A strategic approach to overhead management

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The average company spends 23 cents out of every dollar of revenue on overhead, yet most firms lack a plan or system for managing the spending for greater value. Managerial attention to overhead tends to be sporadic and is often driven by the need to cut costs in the near-term. Even if short-term cost reductions are achieved, companies then find themselves tied to a roller-coaster cycle of cost-cutting, costs creeping back over several years, and then cost-cutting again. Companies that get off the roller coaster will discover not only that financial markets rewards better overhead management, but also that changing the very way they view and manage overhead can significantly increase the return they get for every dollar invested in it.

This problem is not new. Managers have grappled unsuccessfully with overhead for decades. In the 1950s, management guru Peter Drucker complained about the variety of costs that accountants ''lumped'' together as overhead and warned managers to make a careful distinction between ''productive'' and ''non-productive'' overhead.[1]

However, most managers lack the time and patience to categorize and assess their company's overhead thoughtfully. As a result, the process devolves into either indiscriminate across-the-board cuts, or cuts based on benchmarks or the subjective perceptions of value provided by an overhead service or department.

Benchmarks and employee perceptions can certainly be useful reference points, but neither approach really helps companies make the distinction referred to by Drucker. A cautionary tale on benchmarking comes from a large industrial supplier that, believing customers bought on price, launched a major overhead cost reduction program. The company took pride in the finding that, when benchmarked against its primary competitor, their customer service costs were 15 percent lower than the competition. They took pride, that is, until customer satisfaction research revealed that customers were switching to the competition for better service. Strategic investments in overhead had given their competitor a valuable advantage.[2]

Clearly, neither benchmarking nor an aggregate target approach adequately considers ''value'' and ''productivity.'' First, both are based on a static, point-in-time assessment of spending that fails to address the nature and timing of expected future benefit streams. Since productivity and value are measured against what outputs are generated today, what tends to get cut first are the more speculative overhead spending programs, which have greater potential return on investment. It is often the case, for example, that all unfilled job positions are frozen or cancelled during a time of cost-cutting. This decision assumes that all those jobs are irrelevant or unnecessary. We have found, however, that the empty jobs are often unfilled precisely because they are being kept as placeholders for missing critical capabilities.

Second, both approaches add little to management's understanding of the reasons behind the spending – the root drivers of costs. As a result, costs creep back in and accumulate

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over time, only to be scrutinized and cut again. This cycle can go on for years. In a survey of nearly 2000 companies, Monitor found that two thirds of respondents endured three or more cost-cutting initiatives within the past seven years; 27 percent of them, in fact, had witnessed over six cost-cutting initiatives. And yet, over half of the respondents felt that these programs were at best a partial success, and only seven percent felt that they exceeded expectations. Forty-eight percent pinned the blame on a failure to address underlying drivers of spending, and 47 percent have seen the costs grow back.

Even worse, 40 percent of our survey respondents reported that the critical capabilities of their organization were not protected during cost-cutting initiatives.

Consistency counts

There’s a substantial upside that can come from avoiding the roller coaster approach to managing overhead. Monitor Group conducted a study of overhead management and the financial performance of nearly 800 large public US companies over the last five years. The study looked at the five-year change in market value of companies that consistently reduced their overhead ratio year after year and compared that to the market value of companies that took the roller coaster approach, allowing their overhead costs to grow and then cut them, only to see the costs grow again.

The results were startling. The consistency group achieved an increase in market value two times that of the roller-coaster group. In fact, even those companies that had lower overall reductions, but managed the ratio down consistently, were better rewarded than those companies that reduced their overhead more severely .

Given the diffusion of accountability and the lack of transparency, most companies underestimate their total support-cost spending by at least 50 percent and often by as much as 80 percent.[3]

To set a new course, think assets, not costs

The first step in applying the brakes to this damaging cycle is to change the nature of the conversation about overhead. Rethinking the conversation requires dispensing with an ‘‘overhead is a burden’’ mindset and fundamentally reframing how all parties view overhead spending. It starts with challenging some basic tenets; consider, for example, how the fundamental attributes of overhead closely resemble those of an investment, and how overhead costs can be better thought of as investments in competitive competencies:

1. **Overhead requires sustained multi-period funding.** For many overhead activities to operate effectively and achieve desired results, funding must be sustained over a period of time. Because much of overhead is about underlying capabilities (training and education, product-development forecasting), a company cuts funding at the risk of eliminating critical expertise, experience, and knowledge.
2. **Overhead activities generate outcomes.** Overhead spending can be linked to specific outcomes (received payments, settled lawsuits, retained and trained employees).
3. **Overhead spending benefits multiple constituencies.** Because much of overhead spending is in cross-functional processes and systems, the investments tend to benefit multiple businesses, products, functions, and geographies within a company.

