structure, and the scope and scale of accountability for profit?
- Need all the existing business units report profit and loss?
- Could some processes be contracted out to add more value?

It is common for the flows of inter-trading not to be understood by senior managers for whom the properties and health of the business model should be the primary concern. For there to be managerial control over a business, inter-trading data need to be reported for:

- inter-trading sales
- margin and margin percentage on inter-traded sales
- volumes of sales
- average selling prices (ASPs)
- all the above broken down, if necessary, by product or process
- comparison between inter-trading data and the equivalent for external sales.

10.6 Contracting out

A parent organisation that is in control of its business model, the configuration of its value chain, and its inter-trading terms is in a position to consider whether there would be any advantage in contracting out the processes of its business units. In this way it might be able to control the value chain and the inter-trading pricing structures without having to own all the assets employed.

The oil industry again provides an example. In fact, oil companies often contract out major processes such as drilling. For contracts to work properly, it is essential that the inter-trading prices should add value and that risk should be taken fully into account.

In extreme cases of contracting out, inter-trading offers examples of virtual models in which the owner of the business model will itself own very few of the assets employed in the value chain. Despite this, it may be able to retain control over the configuration of the value chain and the inter-trading prices charged, and to seize the lion's share of profit.

In a real example, a company requiring shipping containers for its leasing business contracted out their manufacture. It exercised control over the whole manufacturing chain of value by negotiating the inter-trading prices for the raw materials and the value added by the first and second-tier suppliers with the final builder. The option to put all its effort into negotiating the lowest possible purchase price of fully built containers was replaced by a series of separate contracts with each supplier in the chain. Each contract set an inter-trading price, a part of which was remitted directly to it as the owner of business model. It thus banked margin at each stage as the product moved down the value chain as well as from the final process of leasing, which it operated through processes and resources wholly its own.

A particularly complex example of such a virtual value chain owned by a single owner in control of the business model is to be found in the insurance industry. An insurance company may own the model through which it conducts its business while sharing the value chain with other participants with whom it contracts. Thus an insured customer buys a policy from a sales and marketing agent such as a bank or a broker for whom the commission is a negotiated inter-trade price at the front end of the value chain. The underwriter's fee is another inter-trade price. In the event of a claim, the

claims handler and (if appropriate) the specialist medical or other service provider are remunerated through further inter-trade prices pre-arranged with the insurance company.

The whole value chain is owned and commercially orchestrated by the insurance company, whose business model determines and controls the operational relationships of all parties. The inter-trading prices all along the complex value chain are devised and owned by the company to which all other players are symbiotically linked. At one time insurance companies themselves performed these processes on what was then a wholly internal value chain in a single profit centre model. Now, although contracting out these processes, they continue to own the network of what are in effect a series of virtual inter-trades off a tariff that remains their own.

11. The transfer costing organisational model

11 The transfer costing organisational model

11.1 Approach

Transfer costing is Collinson Grant's term of choice for a specific model of organisational structure and control. Having a much wider industrial application than inter-trading, it combines a particular structural template with a regime for management accounting and business reporting that is supported by a robust philosophy of accountability and control developed by us in conjunction with a major industrial company and client of long standing.

The result sought is an organisation that maintains tight control over its costs and margins in pursuit of sustainable profit. This model comes into its own in stable industries where improvements in profitability can be made by operating disciplined management of margins and costs. It should not be confused with international transfer price accounting between differing national taxation regimes.

11.2 A tough regime for managers

Most managers would be offended were it suggested they do not aim to pursue profit. However, the reality is that most businesses are not run by senior managers exclusively dedicating all their actions and decisions to that end. However, successfully implemented, transfer costing allows no place for managers to hide their short or long-term performance from the scrutiny of those to whom they report.

The unforgiving nature of the transfer costing regime pushes pursuit of profit harder than any other we know. Not all organisations are comfortable with the amount of transparency to which business reporting expose managers' actions and decisions. But where radical, sustained improvement is desired such as post-acquisition, during a turnaround or a change of management, the results can be startling.

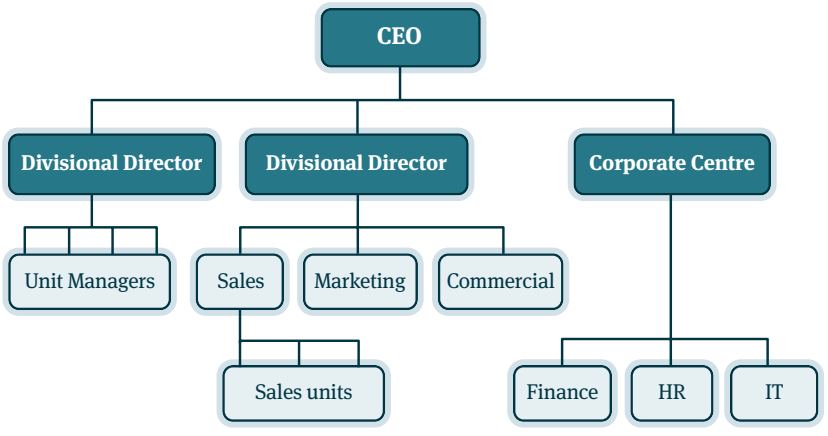
11.3 Organisational design

For transfer costing to work successfully, it must be possible for the foundations of an organisation to be restructured around three discrete senior managerial remits involving three very different types of accountability.

The business is structured as a single profit centre with two generically defined divisions. Transfer costing is often referred to as the operator/trader concept because the majority of managers reside in one or other of the two structures of the organisation.

- The Operations division is a production and/or a supply function with both fixed and variable direct costs where value is added by processing or procuring products, and the main financial concerns of managers are costs and volume of throughput.
- The Trading or Commercial division is a sales function with responsibility for pricing, product mix and inventory, and selling (and possibly distribution) costs, and the main activities are marketing, sales, commercial and others that face the customer, and where the main financial concerns of managers are prices, margins and volume of sales.
- There is also a corporate centre housing overhead functions and costs which are largely unrelated to the day to day managing of the operations and trading divisions but are to do with general management, direction, strategy and financial control of the company.
- The Operations and Trading divisions may be sub-divided into smaller production or sales centres by scale (size and number of processes), diversity (types of product, process, markets, channels, territories, sites) or length of value chain (number of discrete processes), so that the design can accommodate an organisation of any size.
- Sub-divisions of Trading are often known as customer-facing business units (CFBUs) – an important label since much of the value of the transfer costing structure and accounting is to emphasise the critical accountability of sales and marketing managers for looking to the market to develop margins on their sales and to leave operating cost accountability to operations managers.

The structure shown here is more radical than it first appears. The divisional Director of Operations is responsible for cost, not profit, as are all his subordinates. And the divisional Director of Trading is responsible for all the margins made on sales to external customers, except for any effect (for better or worse) that is caused by variation in cost.



