Organizational DNA
Reading Materials
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Visit [www.orgdna.com](http://www.orgdna.com) to profile your own organization. The Org DNA Profiler consists of 20 questions and takes five minutes to complete. Profiling results are immediate, and individual responses are confidential. A summary report of aggregate results will be available on the site by mid January, 2004.
Introduction

If every economic era has a theme, then we seem to have entered the Era of Execution. Today, we work in a global business environment where the only constant is discontinuous change...where corporate excesses and bad behavior make daily headlines...where boards and other stakeholders clamor for improved results and greater accountability. A company's success or failure in the marketplace today is often not a matter of strategy; it is a function of execution. And execution is the product of organizational DNA.

In our experience, when companies experience problems in execution, they have only to look to their own organization structure, decision rights, motivators and information flows for answers. These form the substance of an organization's distinct identity and personality—the four “nucleotides” of its DNA, if you will.

Just as these base components join in unique combinations in organic DNA, so they combine and recombine in organizational DNA. The only difference is that organizations, unlike humans, have the ability to change their DNA...to rectify entrenched flaws in structure, decision rights, motivators and information flows to build better performance.

The DNA metaphor and its provocative implications are explored in The Four Bases of Organizational DNA, an article authored by Gary Neilson, Bruce A. Pasternack, and Decio Mendes in the Winter 2003 issue of strategy + business magazine.

As a companion to the s+b article, Booz Allen has developed a web-based self-assessment tool, the Org DNA Profiler™ (www.orgdna.com), which enables individuals to diagnose the “personality profile” of their own firms by answering a few simple questions about their organizational structure, decision rights, motivators and information flows. The Profiler, which takes only five minutes to complete, delivers a real-time evaluation of not only an organization’s personality (Resilient, Just-in-Time, Military, Passive-Aggressive, Fits-and-Starts, Outgrown, Overmanaged), but also its inherent flaws and how they derail effective execution.

Results and key findings from the Org DNA Profiler are featured in the summary research report, Profiles in Organizational DNA: Research & Remedies based on the first 4,000 completed profiles. The data we collected overwhelmingly confirm the hypothesis that most companies today face organizational impediments to effective execution. Whether they fall into the Passive-Aggressive category or the Outgrown, their organizational DNA is thwarting their own best efforts...and ultimate success.

When an organization’s DNA is poorly configured, it exhibits unhealthy symptoms and counterproductive behaviors. The first step in fixing these problems is to identify and isolate them. Then, managers need to focus on the root causes of these organizational disconnects and execution problems and develop sustainable solutions. Booz Allen can help. Our teams of experienced, cross-functional experts help senior management of large companies identify, diagnose and remedy common organizational “roadblocks” to effective execution with an array of services and tools to facilitate one-time change initiatives, as well as longer-term transformation programs. The readings in this volume are the first step. They represent Booz Allen’s best thinking on how to build a productive organization and a lasting capacity for effective execution.

When Everyone Agrees But Nothing Changes. From the CEO on down, senior executives continually lament the amount of time they spend wrestling with organizational problems rather than building their business. This viewpoint explores how to align people, incentives, and knowledge to overcome organizational inertia.

Managing Customization Complexity in Service Organizations. Too many service companies have embraced customization in the name of growth without adapting their operating model to balance the resulting complexity costs. Consequently, companies outgrow their operating model, thereby risking their business resilience. The solution lies in adapting the “DNA” of the organization to identify, isolate, and optimize complexity.

Shining the Light on Shadow Staff. Regardless of the industry, shadow staffs lurk in the corners of most large enterprises. Once brought to light, these positions can add another 30% to 80% to total support staff headcount. To improve operational efficiency over the long run, an organization needs to understand the reason shadow staffs exist. The organization must then eliminate that reason, but not necessarily the position. That is the surest way to eliminate duplicative and wasted effort for good.
**Management Spans & Layers.** If you look closely at the management ranks of many Fortune 500 corporations, all too often you will see the hourglass organization: excessive layers and narrow spans of control, particularly among mid-level directors and managers. The result is often bureaucratic buildup, bottlenecks in decisionmaking, and a general lack of innovation. Organizations like these need to look beyond simple headcount reductions to find more lasting and effective methods for getting in shape.

**Attacking Overhead Costs from Both Sides.** Standout companies are now stepping back and adopting a new and broader perspective on the age-old cost reduction problem, one that encompasses not only traditional supply-side cost restructuring (e.g., business process reengineering (BPR), shared services, ERP, strategic outsourcing), but also demand-side optimization strategies. Approaching the cost reduction challenge from both sides has unlocked major benefits and savings for such companies.

**Optimizing Internal Demand.** As in the past, companies today are looking to internal services first to pare expenses. What is different is the lens they are applying; the perspective has broadened. Instead of relying solely on supply-side tactics to cut costs (e.g., BPR, automation, outsourcing, offshoring), companies are now managing the demand for internal services as well, challenging service providers and business-unit customers to make serious affordability and service-level tradeoffs.

**Driving Demand Management for Internal Services.** The search for step-change cost reduction sets up a natural contest between line and service organizations. Business units complain that they bear the brunt of the belt-tightening and point to support services as a drain on their resources. Support functions point to benchmark studies that show they are performing at best-in-class levels and have already squeezed out potential cost savings. Can they both be right? In a word, yes.

**The New CFO Agenda.** According to a benchmark survey conducted by Booz Allen Hamilton, best-in-class companies are increasingly recognizing corporate officers’ roles in setting strategic direction, allocating resources, and serving as an “early warning system.” Particularly visible is the chief financial officer (CFO). More than a control agent or scorekeeper, the CFO has become an internal investment banker and the custodian of value-based performance management.

**The View from the Top.** Historically, many firms have relied on culture to manage the executive dialogue. As companies globalize, expand through acquisition, and diversify their operations, however, their ability to rely on tradition and shared experience diminishes. In the absence of “culture,” companies need to put in place more formal and engineered management systems, processes, and roles to keep diverse operations running smoothly and on the right path.

**A New Take on Business Process Redesign.** Product-focused organizations are becoming more customer-centric and learning that their current processes cannot deliver on new market requirements. Thus, once again, companies are reevaluating and redesigning their business processes—customer- and non-customer-facing—in search of increased customer value, and internal efficiency. This new round of BPR (1) differentiates processes based on customer profitability and cost to serve; (2) occurs within the context of an overall organizational change; and (3) is built on sustainable behavior change.

**Business Process Outsourcing & Offshoring.** Having exploited most of the first-generation cost savings available through outsourcing, leading companies are now focusing on business model transformation. They are looking beyond IT and general and administrative (G&A) services and outsourcing processes closer to the core, including line operations, often using offshore resources. Moreover, many are exploring ways to commercialize their own world-class internal services through spin-offs and joint ventures.
Trait by trait, companies can evolve their own execution cultures.

The Four Bases of Organizational DNA
by Gary Neilson, Bruce A. Pasternack, and Decio Mendes

Every economic era has a theme. The 1960s are still recalled as the “Go-Go” years, when Wall Street was fueling mergers and conglomerations of unprecedented scale. The 1990s were the “Internet Boom” years, when a rising economic tide lifted the boat of just about any company with a plausible business model tale to tell. The agonizingly slow recovery since the Internet bubble burst has inspired the latest motif. Executives no longer believe that a strategy — consolidation, transformation, or breakaway — is enough. “We’ve made the right strategic decision, but my organization isn’t motivated or set up right to get on with it,” they are saying. “Everyone says they understand the vision, but the businesses and functions just aren’t working together to get results.”

Welcome to the Era of Execution.

Execution has become the new mantra for this first decade of the new millennium. Larry Bossidy, who led AlliedSignal Inc.’s turnaround and its merger with Honeywell International Inc., wrote a book with Ram Charan, titled Execution: The Discipline of Getting Things Done (Crown Business, 2002), that’s been on the business bestseller lists for more than a year. Former IBM CEO Louis V. Gerstner Jr. put forth the same message in his memoir, Who Says Elephants Can’t Dance? Inside IBM’s Historic Turnaround (HarperBusiness, 2002). In it, he says flatly that the revival of the computer giant wasn’t due to vision. “Fixing IBM,” he wrote, “was all about execution.”

Boards of directors, increasingly impatient with CEOs who don’t deliver, have climbed on the execution bandwagon too. Booz Allen Hamilton’s annual study of
CEO succession trends showed that forced turnover of underperforming CEOs at major corporations reached a new high in 2002, rising a staggering 70 percent from 2001 and accounting for 39 percent of all chief executive transitions.

But is execution simply a matter of firing the CEO and bringing in a charismatic leader who can get on with “getting things done”? Not at all. Underlying the quest for an execution-driven enterprise is one central question: How does a company design its organization to execute the strategy — whatever the strategy is — and successfully adapt when circumstances change?

Execution is woven deeply into the warp and woof of organizations. It is embedded in the management processes, relationships, measurements, incentives, and beliefs that collectively define the “rules of the game” for each company. Although we often think of companies as monolithic entities, they’re not. They’re collections of individuals who typically act in their own self-interest. Superior and consistent corporate execution occurs only when the actions of individuals within it are aligned with one another, and with the overall strategic interests and values of the company. Performance is the sum total of the tens of thousands of actions and decisions that, at large companies, thousands of people, at every level, make every day.

Because individual behaviors determine an organization’s success over time, the first step in resolving dysfunctions is to understand how the traits of an organization influence each individual’s behavior and affect his or her performance. We like to use the familiar metaphor of DNA to attempt to codify the idiosyncratic characteristics of a company. Just as the double-stranded DNA molecule is held together by bonds between base pairs of four nucleotides, whose sequence spells out the exact instructions required to create a unique organism, we describe the DNA of a living organization as having four bases that, combined in myriad ways, define an organization’s unique traits. These bases are:

**Structure.** What does the organizational hierarchy look like? How are the lines and boxes in the organization chart connected? How many layers are in the hierarchy, and how many direct reports does each layer have?

**Decision Rights.** Who decides what? How many people are involved in a decision process? Where does one person’s decision-making authority end and another’s begin?

**Motivators.** What objectives, incentives, and career alternatives do people have? How are people rewarded, financially and nonfinancially, for what they achieve?
What are they encouraged to care about, by whatever means, explicit or implicit?

Information. What metrics are used to measure performance? How are activities coordinated, and how is knowledge transferred? How are expectations and progress communicated? Who knows what? Who needs to know what? How is information transferred from the people who have it to the people who require it?

Any metaphor can be pushed too far, of course. Although the basic comparison of corporate and human DNA is often invoked in general discussions of institutional culture and conduct, we think it provides a practical framework senior executives can use to diagnose problems, discover hidden strengths, and modify company behavior. With a framework that examines all aspects of a company’s architecture, resources, and relationships, it is much easier to see what is working and what isn’t deep inside a highly complex organization, to understand how it got that way, and to determine how to change it. (See “Focus: Testing Quest Diagnostics’ DNA,” page 5.)

Structure
In principle, companies make structural choices to support a strategy (for example, the decision to organize business units around customers, products, or geography). In practice, however, a company’s organizational structure and strategic intent often are mismatched. The variance can usually be exposed by, in effect, superimposing the organization chart — an efficient communicator of power and status in a firm — over a business unit’s strategic plan.

A common structural problem impeding the execution of strategy is the existence of too many management tiers (deep layers), with too many individuals at each tier having too few direct reports (narrow spans). Portrayed graphically, this structure resembles an hourglass. (See Exhibit 1.) Narrower spans in the middle often result from unclear decision rights and the company’s mix of motivators. Generally, a structure shaped this way indicates trouble.

There are many reasons a certain management position may legitimately call for a narrower or wider span than another position’s. Managers in complex jobs that require them to create and maintain multiple information linkages across individual units cannot handle the same number of direct reports as managers with simpler information aggregation roles. But it’s also easy for spans to become too narrow for no legitimate reason.

Consider the spans of control for three senior positions at one consumer goods company with which we have worked. As shown in Exhibit 2, the category/product line manager had five direct reports, compared with seven and 10 reports for senior managers at two best-practice companies. The vice president of sales had six direct reports, versus eight and 10 at the other companies. The manufacturing manager had only seven direct reports; in other companies, similar managers had 11 or more. We have taken this measurement at more than 100 companies, and our data indicates that this company fell well outside the range found at comparable firms.

In our experience, numbers this far off the norm provide strong evidence that a company’s spans are

Exhibit 2: Comparing Spans of Control

<table>
<thead>
<tr>
<th>Category/Product Line Manager</th>
<th>Vice President, Sales</th>
<th>Manufacturing Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 7 5</td>
<td>10 8 6</td>
<td>23 12 11 7</td>
</tr>
</tbody>
</table>

Best-Practice Company Consumer Goods Company

Source: Booz Allen Hamilton
DNA testing can be as valuable to corporate health as it has become to human health care. An analysis of a company’s “genetic material” can isolate the underlying causes of and potential solutions to organizational dysfunctions, and even head off problems before they start. Immediately after the spin-off, Mr. Freeman and his top management team took control of key decision rights to ensure that the company’s turnaround effort was coherent and driven hard. When the company acquired SmithKline Beecham Clinical Labs in August 1999, they again deliberately centralized decision rights among a small senior team. A set of integration teams headed by the leaders of both companies methodically worked through the long-term vision and short-term tactics for each area of the new company, again, to ensure consistency across the enterprise. The financial payoff was immediate: Prior to the deal, revenues had typically declined upward of 20 percent following a major acquisition. In this case, Quest Diagnostics not only didn’t lose business, revenues grew at or above industry growth rates during the integration process. This was the first time such postmerger growth occurred in the industry. As Quest Diagnostics’ turnaround progressed, decision rights were decentralized gradually, first by placing supervisors into various units who led change and taught employees new behaviors, and then by empowering frontline staff. Although many parts of the Quest Diagnostics organization are now high performers and largely self-directed, it has taken seven years to get there.

Today when Quest Diagnostics acquires a company, Mr. Freeman and his team concentrate on two of the four organizational bases, motivators and information, recognizing their interdependency and combined influence on individual and organizational behavior. Among the first “gene therapies” they perform is to introduce a comprehensive and varied set of metrics that go well beyond the typical narrower than they should be. Often this results in a structure that has too many layers as well. This became evident when we explored how senior managers at the consumer goods company spent their time. About a third of it was devoted to making plans, ensuring target corporate goals were met, and dealing with exceptions and high-impact/high-risk decisions, all appropriate roles for these managers. But they were spending far too much time (roughly 40 percent) justifying and reporting performance to senior executives above them and participating in tactical, operational decisions with their direct reports. In other words, too much of their time was devoted to second-guessing the work of people below them and preparing reports so that superiors could second-guess their work. They should have been giving more of their time to preparing action plans to achieve the strategic and operational objectives of the company.

This structure kept the consumer goods organization from executing to its potential. Among specific dysfunctions we found:

• Because there were no clear standards that allowed basic decisions to be made at lower levels, decisions regarding such matters as authorization for PC purchases and travel were decided too high in the organization.

• Managers and supervisors tended to discourage their staffs from troubleshooting to resolve routine problems on their own.

• Managers rotated rapidly through jobs, reaching senior positions without sufficient experience. Not only did they require close supervision, but they continually struggled to figure out what they needed to know.

• The company seemed to rapidly promote its best and brightest just so it could retain them. This added unnecessary layers to the hierarchy and created more work at lower levels.
financial performance measures that most companies use. There are measures for customer retention, the time it takes to pick up a call in the call center, the time it takes to process a specimen in the labs, employee satisfaction and attrition rates, and more. The system is designed so that all employees know how they can personally influence one or more core performance measures.

