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Keeping the
Weight Off
*Sustaining Cost
Reduction Over
The Long-Term*



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Keeping the Weight Off

Sustaining Cost Reduction Over the Long Term

You know the drill. It's time to cut costs—again. So you resort to the latest crash diet: the across-the-board budget cut, the exercise in de-layering the organizational chart, the voluntary severance and retirement packages, and/or the tried-and-true reduction in force. Any and all of these tactics can be effective in taking off weight. However, it seems that none of these approaches succeeds in actually *keeping* that weight off. And actually, some may do more harm than good by cutting into productive muscle rather than removing the fat. These cost-cutting drills are typically not sustainable because they address only the superficial symptoms of organizational bloat, not the root causes of the problem. Such drills help organizations shed the water weight, but as any yo-yo dieter knows, that's a purely temporary palliative. The fat still lurks in the system.

The drivers of chronic corporate obesity are genetic; they are embedded in the organization's DNA or, more precisely, in the four fundamental building blocks of organizational DNA: (1) decision rights, (2) information, (3) motivators, and (4) structure. Traditional cost-cutting exercises have generally addressed only structure—the water weight, if you will. But, unless you also address decision rights, information, and motivators—the “who,” “how,” and “why” of

organizational effectiveness—in a concentrated and coordinated fashion, it will be difficult to sustain significant cost reductions over the long haul.

Structure-based solutions are valid and useful starting points, and they frequently yield immediate results. But more often than not, they treat the symptoms of organizational obesity rather than provide a real cure. In our experience, the true root causes of escalating costs are often buried deeper within the organization. Such expenses might result from process inefficiencies, lack of understanding of internal costs, insufficient management of internal demand, fragmented functions, shadow staff, second-guessed decision making, and/or misaligned incentives.

Removing lines and boxes on an org chart is important and will furnish short-term savings but won't eliminate these root causes. Such a move eliminates positions but does not address the way the people in those positions are empowered (or not), informed, and motivated. It is only when you address *all* of these factors—structural and nonstructural, together and in an integrated manner—that you drive real, sustainable cost reduction.

The Forgotten Fat

So, let's examine the four building blocks mentioned above to diagnose the root causes of organizational obesity.

Decision rights. Arguably the most important determinant of organizational performance is that

of “decision rights.” This term describes decision-making authority and accountability and where these responsibilities reside in an organization. If decision rights reside at too high a level, the organization bogs down while waiting for senior management to sign off on every decision. Senior managers need to know when to delegate decision making to the people who report to them and then monitor those decisions, rather than making the decisions themselves. Only then can senior managers’ span of control widen and costs come down. Conversely, overly decentralized decision rights also lead to inefficiencies and redundancies, as each division invents its own wheel; there is no enterprise-wide perspective on overall demand management. Possibly worst of all is when decision rights haven’t been clearly defined. In such scenarios, decisions are made either everywhere—or nowhere. Imagine everyone at a large meeting standing up, thinking he or she has been tasked with the decision rights on a project because no one bothered to clarify exactly why they were invited to the meeting. Or, just as easily, thinking they could return to their offices on the assumption that they were off the hook, that someone else at the meeting would move the ball forward. Those are unclear decision rights.

Companies need to take a top-to-bottom look at decision rights and clarify who decides what in which circumstances. When decisions are aligned with relevant information access, they are automatically more efficient and productive; that generally means decisions are delegated down to the lowest possible level, which broadens accountability and lowers the cost of decision making.

Decision rights can be powerful resource deployment tools, enabling business units to make more informed and empowered support service choices and thus reducing the need for extraneous shadow staff. Take training as an example. Training is an area where shadow staff abounds, as each business unit develops its own program. One of our clients, after a thorough assessment of costs, decided to consolidate all of its training company-wide into a single Training Center of Excellence. By centralizing and clearly stipulating decision rights about how to support training across

the enterprise, and by leveraging skills and training modules across divisions, the organization was able to reduce its training spending by nearly 30 percent. Critical business needs were still met, and the company as a whole realized significant efficiencies.