This concentration of power can be difficult for some managerial teams to swallow. However, where context dictates there might be more than one Operations and/or Trading division, which can ease the problem of implementing changes in managerial hierarchies.

11.4 Accounting for transfer costing

Production or supply by Operations is to the order of the Trading division. Work in progress moves within the Operations division at standardised costs until the outputs (or procured finished goods) are complete. Then, their value at the final standardised cost (the transfer cost) is charged to Trading's inventory or sales.

Thus:

Transfer cost per unit produced x no. of units = transfer value.

Operations is credited with the value of output at the transfer cost as income on its internal account. The difference between that total transfer value and the total cost of Operations' expenditure is a (cost of sales) variance which serves as the performance criteria for the Operations division. Budgets may be set for break-even or a favourable variance if the assumption is that costs will be reduced year-on-year.

Thus:	Actual	Budget	Variance
Transfer value credited (transfers to Trading)	95	100	(5)
Actual direct cost of production and supply	80	78	(2)
Actual Operations Division indirect costs	25	22	(3)
Surplus or (deficit) on Operations	(10)	0	(10)

Trading division is credited with the value of sales to customers. From this income to its internal account are debited the transfer costs credited to Operations, the balance being gross margin. Gross margin totals are debited with the actual costs of selling and marketing to record net margin.

Thus:	Actual	Budget	Variance
Actual sales	150	160	(10)
Transfer value debited	95	100	5
Gross margin	55	60	(5)
Gross Margin %	37	38	(1)
Selling costs and Trading overhead	10	11	(1)
Net margin	45	49	(4)

The simplified version of performance reporting illustrated above can be elaborated into a full set of management accounts. These will draw out more detail for multiple production and selling centres or units, full cost and sales analysis which can be overlaid on the managerial structure of layers and spans, and detailed analysis of variances by volume, mix, price and expenditure.

11.5 Making transfer costing work

This is not the place for detailed instruction into the mechanics of a system of transfer costing or, for example, templates for business and performance reporting. But in order to understand the importance of considering transfer costing as an organisational design option, the following is germane.

- There should be an intense focus on systems of management that support executive decisions and promote action to create profit. This bias to action has two clear, enduring priorities – to optimise margins and to control costs.
- Margin and cost are both controlled, but measured separately so that change affecting the one can be known, free from the knock-on effects of the other. For example, actual costs of production, however they vary,

stand isolated from any effect on margins which other managers are accountable for.

- Sales employees concentrate upon selling prices to enhance margins, and are allowed to ignore production or supply costs which are the sole accountability of operations managers.
- The system of information and control that fixes accountability for financial results must exactly overlay the organisational structure. Thus, information reporting, measurement and accountability are layered so as to mirror the managerial chain of command. Operational controls are important but are connected to and absorbed into reports for financial control.
- Management and cost accounting is an integral part of day-to-day management for everyone. Management accounting does not just keep the score – it supports decisions using variance analysis.
- Internal markets can obscure trading reality – so the value chain must be transparent and the movement of value reported with rigorous consistency. Cost is considered to be the only rational basis for valuing work-in-progress passing down the internal value chain. Margins artificially attributed by policy or negotiation to production or distribution business units are not used here.
- Business units and sites that produce product cannot generate margin or profit, only cost; added value is considered to yield a margin only at the point of sale to a third party.
- Units of production or supply are valued using fixed-cost standards for each operational stage. Partly finished product and stage costs are transferred between points, into inventory, and at full-cost value when the final product is sold by trading.
- Profit and loss can only be measured for a full-service business unit. It comprises Operations' variances carried forward to profit and loss, Trading's net margins also carried forward, and the cost of the central overhead, perhaps allocated back to activities and included in the cost of Operations.
- The values budgeted for costs and margins are derived from budgeted unit costs and prices at budgeted volumes: and these are always clearly reported against actuals.
- Note that Operations adds value but cannot add contribution or profit; and Trading adds contribution; while profit is only registered in the profit and loss account – the statement that consolidates all revenues and all costs, including those at the corporate centre.

11.6 Transfer costs and transfer value

Setting transfer costs

The transfer costs from which the transfer costing system takes its name are the units of value or currency that are applied to production or supply outputs. The transfer cost at which each product is valued will be based on the organisation's knowledge of its costs. From this an expected or standardised cost is developed by means of any appropriate tool of cost-finding analysis.

Transfer costs are not standard costs in the sense that they are routinely updated. Once set, they are moved infrequently in order to benchmark costs conservatively, and prevent the effect of cost increases migrating into the margins for which Trading managers have accountability. That would weaken their challenge, which is to build margins from their sales and marketing strategy and effectiveness.

Calculating transfer value

In a simple illustration, a manufacturing division which we call Operations makes three products – A, B and C – bearing transfer prices set at £50, £70 and £20 respectively.

In a period, output is A = 10 units, B = 20 units, and C = 25 units so, by multiplication, £2,400 of transfer cost value has been created that can be credited to Operations and the debit transferred to the Trading account in exchange for the goods.

If Operations' cost of production is more than £2,400, it records a deficit on its account. If less cost has been incurred, it records a surplus. Either result shows as a positive or negative charge against profit and loss.

In the same way, Trading, which has 'paid' £2,400, will make a positive margin if it sells for more than that, or a loss if not.

Ideally, costs will remain close to what is expected and selling prices will be such that margins can feed profit and loss to give adequate returns on sales or capital.

11.7 Accountability and control

Transfer costing allows managers to be held to account: in Operations for their costs against a target of break-even, and in Trading for margins achieved against target or budget.

The margins are measured from the cost base on which transfer prices are set and not from the actual cost in each accounting period. So margin is neither enhanced nor eroded by the skill or fortune with which manufacturing costs (materials, conversion and manufacturing overhead) are managed.

Arranging the structure of the organisation around these two distinct types of operational accountability, while employing the simple accounting devices of transfer costs and the accounting mechanics of transfer costing, ensures measurement and control over the two most critical influences on profit in the types of businesses where the system is most effective.

For a complete philosophical embrace and the best results, all strategy, role definition, information management, reporting, and related aspects of business management must be organised around both Operating and Trading dimensions as clearly distinct aspects of decision making and accountability (though not each to the exclusion of the other, since they are joined at the hip in the common pursuit of optimum profit).

Although it is accepted that some costs may need time if they are to be challenged and reduced by managers, the accounting system does not provide for this – it reports the nature and size of a cost problem to managers and quantifies the challenge accordingly. There is no soft option just as there is no blame. Thus:

- When volume falls, the challenge is to make all costs fall in direct proportion.
- When volume increases, the challenge is to stop costs from rising in proportion.

Measures of performance should shine like beacons – they are the most visible signs of what managers must regard as important. When linked to financial incentives, the light shines so much more brightly.

11.8 A transfer costing universe

The canvas over which the simple principle of transfer costing operates becomes the organisation's transfer costing universe. Within it the organisational design, and the mechanics of management accounting, costing and business reporting are all subordinated to the policies and protocols that the regime imposes.

