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COST REDUCTION AND CONTROL

Best Practices

SECOND EDITION

THE BEST WAYS FOR A FINANCIAL MANAGER TO SAVE MONEY

IOMA

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The Best Ways for a Financial Manager to Save Money

INSTITUTE OF MANAGEMENT
AND ADMINISTRATION (IOMA)

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Contents

Preface

The United States is currently experiencing one of the strongest economic environments and profit rebounds of the past 20 years. Nonetheless, most businesses are still targeting areas in which to further streamline costs and ultimately set the stage for a resilient bottom line during the next downturn. Because of the strength of the current rebound, though, most top executives have altered their cost-control focus. How can they—and you—be certain about what to focus on next?

The appropriate focus can virtually be assured when you have the security of knowing that you are implementing the cost-control strategies recommended by your peers and other leading experts in the field. This is the purpose behind IOMA's *Cost Control and Reduction Best Practices,* and the reason we created it four years ago.

As your company's main line of defense against the rising tidal wave of costs, this guide will ensure that you are focusing on what exactly has to be done. There is no substitute for making decisions on a scientific basis, and this book ensures that you will not waste time and money by using strategies based on "soft" grounds—intuition, guesses, or the latest management fad. With this guide you will be able to identify the no-nonsense, balanced, and practical strategies for controlling costs that are being targeted and used nationwide by thousands of companies in areas such as HR, compensation, benefits, purchasing, outsourcing, use of consultants, taxes, and exports. These best practices are based on in-the-trenches experience, research, proprietary databases, and consultants from the Institute of Management and Administration (IOMA) and other leading experts in their respective fields.

We wish you the best of luck in your cost-control endeavors.

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Editorial Contributors:

Andy Dzamba
Tim Harris
Chris Horner
Joe Mazel
Rebecca Morrow
Susan Patterson
Brad Pickar
Mary Schaeffer
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Special Reports Editor:

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Janice Prescott

Vice President/Group Publisher:

Perry Patterson

Chapter 1

Corporate Cost-Control Strategies

CONTROLLERS' CORPORATE COST-CUTTING PLANS

Despite the strongest economic environment and profit rebound in the past 20 years for most businesses, companies are still targeting areas in which to further streamline costs. Because of the strength of the expansion, though, controllers at smaller companies have dramatically altered their focus—away from capital spending, where increases are now the norm, and toward areas such as health care costs and purchasing/materials costs, where prices still can be hammered away at (see Exhibit 1.1). An IOMA survey revealed that although hundreds of controllers at larger companies are still focusing mainly on capital spending, other areas are increasingly coming under the spotlight.

Exhibit 1.1 Most Critical Cost-Control Areas, by Number of Employees

	Overall		< 250		> 250	
	2004	2003	2004	2003	2004	2003
Health care benefits	55.7%	49.6%	70.2%	50.0%	42.6%	45.7%
Purchasing/materials costs	51.5	53.8	53.2	53	48.9	54.3
Capital expenditures	42.3	56.3	34	56	51.1	55.3
Manufacturing/production costs	39.2	41.3	36.2	35.1	40.4	51.1
Professional services costs (i.e., legal, accounting/auditing, banking)	35.1	40	29.8	41	38.3	35.1
Compensation	33	36.3	36.2	40.3	31.9	29.8
Inventories	30.9	45.4	23.4	42.5	36.2	46.8
Advertising expenditures/budgets	27.8	20	29.8	22.4	27.7	13.8
T&E	25.8	27.1	25.5	25.4	25.5	26.6
Use of outsourcing	25.8	—	23.4	—	27.7	—
Sales & marketing costs	22.7	26.3	25.5	25.4	19.1	28.7
Property/casualty insurance	20.6	23.8	27.7	23.1	14.9	23.4
Worker's compensation	20.6	22.5	23.4	19.4	19.1	25.5
DP/MIS expenditures/budgets	18.6	20.8	14.9	20.1	23.4	22.3
Downsizing	13.4	15.4	8.5	12.7	17	21.3
R&D	7.2	5.4	2.1	7.5	10.6	3.2
Pension plans	6.2	2.9	8.5	2.2	4.3	2.1
Retiree benefits	1	2.1	0	1.5	2.1	3.2
Other	11.3	11.7	10.6	11.2	10.6	10.6

Small Firms Identify Health Care Benefits Costs as Main Focus

A whopping 70% of controllers at small firms (less than 250 employees) now target health care costs as their key focus for the next 12 months. To do this, they are increasing cost sharing with employees; increasing co-pays, deductibles, and lifetime limits; changing to prescription programs with two or more tiers; and adding or enhancing voluntary benefits programs.

