Transparency - A Game Changer in Shared Services success

A Thought Paper on
"Profitability & Cost Management"
from the Business Consulting Group

ITC INFOTECH
Business-friendly Solutions

Executive Summary

Recent times have seen significant upturn in exploring for options that might help generate a better bottom line. In such highly cost conscious environment, the desire to pursue a Shared services approach is often driven by potential for savings and efficiency. But Business units often complain that Shared services unit's services often end up incurring more cost than they targeted to save.

This white paper discusses the challenges confronted by Shared services in justifying their costs and pricing their services to chargeback to the Business. It further discusses how these challenges can be addressed by using the "right" costing method for Shared services and by integrating planning and budgeting processes of Shared services units with Business units. These approaches can unlock the investment in Shared services by not only enabling costs transparency for their services but partnering with Business in improving forecasting accuracies and thereby achieving desired benefits of savings and efficiency.

"Maximizing the value of shared services and minimizing the risks entail getting a clear view of the benefits the enterprise seeks. The design, implementation and operation of shared services are built around these benefits, taking into account the enterprise's appetite for, and ability to accomplish, change" – Gartner

The Issue & the Challenge >
Getting the most out of your Shared services?

A Shared services unit provides end to end services of administrative and support functions like IT, HR, finance, risk, compliance etc. to the entire organization. As a Shared service model matures, organizations move from single function shared service to multi-functional shared services. While cost savings due to consolidation of common work and infrastructure is a major driver to adopt this model, more and more organizations are recognizing the other benefits of shared services like increased operational effectiveness and efficiency by standardization of services, delivering high quality and productivity, improved resource allocation and thereby increasing the capability for high performance.

Despite of rapid adoption of Shared service model, it has its own set of issues. To grow as a strategic partner to business, it needs to operate like a business. It means a Shared service needs to have an understanding of their costs and capacity associated with delivering services to Business and aligning its resources with Business demand.

As an example, business units of our client, a leading Bank in South Africa, had two common complaints from their Shared services units:-

- "What are my Shared services costs made up off?"
- "Shared services costs are too high and affecting my product profitability"

Charge back from Shared services to Business units is often a constant source of internal strife and negotiation between them. The question is why?

Our interactions with the client's Business and Shared services unit indicate the reasons as:-

- Lack of cost transparency due to use of costing methodology which cannot validly measure, report and chargeback equitably to the Business units
- Lack of life cycle view of cost
- Lack of concurrence on the costs, hugely due to misaligned capacity between the Business and Shared service units
- Limited understanding of how changing demands of the Business influence the Shared service cost

Summing up the above reasons, Shared service units find difficulty in justifying its costs due to lack of cost transparency and infrequent dialog between Shared Services and Business leads to a misaligned capacity and inaccurate forecasting of Shared services units costs.

Activity based costing can address these issues and act as a translational tool to help Business understand Shared services costs and bridge the communication gap and enable cost transparency.

The Need >
Bringing in Cost Transparency

Cost transparency in context of Shared Services is to show the business

- Services it consumes
- Cost of delivering these services
- Breaking the cost down to activities and resources involved in producing these services

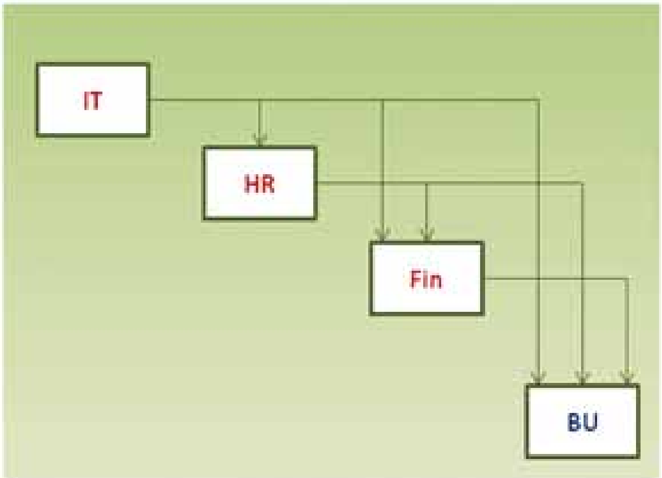
Activity Based Costing can detail the cost of service offerings of Shared service units to the activities involved in producing them and how these activities consume resources and its respective GL costs. This establishes a direct relationship between services used and costs to customer. It further helps in identification of value adding and non-value adding activities. This fosters communication between Business and Shared service to understand how they can work together to reduce costs by eliminating non value added activity and retain the same effectiveness and efficiency.