There is a body of best practice that can be adopted when transfer costing is used in this way as a tool of managerial control. It can be applied in a balanced way throughout all parts of the universe, and is based on our experience of inducing compliant managerial behaviour throughout the structure.

In terms of both the organisation and its systems, the scope of a transfer costing universe must be defined by the network of potential flows of transferred value. The network illustrated on page 117 is a good example of this.

Those parts of the organisation participating in the universe must be bound to a single point of governance. This has to be capable of initiating and owning the method of valuing transfer prices, the definitions of accountability to which they give rise, and the best practice policies to be applied, for example, on the treatment of variances.

This bars any participating part of the organisation from defining any other method of valuation, or from setting or agreeing on any other trading term, either unilaterally or bilaterally. One consequence of this is that transfer prices cannot be devised until the policies – the rules of trading to be held in common – are articulated, understood and verified for compliance. So, it is highly desirable that a suitable part of the organisation should have stewardship of the rules and of the concept and substance of the best practice.

11.9 Role of the centre

The organisational structure associated with transfer costing helps to emphasise the difference between the operational roles of directors and managers in Operations and Trading and the general and financial management in the corporate centre, which manages the overhead functions that serve the whole organisation.

While the former turn the handle on the business machine throughout the month, the role of the latter is governance, direction, policy, objective-setting, authorisation of resources, and critique of performance and strategy.

Conventionally configured businesses often fail to observe this distinction, with the result that everyone from top to bottom in the organisation is mired in the swamp of routine tasks and day-to-day management.

Under transfer costing, the centre works like the bridge of the ship – making decisions about destinations, the rate of passage, the hazards to be navigated, the priorities that need to be observed and so on.

Only small central teams are consistent with this role – transfer costing structures are highly devolved, and managers are focused on the priorities and accountabilities made very clear by the centre.

Central functions like HR and IT, legal and estates, and even quality assurance, may be wholly or partly devolved to Operations and Trading. Where functions are devolved the costs lies with those divisions, and in the case of Operations are included in the unit transfer costs.

11.10 Transfer costing – a case study

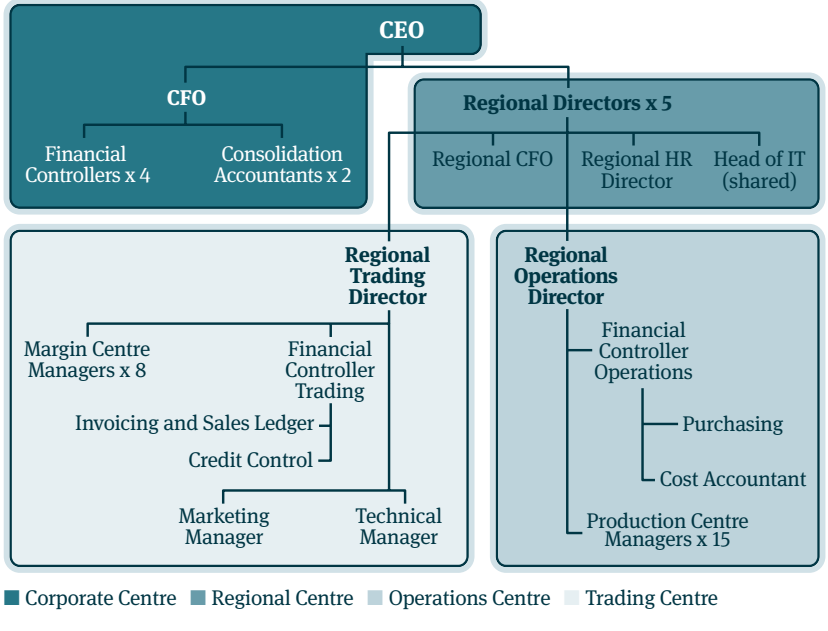
A leading quoted company produced roadstone and construction aggregates. It owned and operated a large number of quarries extracting and grading crushed rock, and pits extracting, screening and grading sand and gravel. In addition to the extractive operations, some primary processed minerals underwent secondary processing to make asphalt for road surfacing and ready-mixed concrete for general construction.

Sales were made to customers directly from the primary processing sites, and material was also transferred to secondary processing plants from where the added-value products were sold on to third parties. Asphalt plants, usually located at primary production sites in largely rural locations, were run by quarry site managers responsible for the whole site's profit and loss. Ready mixed concrete operations came under a separate body of managers in a separate profit centre, at numerous and mainly urban locations.

This traditional structure was replaced by a transfer costing regime with its different conventions for organisational structure and controls. Implementation of transfer costing was varied for quarries and the ready mixed concrete activities, to reflect the greater complexity of the latter. The organisational structure to support the transfer costing regime is shown below in a fully developed form that includes regional devolution of both Operations and Trading, and devolved central functions for finance, HR, and so on.

The benefits of the new transfer costing structure became apparent in the worst sector recession yet experienced by any of the company's managers. Despite sales falling by more than 30%, this Collinson Grant client was the only operator in the sector to trade profitably, because trading managers refused to destroy margin by 'buying turnover', and operating managers worked hard to control the production mix and reduce costs.

A simplified version of the line and staff structure from this case study is illustrated below. The abbreviated diagram scopes an organisation of four large regions, a workforce of 5,000 and a turnover of £1.5bn.



11.11 Managing cost reduction

Managers both in the centre and in Trading are likely to expect Operations managers to win improvements in productivity to lower the cost base. It is an objective of transfer costing to put downward pressure on the costs of operators. This can be achieved in a number of ways, one of which is to respond to the achievement of surpluses by budgeting reduced transfer costs in some or all subsequent budget years – to move the goalposts, if possible time after time. Another approach is to ratchet back the transfer costs in expectation of, or as a directive to achieve, a lower cost base.

A plan for cost reduction over a number of years ahead is essentially an element of the strategy for the business as a whole. Trading will always make clear what it sees as the imperatives, but best practice also sets targets for margins on sales and for profit. While cost reduction is delivered through the downward pressure of the ratchet, Trading is expected to increase margins over and above any saving achieved.

In the long term, overheads such as direct costs are not treated as 'fixed'. Once accountability for costs is established, a manager's job is to tackle both fixed and variable costs as variable downward. This concept is essential if volumes are falling, and should be desired when volumes increase.

While the desire of Trading for reduced transfer prices can be safely assumed, it is the balanced view from the centre that should command the policy going forward. That is to say: how much reduction and how soon? In the integrated company model, Operations is accountable to the centre for meeting the challenge, and responsible to Trading for its delivery to the agreed time, specification and cost. The centre owns the transfer costs and the finance department is the best steward of them because the values they represent calibrate the performance of the Operations and Trading divisions.

"In the end, all business operations can be reduced to three words: people, product and profits. Unless you've got a good team, you can't do much with the other two."