For the past few years, employers have emphasized cost sharing as the most effective means of controlling benefits costs, along with increased co-pays, deductibles, and lifetime limits. The shift shows that more companies are asking their employees to pay for more of the coverage. Employers large and small are using this approach. In many companies, all employees are now expected to contribute to the costs of their insurance, even for single coverage. Many also now offer a three-tiered system of contribution to insurance coverage across the board: the more money you make, the more you contribute toward the insurance. Most companies also offer a buyout of the insurance plan if an employee can show that he or she is covered elsewhere.

Changing to a tiered prescription drug program is the next most effective cost-control technique. Under these programs, cost sharing by employees increases if they choose brand-name drugs and decreases if they choose formulary or generic drugs. (See Chapter 3 for a fuller discussion of each of these approaches.)

Supply Management Best Practices: “Get Tough” Attitude

Controllers at both large and small companies place supply management nearly at the top of the list of areas on which they need to focus. This reflects their response to the economy and the upturn in business conditions. Specifically, it means taking a tougher stand on price increases and renegotiating existing supplier contracts when possible. It also means continuing to consolidate the supplier base, issuing blanket purchase orders for some goods, and shifting inventory to suppliers. At the same time, most controllers increasingly recognize their dependence on their suppliers’ control of their own costs; hence, they are looking across the entire supply chain and their logistics operations for savings.

Another best practice that purchasing managers now increasingly favor is global sourcing. Foreign-based suppliers are able to cut most companies’ materials costs by 30% or more, although the supply chain is longer and better planning is necessary. E-sourcing and e-purchasing processes are also gaining favor with purchasing managers, with about one in five now doing either or both. (These approaches are all described in more detail in Chapter 10.)

Controlling Compensation Costs: Reducing the Size of Merit Pay Increases

Controlling compensation costs ranks fifth on controllers’ list of where they are focusing their efforts. In this area, it is often best to take a cue from compensation managers who face this issue every day. Nearly half of these experienced professionals indicated that reducing merit pay increases was their top method for controlling compensation costs. In many cases, however, companies are combining reduction in merit increases with a new emphasis on performance and rewards to top employees, partially as a way to offset any resulting ill will, as well as to emphasize the "merit" portion of the merit increase concept.

Following well behind reduced merit increases are hiring freezes and head-count reductions. More than one-third of compensation professionals indicated that these were their most effective means of controlling costs. Far more creative and less draconian is to create a pay structure that distinguishes much more sharply between high and low performers. This approach ranks third in effectiveness, but has a much better impact on morale and productivity. (See Chapter 4 for more detailed descriptions of these approaches.)

Growth Stage of Business Cycle Alters Strategies

Given the current growth stage of the business cycle, controllers are, for the most part, no longer focused on reducing research and development (R&D) expenditures or downsizing. Inventory strategy, however, requires constant attention. The best way to control inventory, regardless of the stage of the business cycle, remains the periodic review. Identified by more than 60% of inventory managers for the past five years running is the periodic—daily, weekly, monthly, quarterly, or other time frame—seeking-out of slow-moving, excess, and obsolete stocks. This involves virtually everyone in the company who has any impact on inventory. (For more on this and other approaches, see Chapter 11.)

BAIN STUDY OUTLINES STRATEGIC IMPORTANCE OF CONTINUOUS COST-REDUCTION PROGRAMS

More controllers are working with senior managers to develop a new framework for examining and continuously reducing costs. Under this approach, top managers have decided that cost discipline will be a program, not just an implicit element of operations. Further, they expect this program to become a core competency.

In many cases, controllers who participate in these continuous cost-reduction programs are helping to remake corporate culture. *Reason*: At most businesses, cost discipline is an incidental reaction to events—usually a sales slump—and a byproduct of budgeting. Though this cultural change is hard work, controllers usually say the eventual success justifies the effort. Indeed, the consulting firm Bain & Company claims that businesses with successful programs of continuous cost reduction typically achieve half their increase in annual profits directly from cost reduction.

Controllers who work on these programs often emphasize two additional benefits. First, they say a business with a free-standing program of cost discipline stabilizes more rapidly in a downturn. This means that such companies are ready to grow once the business cycle turns.

Second, these firms adjust more rapidly to so-called trigger events. Bain identifies these as a collapsing market, a new technology, or a sudden increase in competition. *Key point*: All of these have a profound effect on sales and profits. In this situation, companies with weak cost discipline go into a survival mode and respond with across-the-board cost cuts. In contrast, companies with continuous cost-cutting programs tend to be low-cost producers. As a result, trigger events weaken their margins but leave room for flexible responses and decision making.

