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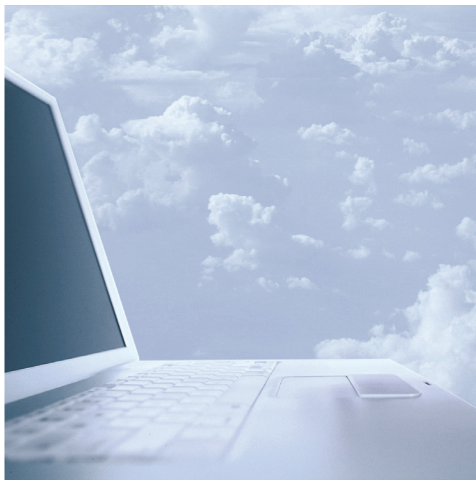

How Performance Management can help you to Navigate through Turbulent Times

Paper #5 – Smart Expense Planning

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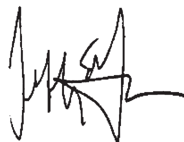
It's a rare company that hasn't had to tighten its belt several notches in an effort to stay profitable—or even in business. The most common way to do this is to cut budgets. You yourself might have been ordered to cut your budget by 10 or 15 percent and perhaps, even now, you're sweating over accounting reports with bleak revenue figures, not sure how you can accomplish this.

You're not alone. Few firms appear to be making much headway in reducing expenses. Only about a quarter of companies in the Global 1000 can keep their costs in line with lower revenues. One of the problems is that the accounting reports they receive only show declining revenues and do not get at the root causes of costs. The reality is that accounting numbers (and especially budgets) encourage the wrong thinking and behavior.

The good news is that you can change that thinking and behavior, says Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, by knowing your key revenue drivers, your key cost drivers and which costs add value to your products or customers.

In this last in a series of five articles about how you can use performance measurement to weather and even thrive in turbulent economic times, Hope explains how you can move away from accounting rules and focus on adjusting your expenses more rapidly in line with changing demand while eliminating many unnecessary costs.

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



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Introduction

In the wake of Sarbanes-Oxley and recent corporate failures, many leaders have tried to tighten management control by adding more planners, target setters, inspectors, controllers, compliance officers, internal auditors, risk managers, project teams, consultants, analysts and advisers. Each management and support person increases not only salary line items, but also expenses bill because more accommodation, technology and travel is required. The management control bureaucracy has grown rapidly in both the private and public sectors. It can absorb up to 20 percent of total costs and, in many organizations (as a recent McKinsey study shows), it is growing faster than the top line.

Not only is the control bureaucracy growing but also the extent of waste that it generates is truly astonishing. In a recent interview, the CEO of General Electric Jeff Immelt lamented that 40 percent of GE consists of unproductive administration and back office work and he wants to halve that in five years.[1] And a Deloitte report noted that, depending on their dedication to change, executives can slash sales, general and administration cost by up to 40 percent.[2]

Few firms appear to be making much headway in reducing expenses. In a 2009 study by the Hackett Group only one company in four was able to manage their selling, general and administrative (SG&A) costs in line with revenue reductions. Although revenue was cut by 23.7 percent, SG&A costs reduced by only 6.7 percent. As a result, SG&A costs, as a percentage of revenue for Global 1000 companies, have risen significantly from 12.6 percent of revenue to 15.5 percent of revenue. Hackett conclude that Global 1000 companies (with an average of $26 billion in annual revenue) are losing out on as much as $1 billion in annual cost savings as a result of this lack of agility.[3]

Even for those companies that have launched cost reduction initiatives, the prospects for sustainable reductions are poor. Another McKinsey study found that the failure rate after five years was almost 90 percent. It seems that budget cuts are only ever temporary!

One of the problems is the way that information is presented and acted upon. Take a typical accounting report (see Figure 1). What does this report tell you about expenses? It clearly shows declining revenues and it suggests that managers have cut expenses last year in an attempt to stem the losses. They have also cut next year's budget including salaries (by 20 percent) and marketing (by 6 percent) as well as other expenses.

But what does it tell you about the root causes of costs? How many costs really need to be incurred to meet customer demands? Which can be cut without damaging customer relationships and future sales? Other difficult questions remain. Can we cope if the (optimistic) sales forecast turns out to be correct? And how will the marketing cuts affect the future of the business? This typical accounting statement tells us something about what's happened but little about what to do differently. Nor does it help us much to formulate next year's plan.