Viewing overhead as an investment in a capability is the key to preventing stop-and-start, roller-coaster management. It helps ensure regular ROI calculations, the explicit exploration

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Monitor survey on overhead management perceptions

Monitor recently conducted a comprehensive survey of 415 senior executives and managers regarding their perceptions of overhead and overhead management. The respondent population included Board Chairs, CEOs, General Managers, and functional leaders from a wide range of industries. All respondents had been with their respective companies for a minimum of three years, and many of them had tenures longer than five years. The companies they represented had annual revenues ranging from $300M to more than $50B.

The survey results produced several interesting findings:

1. More than 80 percent of respondents believe that overhead is a potential source of competitive advantage, but a majority also believes that their overhead is not currently aligned with their strategic goals.
   - Listed in order of rank are the functions considered overhead (where 50 percent or more of respondents identified the function as overhead) and the percentage who believe that the function is a source of competitive advantage: IT (75 percent), Training & Education (69 percent), Procurement (65 percent), HR (59 percent), Risk Management (58 percent), Finance & Accounting (53 percent), Legal (46 percent).
2. Eighty percent believe that value created by overhead can be measured and managed; however, they do not know the value their company gets from overhead spending because they have no clear measures.
3. Two thirds of respondents believe that their overhead is missing critical capabilities.
4. Two thirds of respondents have gone through three or more cost cutting initiatives within the past seven years; 27 percent of them experienced more than six initiatives in the same time period.
   - More than half of respondents felt that these programs were a partial success at best, and only seven percent felt they exceeded expectations.
   - Forty-eight percent believe that past cost-cutting initiatives failed because they did not address the underlying drivers of spending.
   - Forty-seven percent have seen the costs grow back When asked about their perceptions of how much they were spending on overhead to protect against business and enterprise risks, 23 percent perceive that they are under-investing in protection and 21 percent perceive they are over-investing.
5. Thirty-two percent believe they're not spending enough to improve the efficiency of the organization; 17 percent believe they're spending too much.
6. Twenty-nine percent believe they're not investing enough in strategy enabling activities; 16 percent believe they're investing too much.
7. Sixty-eight percent of respondents reported that they lacked adequate incentives to manage overhead spending.
8. Two distinct segments emerged:
   - Satisfied that overhead management is healthy: 27 percent of respondents.
     - Gaining scale in overhead activities.
     - Making appropriate investments.
     - Getting expected returns.
   - Highly Dissatisfied: 34 percent of respondents.
     - Overhead growing too quickly or shrinking too slowly.
     - Investing in the wrong things.
     - Not getting enough value from overhead spending.

of options, and adherence to standard risk-assessment procedures. And it helps to change the nature of the dialogue from a debate about cutting or adding costs to a discussion based on investment rationale and performance requirements.

Four classes of overhead assets

We identify four classes of overhead assets based on their distinct potential benefit streams. Each class has a different investment logic that specifies how asset performance should be

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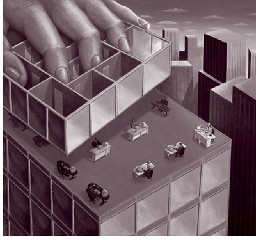

evaluated. For any given function, activities and investments can be classified according to whether they:

- Provide a basic service.
- Enhance the efficiency of the organization.
- Reduce or mitigate risks.
- Enable the strategy of the firm.[4]

1. Basic-service overhead assets

Every company has to perform a set of basic activities that are necessary to the legal and practical operation of the firm. Examples include statutory accounting, financial reporting, payroll administration, and voice and data system maintenance. These services require steady investments to maintain because they are recurring, ongoing activities. As such, these assets should be evaluated based on the efficiency with which the services are delivered.

Basic service assets are clear candidates for periodic make vs. buy evaluations. Companies should not evaluate these services based simply on how much they cost last year. Instead, they should be evaluated for possible outsourcing.