Lee Iacocca

Given their customary views, it is common for Trading managers to think about the possibilities of increasing margins by sourcing externally, or making changes to the specification or mix of products being marketed. Of course they cannot make radical change to supply chain policy unilaterally, but will make representations. The centre has the veto having the responsibility for calculating the effect on corporate profitability of any change or restructuring.

12. Organisation of branch networks

12 Organisation of branch networks

12.1 Models

Many companies reach their customers and provide their services through a network of local or regional branches. Collinson Grant has considerable experience in improving performance by getting organisational practice in branches to align with a corporate business model, designing footprints, lines and substance of reporting, and specifications for the exercise of authority.

Even in days when online trading is growing rapidly, a branch network has many advantages, which is why some models run both bricks and mortar and e-trading side-by-side.

Bricks and mortar advantages include: access and proximity to customers; knowledge of local customs and buying habits; dispersed logistics (sometimes a negative); closer relationships with local suppliers and so on.

But such an organisational model demands clarity on a number of important decisions that could either be made locally or centrally. Typically the branch manager reports to a central head office. The managers there, as well as in the branches, all need to know where authority and responsibility lies for the enterprise generally, what authority is delegated and who is accountable for what. The organisational design needs thinking through at a high level to arrive at an effective model for the corporate business and for each business unit. The business model must have a design in which it is clear where decisions are best taken so confusion cannot reign nor mistakes affect profit.

Since branches are more or less businesses in microcosm, the organisational design must consider accountability and decision taking in all the key areas that can impact on profit: pricing; terms and conditions for trading; procurement and inventory; trading policies; payroll and operating costs; managing employees; and processes and systems.

Broadly, there are two types of organisational model for managing a branch-networked business. The decision on which of them to embrace is determined by the choice of corporate business model and of contextual matters like the scale of operations.

Our view is that most businesses ought probably to default to the first, which we call the 'loose/tight' model with its related protocols and structures, unless there is positive economic advantage in the other type, which we call the 'centric' model.

The main reason for our preference for loose/tight is that it emphasises wide accountability for profit by managers carefully selected for the entrepreneurial qualities they possess. In short, get the right person and give them as much responsibility as they can reasonably and responsibly handle.

The loose/tight model

Much of what is written here can be taken as a guideline for what we call the 'loose/tight' model for control – a framework particularly suitable for managing branches. This sets out the wide discretion allowed to branch managers within a tightly targeted and measured accountability to the centre. A regime for loose/tight control will have most or all of the following characteristics:

- a significant degree of devolved decision taking for local managers involving:
  - ➤ light touch supervision from above
  - ➤ longish timescales between being called to account
  - ➤ a limited amount of day-to-day support from the organisation's centre
- strong and challenging financial and operational objectives set by the centre for the branch and its manager
- a high-level financial measure of performance such as profit or return on capital.

Managers of a local branch should have:

- some authority over prices and terms for customers, which products and services to offer, and the sourcing of products and the purchase prices paid
- an influence on the approved levels of inventory, and the stock turns
- substantial freedom to pursue business wherever it may be found
- substantial authority over staffing levels, operating costs and processes and procedures
- freedom to recruit employees and to discharge or discipline them (within a code of good practice)
- an opportunity to win capital allocations for good business cases.

To make this work a company has:

- to put considerable effort into and be systematic about recruiting branch managers so that a much higher proportion of appointments are successful than is the norm
- to put considerable time and effort into thorough supervision of financial and operational plans, given the relative infrequency with which they will be tested
- to have a clear but firm procedure for holding managers to account
- to have clear and relatively simple measures for assessing performance
- to set challenges based on business results not compliance with process
- to set challenges that stretch managers, and annually review where the goalposts are
- to give serious consideration to paying meaningful incentives.

The centric model

The preferred loose/tight model for managing branches has a rival that is a consequence of modern data processing, retrieval and storage, and rapid communications. By running mathematical algorithms at the centre to analyse real-time sales and inventory, supermarkets and other retail chains can replace a range of local managerial functions.

These techniques enable small groups of people based centrally to determine and control supply in a way that would have been ill-advised in an earlier age. The model is suitable for fast-moving consumer goods (FMCG), many retail businesses and some others like them where the scale of operations supports investment in a powerful, networked infrastructure; and the sophistication of computerised modelling functions mean that they must be in the hands of specialists at the centre. This may also be true for some distributors of industrial goods or where most customers are trade buyers.

The scope of this centric model affects product selection, procurement, pricing, promotions, and all functions facing both customers and suppliers – everything in fact except those used to manage the local costs and resources for which the branch manager in the centre of the value chain could still retain responsibility.

Other factors tend to support the centric model. The regulatory environment governing employment and work is undermining the autonomy that can be

granted to the first line of managers. The risk of decision taking needs to be spread across more than one level of manager, and to involve specialists in supporting roles which are located, inevitably, at the centre. Responsibility for business support costs such as property and utilities are often more easily controlled from the centre, and even locally consumed goods and services may be centrally procured in bulk or outsourced through centrally placed contracts.

12.2 Authority

The essence of the organisational design and managing of branch networks is how authority and decision taking is exercised and where control is vested. The branch manager's authority is embedded in the design of the organisational model. This in turns defines the accountability held. The scope of branch authority can be broad, and includes many dimensions of which the following examples are the most important.

12.3 Authority to set prices

List prices

If the list prices available to branch customers are mandated by the centre, and it denies pricing discretion to branch managers, it is able:

- to be certain that the margins it seeks will (certain other influences apart) be realised
- to discourage customers from shopping around from branch to branch to search for or negotiate a better price
- to dissuade managers from chasing turnover at the expense of margin and profit.

Central authority over prices tends to imply 'national' list prices but even where the centre allowed them to vary by region, the above three points would more or less still hold good.

When branches have authority over their own list prices:

- they can respond flexibly to local competition, for example by making smaller, more frequent adjustments to price than can be done from the centre

- they find it easier to take market share from competitors (when that is the policy).

It is possible to give branches some degree of authority to set list prices so as to create local competitive advantage, with the revenue and margins achieved as a result being captured in the budget. After the budget is approved, the centre could exercise control over the degree or frequency with which prices might then be modified and the budgetary assumptions changed. But essentially the prices set by the branch manager would be those paid by the customers.

Spot prices

Spot prices are off-list prices that can be used to favour some customers for some products, or all customers for some products. Spot prices are likely to be used alongside the list prices, to which all prices default if neither customer nor product qualifies for spot.

By their nature spot prices are without longevity, and may be associated with a single promotion. They can also be invoked for a one-off sale to a single customer. For example, a trade customer quoting for a large job may wish to quote competitively, and ask the branch manager for a spot reduction on the price of a vital material so that both branch and customer may profit from their respective sales.

The centre may retain authority to authorise spot pricing, so whenever branch managers believes there is a case they would seek authorisation from the centre. This gives the centre an opportunity to recognise and consider the effect of a lower price for that sale on the planned margins and profit.