Budget for 200X	Next Year	This Year			Last Year
$000s	**Budget**	**Actual**	**Budget**	**Variance**	**Actual**
SALES	**28,000**	**25,000**	**29,000**	**-4,000**	**33,000**
Cost of sale	17,000	16,000	15,000	-1,000	16,000
Gross profit	**11,000**	**9,000**	**14,000**	**-5,000**	**17,000**
GP%	39.29%	36.00%	48.28%	-12.28%	51.52%
Sales, General & Admin					
Salaries	3,000	3,600	3,800	200	4,000
Travel & entertaining	600	650	700	50	900
Marketing	2,250	2,400	2,500	100	3,300
Accommodation	800	850	900	50	850
Technology	350	375	400	25	275
Administration	1,500	1,750	1,800	50	1,750
Total costs	**8,500**	**9,625**	**10,100**	**475**	**11,175**
Net profit	**2,500**	**-625**	**3,900**	**4,525**	**5,825**

Figure 1. What does this report tell you about expenses?

The reality is that accounting numbers (and especially budgets) encourage the wrong thinking and behavior. Here are some of the reasons why:

- Budgets are usually based on last year's numbers plus or minus a percentage.
- Managers "sandbag" budgets by up to 5-10 percent and this extra "provision" is always spent whether justified or not. How much waste does that add up to?
- Budgets are a license to spend. You often hear employees ask before making a spending commitment, "How much is left in the budget?" when the question they should ask is: "How will the proposed spending add value to the customer?"
- Budgets remain fixed even when demand changes – so capacity can be either too high are too low to meet demand.
- Arbitrary budget cuts are just as likely to hit "good" costs (that is, those that add value) as bad costs (that is, those that add *no* value) and damage customer relationships and sales.

Many organizations have set up Shared Services Centers and some have gone further and outsourced back office processes such as accounts payable and benefits administration. There are undoubtedly some efficiency savings from taking this approach. But the effectiveness of much of this spending is left unchallenged. Think about it. If you are intending to outsource any process that has 40 percent waste included you are transferring this waste to the outsourcing provider. If they have well-designed processes then there is a huge potential profit margin on the contract. However, if their processes are similar to yours, they could generate even more waste and increase your costs per transaction. But why can't *you* cut the waste and pocket the savings?

There is no doubt that we need deeper knowledge to plan and improve our businesses. For example, we need to know our key revenue drivers, our key cost drivers and which costs add value to the product or customer. If we had this type of knowledge, we could adjust expenses more rapidly in line with changing demand and eliminate many unnecessary costs. The following six implementation guidelines can help your company acquire the information and improve expense management:

1. Manage processes and drivers rather than functions and budgets
2. Do an inventory of 'good' and 'bad' cost drivers
3. Build expense forecasts from cost drivers and revenue drivers
4. Allow expenses to 'flex' according to rolling income forecasts
5. Give front line teams full P/L accountability
6. Use ratios, benchmarks and transparent numbers rather than budgets to drive the right expense behavior

You might not be able to implement all of these, but just executing a few could have a dramatic effect on your cost base.

Manage processes and drivers rather than functions and budgets

A number of years ago a Scottish plant belonging to a large American computer company decided to undergo an activity-based costing project and from its results, it translated its accounting costs (which were analyzed by account code such as manufacturing, R&D, marketing and administration) into process costs. It identified six core processes: Strategy formulation, product generation, new product introduction, order fulfillment, sales development and control.

The first surprise was that 15 percent of plant costs were concerned with "control." The second was that 40 percent of all its costs added no value for the product or customer. Over the next two years, the project leaders took a number of actions that eliminated over half of these non-value costs and dramatically improved the profitability of the plant. What the Scottish project uncovered would not be surprising to quality, process reengineering or activity accounting experts. In fact, most reckon that 40 percent non-value work in any process is about normal.

There are many processes in the orbit of Finance, including processing a sales order, receiving payment from a customer, paying a supplier and completing the month-end close. Identifying processes and drivers and preparing process maps is not rocket science. Financial managers can learn to do this as well as anyone else. As we will see from the next example, the potential for cost reduction is huge.

Let's illustrate the power of this change in thinking and practice with a simple process example based on procurement. In this example, all that's required is for the purchasing department to order supplies to ensure that sufficient parts are available to meet current orders. There are three major steps in the process. The first is planning and purchase order processing; the second is quality assurance; and the third is warehousing management (see Figure 2).

