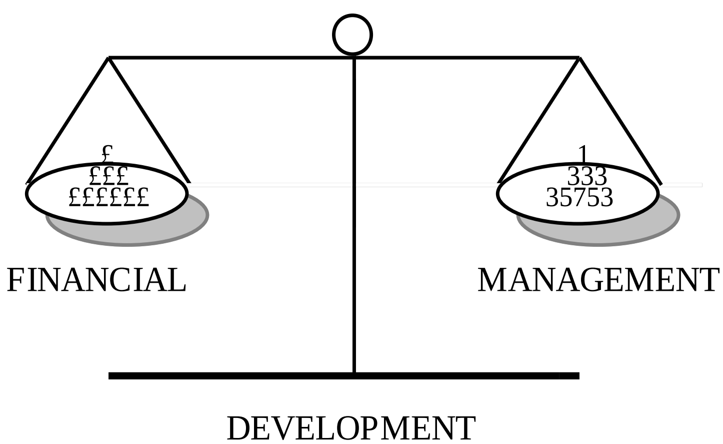
FINANCIAL MANAGEMENT DEVELOPMENT

DISCUSSION TOPICS

NO 806

CENTRAL SERVICE FUNCTIONS - EVOLUTION AND REVOLUTION



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CENTRAL SERVICE FUNCTIONS
EVOLUTION AND REVOLUTION

GROWTH IS VITAL BUT SO IS PRUNING

As organisations grow they accumulate overhead functions. The management of such activities is not an easy task. Objective setting, measurement and control involve subjective as well as objective judgements. Busy executives need coffee, a good Finance Director would estimate the cheapest way of meeting this need is to provide 2 pints of hot coffee per person to be collected from reception by the executives in reusable containers at 9.00 am on their way to their offices. The executives might consider some extra expenditure worthwhile, but how would you justify it financially and how would you measure performance? Similar problems exist with arguably more important functions like Marketing, IT, Personnel and even Finance itself

Even conceptually, it is rarely obvious what the objectives of a central service function are, and in practice the process of creation of service level agreements and the like causes considerable disagreement between "buyer" and seller". In many organisations some service functions have become so difficult to control that management have abdicated responsibility by "outsourcing". This at least has the merit of creating financial parameters against which service provision can be measured. This paper sets out the stages of the evolution of Central Service Functions in order to assist management consider the implications of the next few stages in the cycle. Anticipating the next stage may reduce the cost of change even if the organisational issues remain. Characteristics of each stage are set out below.

1. **<u>Identification of Potential Economies of Scale</u>**

   Whilst many commercial operations are carried out by self employed sole traders, the majority of trading activities are organised in corporate entities which, as they grow, are formed into geographically or functionally separate units linked to some form of Head Office. This arises because certain functions e.g. accounting, require a level of expertise and investment which make it economically sensible to have them centrally located to reduce unit cost and ensure consistency. Dependant upon the organisation the central functions may also include sales, marketing, IT, logistics, purchasing, human resources, research, finance, etc.

2. **<u>Creation of Central Service Function</u>**

   At Head Office direction, or by mutual consent, all the service provision is transferred to a central unit - either based around an existing service provider, or more likely - based at the Central Head Office to avoid favouritism. Initially no charge is made for the service to encourage its use and considerable benefits are predicted from greater expertise and economies of scale etc. In a rapidly growing organisation the resources and people which have been freed up at the regions are easily redeployed.

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3. **Extension of Activities**

The Central Unit gradually expands the range of services it offers, adding new staff and increases its power and status within the organisation. Each new activity is justified on the basis that the resources and expertise are already in place and there will only be a small incremental cost. Thus it would not be cost effective to have one of the operating units work alone or merely buy in the expertise.

4. **Cost Growth**

The Central Unit's costs grow rapidly and other units, particularly the more remote operating units become jealous of its activities. "We have to make (save) money by creating/selling the product while they spend it and are not held accountable". This criticism is frequently made of research, marketing, IT etc. departments and even of the Board of Directors itself!

5. **Allocation of Costs to Operational Units**

In order to stimulate efficiency at the centre and place peer group pressure on the Central Unit Managers the costs are allocated to Operational Units. This has the added advantage of focusing Operational Managers on the need to cover the costs. "You must make a profit after covering Head office allocation". Since there needs to be some degree of fairness costs are allocated on some reasonable basis: marketing costs on sales value, finance on net asset value, personnel on headcount, administration on floorspace etc.

6. **Disputes over Allocation Methodology**

As the Business Units are now being penalised, heated discussions arise on the basis used for allocation "Do corridors counts as floor space? Are temporary staff in headcount? What is the sales value (before or after discounts)?" Operational managers spend considerable time and money to avoid allocations - roping off unused areas of offices, firing staff and re-employing them through agencies, taking arrangement fee income rather than buying and reselling, turning down business that does not cover the allocation etc.