But an approval process by which the centre exercises total control over all types of spot pricing might be so laborious as to make control an impractical, blunt instrument.

Branch managers may be given authority to agree or veto sales at spot prices proposed by the centre. Here there can be both risk and opportunity in equal measure, price having the greatest and most direct effect on profit of all the factors of influence. There is a need for keen judgement on the amount of margin to yield, to which customers and on which products. The effects can be good and bad at the same time.

Spot pricing is a tool for the branch to get or keep sales when it needs to act decisively to exert competitive pressure or defend market share.

However, used too frequently and freely the branch's customers may learn from experience about the branch manager's selling behaviour and may, in effect, be given an unintended lesson in how to negotiate prices down. Branch managers who are known to be spot price 'pushovers' may find turning the situation around and preventing the permanent erosion of margin and profit to be all but impossible.

The centre could ration spot opportunities by giving a standing authorisation for a limited number or value of spot concessions, thus forcing branches to prioritise opportunities and use the facility selectively. In this way the centre could retain a measure of control over margins and the branch profit plan by writing into its budget the effect on sales and margin of the spot pricing it has authorised in advance.

Furthermore such reduced control over margins can be mitigated if the centre gives branch managers an incentive to meet targets for profits and capital employed that cannot be achieved if spot pricing is used too liberally.

Discounting, rebating and giving away concessionary value

Discounts are reductions applied to the list prices of selected products, or to groups of them. Their availability is advertised to all customers or, in some cases, to pre-qualifying customers (perhaps those who have earned vouchers) or selected purchases, such as 'buy one, get one free' (BOGOF).

Rebates are reductions applied not to the product but to a customer's spending, often on all of it but sometimes excluding certain types of products or expenditure. Exclusions normally include sales where another offer such as BOGOF already applies. Reductions are usually conditional on the customer's exceeding certain volumes or values of expenditure on any particular occasion or over a certain period.

Concessionary value is a non-cash benefit. An example is free delivery for major customers or for qualifying purchases where expenditure is more than a certain value.

Authority to modify prices in these ways can be kept at the centre in the same way, and for the same reasons, as for list prices and spot pricing.

Discount offers can be planned as schemes by managers at the centre, by general sales managers or marketers, and implemented over the heads of branch managers. Branches may have a choice to opt in or opt out, or it might be compulsory.

The options for branches to promote the sales of some products to all customers, or of all products to some customers, follow the same logic and have the same effects as those described for spot pricing.

Where this authority exists at branch level, it is the primary tool available to the manager to increase sales and market share, and broaden the customer base.

"Meetings are a symptom of bad organisation. The fewer meetings the better."

Peter Drucker

It is common to find situations where absolute authority does not and need not exist at either branch or centre. A broad platform for promotion is created by the branch, submitted to, and authorised by the centre. This will include competitive pricing operated with freedom by the branch but within the envelope of an approved plan, the financial effects of which may have been bought off at the centre through the budget approval process and monitored through the period accounts.

12.4 Authority over credit and customers

Terms for trading and credit

Terms and conditions are normally set at the centre because the specialised legal knowledge required is only likely to be available there. The centre's control of the 'Ts and Cs':

- ensures that the content is professionally written, and so legally watertight and tested
- prevents both branches and their customers from wittingly or unwittingly undermining the company's rights, the most important of which are to be paid, and to reject liability where appropriate
- ensures universal and consistent application of Ts and Cs throughout the branch network, so preventing erosion of the company's policies, and making compliance easier to monitor
- makes the planning of cash flow more predictable by instituting universally applied standard credit terms (for example 60 days), and thus improving liquidity.

Setting terms and conditions at branches:

- avoids excessively legalistic terms and conditions set by lawyers at the centre that may be too restrictive or complex for some customers to swallow, with the possible result that the branch becomes an unattractive trading partner
- may be informed by a clearer insight into what terms are appropriate for the local trade
- may provide a better informed appreciation of the real risks, including credit risks, from which the company needs to be protected.

It is always open to the branch to seek approval from the centre for unique terms for special customers.

Granting credit

The process of granting credit to a customer may be formal or informal, lengthy or short, and done at the branch or at the centre. Companies are inherently vulnerable to mistakes of policy on this subject.

Accountability for granting credit is usually vested in a person such as the branch manager or in a protocol designed and approved at a high (therefore central) location and which could be operated either from the branch or at the centre.

The centre is better able:

- to design a secure and consistent process of credit checking
- to operate any formal process, with economies of scale giving a lower cost per application
- to cover more professionally the legal aspects designed into a system and its operation, such as the process for collection of overdue debts
- to operate credit checks dispassionately and thus objectively
- to put customers on 'stop' dispassionately and thus objectively.

The benefits of which are:

- better quality assumptions when planning cash flow and fewer bad debts
- centrally coordinated information about the total credit taken by customers buying from a variety of branches.

The end result should be fewer defaults and firmer control over cash.

At the branch:

- cheaper, quicker decisions that are less encumbered by bureaucracy may stimulate sales
- applying local knowledge can actually lead to more informed decisions about credit worthiness and therefore reduce risk
- customers may be classified, with more precision than is possible at the centre, as 'no credit', '21 days', '45 days', et cetera. Although standard terms are 30 days, the branch slots each customer into a more diverse but structured classification.

Customer catchment areas for branch trading

This is usually a problem only where customers are trade and account customers.

If the centre designs the geographical perimeter that prescribes the trading area allocated to the branch, then:

- the centre is well placed to take a view of the optimum density of the branch network, including the number of branches and the estimated turnover and customer numbers for each
- this creates an orderly network in which the number of branch units is not excessive in relation to sales and margin, and it is possible to keep to a minimum the need for branches to make incursions outside their allotments
- branch managers can be directed to focus marketing and sales on their given territory and not dissipate effort on peripheral business
- customers are given no encouragement to shop around between branches and to undermine branch margins by seeking ever better deals.

It is also feasible to take a more organic approach to the formation of branches that fits with the natural behaviours of branch managers and customers.

Natural catchments are always, to some extent, subject to the way customers gravitate to branches – something that cannot always be anticipated and planned, and which does not necessarily reflect the obvious geography.

Too tight a definition of boundaries may be pointless – the exact location of branch premises and access to them is likely to cause customers to ignore the designated boundary between branch sales territories, whoever they are set by. Branch managers are rarely in favour of creating a line except where it might stop customers deserting them for a more successful branch.

Customers cannot be refused if they beat a path to the door of a branch outside their 'area', because the alternative is that they will buy from a competitor – the customer has the right to choose. And branch managers with a talent for competitive selling should be allowed to exercise it freely in a spirit of encouraging enterprise.

12.5 Authority over procurement

Selection of the product range offered at the branch

A company's product range defines a large part of its business model. Most companies are associated with and create a brand around the customers' perception of what they sell or do.