	$000s	$000s	$000s	Primary Reason
	Actual	**Budget**	**Variance**	
Purchasing				
Salaries	290	270	-20	Overtime
Expenses	110	100	-10	
Quality Assurance				
Salaries	420	440	20	Fewer inspections
Expenses	170	160	-10	
Warehousing costs				
Salaries	700	660	-40	Disruption caused by fire
Expenses	400	380	-20	Disruption caused by fire
TOTAL COSTS	**2,090**	**2,010**	**-80**	
Number of Purchase Orders	5,000	4,500	-500	Volume of business
Number of inspections	10,000	10,500	500	

Figure 2. Procurement cost statement

You are the manager in charge of this process and you have been called into the CFO's office to discuss this year's results and next year's budget. The CFO starts the meeting by telling you that the company is facing a difficult period ahead and that everyone has to tighten their belts. Not only that, but you have overspent last year's budget by $80,000. He then asks you for your comments. You say that you've struggled to keep costs as low as they are especially when purchase order levels have increased by around 10 percent. You add that it would make life extremely difficult if the budget even remained the same as the actual, never mind if there were any cuts. You also point out that warehousing costs have caused most of the increase because of temporary staff and finally you agree to cut costs in this area. The final outcome is that you accept a new compromise budget of $2,050,000, which is a reduction of $40,000 on last year's actuals.

Now let's replay this meeting but with different information. As the manager in charge, you have been persuaded to prepare a process map (see figure 3).

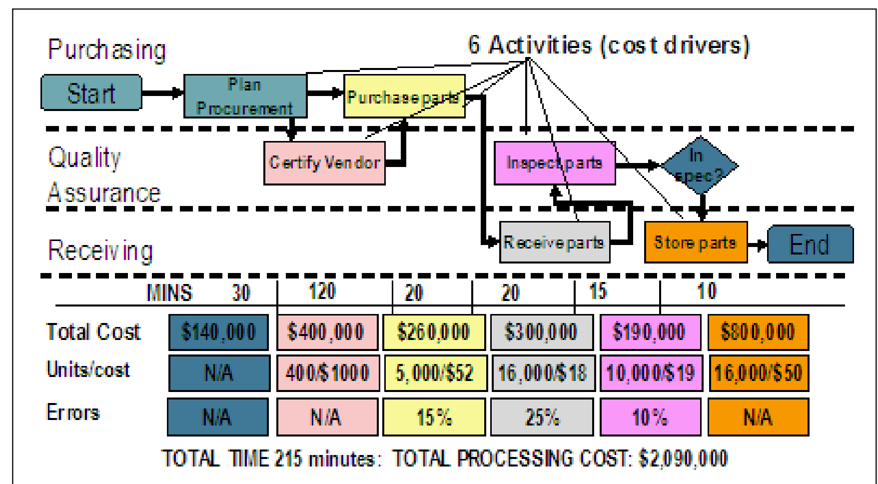

Figure 3. Procurement costs through the lens of a "process map" with cost drivers.

You can now see that there are six activities that drive the costs of the process. You can also see the time each activity takes, the extent of the transaction traffic flowing through the process, the unit cost per transaction and how many errors are being incurred. In other words, you can now see a completely different picture, which prompts a whole new set of questions. For example you want to know:

- Why spend so much on planning when most orders can be delivered within 24 hours?
- Why not pre-certify strategic suppliers?
- Why not agree to block contracts with these suppliers to eliminate issuing purchase orders for their goods?
- How can we find the root causes of purchase order and inspection errors and eliminate them?

- Why not train warehousing staff to handle inspections and abandon the QA department?
- What are the best practices for time and cost and why don't we set benchmark goals based on them?

As a result of all these questions (and the answers), you reassess your cost position. You decide to:

- Cut planning completely.
- Reduce the number of vendors and arrange certification including quality assurance at vendor premises (and if they ship any problem products they take them back immediately at their cost).
- Remove the quality assurance department (placing inspection with the warehouse team that receive the appropriate training).
- Reduce the number of transactions by eliminating the errors and improving the flow.

The overall result is a cost reduction of 33 percent. And, just for a change, the meeting with the CFO will be rather pleasant!