7. **Services Charged For**

In order to avoid the bickering between Senior Managers the organisation decides all services should be charged for. When first introduced this can cause havoc whilst managers indulge in a game of "chicken" over pricing policies. Various charging methods are introduced:

(a) Charged when provided - This leads to endless negotiations based on perceived strengths and weaknesses. There is a tendency to under use internal services at the start of the budget year and then call for them towards the end of the year to "use up the budget". This causes unacceptable peaks and troughs.

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(b) Charged at agreed service levels - This reduces the negotiation time to an annual battle of wills based on estimated use. Problems arise when the expectations of either supply or demand prove unrealistic. There is rarely a penalty clause which has the same impact as the normal breach of contract legal framework between unconnected parties.

(c) Charged at agreed prices - The problems of (a) and (b) are compounded with negotiations taking place at budget time to set the prices <u>and</u> subsequently when the service is required to reflect unusual problems of demand e.g. a call for a volume discount or a one off price.

8. **<u>Disputes over full/marginal pricing</u>**

The service provider will want to show a profit or at least break even. If it has fixed costs it will want to recover these in its prices. This may lead to “interesting problems”. One organisation took the total cost of its pool car fleet and charged its users based on their use divided into the cost on a monthly basis. As a result prices in August (a low use month) rose and those in May (a high use month) fell. The end result was chaos in May when everyone wanted the cheap pool cars, and exorbitant prices in August when it was cheaper to rent externally.

The use of cost data to fix prices, or the imposition of a break-even budget for service departments inevitably leads to inefficiency and arguments over who bears the cost of the idle time.

9. **<u>Transfer prices set by centre</u>**

Eventually the Board steps in and decrees a transfer price - normally pointing out that the issue of price is irrelevant. The same Board will then use profit after internal charges as a motivational tool - and probably fail to see the inconsistency of its approach. The price is normally set to break even at reasonable service levels. Inevitably this leads to cross-subsidisation even if it is only the easy going customer paying a percentage of the cost of dealing with the difficult customer.

10. **<u>Operational Units source from third parties</u>**

The easy or volume customers find they can gain the services at a lower cost from more local external suppliers. Frequently this is because external suppliers can offer marginal prices to use up spare capacity. The central service unit is left with a declining customer demand - usually from the more difficult and costly units.

11. **<u>Idle resources at centre</u>**

The central unit is shows large losses because of low volumes and it is obvious to all that it has spare capacity. Board directives to use the resources are met with a response proving it is cheaper to buy elsewhere. The fact that this is a direct result of the Board’s insistence on prices to cover fully allocated costs is often ignored.

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12. **Central Unit disbanded/dispersed/outsourced**

    To the relief of all concerned, except the Central Service Unit Manager, the unit is broken up and dispersed to the regions. A common approach is to outsource the activity. This is often justified on the basis of concentrating on core business activities and results from an acronymic approach from ABC through BPR, PBB, TQM to ZBB but occasionally adopting ACS (Applied Common Sense). This shows that getting an outside organisation to provide the perfect service in a perfect world with no costs for management or time spent on negotiations, disagreements and procedures will be x% cheaper. It is rare to find the causes of the low cost explicitly specified - not least because the customer might then decide to implement them without recourse to the external supplier.

13. **See 1. above**

    After a decent interval the dispersed units wonder if perhaps there might be some economies of scale in combining certain functions.

THERE IS NO SOLUTION - BUT UNDERSTANDING THE GAME HELPS

The above game is being played in most large organisations. On a National Government scale it has variations based on voucher schemes, local funding, cash limits etc. No simple solution exists but at various stages a few points may be worth considering.

1. The objective is to gain appropriate services at least cost to the organisation as a whole.

2. Time spent discussing transfer prices and the systems to administer them adds to the total cost.

3. The transfer price has no impact on corporate profit, but decisions taken based on it may do so. (Unless there are taxation or customer pricing implications such as cost plus contracts, when there is an obvious approach).

4. There is no rule that says the amount charged to the user has to be the same as the amount credited to the supplier. Thus it is perfectly possible to charge the user on a marginal basis to encourage use whilst crediting the supplier on a full cost basis to encourage full utilisation. Management Accounts do not have to add up on consolidation - the removal of intercompany profit is a common accounting adjustment - internal charges only exist to encourage the right behaviours.

5. Anticipation of the problems likely to arise at each stage and during transition is the key to survival - provided the predictions are acted on. ITYS (I told you so) is a career limiting acronym.

Enjoy the merry go round, but don't expect it to stop even when you jump off!

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

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