This is an issue that concerns the most senior managers and is therefore nearly always associated with the centre. But the centre cannot be omniscient. It is the branches that operate on the front line, where there is much to learn about customers' wants from the customers themselves.

Restricting branches to ordering and stocking from a product range mandated from the centre:

- ensures that the benefits of comprehensive, expert and probably expensive research reach every part of the branch network
- can cross-reference procurement and sales across the widest canvas possible
- uses to the maximum the buying power of the whole organisation
- creates a strong bond between the brand and the range by offering consistency in customers' expectations and experiences
- allows branches' performances to be compared like-for-like (because there is less variation in the mix of products)
- permits sales performance to inform the selection of product ranges for the whole branch network.

Problems can arise if the branch has complete authority to stock the range of products, because the unique character of the range could cause:

- confusion among customers if a branch's mix of products fails to reflect the company's main strengths; or if the differences in inventory between branches is too great
- a gap to appear between the branch's offering and the company's brand that may dilute customers' perceptions of what is on offer and damage sales
- the value of the company's brand ultimately to disappear if the branch does not behave as a part of a network
- dangers of abuses involving branch managers, suppliers and customers, that the centre may struggle to spot, correct or control.

Conversely, if the branch has no say in the choice of products, important potential benefits are lost. Branches:

- may have a better ear for what (their) customers want than the centre
- can move more quickly than the centre to meet new demands
- can be a source of information (particularly if many branches speak with a single voice) about the need to shift the core product range in a new direction as customers' tastes change.

Branch managers always inherit a core range, either formally and precisely defined, or through their understanding about the 'business the company is in'. So it would be unusual for them to want to move away from the perceived core.

However, if the centre has no capacity for accepting feedback from branches, it cuts off the best channel of information about customers' wants and may lose competitive advantage. So the branch may be entrusted with the authority to select non-core product ranges to search for a more exact match between its inventory and what the local market wants.

Selection of suppliers

Selecting the product range is a different task to selecting the suppliers of the products. A given range may present many options for choosing suppliers, while at the same time some products may only be available from a single source.

If the centre selects all suppliers, several of the same effects are felt as when the centre selects the products. For example, it:

- ensures that the benefits of comprehensive, expert and probably expensive research on value for money and strategic procurement reach every part of the branch network
- can integrate procurement with sales on the widest canvas possible
- maximises the buying power of the whole organisation
- allows branches' performances to be compared like-for-like (because products are bought at the same price for all branches and the mix of products varies less).

In addition:

- it is possible for the company to exercise absolute control over prices and terms by using a single negotiating platform
- earnings from purchase rebates and discounts can be retained at the centre and not subjugated to the result of mismatched sales or procurement by branches
- the effectiveness of the centre's procurement team can be measured in the purchase rebates and discounts obtained
- the centre has the resources to investigate the origins of supplies and can check that their provenance complies with regulations on quality, safety, environment, et cetera
- the company can use objective criteria to rationalise the number of suppliers and the supply chain.

For some products, the branch may have a more intimate knowledge of sources of supply, particularly if these are local. Other advantages of procurement by the branch are that:

- using local suppliers selected by the branch may mean lower transport costs
- procurement by the branch may be informal and done with little expense by the branch manager or the staff within their normal working hours.

However:

- low-volume purchases at a branch will usually be at a higher unit price
- the informal process for procurement at the branch may be unsafe, or lacking advantage in a number of ways – shorter credit terms, less watertight guarantees, poorer security of supply, et cetera.

The centre ought to be able to distinguish and measure the overall benefit between choosing suppliers for core and non-core products by branches and the centre itself.

Negotiating discounts on purchasing, rebates, concessionary value, terms, conditions and credit from suppliers

The centre represents the purchasing power of the company and this should be brought to bear when selecting products and suppliers.

A branch, however, can take a more forensic view of opportunities for value, being more selective in claiming concessions from some of its suppliers on some of its higher selling products.

The authority to negotiate need not be the exclusive property of the centre or the branch. But for the branches to continue to negotiate after the centre has already won some concessions would probably require sanction at the centre. Without this, branches may negotiate in vain. The centre can put suppliers on notice that branches may come and 'ask for more'.

12.6 Authority over inventory policy

Deciding the volume and value of stock to hold

In managing inventory the organisation attempts to optimise two conflicting variables:

- the availability of stock in relation to demand
- the value of capital invested in inventory compared with desirable financial and operational targets for business performance, such as stock-turn.

At one time it was a major function of the branch to reorder and so maintain the availability of products without which sales would atrophy and profits evaporate. That became largely unnecessary as soon as technology allowed branches to be restocked on a push system in which information about sales is transmitted daily (or with even greater frequency) from tills directly to computer systems operated at the centre.

Re-ordering can be triggered automatically by systems from either the branches or the centre. The other option is manual or near manual re-ordering done locally, in which case managing of demand signals and managing working capital are functionally separate, laborious and iterative.

When the centre has control over inventory:

- well-designed systems can optimise inventory by making use of all material data such as seasonality, flexibility to respond to weather, transport logistics, suppliers' lead times, et cetera (as in the chain store retail sector)

- sophisticated programs can balance re-ordering parameters and the 'open to buy' control of working capital in a way that traditional branch-based manual or computer-assisted, semi-automatic methods cannot)
- stock turn can closely reflect the short-term patterns of sales
- cash flow can exactly reflect sales
- involuntary stock-outs become rare, being always automatically controlled by the system to stay within working capital limits, or confined to endemic risks associated with suppliers, logistics and other external contingencies.

Central control over re-ordering without computerised system support (as in the past) is problematic and to be avoided.

What happens at the branch depends very much on the business model and operational context. Factors influencing inventory include:

- the number of stock-keeping units (SKUs) to be reordered, and the degree to which simple kanban systems can be applied, (that is to say the size of the manual task of inventory control)
- the suppliers' lead times (re-ordering windows may be critical)
- the overhead cost of paying employees dedicated to inventory management
- the capital available for investment in system support
- whether local knowledge on patterns of demand supports reordering decisions better than knowledge at the centre.

Writing down stock

The write-down of stock has a big effect on key financial measures of performance.

Writing down stock (or avoiding doing so) is a major source of error and malpractice by profit centre (branch) managers.

Independent judgement by disinterested professionals can be critical to arriving at the true and fair view, and this is more likely to be found at the centre, where arm's-length judgements are also likely to be more conservative and therefore safer.

However, there is a significant cost if all branches are audited for stock write-down, at arm's length, every year. Local knowledge of demand may give effect to better judgements about slow moving stock. And risks can be

mitigated with incentives or penalties to encourage branches to make true and fair local decisions on write-down.

12.7 Control of resources, costs and operations

Budgeting fixed or variable costs such as permitted numbers of staff

The number of staff is usually a significant, locally variable operating cost and a driver of other direct and indirect costs.

The centre has options in which it can either seek control over:

- each element of branch cost such as payroll, or
- only over the total branch cost.