The only way this information can influence the day-to-day behavior and decisions of employees throughout the organization is if decision makers have the information on hand when they need it. Quest Diagnostics posts various metrics on different time-tables depending on the type of management issue: Customer retention metrics are posted at least once a month; specimen turnaround time is posted every morning. Finally, the company ties these metrics to individuals’ bonus payments so that information not only informs, but also motivates productive behavior. Since virtually everyone in the company can affect customer retention in some way, Quest Diagnostics uses the customer retention metric very broadly in its performance-based compensation programs. Ultimately, the bonuses of all 37,000 Quest Diagnostics employees depend in some way on meeting the customer retention target.

“If we have a shared goal that says we’re going to reduce customer attrition, that doesn’t mean it is only for people in sales. It impacts people picking up the specimens, people who draw and perform tests on the specimens, and certainly people in billing. If there are lots of complaints, the customer is going to leave. By having shared goals, you get speed and alignment,” says Mr. Freeman. To make the motivators as specific and powerful as possible, customer retention metrics are measured not just organization-wide. They are divided up by region, so that people are paid on the basis of customer retention performance in their own region, where they can have the greatest influence.

The aligning and motivating power of bringing information and incentives together is reflected in the firm’s strong financial performance. Since Quest Diagnostics was spun off from Corning in 1997, the company’s stock price has increased 730 percent, compared with a 41 percent increase in the S&P 500 Index during the same period. Having successfully carried out a classic turnaround and taken the lead in consolidating the industry, Quest Diagnostics is now driving growth organically and has become the clear leader in the U.S. medical laboratory testing market. Last year, the company earned $322 million on $4.1 billion in revenues.

— G.N., B.A.P., and D.M.

• Large cross-departmental meetings filled the workday. The rationale was to have all parties “in one room to resolve the issues.”

All of this activity is costly — these are managers with salaries in the low six figures. Their compensation, plus the actual cost of their activities, pushed the company’s general and administrative costs to a level that was 20 percent higher than the average of our benchmark companies. Because each of its many layers got involved in almost every decision, the company’s speed to market was slowing, and it was losing share to new, more nimble competitors in several categories.

The obvious structural change was to reduce layers and increase spans — that is, to add direct reports to each manager. We recommended a new structure that resulted in a reduction of 10 percent of the positions in the management ranks across all six divisions. Ultimately, with the elimination and repositioning of managers and support staff, about 2,300 management jobs were cut, which saved the company more than $250 million.

Still, simply cutting layers and extending spans would have had little long-term effect if underlying behaviors didn’t change. One way the company could do this was by setting clear standards (e.g., which PC to buy and which airline to fly) so high-level managers would not need to review every transaction and provide approvals. With a monthly report, they could easily track exceptions to the standards. Another solution: Reset promotion expectations to slow the upward movement of managers and encourage more horizontal moves — use promotions not just as a reward, but to develop a manager’s breadth of experience. Long and cumbersome reporting processes designed to satisfy the information preferences of each layer and the tremendous desire for detail also had to go. In their place would
Executives promoted to new positions often cling to their prior responsibilities, burdening themselves with unnecessary tasks and disempowering their subordinates.

be a report on the key lagging and leading measures of critical business activity, a top-down setting of targets, and the monitoring of variances. To further dissolve the reflexive addition of layers, the company also had to do more managerial training and communicate better about the change in promotion principles. Following the restructuring and changes in management, time to market for product introductions shrank by months, enabling the company to regain the first-to-market advantage it had traditionally held.

Decision Rights
Decision rights specify who has the authority to make which decisions. Clarifying these rights puts flesh on an organization chart and makes crystal clear where responsibility lies.

Clear decision rights enable wider spans and fewer layers, which translates into lower costs and speedier execution. Unarticulated decision rights are more than a time sink; they’re a central cause of substandard performance — and even of nonperformance. An employee at a financial-services company expressed this problem quite concretely in a focus group we conducted, saying, “Responsibilities are blurred intentionally around here so everyone has an excuse for not getting involved.”

At one industrial company, we found yet again that senior executives were spending too much time reviewing small projects. It turned out the company had not reassessed managers’ spending-approval limits in more than 10 years. We suggested the authorization process be adjusted so that managers lower in the organization could be accountable for the final approval of more projects. The capital expenditure amount requiring CEO authorization was raised from $5 million to $15 million. The objective was to free up senior management’s time to focus on the longer-term issues associated with market growth and potential acquisitions. Based on historical analysis, it was determined that raising the level at which projects required CEO authorization to $15 million would reduce the number of projects crossing the CEO’s desk by 49 percent. All large projects would still come to the CEO, so the aggregate value of projects approved at the top would decline by only 13 percent.

Decision rights become blurred for many reasons, not all of them intentional. After a large industrial company completed a leveraged buyout, the management of one of its business units became the new entity’s corporate management, charged with reviewing the operating decisions of all business units. That change required every level of management to take on greater decision-making responsibility — an unnatural act for executives accustomed to hands-on involvement in operating unit decisions. Rather than allow their general managers to make basic decisions about product design and resource allocation, the CEO and COO still involved themselves deeply in these activities. Meanwhile, they were neglecting other areas where their attention was expected, notably strategic planning, long-range business portfolio decisions, and the firm’s financial condition.

The solution was to create a process for corporate officers to delegate decisions to the business unit’s general managers. An executive committee was established to review business unit decisions, and several general managers were charged with integrating marketing, product engineering, and manufacturing. These structures and processes made effective delegation possible.

It doesn’t take a leveraged buyout to distort a company’s decision-rights structure. People naturally lean
toward the familiar when faced with change. Executives promoted to new positions often cling to their prior responsibilities, burdening themselves with unnecessary tasks and disempowering their subordinates. The press of the urgent at the business unit level drives out the important at the corporate level. The lesser decisions seem concrete and knowable. Forward thinking and big decisions regarding long-term direction seem undefined, amorphous, and tougher to tackle.

Often the process of assigning decision rights is a response to a crisis or a shift in political power. When this happens, decisions can fall between the cracks. Or they can be made twice by different parties. Or they can be reviewed repeatedly, becoming a Sisyphean exercise in backsliding.

It is possible to assign decision rights systematically and rationally. At a global industrial company, we helped create an organizational matrix of functions, products, and geographies. The structure was underpinned by a set of specific organizational and decision-making principles, among them: responsibility does not imply exclusive authority; different units should have joint goals and performance measures; and certain positions need to report upward to multiple managers.

Over several months, we worked with the company to apply these and several other principles to more than 300 critical decisions. Because we undertook this effort explicitly while also changing the structure, the company was able to execute its new strategy faster, and with fewer missteps. The overall change process took two years (one less than had been anticipated). The company returned to profitability, reduced its net debt by the targeted amount, and reached several other critical financial goals a year ahead of schedule.

Making decision rights explicit in companies in which they are not requires management to set rules for the most common business situations — and for each position. In effect, the company is creating a constitution that says who will decide what and under what circumstances.

The decision rights of groups must also be clear. At a consumer goods company, we saw large numbers of executives meeting frequently to resolve conflicts among functional units. It appeared that operations, finance, and marketing were each doing an excellent job of analyzing new factories, new products, and new business opportunities, but they weren’t talking to one another along the way. Operations planned the perfect factory — without guidance from finance on the cost. In marathon meetings, managers from each function brought their independent analyses together. Then they struggled to reach a joint conclusion, because each unit, by that time, was wedded to its own recommendation.

To solve this silo problem, one top executive was made responsible for managing a cross-functional team, so there would always be communication across disciplines. As a result, only a few top executives were needed to make routine decisions, and the company reduced dedicated staff support for these efforts by more than 30 percent.

Motivators
The third of the four bases in a company’s DNA-like makeup involves motivation. Employees generally don’t deliberately act counterproductively; they don’t try to derail a company’s strategy. Rather, they respond quite rationally on the basis of what they see, what they understand, and how they’re rewarded. An exhortation to follow the vision and pursue the strategy is only so much air if the organization’s incentives and information flows make it difficult for employees to understand and do what they’re supposed to do.

An organization can send confusing signals to individuals in many ways. Think about what happens when an appraisal system inflates performance ratings. At a consumer goods company we once worked with, employees were appraised on a 1 to 10 scale. Eighty percent received a rating of 9 or above, and everyone felt good. But superior employees didn’t feel they needed to do any better. Other workers thought their performance was acceptable when it wasn’t. Appraisers were avoiding the unpleasant task of delivering bad performance ratings, and the organization wasn’t giving them any reason to be tough. For every deficient employee who stayed at the company because the organization said he or she was competent, the company’s execution suffered. Because of its unwillingness to differentiate people’s contributions through performance assessments and raises, the company lost the opportunity to send important feedback to employees on what was relevant to executing the strategy — and where their performance was unsatisfactory.

Several years ago we worked with the new CEO of a technology company who had been the head of a business unit and had served for several years on the executive committee that made investment decisions. The new CEO knew from experience that the committee wasn’t tough enough on new investment requests. They were a collegial group; members supported their col-


leagues’ investment requests with the understanding their own requests would be supported in return.

The new CEO wanted a more discriminating process that would judge investment proposals on their merits. He also knew executive committee members faced little downside from approving unsound investment requests. Future bonuses might suffer if company performance wasn’t good, but that money wasn’t already in their pockets.

So the CEO introduced a new system to change this attitude: Each committee member was required to take out a personal loan of $1 million and invest it in company stock (the loan was guaranteed by the company, so the individuals could borrow at good rates). Unlike an outright stock grant, this scheme ensured that the executives had existing wealth at risk, and that they would lose money, and perhaps the ability to repay the debt, if they permitted poor investment decisions. With this new incentive to scrutinize investment requests, the committee became much tougher and more effective. And after a few sessions, teams began bringing better-researched and smarter investment proposals to the table because they knew if they didn’t, the committee was likely to turn them down.

There are other market mechanisms that can be used to send more accurate signals to managers about the cost and value of certain activities. This approach was used successfully at a large agribusiness company that came to us for help in improving the services of its human resources department. The HR department’s performance had always been judged by how well it stayed on budget. Internal customer satisfaction was rarely measured. Each customer was allocated a share of the HR budget, but these figures didn’t represent the true cost of the services. Meanwhile, customers had little influence on the kind and amount of services they received. Neither HR nor its customers had an incentive to offer or ask for services tailored to the specific needs of a division.

Working with the company, we created a scorecard to measure HR performance on such things as call center response time and payroll errors. Achieving scorecard targets became a significant component of management incentives and rewards. HR’s internal customers were given the right to negotiate service level agreements with HR. The true cost of services was established using outside benchmarks. Once HR’s customers understood what they were paying for and could better manage their costs, they had an incentive to use HR services more wisely. Today, they often decline or reduce some services and request new ones. The market-based measurement and incentive program improved the quality of the company’s HR services and reduced costs by more than 15 percent.

Organizations that are ready to implement multiple profit-and-loss statements and market-based motivational systems will find that these powerful new tools can help them operate effectively with less command-and-control oversight. But not all companies are ready for these systems; it takes strong leadership, persistence, and patience to introduce them and overcome employee resistance to using them.

Information

Underlying a company’s ability to ensure clear decision rights and to measure and motivate people to apply them is one critical matter: information.

Making sure high-quality information is available and flowing where it needs to go throughout a company, all the time, is among the most challenging tasks of the modern corporation, and one of the most under-appreciated contributors to high performance and competitive advantage. A 2002 study of the management and financial performance of 113 Fortune 1000 companies over the five-year period 1996 to 2000, conducted by Booz Allen Hamilton and Ranjay Gulati of the Kellogg School of Management at Northwestern University, found that the companies with the highest shareholder returns were more focused on managing and enhancing communication with their customers, suppliers, and employees than other firms in the study.

We have seen this information–performance linkage often in practice. A few years ago, the board of an agricultural grower and processor became concerned about the company’s operating efficiency. Among other problems, farm managers were using equipment without discipline — ordering a machine at will, driving it hard, and returning it with an empty gas tank, all because headquarters was responsible for maintenance and replacement costs. Our benchmark data indicated that this company’s expenses were far higher than those of independent farms. We worked with corporate and farm management to develop a new business model, centered on turning each farm into an independent business. For this to happen, farm managers needed new information — specifically, individual farm P&Ls that reflected, among many other things, the cost of the equipment they used. The redesigned organization exe-
cuted more efficiently, as reflected in a 48 percent jump in its imputed share price in the first year.

Better information flows did more than keep costs down; they helped allocate scarce resources far more efficiently than before. The company had a silo problem — literally and figuratively. Any field ready for harvest had a peak yield window of about 15 days. But there was only so much mill capacity during the peak window. Coordinating and timing the harvesting and milling activities fell to a hapless employee at headquarters, a central planner who relied on historical data that didn’t reveal much about current conditions.

We showed in a simulation that if farm managers could bid for use of the mill on particular dates, it would strikingly improve the company’s efficiency. If a manager saw that his highest-yielding acreage was ready to harvest and couldn’t wait because rain was predicted, he could bid more for mill time. No longer would someone back at headquarters have to hunker down with a spreadsheet, making educated guesses based on the previous year’s yield data and taking frantic phone calls from farm managers. Market-based pricing of mill time would allocate scarce resources better than a central planner could. And with this new system, decisions would reflect the real-time knowledge of the farmer in the field observing the sky, testing the ripeness of the crop, hour by hour, acre by acre.

Adaptive DNA

Although we have illustrated the four bases of organizational DNA separately to emphasize their distinct characteristics, they clearly are intertwined. Changing structure requires changing decision rights; to make effective decisions, employees need new incentives and different information. At the agricultural grower and processor, the new structure touched each of these elements — the individual farm as a business required new decision authority for farm managers, new metrics by which to measure their performance, and new rewards based on their individual success. This interdependency is evident in all of these company stories.

Considering — and changing — a company’s DNA holistically means weaving intelligence, decision-making capabilities, and a collective focus on common goals widely and deeply into the fabric of the organization so that each person and unit is working smartly — and working together. It’s one thing to achieve well-coordinated intelligence among senior executives. It’s another thing entirely to touch every level of an organi-

zation all the way down to the loading dock. What every employee does every day, aggregated across the company, constitutes performance.

The best organizational designs are adaptive, are self-correcting, and become more robust over time. But creating such an organization doesn’t happen quickly; it can take several years to get the basics right, and there is always a need for fine-tuning. This may explain why leaders of companies that are truly ailing — and who need to reassure shareholders as fast as they can — often don’t have the patience for changing decision rights, motivators, and information flows. They’re more likely to cut the structure and see what happens than to take time to ensure that structural changes actually result in sustained productivity improvements and steady gains in shareholder value. But neglecting this hard work may also partly explain why some of these CEOs are no longer in charge.

No company may ever totally master the enigma of execution. But the most resilient and consistently successful ones have discovered that the devil is in the details of organization. For them, organizing to execute has truly become a competitive edge. +

Resources


Senior executives continually lament the amount of time they spend wrestling with organizational problems rather than building their business. From the CEO on down, business leaders routinely express variations on the same fundamental themes — “We have the right strategy and a clear action plan, but we can’t seem to execute,” “Our industry is undergoing tremendous upheaval, but our people either don’t recognize it or won’t do anything about it,” “The merger is supposed to be behind us, yet even Wall Street recognizes that we’re still acting like separate organizations” — in essence, “Why is it that everyone agrees, but nothing changes?” Addressing these concerns — or rather the critical organizational constraints that underlie them — is often the key to unlocking superior financial performance.

Of course, this is easier said than done. To resolve persistent organizational problems, executives must first understand where critical breakdowns are occurring and why. They must then determine what changes to the existing operating model are necessary to create the conditions for optimal performance. In designing these changes, they must be mindful of the ripple effects that can cascade across an organization once one element of its architecture is altered. In sum, executives need to determine how to effect deliberate and major change ... and how to drive and support that change across the enterprise.