Information. Properly allocated decision rights are great, but in the absence of appropriate and accurate information, meaningless. The failure to furnish such information in a timely manner can contribute substantially to organizational inefficiency and hence higher costs. For example, when departments are not given clear and accurate information on internal costs, they behave as if they have a blank check. We had one client who did not charge back for IT work or even share IT budgets with its business units, so the economics of supply and demand never took hold. The business units simply asked for whatever they wanted, and the requests were fed into a long queue and eventually addressed. The businesses had no idea whether their requests cost \$200,000 or \$2 million, so there was no need to rationalize requests. Not surprisingly, the IT cost structure ballooned.

Perfect information in a cost-reduction context is price transparency. Whether it’s through demand management, transfer pricing (see “Rate Cards Inform Distribution Demand,” page 3), or open, competitive bidding against outside providers, support services must win over their business unit customers with better information, which, in turn, enables better choices and superior cost performance.

Motivators. If properly designed and implemented, motivators can be a valuable key to unlocking organizational efficiency. Many companies have failed to capitalize on this opportunity by perpetuating salary and benefit structures that are outdated and/or out of touch with current market practices. Instead of promoting and supporting lateral transfers as a valuable career move and a viable alternative to traditional vertical promotions, for example, companies continue to overemphasize the “onward and upward” trajectory, which results in the creation of more organizational layers. Moreover, the lack of substantive differentiation in performance bonuses discourages the

Case Study: Rate Cards Inform Distribution Demand

The forces of supply and demand dictate pricing in the outside world; there's no reason they can't do the same inside a corporation. Many companies have enjoyed great success in sustaining cost reduction by establishing internal transfer pricing schemes based on rate cards. These rate cards spell out the costs of a standard level of service, as well as the incremental charges for added or special services above and beyond the base package.

One consumer-products company realized significant cost savings in its distribution function after establishing such a rate card. The customer teams charged with overseeing the overall profitability of various client relationships had always taken distribution for granted. Until the rate cards were established, the costs associated with inventory, sorting, shipping, and returns management were treated as fixed and charged back to the customer teams as a uniform percentage of sales. In other words, customer teams were all "taxed" at the same rate, whether or not they drove added costs through special handling requests.

The solution was to let market forces dictate pricing by arming the customer teams with information. The distribution function published a rate card, competitive with that of third-party providers, that stipulated what the specific charge would be for added levels of service, the logic being that those who drove additional costs should pay for them. Key to the success of this approach was that it was introduced up front as the service-level agreement was being hammered out, and costs were transparent. Armed with this information, flexible and foresighted customer teams could avoid cost-inducing behaviors and prioritize their distribution expenditures accordingly.

Needless to say, the rate cards brought costs down substantially and special orders and requests dropped dramatically. Customer teams that had demanded store-level shipments three times per week suddenly adjusted their expectation to one delivery per week. Those that had required special stickering (and thus increased handling) now dispensed with the stickering. The requests for expedited shipping dropped by half. Not surprisingly, the overall savings generated by the rate card initiative surpassed the company's expectations and proved sustainable over time.

stars and overcompensates the weak links. Costs rise, but not the cream of the talent pool.

For example, we worked with one client that had a culture that prized title and hierarchy. To interact with a senior executive, you needed a senior title yourself, or your request would be disregarded. To compound the problem, the bonus structure did not directly reward performance, so the only way to retain high performers was to promote them. The result was a surfeit of "managers" who were really individual contributors at elevated salaries.

Motivators, if properly applied, can reinforce and help sustain cost-reduction "diets" by aligning incentives with the achievement of specific targets. Career paths should emphasize lateral promotions, which not only reduce layers, but also increase cross-department knowledge and information flow.

Structure. Structure-based solutions are still necessary and valuable. Companies should continue to consolidate organizational layers and increase managers' spans of control (i.e., more direct reports) to remove costs. Executives should reassess their

primary organizational axis to align their cost-reduction efforts with their strategic priorities. They should also centralize scattered and fragmented functions.

However, to sustain the savings released by these structural remedies, we urge clients to reinforce them with the appropriate decision rights, information access, and motivators.