In either case (elements of cost, or the total cost), these can be controlled, by the centre or locally, as a fixed sum or as a sum flexed against an appropriate variable. For example, the size of the staff may be controlled as a variable of productivity – sales per employee, transactions per hour worked, or £ margin per £ payroll.

Alternatively, the centre may confine its authority to approving budgeted headcount and/or fixed payroll because it requires certainty about the cost as well as having a solid basis for comparison of the key operating costs by branch and around the network.

A monthly reporting process may operate from the centre that will show the actual and budgeted manpower and cost associated with it.

However, the centre may require no control over costs at all, confining its control to high-level financial measures, such as profit and return on sales or capital employed, and possibly some indication of trading health such as new customers won.

On the other hand, the centre can be over-prescriptive, removing scope for branch initiatives to respond flexibly to changing circumstances.

Staff, payroll, and productivity can be matters solely for the discretion of branch managers who need to exercise their own local controls in order to achieve the financial performance required from them.

Thus reporting from the branch could be skeletal, confined say, to indicatives of financial health – sales, margin and profit – with the analysis of numbers 'in-between' being assumed.

This saves cost and time for reporting and debate, but the risk is increased of misrepresentation and disguised underperformance that it would be better to detect as early as possible.

Setting rates of pay and assigning jobs to a structure of grades

The centre's HR professionals – a substantial overhead cost for many companies – are qualified to create robust structures for grades and pay rates based on job content and evaluated differentials.

The centre has the knowledge and opportunity to research and set rates of pay nationally or regionally, but is unlikely to be able to discover for itself the local market rates in each branch area.

The advantages of doing this at the centre are that:

- uniform company structures inform branch managers how to organise the staff, functions and tasks
- common pay structures avoid glaring differentials, which can cause problems when employees move between branches.

But branches should have some freedom of manoeuvre, because:

- it is at the branch that local labour markets are best understood. Branch managers can decide to recruit into grades and pay with freedom, in accordance with their own direct responsibility for results
- branch managers are best placed to judge the most economic balance between the efforts made by the staff and the rewards paid to them, usually without the company running an excessive risk.

Hiring, firing and disciplining employees

The competence of the centre's HR professionals can be relied on to make good final decisions on all matters of managing personnel, so the company's processes should be constructed around that function. Conversely, branch managers usually lack HR skills and legal knowledge, exposing the company to greater, avoidable risk.

Putting the centre in charge of HR:

- prevents branch managers from making serious errors in law and practice
- may undermine the authority of the branch manager, if too many decisions about local matters are made remotely.

Branch managers understand the local context and can make practical, expedient HR decisions accordingly. Branch managers often have only a few employees reporting to them, have probably hired them and know them personally, and if they have devolved accountability for performance, HR decisions are usually handled sensibly.

If the branch has responsibility for HR:

- decisions are often made more quickly, which is usually best for everyone
- poor decisions by too many branch managers may give the company a bad name as an employer and also prove costly in employment tribunal awards and severance payments.

In practice, a scale of gravity determines how and where disciplinary cases should be dealt with. The centre would need to ensure that managers receive appropriate training to equip them for whatever decisions they are expected to take.

> *"If you don't like change, you will like irrelevance even less."*
>
> **General Eric Shinseki**

Design or specification of operating practice

The centre may choose to design and define processes, procedures and practices that are mandatory at the branch. These fall into two categories.

First, there are those whose purpose is to regulate the connections between the centre and the branch, such as the regular reporting flows in which the form and content are prescribed to make assimilation, consolidation and inter-branch comparison easier.

Second, there are those practices done wholly within the branch, such as recording staff sickness, or disposal of waste materials and countless others. For example, the centre may prescribe that all employees clock in. It may direct that waste be recycled in a certain way. It may wish to direct how an insurance claim is made in order to disseminate throughout the network the most efficient or foolproof method. Or it may choose to leave these things to the discretion of the branch.

The centre may issue Standard Practice Instructions (SPIs) to branch managers, and require the whole network to comply as directed. Prescribing process and practice at branches from the centre comes at a cost, because it consumes time and effort in both places: enforcement, if taken seriously, also has a cost.

But often the cost is less than the consequences of doing nothing, particularly for:

- financial recording for audit and business reporting
- regulated activities carrying a risk that the centre needs to mitigate
- activity in which errors, omissions and poor practice at a local level can result in corporate liability or dispute.

Branches are an integral part of the company in a way that an operating subsidiary is not. For this reason, branch managers should be expected to comply with SPIs, or the equivalent, and accept the support they afford in the interests of efficiency and effectiveness both at the centre and at the branch.

However, the centre has the option to give the lightest possible touch to how branches conduct themselves, particularly when branches are measured against high-level financial objectives.

If confidence is high, it pre-supposes that risk is being managed and that the costs associated with managing from the centre can be reduced.

12.8 Authority to allocate and invest capital

Access to capital is always conditional, and it is the centre that defines the conditions. Access can be planned, provided for in the budgeted year, arranged in an emergency, or made available for an opportunity.

Capital would normally be allocated on application supported by a business case prepared by the branch. The centre is able to make judgements about need or opportunity from a comparative standpoint and can allocate scarce capital around its branch network according to the best returns promised. Conventional control of this type can only be operated from the centre.

Branches hardly ever hold capital sums: it is the role of the centre to raise it and make it available where it will productively feed the business. But profitable branches may generate free cash and can be incentivised by the right to apply for and use some of it.

The case for capital expenditure is often associated with local enterprise, so an excessively tight central control over capital could stunt initiative. Capital requirements at the local level are often for relatively small sums needed quickly, so a lengthy vetting process at the centre may snuff out opportunity.

13. A word in conclusion

13 A word in conclusion

The days are long gone when the only copy of the company's organisation chart was pinned up on a large sheet behind folding doors on the wall of the Personnel Director's office. Yes – it happened, and not only in fiction. Now, in some organisations, modern practice is for out-of-date charts on scraps of A4 paper to gather dust in the bottom drawers of departmental managers' desks. Is this progress? It could not happen in your organisation, of course!

14. Collinson Grant

14 Collinson Grant

Collinson Grant is a management consultancy. We help firms all over Europe and worldwide to restructure, merge acquisitions, cut costs, boost performance and profit, and manage people. This builds long-term relationships. We have kept some clients for over 40 years.

Our emphasis is on results and value for money. We expect to give a first class return on the investment in us. So we do not recommend action unless we are sure that the outcome will be worth it. We are not afraid to give bad news, or to champion ideas that may not be welcome.