Universal Problems
Anyone who has worked in an organization, whether in the public or private sector, has seen firsthand the counterproductive behaviors that impede performance. We have all sat in meetings where someone advances his or her own agenda over that of the firm. We’ve collectively suffered when decision-makers — overburdened or lacking access to the right information — inject delay or inefficiency into programs and processes. Everyone has experienced the struggle to get different organizational units or functions to work together toward a maddeningly elusive common goal. Individually, these behaviors are irksome; collectively, they can spell the difference between spectacular success and abject failure. Yet few organizations have discovered the right formula to fix these common problems. Most of us, sadly, are still living inside a Dilbert cartoon.

Despite the wealth of material touting teams and teamwork, our experience, as well as modern economic principles of agency and information asymmetry, suggests that most organizations are collections of individuals who act in their own self-interest. These individuals each make decisions that are limited by their ability to process the information available to them, and they rely on others to act on their behalf or in coordination with their efforts. The challenge in motivating superior organizational performance, then, is to align individual actions with the actions of others and the interests of the firm as a whole. This challenge increases as companies grow, partially offsetting advantages such as economies of scale and knowledge specialization. Growth, while a laudable goal, increases complexity, making coordination and alignment of interests more difficult and giving rise to many of the problems firms experience today.

Custom Solutions
Our experience with clients around the world confirms that organizations win when the right people — armed
with the right information and motivated by the right incentives — possess clear authority to make critical decisions. This view — captured in Exhibit 1 — suggests that organizations need to align themselves around three critical dimensions: People, Knowledge, and Incentives.

How organizations go about achieving this alignment will vary from company to company. There is no right answer or universal prescription. The same company could design any number of successful operating models and achieve similar results as long as these three dimensions — People, Knowledge, and Incentives — are in alignment.

If any of the three dimensions falls out of kilter, however, a company will not achieve its full potential. Moreover, it is the interaction among these dimensions that defines the trade-offs among different organizational models.

Dimension 1: People: Who Decides What
"We have to assemble ten executives in a room to make routine business decisions."

As noted, organizations are essentially Hobbesian cultures: communities of individuals and groups that act, more or less, in their own self-interest. Therefore, if you want to change the operating model, you must first understand how authority is distributed among organizational units and roles. This investigation takes you quickly past the lines and boxes of the organization chart into the underlying mechanics of how and where decisions are truly made (see Exhibit 2).

As organizations strive to clarify and refine the assignment of authority and roles, they must actively consider and address potential trade-offs. For example, the complexity of the information processing required in a single position may dictate decentralizing authority in that arena. Organizational units may have to be combined in order to reduce interdivisional transaction and coordination costs. Myriad such issues attend the assignment of not only decision-making authority in an organization, but also the distribution of relevant information.

Dimension 2: Knowledge: What They Need to Know
"We never have the data we need to make key corporate decisions."

Information is the lifeblood of the large modern corporation. Almost every manager has been in a situation where, despite having the best intentions and explicit incentives, she simply did not have the right information to make an effective decision. The key to success is to identify the critical information required to make the correct decisions and to ensure that this information is in the decision-maker’s hands if and when she needs it.

Dimension 3: Incentives: What’s in It for Them
"We changed strategy, but no one seems to behave any differently."

A successful operating model must ensure that reward and incentive systems provide decision-makers with clear direction and compelling reasons to act in the firm’s best interest. An organization's seniormost executives must assess not only how to allocate decision authority but also how to motivate the right executives to act in the firm’s best interest. An organization's seniormost executives must assess not only how to allocate decision authority but also how to motivate the right executives to act in the firm’s best interest.
Moreover, incentives should be carefully crafted at all levels in the organization. At the line employee level, where decision authority is limited to (a) how hard to work and (b) how to manage the trade-off between quality and quantity of output, an optimal incentive program might be a variable pay structure based on quantity of output and number of defects. A division manager with much broader decision authority, on the other hand, might require a broader array of incentives, reflecting both divisional and firm performance: stock options, fast-track promotions, enhanced CEO exposure, etc.

Success Stories

We have helped many global clients align their organizations more effectively around these three critical dimensions. Recent examples include:

Case Study 1: U.S. Agribusiness Company

Using these organization principles, a U.S. agribusiness firm developed a new operating model to respond to pricing pressures from low-cost overseas producers. The key transformation in this company’s operating model was to convert individual farms from cost centers into profit centers and redefine how corporate headquarters would support them.

All three dimensions of the alignment framework came into play. In an effort to co-locate knowledge and decision-making authority, the firm decided to delegate to the farm profit centers “local” decisions regarding planting and irrigation. Authority over harvesting schedules remained centralized, however, to promote more efficient utilization of harvesting equipment, mills, and grain elevators. A new bonus system motivated farm managers to optimize production across a range of price levels. New decision-support systems provided farm managers the information they needed to make the best use of their authority. Shareholder value climbed 48 percent once this new operating model was introduced.

Case Study 2: Global Consumer Products Company

The dominant player in multiple mature product markets, an international consumer products company was looking for next-generation profit improvement opportunities. Working with Booz Allen, it developed a new operating model that not only significantly reduced overhead but also positioned its businesses to outperform the competition well into the future. This model pushed decision-making power outward and utilized detailed coordination mechanisms and common metrics to improve the cooperation and alignment among functional business leaders. It also redirected the agenda of top management, emphasizing vision-setting and leadership over detailed micromanagement.

Our Approach

Booz Allen has developed a two-stage approach to developing new operating models that can achieve significant and sustainable performance improvement.

Stage 1: Conduct Organization Diagnostic

We begin with a four- to six-week assessment of the current organization. Three steps are typically involved:

Understand Strategy

Developing a solid understanding of short- and long-term strategy ensures that the new operating model will be consistent with the current and future aspirations.
of the company. Many performance problems stem from fundamental disconnects between strategy and organization model.

Identify Problems in Current Organization
The heart of the organization diagnostic effort is the application of proven diagnostic tools to identify problems and opportunities in the organization. This analysis addresses all three dimensions of organizational alignment.

Assess Degree of Change Required
Based on the diagnostic, senior management determines how much change is required. Sometimes only minor tweaks are needed, such as clarifying roles or implementing basic cross-functional coordination mechanisms. Other times, the entire organizational model needs to be overhauled.

Stage 2: Develop New Operating Model
The scope of Stage 2 depends primarily on the magnitude of change required and specific change initiatives involved. The new operating model must address much more than just organization structure (see Exhibit 2, page 3).

While relatively minor changes usually can be designed and implemented over a several-week period, more significant changes generally require a major transformation with sustained support over a longer term.

What Booz Allen Brings
Booz Allen Hamilton helps clients across industries implement new operating models designed to improve their organization performance.

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 80 years. Booz Allen combines strategy with technology and insight with action, working with clients to deliver results today that endure tomorrow. With 11,000 employees on six continents, the firm generates annual sales of $2 billion.

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Managing Customization Complexity in Service Companies

...Through an Enabling Organization

The conundrum of growth for today’s service companies is that it comes at great cost, the cost of complexity. In fact, the cost of complexity often overwhelms the economies of greater scale. As companies become smarter about customizing their offerings (via increased customer intimacy, differentiated service bundles, and new channels and outlets), they necessarily incur associated complexity costs. The problem is, the cost of complexity often exceeds the value of variety, eroding profitability. Too many companies have embraced customization in the name of growth without adapting their operating model to balance the necessary cost tensions that result. In essence, companies have outgrown their operating model, thereby risking their business resilience. The solution lies in adapting the “DNA” of the organization to identify, isolate, and optimize complexity.

Complexity, like cholesterol, is not inherently bad; it is the natural by-product of organic growth in today’s marketplace. All service companies contend with the same challenge of increasing sales volumes through customization while increasing profitability by ensuring the customization is affordable and customer-valued, i.e., “smart.” But most have failed to find the right trade-off because they have not approached the problem holistically—they either reengineer supply (e.g., lean practices, process automation) or they manage demand (e.g., promotions, service rationalization). If neither approach works, companies often try next to bury the complexity by outsourcing it.

At worst, these tactical “fixes” have merely transferred, temporarily displaced, or cemented complexity within the organization. At best, they have moved a company along a given cost/variety curve. The real opportunity, however, lies in shifting the curve itself, so companies can reap the value of greater variety without increasing the cost of complexity.

Exhibit 1
Approaching Complexity Management from both a Supply and Demand Perspective

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Source: Booz Allen Hamilton

1Correlation between volume/profit growth and smart customization has been established in a recent Booz Allen survey of “smart customization” best practices.
To achieve such a curve shift, however, service companies must address both supply and demand simultaneously. They must understand and measure both the value of variety (demand) and the cost to provide that variety (supply). Once those drivers and metrics are clearly understood, companies can make informed trade-offs in delivering customer-valued variety at a reasonable cost of complexity. What many companies fail to understand, however, is that these trade-offs cannot happen in a vacuum. The entire operating model needs to evolve to support these higher-order choices. This viewpoint addresses the organizational contribution to managing complexity (see Exhibit 1 on previous page) and complements previous Booz Allen viewpoints on IT and Operations solutions.2

Using a Tailored Business Streams (TBS) approach, service companies can identify and isolate the complexity in their operating models and then realign their organizations to support optimal value/cost trade-offs, thus expanding the “sweet spot” of profitable growth.

**Tailored Business Streams Isolate Complexity**

The objective of the TBS approach is to identify and isolate complexity within a system. Originally applied to component parts, it has also been successfully applied to processes, first in the manufacturing sector and, more recently, in service industries such as financial services, telecommunications, and government agencies. Now, we see companies applying the principles of TBS to the organization itself with great success.

Using TBS, companies break down their operating model into a number of streams. A commonly used set of streams is: 1) basic and stable, 2) selectable options, and 3) custom solutions. The goal then becomes to direct as much of the work as possible through the basic and stable stream, while reserving custom solutions for one dedicated part of the operating model.

Using telecom service order fulfillment as an example, the TBS methodology and objectives become clear (see Exhibit 2). While today, 60% of the work is TBS2 (i.e., handled by selecting among a set of familiar options), the goal is to move more orders into TBS1, where they can be standardized and codified, lowering costs.

Examples abound of how service industries are applying the TBS methodology to manage the complexity of their business models. Retail financial services firms have steadily shifted lower-value customer support functions from the branch to centralized service agents and, ultimately, to Interactive Voice Response (IVR) and web-based applications, reducing cost at each step. They reserve personalized banking, investing, and insurance services for those customers who really value them. Airlines like Southwest have built their entire business model around a basic and stable stream (e.g., one type of plane, no assigned seats, standardized gate turnaround process).

In applying this concept to the organizational model itself, it is tempting to redraw lines and boxes on an organization chart and declare victory. Certainly, these sorts of changes are arguably the easiest to make and communicate, but we find that modifying organization structure only delivers 20% to 40% of the total benefit. To identify, isolate, and optimize complexity in the operating model, senior management needs to look below the surface at the non-structural elements of organizational DNA: Information, motivators and, most importantly, decision rights (see Exhibit 3). That is where 60% to 80% of the change effort should be focused.

True organizational alignment and, by extension, behavior change only occurs when people have clear decision rights, the right information, and strong motivation to act in the best interests of the firm (i.e., make the right growth/complexity trade-offs). Employees both in the management ranks and on the front lines need to know who decides what, what they need to know, and what’s in it for them. While that may

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sound self-evident, it is a far cry from the way many companies are organized and managed today. Hence, it is little surprise that complexity proliferates unabated.

In our experience, very little of the low-hanging fruit in complexity management can be captured through structural change alone. Companies need to revamp the non-structural elements that hold that structure together and make it work.

**The Time Is Right**

Complexity management has become the starting point for many business transformations and understandably so. As service companies strive to achieve growth through customization, they are courting complexity, which can impede performance if left unfettered.

To manage complexity effectively, companies need to limit service variety to that which generates incremental value. Variety that does not cover its complexity costs must be eliminated, standardized, modularized, or managed through tools like TBS.

Companies intent on leveraging the best of complexity need to adopt a holistic, interactive, and iterative view. They need to quantify both the value of variety and the cost of complexity, and then determine ways to enhance both, not one at the expense of the other. Key to effective complexity management is developing a way to translate what changes in demand mean for supply, and vice versa. The objective, as always, is to offer meaningful variety to external customers at the lowest cost to serve, and, in so doing, increase the company’s inherent resilience.

Complexity optimization is not about improved housekeeping; rather, it is engineered into the organization both structurally and non-structurally. It requires a thorough understanding of business priorities and underlying economics, which in turn drives meaningful variety to external customers at the lowest cost to serve, and, in so doing, increase the company’s inherent resilience.

**Case Study—Government Service Organization**

The organizational challenges of managing complexity became clear during the recent business transformation of a government service agency. Engaged in building a single new operating model nationwide for up to 30,000 users, this agency nearly had to shut down the initiative as the costs of complexity in customer-facing operations escalated. The challenge was to automate simple customer interactions and improve service levels from an unsatisfactory 50% to a more commercially viable level of 80% to 90%,...at an affordable cost.

The first step in reshaping and redirecting the operating model was to identify and understand key supply and demand drivers. A joint Booz Allen/ client team confirmed the decision rights held by each party in the process—the customer, front line clerks, and their managers in the organization.

The solution to managing the complexity was built on Tailored Business Streams. For simple customer interactions, the agency incorporated customer decision rights into web-based scripts, enabling streamlined, convenient, low-cost execution. For more complex work, they retrained clerks to handle customer requests based on a clearly articulated set of decision rights. In the process, the agency designed a new, more segmented structure for clerk workgroups. Instead of operating interchangeably, workgroups now took on more focused roles either as specialists handling particular issues, or as generalists. Clerks were armed with the right information and motivated with appropriate incentives.

The result was a set of streamlined workstreams that led to an effective overall business transformation and greatly enhanced customer service levels. Moreover, this approach to smart customization was institutionalized, leading to enhanced and enduring business resilience.
thoughtful and structured trade-off decisions between value and cost levers.

Full value is achieved when business and functional players jointly address the challenge—on an enterprise-wide basis—from inception to implementation. The time is right. Business pressures and advances in information technology provide the foundation. While each company will apply the levers differently to suit its own unique organizational context, all companies should apply the same litmus test: Embrace complexity where it adds real value and isolate it within the operating model to where it is essential.

What Booz Allen Brings

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Shining the Light on Shadow Staff
Understanding and Minimizing Hidden Staff Costs

Peer into the hallways of any business unit, and you will likely find “shadow staff,” people performing tasks that duplicate those performed elsewhere in the organization, typically by corporate functions (e.g., HR, finance, IT). No matter the industry, shadow staffs lurk in the corners of most large enterprises. Once brought to light these positions can add another 30 to 80% to total support staff head counts (see Exhibit 1). In the case of one telecommunications carrier we worked with, the shadow IT staff was three quarters as large as the entire official IT department. As one CIO client put it, “Even the shadow organizations cast shadows.”

The traditional prescription for shadow staffs has been to identify and eliminate these redundant positions, but this approach is flawed in our opinion. By weeding out shadow staffs in the business units, a company does not actually address the root cause of the problem, only its symptoms. As many companies have discovered, a shadow staff position is like the head of a hydra. You cut it off, and two more grow back in its place. To improve operational efficiency over the long run, an organization needs to understand the reason shadow staffs exist … and then remove that reason, not necessarily the position. That is the surest way to eliminate duplicative and wasted effort.

“Mine The Noise”
When organizations are not running smoothly, the points of friction in the operating model can often be valuable sources of information. Rather than systematically sweeping away problems and issues, companies should “mine” them for useful intelligence. Understanding what went wrong is the first step in getting it right.

Shadow staffs are leading indicators of problems in a company’s operating model. They serve as “workarounds” for failed or inadequate processes and functions in the service delivery model. If a corporate function is not meeting the particular needs of a business unit, the business will fill the gap by hiring its own personnel.

Exhibit 1
Casting Shadows

Source: Booz Allen Hamilton
The problem here is not the existence of shadow staff, but the inadequacies in the normal service delivery model that prompted the business unit to circumvent it.