Starting Continuous Cost Reduction

There are four basic and widely recognized categories of cost reduction:

1. Eliminate waste and duplication
2. Implement best practices
3. Introduce technology where it is effective
4. Create virtual operations through Web enablement

Often, companies that develop continuous cost-reduction programs focus first on eliminating waste and implementing best practices. These are frequently two sides of a single coin and are often achievable through low-tech change.

The monthly close—where costs rise with the duration of the close—is a case in point. Best practices for accelerating the monthly close usually include eliminating multiple approvals, eliminating the filing of multiple copies of a single document, and automating recurring journal entries.

Tying Cost Discipline to Strategy

Certainly, all controllers support the elimination of waste and the implementation of best practices. *Key point*: When these measures are in place, employees are better able to use their natural problem-solving abilities to cut costs and work more effectively.

Even so, top management has to clarify how these cost-reduction efforts fit with the company's strategy. Cost cutting that occurs without reference to an overall strategy feels like torture to employees. Yes, they are happy to have jobs as their companies, say, downsize. If they do not know where the cost cutting is headed, though, they may consider cost reduction a mere tactic to pile more work on their desks, with top management lacking a real vision for converting spending and costs into business growth.

Writing for the *Harvard Management Update*, Bain consultant Vernon Altman described the importance of strategic cost cutting as follows:

> Managers have to address two critical questions. What is the urgent situation that requires reducing costs? How will the company use cost discipline to build momentum for growth? A company's leaders must make their reasons clear, communicating them over and over, so as to create a collective will for tackling the issues.

It has been emphasized that the payback for helping employees work more efficiently is enormous. Altman observed: "The basic insight is that a company that manages to lift the efficiency of its employees from 65% to 70% gets a 5% improvement in productivity. In terms of cost-discipline, that is huge."

Identifying and Empowering Advocates

When implementing a continuous cost-reduction program, top management identifies and empowers champions. These share one quality: they are employees who enjoy focusing on the cost side of the business. Here, top managers work from a premise that is obvious to controllers through their budget monitoring responsibilities: namely, that most managers like the revenue-generation game and are not wired for cost reduction.

Interestingly, Bain recommends giving these champions small centralized teams to plan cost-reduction initiatives. In the Bain scheme, members of these teams come from line organizations (i.e., not sales) and are familiar with potential cost-reduction opportunities. The teams then do rigorous benchmarking, data collection, and diagnostic work, developing a solid analytical basis for any cost-reduction targets they set. *Key point*: By forming these teams from line employees, champions endow their cost-reduction diagnostics with the credibility of insiders who know how the company operates.

These continuous cost-reduction programs use the 80/20 rule, but they apply it with great care. The 80/20 rule states that 80% of a company's cost savings can be extracted from 20% of its activities. Warns Bain: "If the cost champions apply this rule at the company level, they'll overlook a big chunk of potential savings—perhaps as much as 40%."[1] Controllers will make these programs successful by applying the 80/20 rule within divisions or, even better, within departments. "This," says Bain, "will spawn hundreds of worthwhile initiatives across the entire company, with no single team responsible for implementing more than a handful of the most important programs."

Funding Continuous Cost Reduction

Controllers often say the biggest problem that continuous cost-reduction programs face is funding. This is because many of the most promising initiatives that emerge from team diagnostics require up-front investment, especially in process reengineering. *Key point*: Set some money aside, even before teams develop cost reduction ideas.

Certainly, it is important not to overinvest, as big bets on information technology (IT) are risky. Nonetheless, cost-reduction teams often strike gold when examining IT. Says Bain: "Time after time, the largest cost improvement and synergies come from optimizing information technology systems and tightening supply chains to take out procurement costs."

Follow-Up

Top management communicates the strategy. Teams working for cost-reduction champions then identify targets that are consistent with the strategy. What remains? At this point, execution becomes the priority.

Successful programs of continuous cost reduction usually feature weekly reviews by senior management, certainly in the early stages. For these reviews, controllers make sure top managers have simple but precise measures for discussing progress. These are their tools, when top managers meet in regular face-to-face appraisals with the line leaders who are implementing cost-reduction programs.

Unresolved issue: Managers definitely deserve to be compensated for executing a company program successfully. “Be wary of special compensation plans geared to cost reductions: it is difficult to get compensation plans of any kind right, especially those focused on special cost-reduction efforts.”

SHOULD YOUR COMPANY DO AWAY WITH THE BUDGET PROCESS?

Should budgeting, as most companies practice it, be abolished? In effect, should the old-fashioned, slow-to-respond, fixed-performance contract be replaced by a more flexible form of budgeting (along with other types of goals and measures) that tracks the performance of the company relative to its peers and world-class benchmarks? It certainly seems to make sense—but only to a point.