Shared service units have substantial expenses and are seldom revenue producing unless they cater to external clients as well. Most of the Shared services cater to other Shared services and Business in the organization. It is finally a zero sum game for Shared service wherein its costs are reassigned to other recipient Shared service units and eventually to Business units.

Total cost of a Shared Service unit = Its Own Direct cost + Net inward cost

So the method of calculating inward cost through cross charging should be simple to understand and equitable in its approach as well. So let's look at various methods generally used to calculate net inward cost:-

Sequential charging

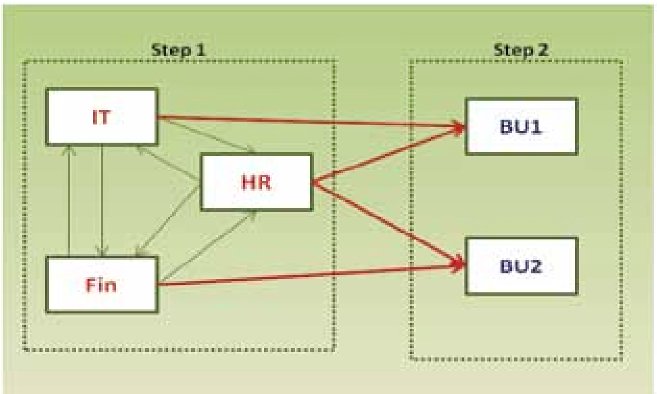


Sequential charging also known as Waterfall costing, the charging begins with one Shared service area like in this figure "IT". IT assigns all its costs to HR, Fin, other Shared service units and Business units. Next step is to assign all the costs of HR including the cost received from IT to Fin, other Shared service units and Business units. Finally, Fin assigns all its costs to Business units. Simple and easy to understand approach but lacks the simultaneous approach of cross charging.

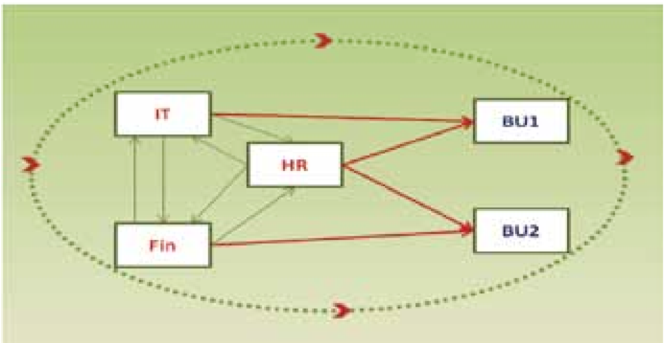
Simultaneous charging

Cross charging between Shared services units before charging eventually to Business units, can be one time assignment using reciprocal costing or iterative assignments using recursive costing.

- **Reciprocal costing** is the method of simultaneous charging. It is a 2 step method. In the first step, there is a onetime assignment of costs between the Shared services units. In the second step, Shared services unit costs including the allocated cost from other Shared service units are eventually charged out to the Business units.



■ **Recursive costing** also a method of simultaneous charging enables iterative assignments of cross charging between the Shared services units till substantial costs of Shared services is transferred to the Business units.



We have seen that Reciprocal costing method is more accurate than the Sequential charging method but less accurate than Recursive costing method. But Reciprocal method is easy to understand and costs can be easily traced to its orgin which enables Cost Transaprency for Shared services units unlike that of Recursive method.