While shadow staffs pop up everywhere, support functions such as IT, HR, purchasing, and finance cast, by far, the greatest shadows. Examples of shadow staffing that we’ve come across include:

- Meter readers at an electrical utility sitting at desks and crunching financial data
- IT staff spread throughout an airline’s organization despite the existence of a centralized IT department
- Administrative assistants at a professional services firm maintaining e-mail servers
- Engineering drafters at a defense contractor writing software code, even though all programming is outsourced.

While perhaps amusing on a case-by-case basis, the proliferation of shadow staffs can debilitate a company. In addition to the direct costs of duplicate labor, there are collateral costs associated with breakdowns in communication and cooperation between organizational units.

**Shadow Drivers**

People are rational creatures. They will make the best decisions they can based on the information available to them and their ability to process it. If shadow staffs exist, they exist for a reason. They address meaningful gaps in the overall business model in one of five areas 1) Availability, 2) Access, 3) Quality, 4) Cost, or 5) Governance (see Exhibit 2).

**Driver 1: Availability of Service**

“We don’t have a choice.”

When multiple managers independently hire staff to fill the same service gap, then clearly the corporate functions have failed in making needed services available to the enterprise. Sometimes, however, a business unit’s needs are unique. In such cases, it might make sense to keep that particular service housed in the business unit, where it can be close to customers.

**Driver 2: Access to Service**

“Sorry, we’re all out.”

Even when a needed service is available within an organization, not all managers may have ready and equal access to that service. Access is a particular issue in IT application development. Smaller business units are often frustrated at their inability to compete for limited, budget-driven, centralized IT resources. Are competing investments being evaluated in the appropriate context and with the right yardsticks? Again, shadow staffs can be a flag for further study.

**Driver 3: Quality of Service**

“Mercedes? How ’bout a Chevy?”

Just like any other consumer, line managers will “shop” elsewhere if they are not satisfied with the products and services they receive. Dissatisfaction can result from poor quality (e.g., inadequate speed, accuracy) or simply a mismatch between what customers receive versus what they desire. For example, a manager may require and be willing to pay for a customized financial report instead of the standard “canned” product offered by finance.

**Driver 4: Cost of Service**

“It’s cheaper if we just do it ourselves.”

“We can do it for less” is the most common rationale used by managers to justify their shadow organizations. However, in most cases managers are reacting to what they perceive to be excessive cost allocations or outside vendor invoices without full information. To really evaluate the cost of providing a service, you need to assess the full economic impact of that decision, including associated overhead charges. If, after this analysis, the manager can still do it for less, he or she should be encouraged to do so.

**Driver 5: Governance of Service**

“Who’s gonna stop me?”

The lack of effective governance mechanisms acts as the final green light in the development of shadow staffs. If there are no clear corporate policies defining roles and responsibilities or measures and incentives to monitor and encourage desired behaviors, then shadow staffs become an unofficially sanctioned fixture in many organizational structures.
Minimizing Shadow Costs

Clearly the first step in addressing the hidden costs of shadow staffs is to understand the magnitude of the challenge. Without counting heads and understanding the size of both acknowledged and shadow staff, it is hard to diagnose the root cause of the problem or monitor improvement.

Since shadow staffs are, by their very nature, hard to identify, it is recommended that companies capture and categorize all costs incurred within the organization. We refer to this exercise as “four walling,” counting all the costs in the four walls of the organization. This effort will require not only staffing system information, but also close analysis of budgets, as well as interviews and surveys designed to ferret out information on who is really doing what.

Exhibit 3 features the rather dramatic results of this analysis for one Global Fortune 100 company. When included in functional head count, shadow staff positions accounted for 23% of the total. In finance and IT, shadow staffs were two thirds as large as the official staff in these functions.

Once the magnitude of the shadow staffing problem is understood, companies need to address the “why” of this phenomenon to prevent its recurrence. Which of the drivers noted above is responsible for the appearance of shadow staff and how can service delivery systems be modified to disable that driver?

Based on our experience, we’ve seen several solutions take hold, all designed to improve cost transparency and optimize service delivery.

Shared Services

More and more, companies across industries are consolidating support functions from headquarters and business units into a single shared services organization. Rather than functioning as an arm of the central hierarchy with costs allocated to the rest of the organization, this new support services delivery organization operates in a more commercial context. It sits down and collaboratively plans requirements and pricing with its internal business unit “customers” and competes, in some cases, with alternative service providers to win business.

This move to treat support services like a business introduces market-like discipline and incentives to the internal service delivery model. The transparency and responsiveness that results addresses all of the key drivers of shadow staff formation — availability, access, quality, cost, and governance.

Demand Management

Demand management is another way to address the shadow staff cost issue. To date, companies have attacked internal service costs from the supply side, applying reengineering techniques to increase efficiency and productivity or leveraging best practices and scale. Our recent client experience, however, suggests that managing the demand for such G&A services yields as much, if not more, in terms of cost savings and benefits. One of the most important tools in managing demand is pricing.

Fit-for-Purpose Solutions

Conventional wisdom has long held that one-size-fits-all solutions result in the lowest overall costs, but
our recent client work suggests that logic is faulty. Standardized solutions actually overserve many business users while underserving others. The result is higher than necessary costs and dissatisfied users who are not receiving an appropriate level of service (i.e., a Mercedes rather than a Chevy). Conversely, if service providers offer too many options (e.g., supplying each business unit a customized menu of services) without establishing sufficient scale or standards, costs quickly and predictably escalate.

Fit-for-purpose solutions represent the happy medium in the enduring tug-of-war between one-size-fits-all and custom-tailored service offerings. Fit-for-purpose solutions are tailored but efficient service delivery solutions that align supply and demand for various customer segments at optimal levels. By assessing the economics of service delivery from a cost-to-serve and ability-to-serve perspective, and by segmenting customer needs and priorities, companies can radically restructure service delivery, resulting in a set of affordable yet responsive solutions.

**Governance Mechanisms**
Corporate polices, processes, and performance measures can help drive the organization toward one or more of the above solutions. Policies should clearly define the roles and responsibilities of each organization unit in the provision of services. Key processes, particularly within HR, can serve to highlight the emergence of shadow staff, so that the organization can respond swiftly. Finally, performance measures and incentives can motivate adherence to desired behaviors among both business and service units.

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Do you recognize the hourglass organization (see Exhibit 1)? If you look closely at the management ranks of many Fortune 500 corporations, you’ll see this unfortunate phenomenon: excessive layers and narrow spans of control, particularly among mid-level directors and managers. The result is often bureaucratic buildup, bottle-necked decision-making, and a general lack of innovation. Employees laboring at the customer-facing end of this attenuated organization structure are hamstrung by vertical decision-making and multi-matrixed reporting relationships. Their career prospects are unenticing and their creativity diminished. The view at the top is equally uninspiring…and crowded. Organizations like these need to look beyond simple headcount reductions to find more lasting and effective methods for getting in shape.

Rooting Out the Underlying Causes
The objective in streamlining the hourglass organization is not just the obvious potential for stripping out excess cost; it’s the concomitant opportunity to increase revenues by simplifying decision-making, enhancing customer responsiveness, and unleashing innovation. Achieving these benefits, however, requires a new approach to organizational restructuring, one predicated on true and lasting behavior change, rather than slashing boxes on an organization chart. Headcount reduction alone is a shortsighted remedy; it does not address the underlying drivers of organizational obesity. Indeed, it can often do more harm than good. Companies thinning their ranks often either cut into the productive muscle of the organization or lop off excess positions only to have them reappear elsewhere a few months later.

To achieve enduring, productive gains, companies need to look beyond simple headcount reductions to find more lasting and effective methods for getting in shape.
assumptions, beliefs, habits, incentives, and rules that determine how people work together (see Exhibit 2).

An organization’s DNA is less visible and harder to get at, but it is essential to motivating stronger performance and ensuring sustainable gains.

While proliferating lines and boxes on an org chart are an important indicator, not all spans are created equal; some spans legitimately should be narrower than others. But narrow spans can also be symptoms of serious organizational problems. By this logic, eliminating lines and boxes does not cure a dysfunctional organization; it merely masks the symptoms. The root causes of organizational dysfunction and obesity are more fundamental:

**Root Cause #1: Lack of Accountability**

_“We need to protect our employees from themselves”_

Organizations that do not hold employees accountable for their actions, results, and budget commitments breed a culture of mistrust and incur extra costs associated with excessive oversight. Additional layers of management become institutionalized to “chaperone” employees as they make day-to-day decisions. From the outside, the organization looks bureaucratic and/or incompetent, when the real culprit is ill-defined accountabilities and performance measures. There is no license for employees to improve the organization and no incentive to deliver against critical objectives. Moreover, redundant levels and approvals enable everyone to pass the buck until the people making the decisions are no longer accountable for the decisions they make.

**Root Cause #2: Suboptimizing Silos**

_“What’s good for my unit is good for the company”_

Business unit and/or functional silos will naturally crop up in any large, complex organization as managers compete for capital and other resources. In the attempt to optimize individual performance, however, business units and functions often suboptimize the overall company’s performance. Typical symptoms of silo behavior include poorly placed investments, redundant staffing and services, and inconsistent messages to the marketplace. While some might diagnose the symptoms as warring internal factions, the truth is most units and functions probably don’t know each other well enough to battle. The organization is too highly fragmented and/or dispersed, and corporate coordination and governance mechanisms are absent. Ironically, this very fragmentation drives the need for more managers to coordinate both within and across silos.

**Root Cause #3: Micromanagers**

_“Our managers like to get their hands dirty”_

It’s no coincidence that slow-moving organizations tend to be bloated in their midsection with multiple layers of management, all eager to justify their positions. In pursuit of that goal, they “make work,” manifesting an insatiable desire for detail and requests for tremendous volumes of information that must be assimilated and reconciled at each level. Excessive time is spent requesting, tracking, and approving spending, personnel, and operating decisions. While the resulting organizational sclerosis could be attributed to inexperienced or incompetent subordinates, the root cause is management’s unwillingness to delegate decision rights to those employees closest to the relevant information.

**Root Cause #4: Implied Promotion Promises**

_“It’s been two years...time for another promotion”_

In the paternalistic corporate cultures of yore, it was an article of faith that promotions automatically accrued to those solid performers who “did their time” in a particular position. That practice has fostered unrealistic
career advancement expectations among the current generation of middle managers. To keep the best and the brightest from exiting, companies are instituting “promote from within” policies and dangling vertical advancement opportunities. The problem is too many companies rely on promotion as their chief incentive mechanism, placing pressure on the organization structure to create additional—and largely artificial—levels of management.

How to Be Flat and Happy...for Good
As with any type of organization change, there is no single best way to remove layers. Some start at the top, with the CEO or CFO commissioning an organization audit. After benchmarking the organization against internal and external best practices, the senior team sets stretch goals to restructure management spans and flatten layers.

Others “bubble up” solutions from below by engaging the entire organization in “spans and layers” interviews and workouts. These sessions drill down to uncover the root causes of dysfunctional organization structures. Once these root causes are identified, organization leaders are charged with addressing them. Solutions might include setting up self-managing teams, altering management and employee responsibilities and incentives, and redesigning career paths.

Whichever solution is adopted, however, it is wise to remember the eight tenets of genetic reengineering when it comes to organizational DNA.

1. Not all spans are created equal. Avoid the seduction of simplistic targets (e.g., “no more than five management layers/no fewer than three direct reports”). Sustained improvements hinge on developing the right size and number of building blocks based on the nature of work, the core business processes involved, and the interactions required to drive smart decision-making.

2. Create cross-functional teams with process owners around key business processes. These teams cannot be afterthoughts or window dressings. They need real authority.

3. Design fulfilling career paths and staffing strategies, including horizontal moves and increased compensation, to challenge and reward managers faced with fewer classic upward promotion opportunities.

4. De-program micromanagers. Train and hold accountable the next generation of middle management to delegate more decisions to the front lines where relevant information resides.

Case Study: Spans and Layers
As the lead initiative in an overall global effectiveness program, a Fortune 100 client of Booz Allen Hamilton launched a “spans and layers” program designed to reduce high G&A costs driven by organizational complexity. Recognizing that the existing multi-matrix structure was costly, sluggish, uncoordinated, and inwardly focused, management was convinced that a flatter and more streamlined organization model was critical to effecting its strategy and competing in a global marketplace. The team charged with leading this effort followed a four-step process over a period of 12 weeks, first baselining the existing spans and layers, then sizing the prize from a top-down perspective, then designing and implementing solutions to reduce layers and optimize the organization model. In the end, the company realized approximately $200 million in savings, which constituted 25% of the total cost savings generated by the entire global effectiveness program.
5. **Modify job titles and compensation levels** to reflect and encourage more simplified and streamlined work processes.

6. **Institutionalize communications vehicles** to break through traditional roadblocks to the free flow of information.

7. **Implement measures and incentives** that sharpen the organization’s focus on accountability and consequences for performance gains and losses.

8. **Coach the change agents**, the line managers who will not only design and deliver the changes, but who will most directly feel their implications.

In a competitive environment where fleet-footed rivals and finicky customers drive the pace of change ever faster, organizations need to be fit and flexible to prosper. Too many, however, are burdened with excessive organizational structure. Developing a flatter, more streamlined profile is not only a key to reduced costs in the short term, it is an invitation to increased revenues over the longer haul.

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Attacking Overhead Costs from Both Sides
Optimizing the Supply and Demand for G&A Services

“Business is flat. I need to cut overhead costs quickly to meet my earnings forecast. At the same time, I have to launch an even bolder round of restructuring to bring costs down 30 to 40 percent over the next three to five years. And I need to achieve these goals without undermining the core functional capabilities needed to keep my business moving and, ultimately, achieve above-market growth.”

Sound familiar? Seem impossible?

Having weathered a series of numbing blows recently, companies the world over are reassessing their business models and fundamentally redesigning them from within. With top-line growth stalled in many industries, overhead costs are a primary and persistent target of these reviews.

Over the past decade, most global 500 companies have implemented several waves of restructuring programs to cut general and administrative costs, including business process reengineering, shared services, ERP, and strategic outsourcing. While these traditional initiatives have often been effective in improving the bottom line and enhancing shareholder value, they have largely run their course. Companies just cannot keep squeezing the same functional service areas in the same way without compromising the value these services provide. So exactly how are companies supposed to wring additional and significant savings from their overhead functions?

Standout companies are stepping back and adopting a new and broader perspective on this age-old problem, one that encompasses not only supply-side cost restructuring but also demand-side optimization strategies (see Exhibit 1). Approaching the cost reduction challenge from both sides has unlocked major benefits and savings for such companies. The notion is grounded in basic microeconomics: By aligning supply with demand, companies can achieve a value-based equilibrium in their G&A cost structure. It’s this alignment of supply and demand that distinguishes next-generation overhead cost reduction strategies.

Blowing Up and Rebuilding Overheads

Traditional approaches to cutting overhead costs usually lead from the supply side. Companies challenge how overhead functions are organized and delivery processes are designed by applying classic reengineering techniques to increase efficiency and productivity. Our recent client experience, however,

Exhibit 1
Booz Allen’s Approach to Attacking Overhead Costs from Both Sides

Source: Booz Allen Hamilton
suggests that managing the demand for such overhead services yields as much, if not more, in terms of benefits.

Managing demand is not simply a matter of assessing the overall appetite for overhead services and lopping off 10 percent across the board. When done right, it is a careful, systematic, and business-specific assessment of what services are needed at what level of performance and why. This assessment measures the relative criticality of various functions and services to determine the need for excellence versus adequacy. To make this determination, executives need to understand and openly question fundamental business drivers on a unit-by-unit basis, including decades-old standards and policies, strategy-based business model requirements, customer-driven market priorities, and economic and competitor-driven affordability levels.

Supply and demand cost reduction strategies are by no means mutually exclusive. In fact, an organization can achieve maximum efficiencies only by exploiting both and discovering the supply-demand “sweet spot” – the strategic equilibrium where supply and demand for services are aligned. To locate this sweet spot, companies must disaggregate overhead services from both a supply and a demand perspective (see Exhibit 2).

