

COVID-19: Impact on Cost Allocations

Swiss Business Modelling

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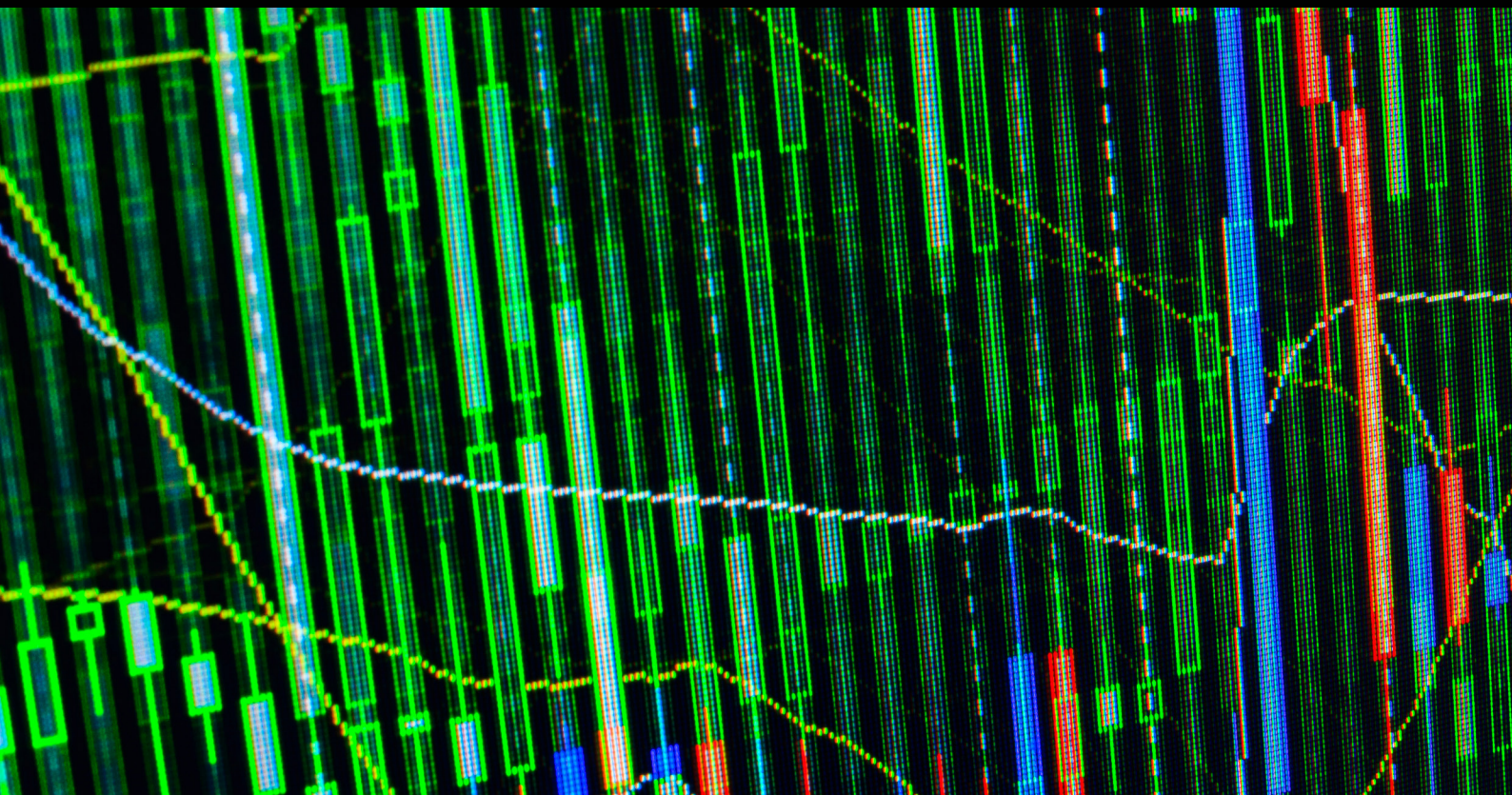


Introduction

A fall in demand for products and services across multiple industries has **greatly altered the expected gross margin of individual business units** and consequently triggered a need to re-evaluate performance and profitability on all products and services in the portfolio.

We anticipate that many global corporates will take measures to re-adjust their cost allocations in the coming year. We observe however that more often than not these efforts are ineffective, can have the opposite effect to what was intended and make it harder to appraise performance.

In addition, as we look beyond the COVID-19 pandemic, improving cost allocation helps to 'pull back the curtain' on utilisation of shared services, helping to achieve savings and **build a more agile service cost structure** going forward.



Deloitte Perspective



Why are cost allocations so contentious?

Cost allocation is a topic that divides **rather than unites opinion** within large corporates. Support functions (IT, Finance, Risk & Compliance, HR etc.) are required to justify their spend and their proposed methods for **allocating these costs between business units**.

This can be contentious because:

- Allocation methods are **often subjective**, based on a 'best guess' which can be challenged
- Business units are often limited in how they can **influence large parts of their cost base** (costs are semi-fixed or fixed) – this is frustrating for them
- **Balancing perceived accuracy with simplicity** is not easy, and business units habitually have differing requirements

“These are not my costs, I cannot control these costs”



What has been the impact of COVID-19 on cost allocation?