This is the focus of Jeremy Hope and Robin Fraser’s book, *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap*.[2] Hope and Fraser point out that the same companies that vow to respond quickly to market shifts cling to a budgeting process that slows response to market developments until it is too late.

Though we agree with the book’s premise, a company’s financial toolkit will always have room for the traditional budget. True, the use of a new, more dynamic form of budgeting—such as the rolling forecast—is now needed to support more responsive overall corporate strategy development. However, the traditional budget will continue to play a role. For example, the conventional budget is the most effective tool for controlling costs.

The use of more flexible budgets and alternative performance measures is becoming more prevalent, as part of the new concept of corporate performance management (CPM). For instance, a survey from CFO Research Services found that three-quarters of companies polled want the capability to develop rolling forecasts. A Hackett Group study revealed that most companies have already adopted a balanced scorecard, which combines financial and nonfinancial metrics to track corporate performance.

As Hope and Fraser correctly point out, companies have a lot of work to do to revamp their budgeting processes—and their book provides some valuable insights into this process.

Perils of Extremism

Hope and Fraser correctly illustrate how, in extreme cases, use of the budget to force performance improvements can lead to a breakdown in corporate ethics. People who worked at WorldCom, now bankrupt and under criminal investigation, said CEO Bernard Ebbers’s rigid demands were an overwhelming fact of life there. “You would have a budget, and he would mandate that you had to be 2% under budget,” said a person who worked at WorldCom, according to an article in *Financial Times* last year. “Nothing else was acceptable.” WorldCom, Enron, Barings Bank, and other failed companies had tight budgetary control processes that funneled information only to those with a "need to know."

Companies that have recognized the damage done by improper budgeting are moving away from reliance on obsolete data and the long, drawn-out, self-interested wrangling over what the data indicates about the future. They have also rejected the foregone conclusions embedded in traditional budgets—conclusions that overshadow the interpretation and circulation of current market information, the stock-in-trade of the knowledge-based, networked company.

Alternative Measures

Hope and Fraser correctly point out that, in the absence of budgets, alternative goals and measures—some financial (such as cost-to-income ratios) and some nonfinancial (such as time to market)—move to the foreground. Under this setup, business units and personnel, now responsible for producing results, are no longer expected to meet predetermined, internally selected financial targets. Rather, every part of the company is judged on how well its performance compares with that of its peers and against world-class benchmarks.

At these companies, an annual fixed-performance contract no longer defines what subordinates must deliver to superiors in the year ahead. Budgets no longer determine how resources are allocated, what business units make and sell, or how the performance of those units and their people will be evaluated and rewarded. Some companies estimate that they save 95% of the time that used to be spent on traditional budgeting and forecasting.

Instead of adopting fixed annual targets, business units set longer-term goals based on benchmarks known as *key performance indicators* (KPIs), such as profits, cash flows, cost ratios, customer satisfaction, and quality. The criteria of measurement are the performance of internal or external peer groups and the results in prior periods.

KPIs, which tend to be financial at the top of an organization and more operational the nearer a unit is to the front line, can fulfill the self-regulatory functions of budgets. KPIs need not be precise to be effective. For example, Sight Savers International, a U.K. charity, has begun to develop target ranges for its KPIs. While managers are free to devise ways of achieving results within these ranges, senior executives look at the risks and test the assumptions of strategic initiatives that require very substantial resources.

At an increasing number of companies, rolling forecasts that look five to eight quarters into the future play an important role in the strategic process. The forecasts, typically generated each quarter, help managers to continually reassess current action plans as market and economic conditions change. Sidebar 1.1 gives an example of one company's approach to eliminating its traditional budgeting process in favor of one that includes rolling forecasts.

Without budget expectations to worry about, staff members can do something with all of the customer and market information they collect. The reporting of unusual patterns and trends as they unfold helps the business make rapid changes in a strategic direction. Instead of being imposed from above, strategy seeps up from below.

Sidebar 1.1. How Ahlsell Discarded Its Budgeting Process

Since Ahlsell, a Swedish wholesaler, abandoned budgeting in 1995, its main lines of business—electrical products and heating and plumbing—have overtaken their Swedish counterparts in profitability. After suffering through a severe business slowdown in the early 1990s, the company realized that it could achieve substantial savings and operational improvements by centralizing warehousing, administration, and logistical support, while devolving responsibility to large numbers of profit centers.

At one time, there were only 14 such centers; now, after a series of acquisitions, there are more than 200. Business-area teams (such as heating and plumbing) within each local unit are now separate profit centers, and they are fiercely competitive with one another.