Supply-side disaggregation involves breaking up services into their component activities and then reassembling them based on 1) the inherent nature of the service (e.g., routine versus highly knowledge intensive), 2) the frequency of service usage (e.g., daily versus semiannually), and 3) the channel through which the service is accessed (e.g., on-site staff versus call centers). In HR, for example, such a tear-down and build-up exercise results in four broad overhead service groupings, each with its own unique set of economics and cost reduction levers (see Exhibit 2).

Demand-side disaggregation focuses on breaking down the appetites for various services among business unit customers. What results are categories of “must have,” “want to have,” “smart to have,” and “nice to have” services based on why customers need them, where they access them, and how they apply them to support specific business decisions, operations, and processes. The resulting disaggregation provides a view on the service breadth and levels currently being consumed across the organization as well as the business case

Exhibit 2
Disaggregation of Supply and Demand for HR Services

<table>
<thead>
<tr>
<th>Supply-Side Disaggregation</th>
<th>Demand-Side Disaggregation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy &amp; Governance Intensive Services</td>
<td>HR policies</td>
</tr>
<tr>
<td>Knowledge Intensive Services</td>
<td>Succession planning</td>
</tr>
<tr>
<td>Transaction Intensive Services</td>
<td>Labor relations</td>
</tr>
<tr>
<td>Infrastructure Intensive Services</td>
<td>Payroll</td>
</tr>
<tr>
<td>Mandatory “Must Have” Services</td>
<td>Timekeeping</td>
</tr>
<tr>
<td>EEO compliance</td>
<td></td>
</tr>
<tr>
<td>Core “Want to Have” Services</td>
<td>Employee data maintenance</td>
</tr>
<tr>
<td>Payroll compensation and benefits</td>
<td></td>
</tr>
<tr>
<td>Critical “Smart to Have” Services</td>
<td>HRIS</td>
</tr>
<tr>
<td>Labor relations</td>
<td></td>
</tr>
<tr>
<td>Non-Critical “Nice to Have” Services</td>
<td>Training</td>
</tr>
<tr>
<td>Organization development</td>
<td></td>
</tr>
<tr>
<td>Change management</td>
<td></td>
</tr>
</tbody>
</table>

Examples
- HR policies
- Succession planning
- Labor relations
- Training
- Compensation/benefits design
- Recruiting
- Payroll
- Timekeeping
- Employee data maintenance
- HRIS
- EEO compliance
- External reporting
- Payroll compensation and benefits
- Labor relations
- Training
- Career planning
- Organization development
- Change management

Service Characteristics
- Company and business-specific
- Company planning-cycle driven
- Domain expertise intensive
- Demanded sporadically
- Needs face-to-face interaction
- Routine, repetitive, and scale intensive
- Demand frequently
- Can be provided remotely
- Systems development/maintenance intensive
- Can be provided remotely in some cases
- Essential to comply with legal/regulatory requirements
- Essential to support day-to-day operations
- Essential to support business priorities
- Non-essential/discretionary services

Cost Reduction Levers
- Streamline cumbersome committees, policies, and controls
- Consolidate for critical mass
- Rationalize programs
- Redefine line-staff roles
- Standardize and automate
- Consolidate into a service center
- Seek labor arbitrage
- Offshore and/or offshore
- Do only what is necessary to meet legal and regulatory requirements
- Do only what is necessary to “keep lights on”
- Outsource selectively
- Make new investments self-funding
- Prioritize based on where value to the business is greatest
- Reduce services and/or service levels
- Eliminate or right-size

Source: Booz Allen Hamilton
for that breadth and level of consumption – good and/or bad.

**Next Generation Supply and Demand Levers**

Having segmented its range of services from both a supply and a demand perspective, a company can “build” a conceptual and analytical view of its overhead cost structure. More importantly, it can readily identify which supply and demand levers would be most effective and nondisruptive in reducing costs. Our work with clients around the world suggests there are ten basic levers companies can use to identify and exploit the supply-demand sweet spot and achieve next-generation cost reduction (see Exhibit 3). Many of these levers are familiar; however, we’re suggesting turbo-charging these techniques and taking them to the next level as part of an aggressive program to balance both supply-side and demand-side drivers.

For instance, on the supply side, many companies have taken outsourcing to the next level by cleaving off their utility services and relocating them offshore in low factor-cost locations. Some are handing over entire functions to third-party providers. Others are aggressively implementing best practice transfer in core strategic services such as engineering, marketing, quality, and IT applications development.

On the demand side, companies are becoming far more rigorous in “doing the right things with less,” particularly in capital-intensive overhead areas such as IT. Newly empowered executive committees and governance boards are vetting capital investment projects, applying disciplined business case and ROI criteria before approving significant expenditures. Sophisticated customer segmentation is another demand-side lever. Some of the same techniques used to segment and target external customers are now being used to manage internal customer demand for overhead services.

In the next section, we look more closely at fit-for-purpose solutions, a hybrid cost reduction lever that combines demand-side customer segmentation techniques with supply-side service delivery tools.

**Fit-for-Purpose Solutions**

Conventional wisdom has long held that one-size-fits-all solutions result in the lowest overall costs, but our recent client work suggests that logic is faulty. Standardized solutions actually overserve many business users while underserving others. The result is higher than necessary costs, and dissatisfied users who are not receiving an appropriate level of service. Conversely, if service providers offer too many options.

---

**Exhibit 3**

Next Generation Supply and Demand Levers for Overhead Cost Reduction

<table>
<thead>
<tr>
<th>Governance</th>
<th>Supply-Side Optimization</th>
<th>Demand-Side Optimization</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Define and Enforce Corporate Standards</td>
<td>2 Define Clear Buyer-Seller Decision Rights</td>
</tr>
<tr>
<td>3</td>
<td>Leverage Best Practices</td>
<td>4 Strip Out Self-Inflicted Complexity</td>
</tr>
<tr>
<td>5</td>
<td>Leverage Technology and Scale either Internally or by Outsourcing</td>
<td>6 Design Fit-for-Purpose Solutions</td>
</tr>
<tr>
<td>7</td>
<td>Create an Internal Market</td>
<td>8 Start an Affordability Dialogue on Overheads</td>
</tr>
<tr>
<td>8</td>
<td>Corporate</td>
<td>9 Align Overhead Investments With Business Priorities</td>
</tr>
<tr>
<td>9</td>
<td>Businesses</td>
<td>10 Manage Customer Expectations via Incentives</td>
</tr>
</tbody>
</table>

Source: Booz Allen Hamilton
Fit-for-purpose solutions represent the happy medium in the enduring tug-of-war between one-size-fits-all and custom-tailored service offerings. They are tailored but efficient service delivery solutions that align supply and demand. By assessing the economics of service delivery from a cost-to-serve and ability-to-serve perspective, and by segmenting customer needs and priorities, companies can radically restructure overhead services, resulting in a set of affordable yet responsive solutions.

Take IT desktop services as an example. To design fit-for-purpose solutions, start with the customer, defining distinct segments in the IT user population using classic market segmentation concepts. Segmentation criteria might include:

- Where are customers located?
- How do they access their data?
- What job functions do they perform?
- How critical are the business decisions they make?
- What applications and tools do they need to support these business decisions?

Such a demand-side approach to IT desktop illuminates those customers across business units with similar needs, and draws distinctions where there are meaningful differences. Segments are defined not simply by location or function, but by a more sophisticated characterization of the nature of their demand. Those with similar needs are grouped together to create a critical mass that can be profitably served. It’s not unusual to see segments of service users cut across multiple business units, locations, and organization functions.

Once segments are defined and customer needs prioritized into “musts,” “wants,” and “nice-to-haves,” IT professionals can then rationalize and reconfigure their existing portfolio of desktop services into fit-for-purpose service bundles that combine the requisite criteria (e.g., service levels, access methods, support levels, reliability) for each segment. The trick in this process is to design service bundles that optimize the trade-off between being responsive to individual customer segments and being mindful of controlling complexity by minimizing the number of segments and constraining variations.

The next challenge is delivering these fit-for-purpose solutions through the right channels to desktop users. Service delivery channels include the people, the processes, and the systems involved in bringing a service to the customer. A particular channel need not be exclusive to a particular customer segment or service bundle. Once again, the challenge is to find an optimal balance between an over-proliferation of delivery channels and too few. Companies that get this right usually organize the delivery infrastructure around stability, predictability or difficulty.

### Exhibit 4
**What Are Fit-for-Purpose Solutions?**

<table>
<thead>
<tr>
<th>BU-Specific Solutions</th>
<th>One Size Fits All</th>
<th>Fit-for-Purpose Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>BU’s: A B C D</td>
<td>BU’s: A B C D</td>
<td>BU’s: A B C D</td>
</tr>
<tr>
<td>High cost, one-off solutions</td>
<td>Low cost, highly scale-driven solutions</td>
<td>Typically lowest-cost solution with highest performance satisfaction</td>
</tr>
<tr>
<td>High performance satisfaction and accountability</td>
<td>Poor customer satisfaction due to an inability to influence the solution provided</td>
<td>Requires tailoring around the edges (e.g., drive general users to lowest-cost solution and enhance solution for high-end users)</td>
</tr>
<tr>
<td>Standard Solutions</td>
<td></td>
<td>High performance satisfaction is achieved and accountability exists within customer segments</td>
</tr>
</tbody>
</table>

Source: Booz Allen Hamilton
As Exhibit 5 illustrates, fit-for-purpose solutions result in an overhead architecture in IT desktop services that varies widely from segment to segment in its economics and flexibility. For instance, in some locations (e.g., a small remote facility), it doesn’t make sense to maintain dedicated IT staff and equipment. Employees there are best served by the local Best Buy or CompUSA, letting the store perform warranty work. In other areas, however, where decisions made on desktops are business critical, companies should provide far more responsive on-site support.

Exhibit 6
Impact of Supply-Demand Optimization on Overhead Costs

It’s About Time

Those cost-cutting initiatives that require nominal investment and carry low execution risk have long since been tapped. The next wave of fundamental overhead cost reduction will come as companies make difficult, critical and clear supply-demand affordability trade-offs. By applying the framework and levers outlined here, companies can “variabilize” fixed overhead costs, while lowering total overhead substantially. Companies, in our experience, can achieve structural cost reductions of up to 40 percent (see Exhibit 6), but the time to act is now.
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In recent years, as top-line growth has stalled, companies have had to get creative about cost reduction. As always, they are looking first to pare expenses in internal services. What is different is the lens they are applying; the perspective has broadened. Instead of relying solely on supply-side tactics to cut costs (e.g., process reengineering, automation, outsourcing, offshoring), companies are now managing the demand for internal services as well, challenging both service providers and business-unit customers to make serious affordability and service level trade-offs. Our experience suggests that effective “demand management” can unleash “next-generation” savings gains of 5%-15% (see Exhibit 1).

**Demand Management 101**
Demand management complements and reinforces supply-side gains by encouraging and, ultimately, institutionalizing a better alignment between the supply and demand for internal services. Given constrained budgets and service prices based on the provider’s actual cost-to-serve, what would business units choose to buy? What are their “must-have” services? What is “smart to have”? Where will they make trade-offs?

While simple in theory, in practice internal demand management is anything but, as it requires profound behavior change on the part of both buyer and seller.

Despite recent efforts to make internal service delivery more marketlike, most service providers and their business-unit customers still have not moved beyond menu design and order taking to active collaboration.

Moreover, pricing presents challenges. Demand management hinges on true and transparent price signals based not on an allocation or cost recovery formula, but on an accurate assessment of underlying cost drivers. Many businesses fear that the administrative and accounting mechanisms needed to establish accurate price signals will add more complexity than discipline. In fact, our experience shows that many companies can develop effective pricing mechanisms using a simple spreadsheet.

To overcome lingering resistance and facilitate a more economical service delivery model, we propose a demand management approach that focuses on three interdependent levers (see Exhibit 2, Page 2):

1. **Governance** mechanisms to ensure that end users and service providers communicate expectations and concerns fully and regularly;
2. **Pricing** signals that accurately reflect a service provider’s underlying costs and allow end users to make sound economic decisions;
3. **Incentives** that encourage end users and service providers to make the right affordability trade-offs.

To be effective in exploiting these levers, internal service delivery models need to evolve, as Exhibit 3 suggests:

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**Exhibit 1**
Typical Range of Administrative Cost Reduction Potential by Type of Function

<table>
<thead>
<tr>
<th>Shared Services Value Drivers</th>
<th>Supply-Side Restructuring</th>
<th>Demand Management</th>
<th>Price/Buy</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT</td>
<td>15-20%</td>
<td>10-15%</td>
<td>5-10%</td>
<td>30-45%</td>
</tr>
<tr>
<td>Staff Functions</td>
<td>8-23%</td>
<td>5-10%</td>
<td>2-5%</td>
<td>15-35%</td>
</tr>
<tr>
<td>Customer Care Back Office</td>
<td>7-15%</td>
<td>5-8%</td>
<td>3%</td>
<td>15-25%</td>
</tr>
</tbody>
</table>

Notes:
- IT includes: applications development; mainframe/desktop/servers; network infrastructure
- Staff functions include: finance; HR; purchasing; legal; facilities
- Customer Care Back Office includes: contract administration; contact/call centers; billing; reporting

Source: Booz Allen Hamilton
1) **First Generation:** Get the basics right
2) **Second Generation:** Drive true behavior change
3) **Third Generation:** Establish collaborative partnerships

**First Generation: Get the Basics Right**
During this initial phase, management blocks out the structural elements of the internal service organization and addresses customers’ fundamental questions: What am I buying? What does it cost? What choices do I have to reduce these costs?

The most common mistake companies make in setting up service organizations is failing to establish sufficient and effective governance systems and procedures from the outset. Getting the basics right includes:

**Governance:**
- *Service level agreements (SLAs)* are contracts between buyer and seller that stipulate the types, amounts, and performance levels of services to be offered at predetermined price points.
- *Buyers’ councils* are forums in which senior stakeholders from both the service organization and the business units can communicate and resolve issues. Often such a forum already exists within a company and these issues simply can be added to the agenda.
- *Rules of engagement* should spell out key processes and procedures such as variance accountability and methods for dealing with costs mandated by the corporate center. Moreover, management should also make clear the rules of disengagement under which a business unit can decide to outsource a particular service. These rules should detail how stranded costs should be treated and provide for an oversight process to ensure that the entire company’s best interests are being served.
- *External benchmarking* helps service providers identify useful supply-side efficiencies, justify costs to business-unit customers, and maintain a rigorous, continuous improvement focus.

**Pricing & Incentives:**
- *Cost driver-based pricing* conveys to the buyer the true costs of the service provided. To derive this figure, service providers must identify a reasonable set of cost drivers for different services and develop the discipline to measure these drivers consistently and regularly. Moreover, service providers need to find ways—as external suppliers do—of reducing costs (and prices) over time. Pricing is critical to effective demand management; if done right, it serves as a communication vehicle to help modify buying behavior—not as an invitation to needless complexity. The trick is to build pricing from an easily measured set of drivers that make sense to both the service organization and the business units.

**Exhibit 2**
**Demand Management Levers: Governance, Pricing, and Incentives**

**Exhibit 3**
**Evolution of Internal Services Organization**

Source: Booz Allen Hamilton
Incentives should induce service providers to simultaneously reduce costs and improve customer responsiveness. Service provider incentives can be based on regular customer satisfaction surveys as well as annual cost reductions or, alternatively, on how costs compare to external benchmarks.

Second Generation: Drive True Behavior Change
Annual service level agreements alone may be sufficient for commodity-type services but not for services adding greater value. If the initial stage of the journey is all about getting the right structural elements in place, this second stage is focused on some of the “softer” skills involved in customizing service offerings to fit the unique requirements of each customer.