14.1 Skills – the sort of work we do

Most of our work is on three themes – organisation, costs, and people. We use this simple framework to manage complex assignments – often with an international dimension – and to support managers on smaller, more focused projects. We help them:

- to restructure and integrate – following acquisitions or to improve profits
- to rationalise the supply chain – we examine every process and interface to improve efficiency and service
- to set up financial and managerial controls – we create robust systems to improve decision-making and reduce risks
- to introduce Lean manufacturing and refine business processes – we analyse and improve how work is done, and use new ways to create change and make it stick
- to cut costs – we make systematic analyses of overheads, direct costs and the profitability of customers and products; this helps managers to understand complexity, and to take firm steps to reduce it
- to manage people – we draw up pay schemes and put them into effect, guide managers on employee relations and employment law, get better performance from people, and manage redundancy.

Our consultants have held senior executive line positions with responsibility for profit and loss. We work in many different sectors for large private and public companies and also in the public sector.

In projects involving organisational change, we have worked with managers:

- to design and implement new organisational structures
- to review layers and spans of control to find opportunities to reduce costs
- to integrate managerial teams with new accountabilities and controls
- to improve profit and turn around failing companies
- to recruit new staff and/or manage redundancies
- to outsource functions and set up shared service centres
- to serve as interim directors.

Our approach and consulting style is grounded in pragmatism, urgency, value for money and objectivity. Programmes are customised to the requirement. Documentation is what is necessary to the case.

15. Notes on quotations

15 Notes on quotations

Our readers continue to enjoy the quotations which pepper our publications. Some of those quoted are more familiar than others, so here are some brief introductions.

Page reference	
2	**William Edwards Deming** (1900-1993) was an American statistician, professor, author, lecturer and consultant whose work in Japan helped that country's manufacturers to conquer world markets.
9	**Russell Lincoln Ackoff** (1919-2009) was an organisational theorist and a pioneer of systems thinking. As Professor of Management Science at the Wharton School, University of Pennsylvania, he made a speciality of pointing out how managers' real behaviour differed from that prescribed by management scientists.
10	**Geoffrey M Bellman** (born 1938) was a business executive with several Fortune 500 companies before becoming a consultant. His books include *Getting Things Done When You Are Not in Charge*.
15	**John Adair** (born 1934) was an officer in the Scots Guards, an adjutant with a Bedouin regiment in the Arab Legion, and a deckhand on a fishing trawler before going on to write 40 books. More than a million managers have taken part in the action-centred leadership programmes he pioneered.
17, 40, 143	**Peter Drucker** (1909-2005) was an Austrian-born American consultant, educator, and author. He invented the concept known as management by objectives and was one of the first to spot trends such as privatisation, the power of marketing, the information society, and 'knowledge workers'.
19	**Mary Douglas** (1921-2007) was a British social anthropologist who investigated symbolism, culture, and the role of the individual in society.

20 **Colin Powell** (born 1937) was chairman of the US Joint Chiefs of Staff from 1989-93 and Secretary of State from 2001-05.

23 **Agha Hasan Abedi** (1922-1995) was the Pakistani founder of the Bank of Credit and Commerce International, which collapsed in 1991 after becoming implicated in money laundering.

24 **Warren Buffet** (born 1930) controls Nebraska-based Berkshire Hathaway. His value-investing philosophy earned him the nickname 'Sage of Omaha'. Although a billionaire, he is renowned for personal frugality and plans to give away 99% of his wealth.

32 **Muhammad** (c570-632) was orphaned by the age of six and worked as a shepherd and caravan leader until he received visions calling on him to destroy polytheistic idols around *al ka'ba* (the cube), a shrine in Mecca. His followers took control of the Arabian peninsula and Islam was born.

34 **Rupert Murdoch** (born 1931) inherited the *Adelaide News* from his father and acquired other newspapers in Australia, New Zealand and the UK before building a global media empire. At the peak of his power, *Forbes* magazine named him the 24th most powerful person in the world.

35, 103 **Anthony Stafford Beer** (1926-2002) was a professor at the Manchester Business School. An early advocate of computers in business management, he led groundbreaking research into cybernetics before renouncing material possessions and moving to mid-Wales during the 1970s.

42 **Elliott Jaques** (1917-2003) was a Canadian psychoanalyst and organizational psychologist, who invented the concept of the 'time-span of discretion', based on the idea that the higher a person sits in a hierarchy, the longer he can work unsupervised.

43, 133 **Lee Iacocca** (born 1924) made his name as a salesman but also played a part in designing the Ford Mustang and the Lincoln Continental. After the Ford Motor Company fired him in 1978, he got his revenge by leading the revival of the Chrysler Corporation.

45 **Lord Weinstock** (1924-2002) built the General Electric Company into one of Britain's leading industrial conglomerates. He hoarded £3bn worth of cash but his successors spent it badly, destroying the share price. Weinstock's personal stake, once worth £480m, was reduced to £2m.

50 **Lawrence J Peter** (1919-1988) co-authored *The Peter Principle*, a humorous book about the way hierarchies work. Subtitled 'Why things always go wrong', the thrust of its argument is that employees promoted on merit eventually 'rise to the level of their incompetence'.

59 **Charles 'Casey' Stengel** (1890-1975), was an American baseball outfielder and manager. His nickname reflected his Kansas City origins but sportswriters also dubbed him 'The Old Perfessor' because of his wit and quotability.

62 **Tom Peters** (born 1942) was a management consultant with McKinsey before becoming an author and motivational speaker. His first book, *In Search of Excellence*, preached the gospel of empowerment at all levels of an organisation.

64 Dorset-born **Harold Geneen** (1910-1997) emigrated to the United States with his parents and studied accounting. He was president and CEO of International Telephone and Telegraph during the 1960s, when sales increased from $765m to $17bn.

68 **John Kenneth Galbraith**, (1908-2006), was a Canadian economist and author whose support for the ideas of John Maynard Keynes was evident in books such as *The Affluent Society*. He was an adviser to President John F Kennedy, who appointed him US Ambassador to India.

71 **Marcus Aurelius** (121-180), was a Roman emperor and stoic philosopher who defeated the Parthians and the Germanic tribes.

78 **Donald Rumsfeld** (born 1932) holds the records for being the youngest and the oldest person to have served as US Secretary of Defence, holding the post under presidents Gerald Ford and George W. Bush. In between, he was president of G D Searle & Company, a pharmaceutical firm.

104 **Edward Bulwer-Lytton** (1803-1873), was an MP, Secretary of State for the Colonies, and sat in the House of Lords. He also found time to be a poet, playwright and novelist, coining the phrase 'the great unwashed'.

107 **Stephen Covey** (1932-2012) wrote *The Seven Habits of Highly Effective People*, a self-help book which argued the case for character and principles and sold more than 25 million copies. A devout Mormon, he was sent to England as a missionary in his youth.

114 **Cyril Northcote Parkinson** (1909-1993) was a naval historian and author best known for Parkinson's Law, which argued that work, especially in a government bureaucracy, 'expands to fill the time available for its completion'.

154 **General Eric Shinseki** (1999-2003) was wounded in Vietnam, served as Chief of Staff of the US Army from 1999-2003, and was appointed Secretary of Veterans' Affairs in 2009.

Collinson Grant

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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