Now also think about this. The first scenario resulted in a "stretch" target reduction of about 2 percent, yet in the second scenario the reduction was over 33 percent. What does this tell you about the value of negotiated budgets? This type of analysis can be done for every process inside your organization. The potential improvements in time, quality and cost are obvious.

Do an inventory of "good" and "bad" cost drivers

Good cost drivers reflect what we should be doing to satisfy customer needs. Bad cost drivers are usually caused either by doing something wrong or something we don't need to do at all (see the list in figure 4). These drivers need eliminating.

GOOD (but reduce)	BAD (and eliminate)
# of Unprofitable products	# of Planning Activities
# of Product parts	# of Vendor certifications
# of Suppliers	# of Purchase Order Errors
# of Purchase orders/lines	# of Supplier Late Deliveries
# of Delivery Notes	# of Inspection Errors
# of Inspections	# of Order Entry Errors
# of Unprofitable customers	# of Customer Claims
# of Sales orders/order lines	# of Refunds
# of Credit Enquiries	# of Customer Complaints
# of Sales invoices	# of Repeat Telephone Calls
# of Customer Enquiries	# of Irrelevant Reports
# of Cheques Processed	# of Data Corrections
# of Expense claims	# of Staff Changes
# of Budget Meetings	# of Unnecessary Meetings
Do you know the volumes and costs of these cost drivers?	

Figure 4. "Good" and "bad" cost drivers

Costs on accounting statements are *results*. They do not show their causes or "drivers." As we noted in the procurement example, most costs are driven by pieces of work such as "issuing a purchase order" or "inspecting a product." It is at this level of knowledge that costs can be understood and managed. We can see the impact of this approach in an example from the banking sector.

A bank closed hundreds of branches and recruited lower-cost resources to fill three call centers (1,000 people each). The savings looked huge. After six months the demand was so great, it opened a fourth. When the CEO asked why another was needed the reply was, "Because customer demand has increased. Customers clearly like it because they keep calling." The CEO called in a consultant who analyzed the calls. There are basically two types of calls: those that relate to order taking or customer support (they add value) and those that drive customers crazy because they need to call several times to get through, get someone to call back, get an order agreed, get someone to turn up, or send something that's been ordered (they add no value).

When the consultant had done his work the "non value calls" were roughly *half of all the call center traffic*. So that's how the bank got to four call centers. The CEO could now see that transaction traffic was fooling them into believing that customers were happy and that the bank was improving efficiency and reducing costs. In fact, the opposite was true.[4]

Even good activities can be cut and costs reduced. For example, can we agree to a block contract with a supplier and deliver products without paper invoices? Can we reduce the number of suppliers we deal with and the number of parts we stock? The fewer activities we do and the fewer transactions we handle, the lower our costs will be.

These examples demonstrate the benefits of creating an inventory of your cost drivers and finding out how many occur in the 'good' and 'bad' cost columns. Then, you can estimate the cost per transaction and find out how this compares with your peers within the firm or best practices elsewhere. You can then track their progress over time.

Build expense forecasts from cost drivers and revenue drivers

As I have noted, so much knowledge is overlooked when companies simply negotiate cost budgets based on last year's numbers. Building expense forecasts from cost and revenue drivers is a far better approach. Higher numbers of satisfied customers (a revenue driver) translates into fewer complaints (a cost driver) and fewer people required in customer support (a financial forecast). Over 50 percent of expenses vary with customer demand. So, you need to find your key revenue drivers before you can determine your key cost drivers and finally translate these drivers into a financial forecast (see figure 5).