Governance:
- **Top-down affordability analyses** allow companies to put the tenets of demand management to the test. Presented with constrained budgets and “true” costs for internal services, business units are compelled to prioritize services into:
  - **“Must haves”:** Activities that must be performed because of legal and regulatory requirements;
  - **“Smart to haves”:** Typically, control and risk management functions;
  - **“Nice to haves”:** Discretionary activities that allow business units to improve performance, build capabilities, and create competitive advantage.

Top-down affordability analysis serves as a good forcing function; it prompts an affordability dialogue that leads to a better alignment of supply and demand (See Case Study).

- **Fit-for-purpose solutions** are the “happy medium” between a standardized, “one-size-fits-all” offering and completely customized solutions. The goal is an efficient range of semitailored services for distinct segments of demand. Previously overserved customers can reduce costs, while the company reduces its overall cost-to-serve.

Pricing & Incentives:
- **Refined pricing mechanisms** allow the service provider to communicate more than total cost; this way components of the cost structure become clear. Different services have inherently different cost structures (e.g., fixed vs. variable, sunk vs. incremental), and their prices should reflect these distinctions. Transparent pricing equips customers with the levers they need to influence service offerings, costs, and quality. In fact, to simplify the process and to make it actionable, the pricing detail provided to a user should be tailored to the level of control the user has on the spend.

Third Generation: Establish Collaborative Partnerships
The final stage in the evolution of internal service delivery is the metamorphosis from cost-competitive supplier to expert and trusted partner. This is not a subtle shift; it involves a complete change of mind-set for both provider and user. This transformation begins with the following steps:

Governance:
- **Customer relationship management** skills help service providers develop a true partnership with the customer. The service provider needs to dedicate credible senior talent and specialized capabilities to the relationship and establish true expertise in the customer’s business.
- **Participative decision-making** means that service providers are included at the table during business-unit strategy sessions. Moreover, providers should be consulted in acquisition and divestiture decisions. To build a true collaborative partnership, both service providers and their business-unit customers need to understand one another’s strategic requirements and make business decisions with these in mind. To foster this level of collaboration, incentive schemes need to reward business partnering.

Pricing & Incentives:
- **Aligned incentives** help keep service organizations properly focused. Too often, incentives are misaligned and prompt inconsistent behavior from the service organization. Motivated to enhance customer satisfaction, service providers lose sight of the equally

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**Case Study: Affordability Analysis**

Recently, in the midst of a demand management program, a Fortune 500 client participated in a prototype affordability analysis to prioritize internal services according to those services’ perceived value to users. The services were classified as “Must Haves,” “Smart to Haves,” and “Nice to Haves.”

The corporate functions were asked to assess the “Must Have” and “Smart to Have” services, while the “Nice to Have” services were analyzed by the business unit users. Starting with nothing, both groups were asked to build their preferred portfolio of internal services based on three scenarios: 1) an unconstrained budget; 2) a 30% reduction in total service costs; and 3) a 50% reduction.

Charged with minimizing the impact to their operations, participants classified activities as “Eliminate Completely,” “Reduce Usage,” “Reduce Service Level,” or “Maintain Usage and Service Level.”

While no activities were completely eliminated, several were scaled down in usage and service levels (e.g., desktop support, management reporting, budgeting and planning, recruiting, organizational planning and HR consulting, internal process consulting, construction project management).

The identified reductions in usage and service levels translated into a 25% cost reduction opportunity.
important mandate to decrease overall costs by rationalizing business-unit demand. To achieve the desired focus, incentives for senior management in the service organization need to be directly linked to the business units’ cost-reduction goals, as well as to efficient and effective service delivery.

This evolution in internal service delivery is swiftly—and necessarily—gaining momentum in an environment of slowing revenues and tighter belts. As one company put it: “We have to provide value-added service. We are constantly being asked to cut costs and eventually we will disappear. We have made very explicit decisions to move up the value chain, otherwise we would have remained in the overhead category and been cut.”

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Driving Demand Management for Internal Services

The Role of Behavior-changing Pricing in Managing Demand

Faced with stagnant growth and increased competitive pressures, companies in many industries are reexamining their cost structures to extract further savings and sustain adequate margins. This search for step-change improvement sets up a natural contest between line and service organizations, one that plays out in predictable ways. Business units (BUs) complain that they bear the brunt of the belt-tightening and point to support services as a drain on their resources. Support functions point to benchmark studies that show they are performing at best-in-class levels and have already squeezed out potential cost savings. Can they both be right?

In a word, yes. It is true that internal service organizations have become noticeably more efficient and market-oriented in the past decade, thanks to a host of strategic initiatives including business process reengineering, shared services, ERP, and strategic outsourcing. But they have also gained unnecessary weight. During the 1990s, internal service organizations grew at a rate disproportionate to the growth of their companies. As management focused on meeting growing customer demand, the cost of demand-driven support functions such as Finance, Human Resources, and IT drifted off the radar screen and steadily upward. However, now that growth has stalled, management has redirected its focus to cost reduction – thoughtful, lasting, across-the-board cost reduction. The first place companies typically look to for those savings is their support services.

To date, companies have attacked internal service costs from the supply side, applying reengineering techniques to increase efficiency and productivity or leveraging best practices and scale. Our recent client experience, however, suggests that managing the demand for such overhead services yields equivalent benefits (see Exhibit 1). Moreover, there’s a greater opportunity in demand management as these techniques have not yet been fully exploited.

**The Evolution of Demand Management**

For years, support functions were treated as cost centers whose resources were allocated and charged back. Senior corporate executives determined who got what

**Exhibit 1**

Demand Management Delivers Over 40% of the Cost Benefit

![Exhibit 1](source: Booz Allen Hamilton)
services based on perceived priorities, volume of work, and internal politics. The BUs had little say in the matter. The shared services model has now largely supplanted the cost center model. Accountability for allocation decisions has shifted down the ladder to the business units and service providers, who now contract for services at agreed upon levels and prices. However, while the shared services model is advertised as a disciplined mechanism for ensuring market-based, arms-length transactions between buyer and seller, it has not always delivered on its promise. Many companies complain that it has not worked as effectively as they had hoped in lowering their costs. Supply and demand for internal services still do not meet at the equilibrium price point. The reasons for this imbalance are several:

- **Lack of “fit for purpose”:** BUs demand significantly higher service levels and/or greater customization than is optimal from a cost/benefit standpoint. Service providers exacerbate the problem by accommodating these requests so as to maintain high customer satisfaction ratings.

- **Misaligned incentive structures:** Service providers are pulled in opposite directions by conflicting incentive schemes. They are directed to satisfy their demanding BU customers, while also driving down overall costs.

- **Weak governance mechanisms:** There is often little to no communication between service and line organizations. Service level agreements (SLAs) serve as a poor substitute for a more active and engaging dialogue.

- **Inaccurate price signals:** To avoid being micromanaged by BU customers and to allow for comparison with external service providers, service organizations set prices that effectively obscure their true cost structure. While these prices work for benchmarking purposes, they do not facilitate economic decision-making. Moreover, these pricing methodologies are expensive to manage.

To overcome these obstacles and establish the optimal equilibrium between supply and demand for support services, many companies are implementing demand management methodologies. Effective demand management is not an easy endeavor, which is why it has not been explored until now. It imposes on business units some hard choices. To manage their businesses in the most cost-effective manner, BU managers must make tough trade-offs in the nature, volume, and quality levels of the services that they consume. They must distinguish between “must have” and “nice to have” services. To prompt this paradigm shift, companies need to transform their service delivery model by leveraging three critical mechanisms: 1) pricing, 2) incentives, and 3) governance (see Exhibit 2). The focus of this Viewpoint is on the primary mechanism: pricing. (The others will be dealt with in subsequent Viewpoints.)

### A New Perspective on Pricing Internal Services

Prices drive customer behavior and, therefore, are critical to adjusting and balancing demand. Basic economic theory tells us that the optimal price point is where marginal cost equals marginal benefit (i.e., the cost of an additional unit of service is equivalent to the benefit derived from that unit). To arrive at this equilibrium, however, market participants need to understand true marginal costs, and that is simply not the case when it comes to internal service delivery at most companies. Historically, price signals have been inaccurate, obscured, and difficult to decipher. Service organizations sought to recover their costs, and prices reflected

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**Exhibit 2**

**Demand Management Mechanisms**

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*Source: Booz Allen Hamilton*
that imperative rather than revealing the underlying cost drivers. More recently, in the interest of meeting and undercutting external benchmarks, internal support functions have massaged numbers, often merging fixed and variable costs.

The result? BUs do not understand true marginal costs, resulting in poor price signals and suboptimal resource allocation. Pricing should be a demand management facilitator, not a cost recovery vehicle. That objective is possible only if prices are transparent and provide customers with the levers they need to influence service offerings, costs, and quality. Different services have an inherently different cost structure (see Exhibit 3), and their prices should reflect these distinctions. In other words, the price for every service offering should reveal the breakdown among 1) direct fixed costs, 2) direct variable costs, and 3) overhead costs.

Direct Fixed Costs are typically infrastructure-related and therefore not easy—or even possible—to eliminate or reduce in the short run. Ideally, companies want to maximize short-term demand for such services to increase utilization and reduce effective unit cost. From a demand management perspective, however, there is not a lot companies can do with fixed costs. The budget for these “lights on,” nondiscretionary services (e.g., LAN/WAN, telephone network, HRIS infrastructure) is generally set at the corporate level, and individual BUs have limited input in that decision-making process.

Price signals related to direct fixed costs should not convey to customers the impression of flexibility or even controllability. Products and services that have a predominantly fixed cost structure should be charged out on the basis of historical usage. Service organizations should determine the total costs for these services once a year and maintain the resulting price levels throughout the year, since fluctuations in short-term demand have no impact on fixed costs. This approach should free up resources dedicated to pricing such services.

Direct Variable Costs, on the other hand, do fluctuate with demand. These are discretionary, flexible, and redeployable resources and the prime target of demand management efforts (e.g., help desks, printing services, long distance telephone usage). Service organizations should send business units very clear price signals for these services to reflect their variable nature and encourage a reduction in short-term demand.

Products and services that have a predominantly variable cost structure should be billed out based on the actual cost incurred to deliver that product or service. This sort of flexible pricing mechanism encourages business units to optimize their short-term demand, while forcing service providers to adjust supply levels continually to match that demand.

Finally, Overhead Costs are those incurred by the service organization that cannot be directly attributed to the delivery of a service. These costs include management and other administrative functions. The costs for these activities should be separately identified and monitored by an internal services governance body. In the short run, these costs should be treated as fixed and charged out the same way.

Obviously, this discussion oversimplifies the variety of complicated factors that weigh on the pricing of internal services. However, it does make clear the importance of conveying the true cost structure for internal services to the customer.

In addition to exposing the underlying cost structure, service providers need to communicate that information to the customer... at a level where it is “actionable.” If the customer contact is not in a position to make a buying decision, there is little point in billing at that level. Similarly, if a BU manager cannot weigh in on an expense because it is mandated at the corporate level (e.g., corporate security, audit), these costs need not be broken down at the BU manager level. Discussions of those costs should be held at the executive level.

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**Exhibit 3**

**Prices Should Reflect Underlying Cost Drivers**

| **Support Organization Overhead Costs** |
| Definition: | Cost Characteristics: | Examples: |
| Direct Fixed Costs | Costs involved in managing the service organization | Typically fixed costs (e.g., People) | Management/CRM |
| Direct Variable Costs | Rely on flexible/redeployable resources and infrastructure | Costs can be impacted within 2-3 months based on fluctuations in demand for services | Budgeting/pricing |
| | One-time restructuring costs to turn off service | | Helpdesk |
| | Low marginal cost to serve additional units | | Printing |
| | Stranded costs with reduced demand | | Long distance telephone Usage |

Source: Booz Allen Hamilton
Other Demand Management Drivers

**Incentives** are closely linked to pricing in driving demand management. As mentioned earlier, too often incentives are misaligned and prompt schizophrenic behavior on the part of the service organization. Motivated to enhance customer satisfaction by service level agreement incentives, service providers lose sight of the bigger picture, which is to decrease overall costs by rationalizing BU demand. To achieve that goal, incentives need to be directly linked to the business units’ cost reduction goals.

So as not to strain day-to-day working relationships at the line manager level, these links should be established at senior levels in the service and line organizations, where they are bound to be more effective. Bringing that top-level perspective to the matter of internal service incentives fosters optimization within and across BUs.

These proposed changes in pricing and incentives cannot be effective in the absence of effective **governance**. Good governance, at its core, is a matter of communication. By establishing clear, indeed transparent, pricing mechanisms and by motivating the appropriate behaviors, a company will effectively provide the context for an affordability dialogue.

Demand management can be institutionalized only if both BUs and service providers are held accountable. Many companies set up boards to serve as a governance forum with participation from both line and service management. These boards act as a primary interface, providing directional oversight and customer input to the service organization and serving as a BU sounding board and platform for service delivery standardization. This cross-functional team provides the vehicle through which true customer segmentation and fit-for-purpose solutions become reality. The governance board also serves as a forum where cost and service level issues can be resolved. Again, good governance sets the stage for a genuine affordability dialogue and reinforces the alignment of supply and demand in internal service delivery.

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The New CFO Agenda
Setting the Pace for Value Generation

“The primary role of the CFO is to act as a partner to the business units to help them succeed with both their company-wide and specific Business Unit responsibilities. I recognize this represents a major shift in how we perceive this function and how it adds value to the corporation, so I intend to work shoulder-to-shoulder with our CFO to make this transition as smooth and successful as possible.”

—CEO of a Global 500 company

According to a benchmark survey conducted by Booz Allen Hamilton, best-in-class companies are increasingly recognizing the legitimate, active, and value-adding role of corporate in guiding, even challenging, the business units. Corporate officers’ role in setting strategic direction, allocating resources, and serving as an “early warning system” is increasingly prominent, and particularly visible in this turbulent market environment is that of the CFO.

Corporate governance concerns – exacerbated by a weak economy globally – have driven shareholder values sharply lower in recent years. Legislative and regulatory authorities the world over are scrutinizing financial statements and board structures and imposing new accounting rules and codes of conduct to prevent further surprises. The lead corporate contact in these investigations and reforms is the chief financial officer, the steward of the company’s capital resources.

In this climate, the CFO is taking on greater accountability and authority. Traditionally focused on the standard reporting and control functions (e.g., ownership of accounting policies and integrity of the numbers; consolidating results of business units; assessing financial risks; managing investor, analyst, and rating-agency relations; raising capital), the CFO is now also responsible for connecting capital markets requirements directly with business unit operations and raising red flags wherever significant risks exist.

As a result, the CFO’s job is becoming more strategic, less functional. He or she is now called on to provide an independent perspective on the performance of individual businesses, actively challenging line management’s decisions in some cases. CFOs are identifying and focusing on the “billion dollar decisions,” testing the business cases for large investments and allocating restructuring resources. In some of the benchmark companies we surveyed, the CFO has direct authority over significant cost areas and can take fail-safe action to make plan.

In short, while the specifics of his or her relationship with the CEO will differ from company to company, the CFO at leading global firms is serving in a more exposed role as a pacesetter for value generation and as a true partner to the CEO and business unit heads (see Exhibit 1). More than a control agent

Exhibit 1
Emerging Role of the CFO

Source: Booz Allen Hamilton
or scorekeeper, the CFO has become an internal investment banker and the custodian of value-based performance management.

The New Value Management Agenda
While the end goal may be clear, effecting this shift in the CFO function is far from effortless. In an attempt to set the pace for value generation, many CFOs of blue-chip companies have already implemented some form of value metrics (e.g., EVA, CVA) to bring capital market expectations into the performance management of various businesses. Very few CFOs, however, have managed to embed the notion of true value management across the enterprise with these measures. They continue to be used more for reporting rather than for steering purposes.

