The macroeconomic environment in North America remains stubbornly unpredictable, leading companies in all sectors to look for ways to optimize execution and efficiency. Many organizations have already successfully implemented the basics in the wake of the global financial crisis and now seek to invest in targeting consumers more effectively—through analytics, research and development, and other methods.

To fund those efforts, many companies are unlocking capital by reexamining sales, general, and administrative (SG&A) or overhead costs.¹

It is crucial to manage overhead costs proactively. The exact size and composition of overhead costs vary widely by sector. However, any company, regardless of sector, that optimizes its overhead-cost-to-sales ratio by one percentage point essentially increases its earnings by the same amount. Therefore, a company with an above-average overhead ratio for its sector, that can reduce the ratio to near the midrange point (median) for that sector, could increase its earnings by 2 to 12% depending on the industry sector (figure 1).

¹ Overhead costs consist of all personnel and nonpersonnel costs not directly allocated to a product, such as the costs of sales staff and administration staff as well as operating expenditures covering such items as information technology (IT), insurance, and corporate policies such as travel and expenses, relocation costs, and recruitment costs.
A PROACTIVE APPROACH

Many companies seek to optimize overhead costs during periods of recession (figure 2). But such reactive efforts often tend to focus on short-term measures—such as cutting the budget for operating expenditure—involving only limited fundamental structural or process changes to sales or administrative functions.

That approach is problematic for several reasons:

- The overhead cost reductions are often temporary and, as a result, not sustainable. As budget pressures ease, costs often tend to creep back in—often, disproportionately.
- The cuts are often made very quickly and sometimes in areas that can be detrimental to the business. If, for example, the workforce gets reduced but underlying processes or workloads do not get addressed simultaneously, selling efforts and client relationships could be damaged and revenues severely affected.
- The sales and administrative functions often get overlooked when the costs of ongoing processes (such as manufacturing) are being addressed. As a result, companies can miss as much as 5% in annual efficiency gains within their administrative functions.

Managing overhead costs proactively and with a long-term perspective can effectively break the reactive cycle and permanently improve a business’s cost competitiveness.

Benchmarking can be an effective tool for managing overhead costs proactively. By comparing cost items internally (among divisions or regions) or externally (among companies in similar or different industry sectors), management can identify the indicative potential target overhead cost structures.
A FIVE-STEP PROCESS

Overhead costs can be benchmarked in three ways: internally, by peer, and by industry. Internal benchmarking can be approached in two ways. Cost can be compared in a time series (comparing the company’s own relative cost items as a percentage of sales over time), which indicates how the business and its cost competitiveness have changed. Or cost can be compared by their administrative locations and ranked by internal efficiency. Peer benchmarking compares the company’s costs with a peer group of competitors, and industry benchmarking compares the company’s costs with those of the industry as a whole. Even though each of those approaches can provide interesting insights into a company’s cost structure, internal benchmarking is generally the most comprehensive; peer and industry benchmarking are more directional and should be considered accordingly.

Benchmarks can also provide the transparency needed to quickly identify potential efficiency opportunities. But identifying opportunities is not the same as knowing how to act on them effectively. By following a structured five-step process, management can build a workable project plan for ongoing overhead cost management and continuous improvement (figure 3).

1 External functional benchmarking
As mentioned previously, benchmarking can provide directional insights into individual functions (e.g., finance, human resources, IT) and even subfunctions (e.g., accounts payable) and reveal specific adjustments that can be made to cost structures and processes rather than generic, across-the-board cost reductions across all functions. Because the process is transparent and objective, benchmarked data is very useful in persuading managers with functional responsibility that targeted cuts are needed.

2 Quantitative assessment of value drivers
Gaining an understanding of the internal client-supplier relationships among the various functional areas enables management to determine how individual functions can be made more effective (e.g., through process improvements), thereby providing value beyond mere efficiencies.

3 Review of target operational improvement levers
Once potential improvements have been identified, managers must quickly review which improvement levers have already been implemented, to what extent, and what more can be done. These include, among others, the overall design and structure of the organization.

4 Qualitative stakeholder interviews
Discussions with the organization’s key senior stakeholders resulting in an understanding of organizational complexities can provide additional insight into the potential management buy-in and implementation challenges within the organization. Such insights often go beyond the facts and figures and can reveal specific obstacles to implementation that might otherwise remain overlooked.

5 Greenfield idea generation and planning
Finally, based on the preceding analyses, management designs a target organization and uses it as a detailed and analytically derived basis for comparison with the existing organization. A plan for action and implementation can then be developed to correct the gaps between the target and existing organizations.
CASE STUDY
A global consumer goods company set a goal for the company to match the earnings-before-interest-and-taxes (EBIT) margin of its strongest competitor. After improving sales and optimizing manufacturing and procurement, the company turned its attention to overhead costs, which, at around 30% of sales, represented a significant share of its cost base.

However, initial discussions with the administrative functions suggested there was no appetite for further efficiency improvements because substantial progress had already been made in the past, and additional reductions were not viewed as possible. In response, the company completed a comprehensive, five-step diagnostic process, which produced several key findings:

1. **External functional benchmarking**
   Contrary to department management’s expectations, benchmarking identified a clear potential for improvement in specific functions. Internally, while absolute costs had remained the same across most functions, efficiency levels varied by location. Peer and industry benchmarking also revealed significant potential for improvement.

2. **Quantitative assessment of value drivers**
   Detailed discussions with functional heads identified further overhead cost optimization opportunities, along with an initial set of solutions. Management secured the buy-in for a companywide overhead-cost-reduction initiative through a series of internal workshops.

3. **Review of target operational improvement levers**
   Focused analyses identified specific improvement levers and measures, including an expansion of shared services activities, outsourcing of activities to lower-cost countries, and a reduction in the level of complexity of manufacturing processes.

4. **Qualitative stakeholder interviews**
   Through interviews with selected key senior stakeholders, management decided to reconfigure the geographic makeup of the company workforce and streamline and significantly simplify its management structure and complexity.

5. **Greenfield idea generation and planning**
   Finally, the team synthesized all of the findings, designed a target organization for all overhead functions, and built an overall implementation plan around it. It was recommended that the existing shared service center could be significantly expanded and product and process complexity reduced.

   The entire process took less than four weeks. The company targeted an initial 20% overhead cost reduction and deployed a number of small, senior, and cross-functional implementation teams to achieve it. The teams used benchmarking analytics to obtain the support and buy-in of the relevant functional leads and moved forward with the identified cost optimization initiatives. After the initial pilot, the company implemented a corporate wide program focused on reducing overhead by 30% that led to an EBIT improvement of $500 million within 12 months.

CONCLUSION
In times of continued uncertainty across many industries in North America, all companies should strive to actively examine their overhead cost-efficiency. By following a five-step framework, beginning with benchmarking, management can create a well-conceived and documented overhead optimization program and implementation plan in close cooperation with key stakeholders and functional heads.
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