Once the total cost of Shared services units are arrived then Chargeback unit rate for their services should be computed, inorder to issue a Service Catalogue for each Shared service unit for its services.

Chargeback rate are of two types – Budgeted and Actual

■ Budgeted chargeback rate is calculated using budgets at the beginning of the reporting period

Budgeted chargeback rate for a service offering =

$$\frac{\text{Budgeted service cost}}{\text{Budgeted service volume}^{(2)}}$$

■ Actual chargeback rate is calculated using actuals at the end of the reporting period.

Actual chargeback rate for a service offering =

$$\frac{\text{Actual service cost}}{\text{Actual service volume}^{(2)}}$$

[2] Volume can be demand or capacity of the service offering

The difference between the budgeted and the actual chargeback rate i.e. variance or recovery is charged to the buyer units based on the nature of variances and agreed Service volumes.

Using budgeted chargeback rate from Shared services, Business units can have an estimate of the impact of Shared services cost on their product profitability. Reporting period end variances will relate to change in cost and volume from budgets to actual. Using a method of costing which is simple, equitable and allows traceability to the origin helps in increasing the frequency of variance reporting at regular intervals drives accountability among Business units and Shared services and provides early warnings of under or over consumption of resources.

The Way Forward >
Capacity Management and Improve Enterprise wide Forecasting accuracy

To enable business agility in this highly competitive environment, Business units need to plan and budget their share of Shared services cost which are indirect in nature, to get a full picture of product and customer profitability. But in many organizations, the Business and Shared services operate and plan in silos. Shared services and Business units do not work closely in planning and forecasting their respective demand and capacity. This leads to misaligned capacity of Shared services which is counterproductive to the Business and leads to higher costs. If Business doesn't get involved in the process of setting the chargeback rate for Shared services, by integrating their budgets with that of Shared services, then suboptimal capacity and high costs will prevail in Shared services and they need to accept these charges no matter how high they are.

Using driver based budgeting of Shared services and integrating it with high level enterprise wide budgets highlights the impact of external and internal factors on resource and capacity needs of Shared services. Shared services can leverage existing idle capacity to add new services at reduced incremental investments and operational cost. Better alignment of resources across the organization, minimizes the risk of duplication of capital investments and improves forecasting accuracy by enabling the organization to frequently reforecast to keep capacity of Shared services in lines with Business demands are the benefits which can improve the Return on investment.

A Potential Tool Option >
SAP Profitability and Cost Management (PCM)

An important aspect of a cost model implementation or change is the tool capability to support the same. We believe SAP PCM contains a powerful modeling framework which helps organizations allocate costs using activity based costing and budgeting. It is a scalable and flexible enterprise class solution with the ability to process multiple and iterative cost allocation rules, trace back of cost to the origin, cross model integration within the tool and on demand "what if" and scenario modeling capabilities which make operational management and forward planning of enterprise wide cost responsive and simple to control. to keep capacity of Shared services in lines with Business demands are the benefits which can improve the Return on investment.

References

"Planning and Budgeting for the Agile Enterprise" by Richard Barrett, 2007

Summary

Business tends to be critical of Shared services due to the revenue generator vs. cost generator mindset. Cost transparency, closer alignment in planning operational plans and integrating driver based budgeting with the Business, using “what if” modeling and scenario planning for enterprise wide resources enables Business to assess budgets more frequently and accurately. Shared services unit’s resource leverage from economies of scale can help value generation and evolve them strategic partner from just an internal service provider.

About the Author(s)

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About the ITC Infotech Business Consulting group

ITC Business Consulting Group provides rich business consulting capabilities across key business functions such as product design & development, manufacturing & supply chain management, sales & service, loyalty & customer relationship management, etc. The group has expert practices around Enterprise Performance Management, CRM and Loyalty, SCM and Operational Excellence, Auto ID Solutions and Corporate Sustainability. Our domain experts and management consultants bring in expertise of addressing customer needs and problem statements in these areas across verticals such as CPG, Retail, Process & Discrete Manufacturing, Travel & Hospitality, Banking & Financial Services and Logistics & Transportation.

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