Clearly, companies need to push this incipient value management agenda further. They need to break down and manage the unique value drivers of their businesses. Anchoring value metrics into the organization’s planning and rewards systems is a prerequisite, but that alone is not sufficient. CFOs today need to strengthen and leverage three key enablers to set and sustain the enterprise-wide pace on value generation (see Exhibit 2).

1. Refine and complement the existing value management toolbox
2. Develop and recruit “business thinkers” in the finance function
3. Establish and drive a “no surprises” financial management and control system

Enhance The Value Management Toolbox
The most common mistake companies make in introducing value-based performance management is applying an enterprise-wide, one-size-fits-all solution. That sort of uniform approach will never be successful in identifying and optimizing the individual value drivers that define and motivate each business unit’s performance. Each unit uses a unique business model, differing in capital intensity, specific risks, and the scope of managerial discretion required. These factors typically vary not only among business units, but also among divisions, even functions.

To take value metrics to the next level, where they do more than appease Wall Street analysts and actually guide management in running the business, the CFO function is far from effortless. In an attempt to set the pace for value generation, many CFOs

finance organization, working with the business units, needs to calibrate metrics unit-by-unit so that the specific sources of value generation are captured and quantified. This mapping of value generation sources must also identify particular risks to various earnings drivers so that they can be explicitly managed (see inset box, page 3).

Moreover, the CFO and his or her team need to integrate – deeply and systematically – value management metrics into the strategic planning and financial reporting systems and processes of the company. Best practice CFO organizations manage to instill value-based thinking not only at the corporate level, but also at the individual business unit level so that it informs strategy from the outset and is seamlessly integrated into performance management of the enterprise.

Build Business Acumen Within the Finance Function
Much of this emerging CFO agenda is predicated on developing an effective working partnership with the business units that transcends the traditional “scorekeeping.” Asked to take on significantly more responsibility with the same or even fewer bodies, CFOs are struggling with the challenge of integrating more business savvy into their control and reporting functions. What’s needed now in terms of the talent pool is not more accountants, but rather strategic finance types who can apply both financial and business acumen.
Enterprise Resilience Diagnostic℠

Because conventional risk mitigation strategies are generally not aligned with the earnings drivers of the enterprise, companies often don’t know if they are focused on the right priorities. We see the need for a systematic approach to building resilience where companies create a transparent and consolidated view of earnings drivers and their associated risks across the entire enterprise.

At Booz Allen we help clients establish more effective value management approaches and enhanced risk management capabilities through tools such as the Enterprise Resilience Diagnostic℠, which consists of:

- A view of the extended enterprise – the topology
- A consolidated and transparent view of “earnings drivers” or the value network
- Establishment of an existing resilience profile based on risk factors to earnings drivers and overall risk management spending
- A rationalization of current risk mitigation costs and a realignment of spending with priorities
- Specific gap-closing strategies, along with an approach to enhance transparency, management focus, investment effectiveness, and accountability

Naturally, these additional skill requirements prompt the question on the part of many exasperated CFOs: How do I fund and resource this upgrade?

Exhibit 3
Finance Capability Upgrade Path

To be effective, most finance organizations will have to go back to the drawing board and review the products and services in their portfolio. Leading companies start by automating as much of the traditional number-crunching as possible and implementing standardized systems and shared services. In doing this, many of our clients have been able to free up 30% to 40% of their human resources to work with the business units on value generation.

But all too many companies stop there, tackling the talent challenge from a pure systems perspective without also addressing the organizational issues. That’s a mistake. It takes change in both areas to move from auditor/accountant to valued financial consultant.

From an organizational standpoint, CFOs need to question and redefine roles, processes, and incentive structures to motivate this new agenda. As a first step, the existing talent pool needs to be assessed against the new capability requirements. The resulting development needs identified are often significant – some of our clients have established coaching programs to help finance professionals migrate their skill sets and practice new behaviors. To ask the right questions at the right time and to demonstrate persistence, even authority, in many cases requires new communications skills. Some leading companies systematically rotate financial staff through the business units to build business acumen and credibility.

But no matter what the process, finance professionals need to follow the capability upgrade path in Exhibit 3 to build a deeper understanding of business models and a more successful bridge between those business

Source: Booz Allen Hamilton
models and the capital markets. Their focus will have to evolve from validating numbers to setting and monitoring the pace for business unit performance. Finance professionals are becoming change agents, and, as such, they need to build standing with the business units and convince them of their ideas.

**Drive “No Surprises” Management Systems**

Businesses have always faced some degree of risk, but recent events such as the meltdowns of Enron and WorldCom, and the continued threat of terrorism, have provided dramatic evidence that in today’s economy, risk is reality. Not all risks can be anticipated; however, senior executives, most notably the CEO and CFO, have a responsibility to manage risks more effectively. This represents a new standard of care for business leaders that carries an elevated expectation of what constitutes reasonable precautions for a more resilient enterprise (see inset box, page 3).

Traditional risk management programs do not adequately address these new challenges. To maintain earnings consistency and preserve and grow shareholder value, CEOs, CFOs, and business unit leaders need to adapt strategy and business models to sense and respond effectively in the face of increasingly complex risks.

Years of double-digit growth and Internet-inspired hype distracted attention from core management and control processes, such as strategic planning and capital allocation. Now, companies need to revisit these governance mechanisms, and, in many cases, overhaul them.

Take strategic planning as an example. The traditional cycle of strategy development and financial budgeting can take some companies up to a year, rendering results out of date in dynamic markets. Corporate and business unit management and staff resources are largely wasted collecting, compiling, and reporting “old” data, which fails to yield timely or meaningful recommendations and action plans. Finance and business unit professionals need to move from static and cumbersome bottom-up budgeting to dynamic and rolling value driver based forecasting to succeed in today’s competitive environment.

In creating a climate of “no surprises” governance, the CFO needs to design and implement systems and processes that are:

- Quick and top-down to ensure that reporting is focused on what is really important and aligns the business units with the strategic plan
- Based on value drivers and benchmarks that incorporate external expectations from the outset
- Flexible and dynamic to ensure that new insights and risks are reflected in management systems and processes as soon as possible
- Co-driven by corporate development and controlling and functional experts to integrate strategy with financial planning, but with clear end-to-end CFO ownership
- Tied into HR so that incentives and personnel development reinforce governance priorities
- Clear in the division of roles and responsibilities between central and business unit CFO functions

**Implementing the New Agenda**

While many of the responsibilities described here have long been part of the CFO job description, companies are focusing renewed energy on the critical role the CFO plays in disciplining the organization to generate value. The outcome should be a more focused and tightly run enterprise where risks are mitigated and surprises rare. As the CFO steps up to a more strategic role as financial counselor to the CEO and board and performance manager for the company as a whole, so the finance function will become more tightly integrated into the day-to-day running of the business. The CFO will enjoy a better understanding of what is behind business unit numbers, more leverage in implementing company-wide initiatives to improve value generation and increased influence in protecting shareholder value closer to where that value is created.

Booz Allen Hamilton has developed diagnostics that help companies assess their readiness to enable their CFO and finance function to take on these new responsibilities. We take a snapshot of where companies are in terms of existing value metrics, talent pool, and financial management controls and processes. In conjunction with the CFO and senior leadership team, we then assist in the design and implementation of a tailored and comprehensive CFO business impact strategy.
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The View From the Top
Rethinking the Roles of Senior Management

Encouraging and facilitating the “right” amount and type of senior management interaction is a constant challenge. If interaction is too frequent, too transactional or too structured, the management team gets bogged down in tactical minutiae. If interaction is too sporadic, too strategic, or too undisciplined, the dialogue will fail to drive real and substantive action.

Historically, many firms have relied on culture to manage this executive dialogue. As companies globalize, expand through acquisition, and diversify their operations, however, their ability to rely on tradition and shared experience diminishes. In the absence of “culture,” companies need to put in place more formal and engineered management systems, processes, and roles to keep diverse operations running smoothly and on the right path (see Exhibit 1).

Based on our client experience and a benchmark survey we conducted earlier this year of senior executives at a broad range of global companies\(^1\), we have identified three positive trends in the evolution of senior management roles, as well as systems and processes.

1. Business unit heads are expanding their purview and driving the corporate change agenda.

2. Key functional leaders are acting as both master and servant, supporting the business units, while overseeing enterprise-wide change in their own areas of functional expertise.

3. Companies are creating new management structures and systems to legitimize and reinforce these changes in business unit and functional leader roles.

We briefly describe our key findings in each of these areas.

\(^1\) A complete report detailing survey findings is available upon request.
Business Unit Leaders

The trick to developing the right strategy and management system in today’s global market is pulling together and leveraging the combined wisdom and experience of the entire senior management team. That means expanding the role of business unit (BU) leaders beyond protecting the fortunes of their individual units. They are now, more than ever, being asked to take on collective responsibility for the enterprise’s change agenda.

But how can these senior managers take on added accountability, in a way that is meaningful and not just lip service, without diluting their responsibility to drive results within their own BU? And how can the added onus of driving corporate results be made “legitimate”?

Many leading companies answer these questions by including business unit heads in an Executive Committee (EC) or similar corporate management structure designed to allocate resources across various business investments. In this forum, all proposals can be considered together and evaluated in the context of available capital and external performance commitments. The Executive Committee brings multiple points of view, broad judgment, and active debate to bear on the assessment of opportunities. In so doing, it compels business units to develop stronger business cases and business unit leaders to think beyond their role as guardian of their unit’s interests. Now they are also part of a team owning and driving enterprise-wide change.

By placing business unit heads front and center in the corporate planning and resource allocation process, CEOs are fostering a tighter link between strategy and execution, and, by extension, between line and staff management. With these structures, BU leaders are less likely to escalate issues they should be resolving themselves. Moreover, membership on the EC emphasizes that BU leaders are collectively responsible for achieving corporate-wide goals; if some members are falling behind on their commitments, others know to redouble their efforts to exceed their own.

The objective of the Executive Committee is not to reduce the CEO’s personal accountability for results or even to permit the CEO to refocus energy elsewhere. Rather, it is intended to enable the chief executive to engage more effectively with the senior management team and to integrate top-down leadership with bottom-up accountability. The EC enables the CEO to assert control while delegating authority, inspire loyalty while encouraging dissent, and question BU management while relying on their judgment. As one of our CEO survey respondents put it:

“I set the tone — I put team-oriented people in place, so we can challenge one another in a productive way.”

Corporate Functional Leaders

While key functional heads continue to be an integral part of the top team, we see a lot of well-managed companies moving away from staff-heavy executive bodies toward these leaner, business-focused managing structures and systems (i.e., Executive Committees). Meanwhile, many companies we work with are re-orienting the role of the corporate senior staff to not only serve the business units more effectively and efficiently, but also drive change across the enterprise within their own areas of responsibility.

As both master of their functions and servant of the business units, corporate functional leaders help set company performance targets, lead budgeting and capital allocation processes, provide independent assessments of business unit performance, support business units with their respective expertise, and act as the voice of the corporation within their own functional domain.

While each company will institutionalize and implement these new management systems in its own way, one company has created new and unique planning roles to translate strategy into action (see Exhibit 2). Strategic planners operate at the corporate level and focus on formulating business actions that are capable of “changing the game” in the industry. Meanwhile, business unit planning coordinators work at the operating level, integrating strategic initiatives and financial targets into business unit budgets and action plans.

The chief financial officer plays a central role in this new senior management team. At most companies surveyed, the CFO’s role has expanded well beyond administrative and functional duties. He or she is the corporate watchdog, safeguarding its resources and actively challenging the business units to prove their cases for various investment programs. In some companies, the CFO has direct line authority and controls enough of the corporate budget to take “fail-safe” action to make plan.

At the right hand of the CFO is the controller, who, more than any other individual, determines the transparency of the company’s numbers. The corporate controller and his or her business unit equivalents “own the pipe,” controlling the financial and reporting systems and signing off on major expenditures. Moreover, they effectively bridge the business unit and corporate cultures, so they often serve as an early warning system to companies facing trouble. A good controller fosters a bias for action and a sense of openness that
invites discussion on pending issues before they become crises. Moreover, a good controller utilizes the information at his or her disposal to enhance business unit performance.

New Management Structures
To legitimize and reinforce these changed business unit and functional leader roles, many companies have put in place formal management systems to supplement traditional cultural discipline. These systems encompass four key dimensions:

Structure — the formation of an Executive Committee or similar body;

Decision Rights — the vesting of resource allocation authority in this new structure;

Agenda Control — determining how and where the EC spends its time; and

Performance Reporting Systems — tracking strategic initiatives separately from “normal” SG&A.

Comprising the CEO, business unit heads, and senior functional executives, the Executive Committee is charged with:

- Setting and communicating the company’s vision, strategies, and objectives;
- Ensuring that strategy drives action by committing the requisite resources — both financial and managerial;
- Anticipating external challenges that will force the company to adapt its strategies and tactics;
- Fostering open information flow, both vertically and horizontally, within the organization;
- Balancing short- and long-term objectives to ensure that the urgent doesn’t crowd out the important, and the present doesn’t borrow from the future.

The EC structure provides a forum to bring the right people into key decisions at the right time. By vesting resource allocation decisions in this structure, top leadership can address BUs’ natural resistance to being held accountable for corporate performance in addition to their business unit results. By emphasizing corporate functions’ role in the broader strategic agenda, the structure can elevate the nature of those functions’ contribution. By focusing the agenda on driving strategic change as well as monitoring quarterly results, the EC can translate corporate strategy into an actionable change agenda with defined goals and clear accountability. And by tracking strategic initiatives separately, the EC can monitor the ongoing results of prior bets and determine whether to continue funding them or change course.

Rethinking the role of senior management in the current business environment presents its own challenges. Large-scale acquisitions, dramatic performance shortfalls, senior management turnover, and changes in competitive business drivers are transforming nearly every industry. However, by
consolidating and allocating resources through management roles, structures, and systems, senior management can vastly improve their chances of success at both the corporate and business unit level. By leveraging the combined business experience and judgment of the CEO, business unit heads, and senior functional staff, an Executive Committee structure recognizes the mutual interdependence of the senior management team and provides the mechanism for promoting timely and relevant management dialogue that can effectively drive the performance of the various businesses and the company as a whole.

What Booz Allen Brings
Booz Allen Hamilton helps clients across industries implement new operating models designed to improve their organization performance.

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As the economy shows signs of a turnaround, corporations are directing their focus to capturing growth in the upturn. Unlike the 1990s, however, growth in the near term is likely to be organic rather than acquisition-driven, prompting a number of companies to reconsider their operating model. Product-focused organizations are becoming more customer-centric and finding that their current processes cannot deliver on new market requirements. So, once again, companies are reevaluating and redesigning their business processes—both customer-facing and non-customer-facing (see Exhibit 1)—in search of increased customer value, as well as internal efficiency. This new round of business process redesign (BPR) can be distinguished from previous attempts by its three defining attributes: 1) It differentiates processes based on customer profitability and cost to serve; 2) It occurs within the context of an overall organizational change; and 3) Today’s BPR is built on sustainable behavior change.

The business process reengineering approach popular in the mid- to late-’90s may have delivered on the initial cost reduction front, but it is ill-equipped to evolve with new market requirements. Much of the BPR work implemented then rode on the crest of the ERP wave—in other words, “big bang” technology-led initiatives—and so was overly focused on standardization and one-size-fits all solutions. As a result, processes failed to evolve flexibly as customers’ needs became more differentiated and their expectations grew.

Moreover, the last round of BPR failed to take sufficient account of the organizational and people factors that lead to true behavioral change. While processes were reshaped, accountability was not institutionalized. There was plenty of talk about process owners and “cascading” change, but decision rights, coordination mechanisms, governance structures, and other organizational elements were not explicitly addressed until later, if at all. Process efficiency trumped organizational alignment. Consequently, the substantial savings realized often quickly dissipated.
The new approach to BPR addresses these shortcomings in three key ways:

1. Companies are **differentiating processes** and analyzing them in the context of customer profitability and cost to serve, as well as opportunities for greater standardization.