Detailed sales plans are no longer made centrally. Headquarters communicates only general aims, such as becoming number one in electrical products within two years. The local units have been freed to develop their own approaches in response to local conditions and customer demands. The new organization recognizes that customer relationships are forged by front-line units, which can now set salary levels and customer discounts and even decide to obtain supplies from outside vendors if doing so will save money.

Because unit managers also have the authority to adjust resource levels in response to changing demand, they now recruit staff or order layoffs as required, rather than according to the timing and constraints of the annual budget cycle. (*Note*: Staff turnover is less than 5% per year—the lowest in the industry.) The function of the regional leadership, meanwhile, has changed from providing detailed planning and control to coaching and supporting the front-line units. To help the local units manage themselves more effectively, the finance staff teaches everyone how to interpret a profit and loss statement.

Key performance indicators are now used to set goals and impose controls. In the central warehouse, for example, the KPIs are cost per line item, costs as a percentage of stock turnover, stock availability, level of service, and turnover rate. The key indicators for the sales units are profit growth, return on sales, efficiency (determined by dividing gross profit by total salary cost), and market share.

In the days when Ahlsell kept budgets, it did not monitor how profitable individual customer accounts were or how much it cost to replace them. Selling was treated as an end in itself, and the company simply paid its salespeople for selling products. Since the abolition of budgets, the accounting system has been producing information on customer profitability. According to finance director Gunnar Haglund, the architect of Ahlsell's management model: "Salespeople now have a different approach. They know how every customer wants to deal with us—whether [they are seeking the] lowest-cost transactions, value-added services, or a closer, more strategic relationship—and which customers offer the best profit-making opportunities. This is gradually improving our customer portfolio."

Rolling forecasts are now prepared quarterly by staff members at the head office, who make phone calls to a few key people over the course of a few days each quarter. Results from the previous quarter are available with little delay, and employees at every level in the company see them simultaneously. At the end of each year, unit managers—there are now many of them—receive bonuses based on how the year's return on sales compares with that of the previous year.

Source: Jeremy Hope and Robin Fraser, *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap* (Harvard Business School Press, 2003).

Final Point

Budgeting should not be completely abolished in companies; it merely has to be brought in line with today's need for fast and meaningful information. It also must be recognized that traditional budgeting should remain—but simply as one part of a company's financial forecasting toolkit. The use of other tools and measures, such as balanced scorecards, economic value added (EVA) analysis, and the like, must be incorporated as well. Of course, any revamping of the budget process will be predicated on corporate culture; therefore, changing the process may not be as easy as it seems.

SERVICES SPEND

Company spending on services now reaches as much as 25% of revenue and 85% of total purchasing spend. As a result, more controllers are now looking closely at their services spend, as even a modest improvement in this facet of purchasing management has the potential to reduce costs and drop significant savings to the bottom line.

Exhibits 1.2 and 1.3 provide a starting point for examining the management of the services spend at your organization. Developed by the Center for Advanced

Exhibit 1.2 Services Spend as a Percent of Total Purchase Spend: 24 Functions

	Mean	Minimum	Maximum	Median
Accounting	0.40%	0.02%	2.13%	0.12%
Administrative	1.15	0.04	2.34	1.08
Advertising	3	0	11.62	1.61
Call center	0.76	0	3	0.26
Construction/engineering	6.04	0.78	10.16	6.19
Facilities management	1.86	0.02	7.11	0.68
Finance	0.29	0.06	1	0.13
Human resources	2.04	0	5.38	1.31
Information technology	5.24	0.01	15.63	3.36
Inventory	7.93	NA	NA	NA
Legal	1.45	0.06	4.04	0.7
Logistics	4.94	1.07	12.89	4.25
Manufacturing	20.24	1.02	69.22	6.68
Marketing	5.13	0.33	25.28	1.21
Printing/copying	1.51	0.11	8.03	0.35
Professional services	7.61	0.61	21.68	4.1
Project-based services	2.81	0.28	6.77	2.01
Research & development	0.78	0.18	1.58	0.68
Real estate	4.25	0.27	16.03	2
Telecommunications	2	0.1	7.2	0.98
Temporary staffing	0.97	0.04	4.65	0.72
Travel	1.79	0.01	4.82	1.74
Warehouse management	0.14	0.01	0.28	0.15
Other	8.49	0.75	22.19	6.25

Source: CAPS

Exhibit 1.3 13 Benchmarks for the Corporate Purchase Spend: By Average, Quartiles