Some corporates have thrived during the pandemic, but most have not. The drop in revenues and erosion of margins have led many businesses to embark on **severe cost cutting measures**. Corporates typically target business units first, and cost reduction activities on support functions later. This is because the support functions are typically not configured to be scalable so that underlying costs can be reduced quickly. This results in situations where the **support functions are too big** and are over supplying the business units.

We observe that frustration and **disputes raised by business units** around unfair cost allocation are a symptomatic pain point and **an early indicator of oversized or inefficient support functions**.

60-80% of the costs of global organisations cannot be flexed within a 12-month period



What will happen next?

When business units complain, support functions will look to undertake two potential courses of action:

1. **Re-evaluate and justify existing cost allocations.** This can trigger a project around simplifying the existing allocations and/or providing the business units with greater detail behind allocations. These attempts only serve to frustrate the business and deliver a 'least worse' outcome, as percentage allocations are altered, resulting in winners and losers.
2. Engage in **tactical cost reduction projects.** These deliver short-term savings but **fail to address required structural changes**. Costs then rise back up in subsequent periods and there is **no sustained impact**.

2 in 3 companies globally now expect to pursue cost reduction measures, compared to 38% before the pandemic

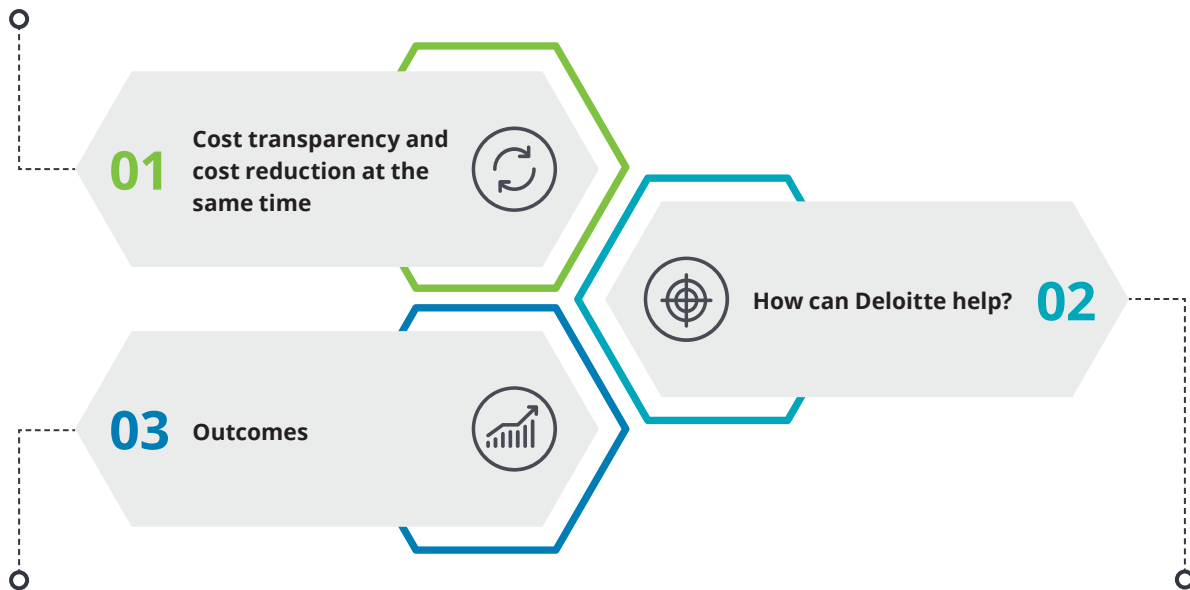
Deloitte Solution

When working with clients we consistently observe that cost allocations become **more complex over time**, often exacerbated by a **long list of services** not fully understood by the business units. A 'spaghetti network' of allocation rules and routines evolves, often without suitable central governance, and becomes unintelligible.

There are often no guiderails that actively seeks to prevent complexity. **Simplification of allocations and rationalisation of services** are a necessary foundation in order to convince all stakeholder groups that allocations are fair and transparent.

However, the simplification of allocation and cost transparency programmes should be executed **alongside an integrated cost reduction strategy**, as there will be significant interdependencies between the programmes. Forming a medium- to long-term cost reduction strategy will require the **service functions and business units committing to engage with each other** in order to understand the future demand for shared services.

Organisations that rely solely on headcount reductions have only an 11% probability of achieving strong performance after a downturn



- **'Reducing the size of the pie'**
- transforming the cost base of IT, Finance, Risk and all other support functions
- Creating greater **insight around the underlying drivers of cost** and awareness around what can be influenced going forward
- Substantially **reducing the management time and effort** that cost allocation unnecessarily consumes
- **Automating the allocation process** and preventing further complexity

We have worked with some of the world's biggest and most complex organisations to design and implement cost allocation environments that **achieve greater transparency and simplicity**, and to assist support functions to **transform their cost base and implement cost saving initiatives**.

We understand how **politically charged** cost allocations can be and how important it is for business units to report performance. Furthermore, there are wider transfer pricing and tax considerations that need to be considered. Our solutions cover **the end-to-end operating model** and include identifying the right systems, establishing governance and controls, defining roles and responsibilities, and developing the reporting environments.

Our extensive experience with support functions mean we are **ideally placed to assist with identifying cost reductions measures** and we work with Functions Leaders to form **comprehensive cost reduction strategies**.

78% of CFOs emphasised cost transparency as the main area for improvement to support strategic decision making

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