2. **Organizational change** efforts are being introduced very early in the transformation, and process redesign is often undertaken as a means to enable the new focus. For example, many companies are currently making an organizational shift from product to customer orientation and then redesigning processes accordingly.

3. Management is far more focused on the front end with creating a culture that enables and motivates **sustainable benefits**: they are proactively managing cost and complexity to prevent their creeping back after the changes are implemented.

**Process Redesign: Tailored Business Streams**

In partnership with our clients, Booz Allen Hamilton has developed a differentiated approach to business process redesign that not only captures the benefits of scale across the enterprise, but enables differentiation.

Our approach starts with the view that every organization has two distinct types of processes—customer-facing and non–customer-facing—with different characteristics (See Exhibit 1, Page 1). While many of the principles, tools, and lessons of BPR apply to both, the details of implementation will vary. The immediate priority for many companies in the current environment is redesigning their customer-facing processes. The first step is developing a superior understanding of the customer experience by identifying and quantifying cost-to-serve and complexity drivers.

At Booz Allen, we use an approach called Tailored Business Streams, which helps companies identify and isolate the sources of complexity in their business model. Once identified, complexity can be optimized such that scale is leveraged where it’s cost-effective and customer solutions are tailored where profitable. The Tailored Business Streams approach comprises three fundamental steps:

**Segment Customers:** Develop a deep and actionable understanding of target customer segment needs. What is high priority versus low priority? What is necessary versus differentiating? What can the segment afford? Direct customer feedback is essential in developing the necessary customer insight: Too many companies fall into the trap of assuming they know better than the customer. This exercise enables companies to distinguish common versus unique demand and build customized processes accordingly.

**Understand Cost to Serve:** Determine the supply-side cost to serve by looking at cost drivers rather than cost pools (see Exhibit 2). Historically, process redesign efforts have focused almost exclusively on realized and systemic drivers of cost, which resulted in an emphasis on improving efficiency and/or reducing spans and layers in the organization. However, most of these cost reduction opportunities are now exhausted; few organizations can “lean” their way to profitability by exercising realized and systemic levers alone. Organizations must now begin to focus on structural and inherent cost drivers, such as product and channel configuration, that offer the biggest benefit but also require the most difficult choices.

**Develop Customer Solutions:** Develop proposed value propositions for target customer segments and future-state designs that strike the right balance between customer-valued variety and cost to serve. Building dedicated front-to-back customer processes for each segment is most likely uneconomical. However, by standardizing shared and simple processes across segments, and tailoring a few critical, complex ones, it is possible to deliver a differentiated customer solution and, at the same time, drive down costs. In fact, companies who have pursued this type of “smart customization” have delivered 2% to 7% more in organic growth over three years based on our research.

**Exhibit 2**

Disaggregating and Optimizing Cost-to-Serve Drivers

<table>
<thead>
<tr>
<th>Choices</th>
<th>Levers</th>
<th>Sample Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;What do we do?&quot;</td>
<td>Inherent</td>
<td>Business Portfolio</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Product/Service Config.</td>
</tr>
<tr>
<td>&quot;How do we do it?&quot;</td>
<td>Structural</td>
<td>Footprint Config.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Product &amp; IT Design</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Channel Config.</td>
</tr>
<tr>
<td>&quot;How well do we do it?&quot;</td>
<td>Systemic</td>
<td>Process Controls</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Organization Systems</td>
</tr>
<tr>
<td>&quot;How well do we apply ourselves?&quot;</td>
<td>Realized</td>
<td>Staffing Levels</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capability Alignment</td>
</tr>
</tbody>
</table>

Source: Booz Allen Hamilton
As with any major initiative, begin Align the Organization: change program that encompasses the following steps:

1. Identify the processes to be redesigned. This involves identifying the core processes that are critical to the organization's success and that are ripe for improvement. The goal is to create a process redesign plan that focuses on the most critical processes.

2. Engage the organization. This involves involving key stakeholders in the redesign process. The goal is to ensure that the redesign plan is aligned with the organization's goals and that the organization supports the change.

3. Design the new process. This involves developing a new process that is more efficient and effective than the current process. The goal is to create a process that is aligned with the organization's goals and that is supported by the organization.

4. Implement the new process. This involves making the change and measuring its impact. The goal is to ensure that the new process is implemented effectively and that the organization is able to measure its impact.

5. Sustain the change. This involves ensuring that the new process is sustained over time. The goal is to ensure that the organization is able to maintain the benefits of the change and that the organization is able to measure its ongoing impact.

For non–customer-facing processes, the fundamental challenge of differentiating capabilities while lowering cost to serve is similar. Here, however, the emphasis on process standardization and simplification is arguably more pronounced. Internal service providers need to define their core processes from the internal customer back and redesign them using measurable business value as the metric (i.e., the traceable impact on business profitability). It is imperative that the provider understand the value drivers of process performance and bring all options to the table, making cost-value trade-offs for internal business unit customers as transparent as possible. Here, too, Tailored Business Streams is a useful tool as are other lessons and methods, although the tolerance for costly customization is arguably lower. Companies are becoming more ruthless about eradicating complexity in support areas that customers don’t value or won’t pay for.

**The Organizational Context: Sustainability**

While Tailored Business Streams can help a company differentiate processes and isolate and optimize the complexity in them, it can’t ensure the sustainability of process redesign benefits. Perhaps the key distinction between ’90s BPR and today’s is the current emphasis on the organizational and people changes needed to overcome initial resistance and denial and institutionalize positive change. Today’s BPR does not occur in a vacuum; it takes place within an overall organizational change program that encompasses the following steps:

**Align the Organization:** In the old-school BPR, project managers were assigned to various processes and their progress assessed based on hitting certain milestones. When the program wound down, so did their level of investment and enthusiasm. Today, BPR is woven into the redesign of the overall organizational model and process owners are business unit or functional managers who will have to “live” with the results of their efforts on an ongoing basis (see Exhibit 3). They are fully accountable and vested in the ongoing success of their process and the organization through measures and incentives. Organizational remodeling is about more than just lines and boxes; in fact, it’s the nonstructural organizational elements that drive how processes are performed and how efficient they can be: governance, decision rights, measures, and incentives.

**Manage the Change:** As with any major initiative, begin the change process on Day 1, blending an analytic approach with a healthy dose of behavioral psychology. Symbols, war stories, and values can be every bit as motivating as hard data. Managing change on this scale is all about inclusion—early and often. It’s about understanding what makes people change (e.g., soliciting their input rather than issuing edicts). Rather than cascading down changes made at the top, companies need to orchestrate them from the customer-facing operations on up. Process owners need to bring all options to the table and make cost/value trade-offs as transparent as possible. Line management can be involved to ensure that reengineering is grounded in measurable improvements to business profitability. In this way, the new wave of BPR lays the foundation for sustainability and continuous improvement.
Conclusion
Rather than being technology-led and stand-alone, the new generation of BPR is customer-led and integrated into the overall fabric of a new operating model. IT serves as a catalyst and key enabler, but is not a big bang transformation agent. In fact, just the opposite; new BPR programs often precede and drive more focused IT renewals. The result is a wave of process redesign that can unfold more flexibly and rapidly to meet the ever-changing requirements of an increasingly diverse customer base.

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Business Process Offshoring
Making the Right Decision

Offshoring business processes can offer companies across a range of industries the opportunity to lower costs by 40% or more. Still, offshoring is not for every firm—and certainly not for every business process. As senior managers look beyond the back office for functions to offshore, they need to determine first whether it makes economic sense to offshore them and then how to do it efficiently and effectively. Our work with clients that are offshoring to captive and third-party vendors—plus recent in-depth interviews with 10 offshoring vendors in India specializing in banking, insurance, telecommunications, and media—furnishes some unique and useful insights into this growing phenomenon.

Though hardly a new concept, offshoring activity has escalated recently as telecommunications and cross-border barriers have dissolved worldwide. Estimates of the overall business process outsourcing (BPO) market range from $200 billion to $500 billion, and a quarter of that work is now going offshore. Indeed, the offshoring of business processes is growing at double-digit rates in the United States and Europe.

Such blue-chip companies as GE Capital, American Express, HSBC, Standard Chartered, British Airways, Bechtel, General Motors, Ericsson, Toshiba, MetLife, and Prudential have outsourced business processes to captive or third-party offshore service providers in the past few years. The functions sent offshore run the gamut from routine IT transactions to increasingly higher end, knowledge-based business processes.

Examples are customer service, finance and accounting, human resources, and even product development and advanced analytics.

In many cases, companies are taking advantage of the opportunity offshoring presents to reengineer operations, source new product ideas, and serve customer segments they could not afford to serve before.

Benefits: It’s Not Just About Cost
Though outsourcing is largely a scale game, offshoring is driven by the dramatic wage-cost differential between Western “onshore” economies and the economies of South and Southeast Asia and Eastern Europe (see Exhibit 1). Labor savings alone—depending on the nature of the work and the skill level required—range from 40 to 70%.

Exhibit 1
Outsourcing is a Scale Game; Offshoring is Driven by Labor Savings
Exhibit 2
Breaking Down the Offshoring Savings Opportunities

Exhibit 2 breaks down the 50+% cost savings opportunity that companies can capture from offshoring business processes to India. Our research indicates that these savings are roughly equivalent to those available in the Philippines and higher than those available in Eastern Europe. Remarkably, clients can expect to save even more from offshoring to China, despite the significant language and trade barriers that still exist there.

Of course, such labor savings do come at a price. The additional technology, telecommunications, and management overhead required to relocate and supervise operations overseas typically reduce the savings captured by 10 to 12%.

However, lower labor costs are not the only persuasive factor recommending offshoring. Our work suggests three other key factors:

1. **People.** Offshore BPO workers are invariably college educated, and many—more than 40%—have an advanced degree (e.g., MBA, PhD). Treated as white collar, salaried employees (in stark contrast to the hourly workers performing the same function in the United States), these individuals are in the 75th percentile with regard to pay for their age group (early- to mid-20s). Proud to work for an international company and motivated by targets and incentives, offshore workers tend to be more productive and proactive in enhancing processes than their onshore counterparts.

2. **Market discipline.** Even captive offshore subsidiaries are profit centers, which differentiates them from their domestic back-office counterparts. They compete in an open marketplace for business, so there is a strong focus on continuous improvement and customer service. Offshore service providers often refer to their operations areas as the “shop floor,” and top performers have already established Six Sigma, ISO 9001, or COPC certification programs.

3. **Access to technology and resources.** Simply put, offshore operations can afford to “throw more brainpower at a problem” to meet their performance goals. Technology know-how is a relatively cheap commodity in ample supply in offshore economies. Dedicating the equivalent technology and personnel to a problem would be cost prohibitive in the United States or Western Europe.

**Risks: Offshoring Is Not for Everyone**

Despite ample evidence supporting the decision to offshore, our experience indicates that it does not work for everyone. In fact, our research shows that most of the companies that have tried to set up instant offshore operations in India over the past 2 years have failed.

That failure rate stems from several factors. For one, not every process is a good candidate for offshoring. Processes that are core to the business, require significant personal interaction, change frequently, or involve high levels of customization will not transfer well to an offshore environment. Our research and experience show that these factors rule out up to 30% of a typical client’s processes. Of the remaining processes, only about one-half are feasible for offshoring (see Exhibit 3).

Even if appropriate and feasible, offshoring significant business processes is a major organizational undertaking—one that is likely to provoke considerable resistance, not only from employees whose jobs are relocated, but also from communities and government bodies concerned about declining domestic employment. Companies considering offshoring must weigh the likelihood of unfavorable legislation, lawsuits, and negative publicity.

**Exhibit 3**
Making the Decision: What to Offshore?

[Diagram showing decision-making process]

Source: Booz Allen Hamilton
Besides the cultural and political risks that must be surmounted at home, there are also risks a company will encounter at the offshoring receive site. Country-specific risks range from weak legal systems to inadequate infrastructure to foreign exchange fluctuations. Social and political resistance, regulatory restrictions, and trade issues need to be resolved. Data security, privacy, and intellectual property rights are all of concern.

There is more. Though attractive, the returns on an offshoring investment typically take 2 years to start rolling in. Those companies that choose to set up captive operations offshore can expect to wait 2.5 years or more to break even. And whether one offshores to a captive subsidiary or to an outsourcer, an intense 18-month effort will be needed to transfer and stabilize the first processes.

Companies must explicitly consider all these risks in transitioning business processes to an offshore location. More important, they must develop an exit strategy or effective fallback plan in case the offshoring initiative ultimately proves unsuccessful.

**Building an Offshoring Business Model: Many Options**

To ensure long-term value creation, offshoring should be considered in the context of a portfolio of sourcing, process improvement, and complexity reduction decisions. Each company's decision to offshore rests on a unique set of factors, but our experience has yielded some general guidelines:

1. **To offshore or not.** Companies need to carefully consider and resolve three key questions:

   - **Where?** Significant differences in risk, reward, and capabilities exist among India, China, the Philippines, and Eastern Europe. Once a country is chosen, city differences need to be evaluated. For example, Chennai is better for finance and accounting, but Delhi has better call center capabilities.
   - **How?** Should a captive operation be built or should you outsource to a third-party vendor? Although captive offshoring provides the greatest rewards and control, it is more difficult to manage and will become increasingly so as the market matures. Outsourcing to an established offshore vendor is the easier option, though less profitable. However, several vendors now offer build-operate-transfer models that reduce the initial investment risk and assure companies some degree of long-term control.
   - **Who?** Many offshore service providers are now in the market—from international companies to local facilities. Track record, scale, and expertise in the specific industry or function (e.g., health care claims processing, credit card collections) are important criteria.

2. **Pick the processes.** Offshoring starts with simple, standardized, measurable, and manual processes that can generate early and significant wins. The technology to support offshored processes should be stable and accessible through a wide area network. To minimize the disruption to the existing organization and ease the change management process, companies should start with processes that are already outsourced and that can be incrementally improved by offshoring.

3. **Manage the migration.** The key to successful offshoring is the smoothness and discipline of the migration process. Best practice companies migrate the first process in 3 to 4 months, and after going through the exercise a couple of dozen times, can offshore a process in 4 to 6 weeks. The migration process comprises the following basic steps:

   - Form a transition team, including “send site” and “receive site” staff.
   - Baseline the process being offshored.
   - Design the migration, including document process flows, technology requirements, people needs,
compliance standards, financial analysis, and disaster recovery.

- Execute in a staged, redundant manner.
- Keep 15 to 20% of the onshore team on-site to ensure a smooth transition.

4. **Manage the relationship.** Will the offshore service provider serve as an off-site “process factory” or a partner? Though either option is viable (depending on the processes being offshored), expectations and pricing for the options will differ significantly. Each firm needs to understand its individual responsibility for keeping the relationship productive over time. On a more tactical level, companies need to establish governance structures to ensure that the right metrics are being measured and tracked and that appropriate steering and escalation mechanisms are established on both sides.

5. **Anticipate the change.** The most common refrain heard from offshoring executives is that they should have started managing the change earlier. More time should have been dedicated to fostering buy-in at the beginning of the process through physical site visits, internal communications, labor relations (as necessary), and legal and regulatory preemptive moves.

**Proceed...with Caution**

The savings that can be realized by offshoring the right business processes are simply too compelling to ignore, particularly in a competitive global marketplace. If companies consider carefully what processes to offshore, exercise appropriate due diligence in selecting a site, and dedicate sufficient forethought and resources to the transition itself, they can realize step-change improvements in operating efficiency and productivity. The right approach to business process offshoring is a measured one that weighs the benefits and risks to the enterprise and focuses on long-term value creation.

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**What Booz Allen Brings**

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 85 years. Booz Allen combines strategy with technology and insight with action, working with clients to deliver results today that endure tomorrow.

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