	Mean	Minimum	Maximum	Median
Purchase spend as % of total revenue	38.37%	8.35%	88.88%	38.33%
Direct goods spend as a % of:				
Total revenue	21.14	1.69	46.67	19.56
Total purchase spend	82.93	0	100	54.79
Indirect goods spend as a % of:				
Total revenue	13.78	1.91	83.72	16.48
Total purchase spend	NA	NA	NA	NA
Services spend as a % of:				
Total revenue	11.38	1.99	25.52	8.42
Total purchase spend	NA	NA	NA	NA
Spend for direct goods bundled w/services as a % of:				
Revenue	3.19	0	13.56	1.12
Purchase spend	12.55	0	63.38	3.43
Direct goods spend	25.24	0	100	5
Spend for indirect goods bundled w/services as a % of:				
Revenue	1.49	0	16.17	0.14
Purchase spend	3.89	0	37.44	1
Indirect goods spend	16.28	0	100	5
Spend for services bundled w/goods as a % of:				
Revenue	1.88	0	11.66	0.68
Purchase spend	5.84	0	27.96	1.46
Services spend	25.25	0	90	10

Purchasing Studies (CAPS) and published in its new report, "Managing Your Services Spend in Today's Services Economy," these exhibits quantify two critical purchasing issues. Stated as questions, these issues are:

1. *Is our services spend high in particular functions?* In Exhibit 1.2, we show the percent of the total purchase spend that companies attribute to 24 functional services. For example, this shows that median and average services spend in human resources (HR) as a percent of the total purchase spend is 1.31% and 2.04%. But suppose your company attributes 5% of its total purchase spend to services used in HR? In this case, your company is approaching the highest services spend of the 35 companies participating in this CAPS survey. This suggests that your company is outsourcing significant HR services and paying top dollar to these HR vendors.
2. *Is our spending on services underreported and under analyzed?* Importantly, the CAPS survey found that a high percentage of the services spend was bundled with other purchases: 25% of the direct spend (i.e., variable spending) was bundled with services and 20% of the indirect spend (i.e., overhead-type cost) was bundled with services. Finally, 25% of the services spend is bundled with goods. At the same time, CAPS found that "many companies could not

differentiate this service spend from either direct or indirect." Many organizations may thus now underestimate their services spend. Exhibit 1.3 provides a range of benchmarks for bundled services spend.

More Authority for Purchasing

CAPS has a clear agenda. Namely, it believes that companies will lower their spending on services if they involve their procurement specialists in services-spend decisions. Dianna Wentz, a CPM writing for the Institute for Supply Management, states this position as follows:

> Purchasing departments have little or no control over services spend. In the 39 service categories studied, only 3 of the services were "managed, controlled, or otherwise influenced" by procurement staff. Purchasing had no control over the procurement spend of the remaining 36 service categories, which included areas such as information technology, facilities management, and telecommunications. This fact is perplexing, since approximately 54% of an organization's spend is focused on services, yet only 27% of those service purchases flow through supply management.

There are advantages to centralizing services procurement within an organization. Centralization, for example, does alleviate maverick spending. Further, companies that centralize service procurement are better able to leverage their volume. Nonetheless, controllers, as a practical matter, are not in a position to advocate the shifting of services-spend management to procurement.

Leadership in the Services Spend

In general, existing practices suggest that there is an effective and less disruptive approach to reducing the services spend. Basically, these controllers:

- *Develop a complete picture of the total services spend.* Observes CAPS: "There are several disparate systems in which this data is located: purchasing and e-procurement systems; P-card databases; general ledger and accounts payable; enterprise resource planning systems; and inventory/materials management." *Key point*: In many companies, controllers are perfectly positioned to initiate and lead a special project that calculates the total services spend.
- *Analyze the spend.* Observes CAPS: "Determine which business units within the organization are buying these services and how much are they spending. Then, determine if there are opportunities to leverage purchases or to shift purchases to less expensive vendors."

This obvious and basic approach bears fruit. For example, half of the CFOs participating in a survey by Forrester Research did not know their organization's ratio of goods and services spend. In contrast, CFOs and supply management executives at participants that the survey called world-class knew their services spend in great detail. *Key point*: These corporations are better positioned for what

CAPS calls "sourcing initiatives," which in turn drop substantial savings to the bottom line.