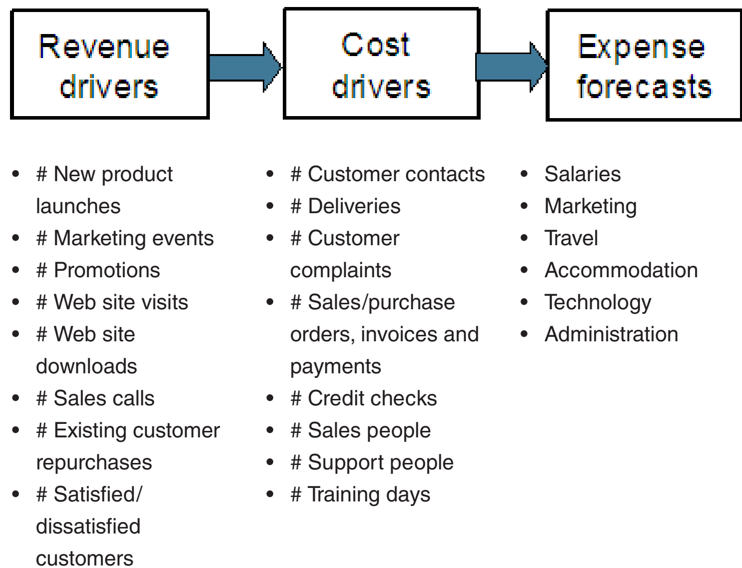

Figure 5. Build expense forecasts from cost drivers and revenue drivers

Allow expenses to 'flex' according to rolling income forecasts

To adjust resources in line with demand continuously, you need to plan and forecast more regularly than once a year. This is usually done quarterly, but in fast changing markets it can be done monthly. Many organizations are moving from annual budgets to rolling forecasts. This is how they work. Let's assume we are just approaching the end of quarter one. The management team gets the rough figures for that quarter and starts to review the next four quarters ahead. Three of those quarters are already in the previous forecast, so they just need updating. A further quarter, however, needs to be added. More time will be spent on the earlier quarters than the later ones, using as much relevant knowledge and business intelligence as can be gathered. Some firms use the four quarters that fit the fiscal year as the annual plan to be approved by the board. There is no need for a separate annual budgeting process. With rolling forecasts, you can "flex" expenses according to the latest view of income and capacity needs. This places managers in far greater control.

Between 10-20 percent of expense budgets are reckoned to be "discretionary," that is not essential to the short-term operation of the business. Examples include some marketing (advertising, campaigns and events), consulting, project spending and capital expenditure. As I noted earlier, if these are allocated to an individual manager's budgets, they are likely to be spent whether sufficient value-adding projects are generated or not. An alternative approach is to hold these spending plans at a higher level and make each team apply for these funds as and when they have worthwhile projects. The higher level team can then continuously monitor spending plans and control the cash flowing in and out of the pool. However, *how* teams access these funds is important.

Let's think about marketing. A significant part of the marketing spend will be for "events" or "actions." If the budget number is fixed then the marketing people will find actions to absorb the budget, whether good or bad. This is how the system worked at a country unit of a global food company with multiple brands. And for years, results were average to poor. But when the country team switched off the annual budget and moved to quarterly rolling plans and forecasts, the company's performance was transformed.

The key change was how they managed the marketing spend. The company no longer allocated a substantial spending plan for marketing to individual brand budgets but instead held it at a country level. Each brand team then had to come up with creative actions and 'bid' for available marketing funds. There was no upper limit to growth and no fixed targets. The best bids won the marketing dollars. While some brands grew beyond even the most optimistic range goals others didn't do so well and questions were directed at the marketing team. When money was tight the discussion was not about how much to cut the marketing budget but how many actions should be funded and how many should be deferred.

How teams access expense pools such as marketing is important. Some organizations enable teams to access these funds in two ways. The first is to enable direct access for amounts under an agreed threshold (for example, $50K). In other words, provided the team follows the access rules, they can draw down the required funds without any external approval. The rules are written into software and include preparing a short business case, providing a risk assessment and doing some form of financial justification, such as ROI. Managers need to know that these controls will be subject to internal audit. For projects over the local decision threshold each team must submit their proposals and these are then considered by a peer group team comprising of all the business heads. These people must take off their local team hats and think about what's best for the whole business

One organization that successfully adopted this approach was Australian utility Sydney Water. In 2000, they cut their budget from $596M (Australian dollars) to $561M – a reduction of $35M. The annual budget was compiled from 1,400 accounts. Like most organizations, it included such budget items as training, consulting and marketing allocated 18 months before anyone knew exactly how this money was going to be spent. Yet, once managers were given these budgets, no one really monitored what happened afterwards. Financial controller Aubrey Joachim's approach was to split the budget into "core" and "discretionary" costs. The latter figure came to around $80 million. If he could persuade management not to spend

some of this discretionary amount, then he could achieve the reduction. So instead of allocating discretionary funds to departmental budgets, they were to be kept in a pool and the business area managers were required to *justify to their peers why they needed extra funds* (although small ticket amounts could be approved locally provided a common process was followed).

The dynamics of these new processes changed behavior. From budgets being a license to spend, now spending was firmly focused on what was best for the business. The savings added up to "tens of millions of dollars" over the three years after the new approach was introduced. And despite the angst, no managers left the organization as a direct consequence of the changes.

