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Operations Practice

Who should pay for support functions?

Traditional allocation of support-function costs isn't working well, executives say. They need a better way to foster value-conscious decisions without creating too much complexity.

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January 2017

This article was republished in May 2024.

Throughout the world, organizations in virtually every sector have revolutionized how they manage their support functions. New technologies, partnerships, and sources of talent are turning areas once viewed only as cost centers into new generators of competitive advantage.

But even with all of these advances, one problem with support functions remains: how to determine who pays for them. Back in 2016, for example, a McKinsey survey found little satisfaction among senior executives about deciding who pays what for functional support (exhibit).

When we asked respondents how effective their company's allocation practices were in achieving several specific goals, such as allocating support costs to the correct profit-and-loss (P&L) line based on usage or providing transparency on each function's true cost, most respondents were equivocal at best. The only goal that a majority of respondents thought was being met "very effectively" was tax-and-regulatory compliance. For the other goals—most of which sought to relate cost allocation more closely to how the functions were being used—respondents described current allocation practices as only "somewhat effective."

In the intervening eight years, less has changed than we would have hoped. Companies still struggle with cost allocation for reasons that technology alone can't solve.

What's going wrong?

But what accounts for the shortcomings? We analyzed a series of more detailed questions to see where current allocation practices may be going astray.

Some allocation methods are too simple

The first potential problem we identified lies in the allocation approaches that companies are using. Almost half are applying a single top-down methodology for all of their functions—typically charging each business based on the percentage of enterprise revenues or head count that the business represents. So, for example, if a bank's credit-card business accounts for 15 percent of the bank's revenues, it also pays for 15 percent of every function's budget.

The virtue of this "spread the peanut butter" approach is its simplicity. But in most cases, that's about all that can be said in its favor, particularly if a company wants to encourage cost consciousness. Under this structure, the only way a business unit can reduce what it spends on support functions is to reduce its revenues or head count—hardly the incentive a leader wants to create. Nor would most companies want their business units to assume that support-function spending should grow in tandem with their businesses. Finally, because a blanket rule isn't very likely to reflect actual usage of a service, it can easily foster resentment among units that believe they're paying more than their fair share—and overspending among the ones getting a free ride. The result actually reduces transparency and accountability rather than increasing it.

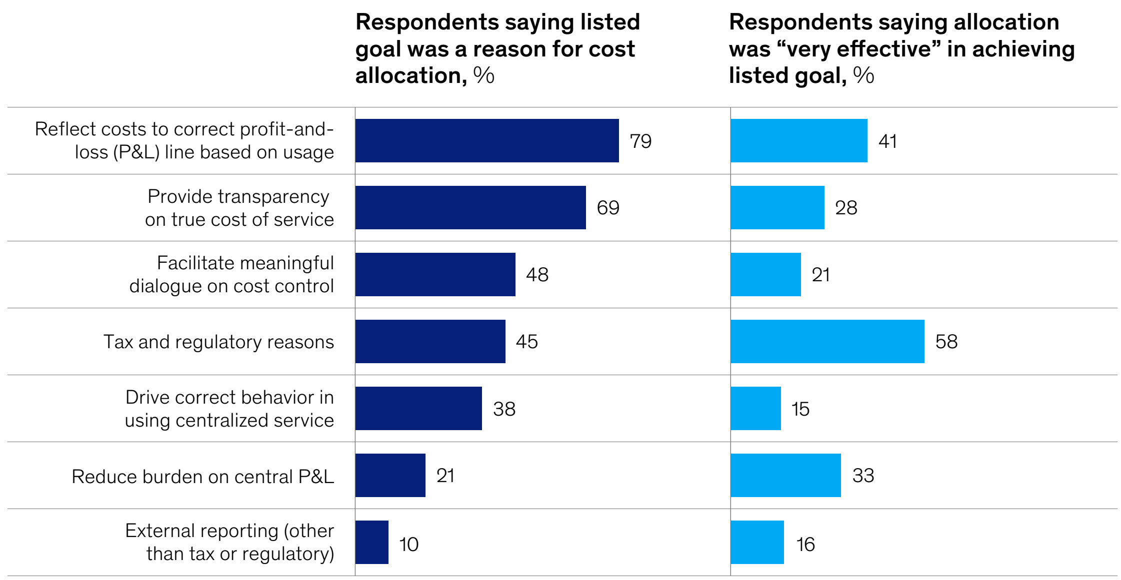
Other allocation methods are too complex

Yet trying to allocate costs in perfect alignment to usage can also be problematic. About 21 percent of respondents reported using bottom-up approaches based on transaction totals, while 17 percent estimated actual resource usage according to time-sheet or capacity-utilization records. These structures can work, particularly in labor-intensive functions where time and effort correlate strongly, such as in a legal function or certain types of IT help-desk support. But the tracking can itself absorb so much time that it may not be worth the additional effort it requires.

A majority of respondents therefore reported following a blend of approaches, usually relying on multiple allocation methods tailored to specific functions. That model comes at a cost, though, as the reconciliation process generally remains resource intensive. With 55 percent of survey respondents reporting "low levels of automation requiring significant work in Excel spreadsheets," the monthly (or quarterly) process to allocate expenses and manually record all the debits and credits creates a lot of additional work for the controllers' organization.

Exhibit

Satisfaction with cost allocation is generally low regardless of a company's reasons for doing it.



Source: McKinsey cost allocation survey (n=30), March 2016

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Too often, the main outcome is a series of management reports that management can't use, leading them to view allocation as a black box. "There's just not much detail provided to back up the amount allocated from corporate," one corporate controller told us. Another company, which had a sprawling network of locations, found that only one person truly understood how support-function costs were allocated to individual sites. That was the person who had designed the original methodology years earlier.

Finding Goldilocks

What are the alternatives? In our work with organizations across a range of industries, business-unit leaders have told us that what they want most from an allocation system is actionable information that they can use to manage what they spend. That insight leads to several implications.

1. Allocate as needed for compliance

Compliance with tax, accounting, and similar regulatory requirements was the one allocation activity that a majority of respondents considered "highly effective." These allocations are usually unavoidable. But organizations should scrutinize many others that they now make only for internal strategic or operational reasons rather than for external compliance.

2. Create incentives for functional leaders to contain costs, instead of allocating costs that business units can't change

A global consumer-services company illustrates one of the basic problems with allocation practices: they often result in business units paying for costs they can't control. In this case, the charges billed to individual units included line items for corporate HR and tax support, which the units could do nothing to reduce. If company leaders thought that corporate HR costs were rising too quickly, the more direct approach would have been to create incentives for the leaders of the function to contain costs, rather than put an added administrative burden on leaders of units whose behavior had little effect on the function's activities.

But changing mind-sets takes work. Functional leaders used to thinking of themselves primarily as service providers may need support in learning to focus not just on service quality but also on cost-effectiveness. Nevertheless, these leaders' greater understanding of the function gives them much deeper insights into potential value-creation opportunities than a business-unit leader making a support request.

3. Allocate to drive spending actions

Allocation works best in specific cases where the cost is mostly variable and related to internal or external customer demand, so that managers receiving the expense on their P&L can see a clear relationship between their organization's activities and behaviors and the expense. For example, usage of an IT service desk or a customer call center varies according to factors such as the quality of training the business unit is providing its employees or the level of service it is providing to customers. In these sorts of situations, costs can be allocated to the appropriate P&L owners. With standard pricing, such as a charge per call to the IT service desk, managers have a clear incentive: reduce the number of calls made.

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