USE OF COST-MANAGEMENT TOOLS

An Ernst & Young (E&Y) and Institute of Management Accountants (IMA) study offers a frame of reference for those who wonder if their reporting systems are up to speed.[3] The E&Y/IMA Survey examines priorities in management accounting, the causes of cost distortions, and factors triggering the implementation of new accounting systems. E&Y claims that this information will also help "management accountants [to be seen] more as business partners, focusing more on key strategic issues, well beyond the boundary of traditional finance."[4]

Systems with 60% Usage

To begin, the E&Y/IMA Survey examines the frequency with which controllers and their colleagues use three types of planning and budgeting tools, five decision support tools, six product costing tools, and three performance evaluation tools. (See Exhibit 1.4.) Thus, controllers can use this survey to determine if they have

Exhibit 1.4 17 Cost Management Tools: Usage Rates at 2,000 Companies

Management Accounting Tool	Use	Under consideration	Rejected
Planning: Budgeting Tools			
Operational budgeting	76%	16%	8%
ABM/standard budgeting	65	23	12
Capital budgeting	62	24	14
Decision Support Tools			
Quantitative techniques	76	17	7
Breakeven analysis	62	23	13
Internal transfer pricing	57	23	20
Supply chain costing	31	43	26
Value chain analysis	27	47	26
Product Costing Analysis Tools			
Traditional costing	76	15	9
Overhead allocations	70	20	10
Multidimensional costing	35	39	26
Target costing	27	40	33
Life-cycle costing	32	37	41
Theory of constraint	32	41	37
Performance Evaluation Tools			
Benchmarking	53	36	11
Balanced scorecard	43	40	17
Value-based management	27	41	32

Source: E&Y/IMA Survey

as comprehensive a system for monitoring and analyzing information as their peers at other businesses.

In reviewing this information, readers are urged to start at the standard of 60% usage. At this level, a system is used at a clear majority of companies. By this rough measure, controllers who do not use 60% systems are a step or more behind most of their colleagues in supplying sophisticated information to top management. So, which are the 60% systems?

- *Planning and budgeting tools.* The survey shows that a clear majority of companies now use operational, standard, and capital budgeting.
- *Decision support tools.* Two of five decision support tools cross the 60% usage watershed. These are quantitative techniques, such as spreadsheets (76%), and break-even analysis (62%). At the same time, two techniques that consultants now tout—supply chain costing and value chain analysis—are used infrequently. Further, more than 25% of companies have actively rejected the implementation of these tools.
- *Product costing analysis tools.* Interestingly, controllers seem content to use traditional costing (i.e., full absorption costing) and overhead allocations to analyze and set costs.
- *Performance evaluation tools.* Surprisingly, none of these tools surpasses 60% usage. The relatively low usage of benchmarking here (53%) probably reflects today's emphasis on the implementation of best practices, which, proponents say, skips past the benchmarking step to improve internal processes. Meanwhile, the relatively low use of balanced scorecards (43%) is disturbing, because it suggests that top management continues to undervalue such measures as customer satisfaction and quality when evaluating the health of their businesses.

Strategic Effects of Costs

Importantly, the E&Y/IMA Survey also revealed significant appreciation for the cost information that controllers monitor and deliver through their reporting systems. The survey examined the significance of this cost information from three perspectives. Basically, these are the contributions this cost information makes to:

Strategy. To the survey question, "How important is the role of cost management in establishing your organization's overall strategic goals?," respondents answered: "very important," 53%; and "somewhat important," 27%.

Decision making. To the question, "Has the current economic downturn generated a greater demand for more precise costing or for more cost visibility?," participants answered: "much greater," 17%; "significantly greater," 28%; and "somewhat greater," 30%.

Profitability. "Is cost reduction considered the prime way to impact the bottom line in the current recession?" To this question, the answers were: "very important," 33%; and "important," 37%.

Ernst & Young offers this overview on the contributions of cost information: "80% of respondents said cost management was important to their organization's overall *strategic* goals. 75% believe the economy has generated greater demand for cost management and cost transparency. 70% say cost reduction is a prime way to impact the bottom line."[5]

Diverging Opinions on Priorities

Though not a major finding, the E&Y/IMA Survey identified a slight difference in priorities of top managers and controllers. The survey asked participants to rate seven priorities, using a scale of one (not a priority) to five (top priority). Overall, the findings across the survey's 2,000 participants were:

- Generating so-called actionable cost information, 4.2
- Cost reduction, 4.1
- Improving processes, 3.7
- Contributing to core strategy, 3.6
- Setting standards, 3.5
- Reducing risks, 3.3
- Automating processes, 3.1

Interestingly, this survey identified only one priority—contributing to core strategy—for which top managers and controllers have even slightly different expectations. Here, what the survey calls "decision makers" rated this priority as third most important, with a 3.8 rating. In contrast, so-called decision enablers rated this priority in fifth place, with a 3.5 score. In doing so, they also rated "contributing to core strategy" below the priorities of "improving processes" (3.7) and "setting standards" (3.6).