As an example, one of our clients decided to significantly broaden its managerial spans of control (nearly doubling them) to reduce costs. Initially, senior-level managers struggled with how to get the work done; they thought they needed to absorb all the decisions made in the areas now reporting to them. By clarifying and delegating decisions farther down the chain of command, the organization was able to sustain the cost savings realized during the restructuring. Now lower-level staff routinely make

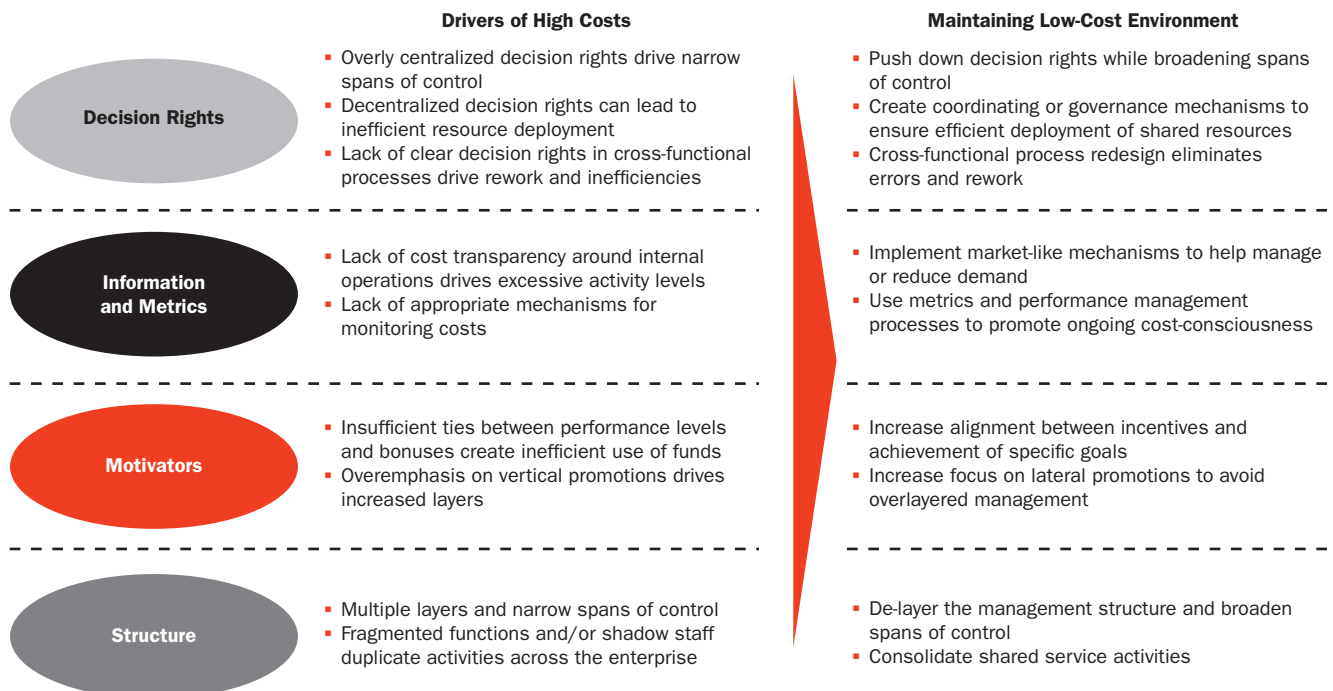
operating decisions that fit within their scope of responsibility, enabling managers to focus on broader and more strategic concerns.

Overcoming Obesity

The overall goal is to create a mutually reinforcing system of organizational levers that can sustain significant cost savings over the long term. If senior executives look beyond standard structure-based remedies and examine the other organizational elements we've discussed, they can more effectively diagnose the root causes of organizational obesity and keep the weight off permanently by instituting healthier and renewing practices and behaviors. A successful and sustained cost-reduction effort requires more than just dieting; it also requires an accompanying exercise program.

Exhibit 1

The Path to Permanent Cost Reduction



Source: Booz Allen Hamilton

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