2. Efficiency-enhancing overhead assets

''It will increase our efficiency'' is one of the more common reasons for adding new programs or starting new initiatives – whether in management information systems, HR, finance or even strategic planning and marketing communications. The claim is often supported by productivity metrics as well as anecdotal evidence. These requests typically relate to one-time spending on such initiatives as a process-improvement program or a software tool.

3. Protection overhead assets

All companies face a wide range of risks – environmental, legal, regulatory, and financial. Based on the nature of the risk and the risk tolerance of the company, the types and amount of protection assets in which they invest will differ. Obvious forms are workplace-safety programs, the legal department, and health and internal-audit programs. Less obvious are the many overhead activities that enable compliance in legal, finance and accounting, and health and safety.

Some risks are predictable and tolerable, while others are volatile and potentially catastrophic. Both the obvious and the more subtle investments a company makes to protect itself against risk need to be assessed as insurance investments. To evaluate these protection assets, senior executives need to ask themselves: What risks are we willing to absorb? What risks can we efficiently and economically buy insurance for, hedge against, or otherwise lay off? Are we over or under insured in certain areas?

4. Strategy-enabling overhead assets

A debate that occurs frequently in companies, especially during budget time or periods of performance pressure, is about whether a given overhead function or activity is ''strategic'' or not. The relevant questions are: Is this activity or investment essential to the firm's strategic success? Is it a ''must have'' for the company to deliver its source of advantage, whether framed as responsiveness to the customer, flexibility, service or product breadth, product innovation and quality of care? Only ''must-have'' activities should be considered strategy-enabling assets, and these assets should be regularly evaluated for their contribution to specific competitive outcomes.

Assessing potential returns on overhead assets

Sorting overhead into these four classes should focus, first and foremost, on the objective – that is, the expected type of return – of an investment:

- Is it required to exist as a legal operating entity?
- Is it expected to increase the efficiency of a process?

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- Is it designed to protect against or mitigate potential risks?
- Is it a ''must have'' to deliver on the competitive strategy?

The next step is quantification: How much value can this asset be expected to provide? While the specific metrics for a given class will vary by company the expected value of an investment can be tested by asking the following questions:

- Basic-service overhead. Is the asset more cost effective and efficient in performing the activities at the required performance levels, relative to either internal or external alternatives?
- Efficiency-enhancing overhead. Will the net increase in efficiency justify the initial outlay of costs and any ongoing maintenance costs, in accordance with the target hurdle rate?
- Protection overhead. What is the risk / return profile of the investment and how does that fit with the company's overall risk tolerance? Will the incremental investment provide marginally greater protection than is currently available at a price we're willing to pay?
- Strategy-enabling overhead. How will the investment increase the competitiveness of the company along specific dimensions of performance? Will an increase in competitiveness translate into a net contribution to reaching the company's strategic goals?

Who answers these questions, what data is collected, and how the data is collected are factors that are critical to the validity of the answers. While each company will craft its own unique process, there are two common, guiding principles:

Principle #1. Ask the question at a level detailed enough to be meaningful. When evaluating current asset performance, identify clear performance metrics and outcomes. For example:

- To what degree have the finance activities protected the company against financial risks, such as currency fluctuations?
- Has the recruiting function improved the tech rep retention rate by bringing in the right applicants and setting early job expectations?
- To what degree has the new customer service representative training program improved customer satisfaction?

Principle # 2. Gather data from a range of perspectives. Given that overhead tends to benefit a range of organizational units across businesses and geographies, rarely is there a single ''right'' view of the importance and performance of a given activity or function. Instead, overhead assets need to be considered from multiple vantage points, depending on the asset and the population of its users and beneficiaries .

Evaluating your overhead portfolio

Equipped with an understanding of the current portfolio of overhead investments and the balance of spending, not only across functions and activities, but also by the type of value they should create, senior management will be better positioned to see – and to seize – opportunities to improve the performance of the portfolio and to align it more strongly with the company's competitive and financial interests. Three questions provide a guide for making choices about the kinds of investments a company should make in its overhead:

1. What type of portfolio do we want and how might it change over time? For example, are there regulatory changes on the horizon that will require new risk management expertise or functionality? Is the company setting itself up to ''leapfrog'' a competitor, and does it

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Creating an Overhead Asset Map

Building an Overhead Asset Map is critical to healthier overhead management. Here are six process steps:

1. **Decide who is going to decide.** Typically, the CEO jumpstarts the process by selecting a small senior team to create the map. The team should comprise a balanced mix of executives, operators, providers, and users.
2. **Take an inventory of the firm's overhead activities.** It is important for a central team to create a master definitions list since different business units will define and organize their overhead resources differently.
3. **Sort the activities into asset classes.** Throughout the sorting process, make the logic explicit as to why an activity belongs in one category or another. Note two tendencies to watch for in this step: functional leaders may over-use the strategic category to describe their services; and operators may over-use the basic services category to describe the services they receive.
4. **Gather cost data for each activity.** The map needs to provide a clear picture of where the firm has placed its investments. Doing so is usually more complex than companies expect; this step often requires activity-based costing estimates and integration of data from HR systems and financial systems. Integrating overhead data from "the field" often leads to surprising new pictures of where money is being spent.
5. **Establish a customized set of performance metrics.** Firms will need to develop a unique approach to assessing the performance or "return" of different functions. These metrics need to be aligned with the firm's strategy and established at multiple levels of granularity depending on the importance of the different sub-functions. Important tools in this step are surveys of different user groups for different functions, and benchmarking (especially for the efficiency-enhancing and basic services assets).
6. **Consolidate the asset maps.** The asset maps should be completed first at the level of individual functions, and then in a consolidated form across the firm's entire overhead portfolio. This will set the stage for strategic decision-making and overall overhead strategy.

therefore need to invest more in strategy-enabling overhead? Has the infrastructure of the organization become too complex and expensive over time, and is it now in need of investments to create significant efficiencies?

2. Given the future goals of the portfolio, where are we over- or under-investing and why? While part of the answer certainly will come from the performance- measurement techniques described above, the rest will be informed by how well the portfolio fits with the company's corporate and strategic goals. Often, this question needs to be addressed at each functional level.
3. How should we best rebalance the portfolio and redirect spending? Here, management will need to decide whether and how to stop or redesign programs, services, studies, and other activities that are not providing adequate value, regardless of whether that implies a failure to deliver adequate efficiency or protection, or to enable strategy.

Constructing the right overhead reduction program and reconfiguring for value

By addressing three key issues, senior leadership can define an overall overhead strategy that specifies investments, performance targets and timing, and the capabilities required to deliver the overhead strategy:

1. **Basic-service overhead.** Activities and functions should be organized and managed for compliance and efficiency. Many, such as payroll and benefits administration, should be treated like corporate "utilities" and therefore consolidated into centers of scale or outsourced to maximize efficiency, depending upon the scale of the operations and the standardization of the processes.
2. **Strategy-enabling overhead and risk-protection overhead**. Assets that rely upon specific expertise and skills can be organized into virtual or dedicated centers of expertise to

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ensure that the right resources and capabilities are networked appropriately and leveraged across the organization.

3. Efficiency overhead. These tend to be project-based investments that need direct oversight to achieve desired savings.

To support the new overhead programs, people need to be held accountable for the results. Systems of reporting, performance management, and incentives need to be strengthened to support overhead programs aligned with company strategy.[5] In particular, most budgeting processes will have to undergo significant change to ensure that the right frameworks are used to evaluate the different types of investments and to judge the appropriate timing of investment outlays. To help steer the organization in the right direction, companies should adopt management tools such as performance scorecards, early warning systems, and tracking mechanisms that provide an integrated picture of total overhead costs and associated multi-period performance.

Armed with a new framework for classifying what is spent on overhead and for evaluating the logic of it, management can instill a new discipline to managing overhead. By tirelessly questioning what overhead the company is investing in, for what returns, and over what time frame, managers can significantly increase the value of its investment and, potentially, increase its strategic capability.

Notes

1. Drucker, Peter, *The Practice of Management*, Page 8. (HarperBusiness, 1993).
2. In the Monitor Overhead Management Survey, 44 percent of respondents considered Customer Service/Customer Care as an overhead function.
3. The Monitor Overhead Management survey was conducted in 2004-2005 and included over 400 companies across multiple sectors. Respondents were all executives, VP rank or higher. Research report at (fee) www.adaptiveoverhead.com.
4. This is an activities-driven classification; items such as utilities, rent, office supplies are therefore accounted for via the activities to which they are relevant.
5. In the Monitor Overhead Management survey, 68 percent of respondents reported that they lacked adequate incentives to manage overhead spending.

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