The lesson is that, although you need to plan ahead, you must respond to changing demand rather be a slave to the plan. As the chairman of one of the most U.S. successful airlines, Southwest, once said: "We manage reality not a plan."

Give front line teams full profit and loss accountability

Who is perceived to own the resources is critical to how managers think and behave. If they see expenses as belonging to "corporate," they are more likely to spend them whether justified or not. But if they see them as their own, they are likely to be more careful. At Swedish bank Handelsbanken, when branch managers were given decision-making authority over staffing levels and even salaries, senior executives thought that expenses would increase. Instead, the opposite happened. As managers were measured on two key metrics: cost-to-income ratio and profit-per-employee, they wanted to take every action to reduce costs. In the old budget model, they would hang on to staff in a down period knowing it would be hard to get them back when better times came along. In the new model, they act like business owners, always trying to match resources to prevailing demand. The lesson is to give managers more accountability for spending but measure their performance relentlessly against peers and benchmarks.

But giving teams full profit accountability only works if they can clearly understand their cost drivers and spend most of their time improving the business rather than preparing irrelevant reports and attending useless meetings.

Front line teams spend up to 30 percent of their time on budgeting, reporting and administration. This overhead burden reduces the time they can spend on planning and improving business. Cutting the complexity of the chart of accounts and general ledger and reducing the time spent on budgeting goes a long way to removing this burden. As one financial leader put it: "When we did this managers, told us we had given them their time back."

Detail has its place but it should be kept at a local level and not rolled up through detailed cost center budgets and reports. These changes enable a faster month-end close and more time for both Finance and their management colleagues to spend on improving the business.

How many account codes do you have for "travel and entertaining'?" Some organizations have over a hundred! Once again, what's important is understanding the drivers. One approach is to whittle the drivers down to just three: (1) customer-driven travel (2) internally-driven travel and (3) training and development. The aim is to cut any travel that is not clearly required to support paying customers. Simplifying the chart of accounts can drive better behavior and lead to a huge reduction in costs.

One company that has recently done this is Cisco Systems, with dramatic results in a short period of time. In fact, in 2008, Cisco slashed travel expenses from around $750M a year to $350M (that is, from around $7,900 per employee down to a run rate of $3,400). Travel for sales, new business and customer opportunities continued unaffected, but internal travel was redirected to Cisco's various virtual meeting technologies. Employees who select customer or external travel land on a self-booking site and, provided travel is booked within the "lowest available preferred," policy, the booking is okay. Employees who select internal travel are redirected to a booking site for WebEx, TelePresence, audio- or videoconferencing. Cisco found that 49 percent of travel was for internal reasons. Now only a senior vice president can approve internal travel.

Use ratios, benchmarks and transparent numbers to drive the right behavior

At Handelsbanken every region and every branch—and even the whole bank—knows how it is performing against its peers. There are no fixed budgets. Peer pressure is a powerful driver of low costs. But how it's done is important. Structured league tables showing everyone's position accompanied by senior management analysis (who has done well and who has done poorly) is not the way forward. The reason why the system works so well and has lasted for decades is because it is low key. It is the transparency in the system that makes it so powerful. Each team knows who they should be beating and they can draw their own conclusions. There are no league tables or management judgments. However, no manager wants to attend a meet of their peers being a consistent underperformer.

There is, however, a sting in the tail. Branches that consistently fail to improve will find that their team is changed or even find the branch vulnerable to closure.

Conclusion

Too many finance managers fail to realize that management behavior does not operate in a vacuum. It is driven by the way we set budgets, recognize and reward people, control their actions and measure performance. Process drivers and behavioral outcomes are two sides of the same coin.

Executives have failed to understand that, although revenues relate to individual customer orders, costs are related to a host of activities, many of which have nothing to do with customer orders., Therefore, the more activities that people do and the more transactions they handle, the more costs they incur. Management ideas and accounting systems are colliding rather than connecting.

About the author

Jeremy Hope is a cofounder of the Beyond Budgeting Round Table. He has written four books on performance management including "Reinventing the CFO", all published by Harvard Business School Press. He has helped many large organizations to improve their performance management systems and is also a keynote speaker at many conferences on performance management. You can contact him at jeremyhope@bbrt.org or call 44-1274-533012

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Endnotes

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