Other information in the E&Y/IMA survey suggests why controllers rate "contributing to core strategy" as a lower priority than do CEOs. In particular, this survey asked respondents to identify factors that distort true cost calculation in their organizations. *Background*: 98% of respondents acknowledged some cost distortion in their reports, with 38% deeming these distortions significant. The survey identified the sources of these cost distortion problems as:

- Distortions from overhead allocations: causes mild distortion, 50%; causes significant distortion, 35%
- Shared services: mild distortion, 59%; significant, 23%
- Greater product diversity: mild, 45%; significant, 25%
- Increasing IT expenditure: mild, 55%; significant, 15%
- Greater customer diversity: mild, 43%; significant, 18%

The top two priorities in businesses are generating actionable cost information and reducing costs. Certainly, these priorities focus controllers on process improvement, which supports both the development of actionable data and lower costs. This pushes the priority of contributing to the core strategy down a notch. To most controllers, moreover, this probably seems like a *critical* operating contribution to the core strategy.

Having an Impact

Certainly, many readers want to improve the cost information they generate. This ambition, of course, begs the following question: What factors will trigger the adoption of new management accounting tools in my organization?

On this final point, the E&Y/IMA survey showed how differently large ($1 billion in revenue and up) and small companies operate. At large companies, the critical factor is management buy-in, which got a 4.2 rating on a one (unimportant) to five (important) scale. Thereafter, significant factors are adequate technology (3.3) and organization expertise (3.2).

In contrast, the two critical factors at “small” businesses are organizational expertise (4.5) and adequate technology (4.4). What’s happening? At large companies, adoption is a top-down process. At smaller firms, infrastructure precedes and enables the adoption of new accounting tools.

TEN MOST EFFECTIVE TECHNIQUES FOR ENHANCING CORPORATE VALUE

With today’s increased scrutiny on corporate financial reporting, it is no wonder that more than 70% of financial managers cite improvements to reporting as the top way to enhance corporate value. This is the main finding in an IOMA survey in which almost 200 participants reported on the financial techniques they used over the past year that had the most impact on corporate value. In addition to improved reporting, participants cited new approaches to budgeting, benchmarking, and changes to corporate and departmental planning as other top ideas.

Improvements to Reporting

Improving the reporting process is the top approach for companies large and small and in both manufacturing and nonmanufacturing sectors (see Exhibit 1.5).

Exhibit 1.5 Most Effective Financial Techniques or Operations Used to Enhance Corporate Value, by Number of Employees and Industry

	Up to 250	More than 250	Overall
By Number of Employees			
Expanded/enhanced reporting to management	73.1%	66.0%	71.5%
Enhanced/changed approach to budgeting, cost, & performance analysis	64.2	60.4	63.8
Instituted benchmarking/added new performance metrics	50.7	54.7	56.9
Changed/enhanced corporate financial/strategic planning approach	43.3	58.5	47.7
Changed/enhanced division/departmental financial planning approach	31.3	47.2	42.3

(continued)

Exhibit 1.5 *(Continued)*

	Up to 250	More than 250	Overall
By Number of Employees (*cont.*)			
Revised how we analyze new projects (i.e., payback, ROI, NPV, etc.)	35.8	35.8	37.7
Analyzed new e-commerce opportunities (i.e., e-purchasing, e-sales, e-logistics, etc.)	20.9	28.3	26.2
Analyzed new or ongoing special projects (i.e., reengineering, joint ventures, alliances)	28.4	17	23.1
Adopted or migrated financial applications on to intranet/Internet (i.e., e-G/L, e-reporting, e-AP)	20.9	20.8	22.3
Expanded/enhanced reporting to suppliers, shareholders, financial institutions	25.4	13.2	22.3
Adopted new FASB, IRS, or SEC reporting requirements	11.9	34	20.8
Used new valuation or analysis approach (i.e., EVA, CFROI, balanced scorecard, etc.)	17.9	11.3	16.9
Changed accounting practices (i.e., for revenue recognition, poling of interests, tax shelters, etc.)	13.4	7.5	12.3
Revised how we analyze M&A candidates	1.5	7.5	3.8
Other	9	7.5	9.2

	Mfg.	Nonmfg.	Overall
By Industry			
Expanded/enhanced reporting to management	68.8	67.0	71.5
Enhanced/changed approach to budgeting, cost, & performance analysis	58.3	63.4	63.8
Instituted benchmarking/added new performance metrics	56.3	52.4	56.9
Changed/enhanced corporate financial/strategic planning approach	41.7	50	47.7
Changed/enhanced division/departmental financial planning approach	37.5	40.2	42.3
Revised how we analyze new projects (i.e., payback, ROI, NPV, etc.)	35.4	36.6	37.7
Analyzed new e-commerce opportunities (i.e., e-purchasing, e-sales, e-logistics, etc.)	27.1	25.6	26.2
Analyzed new or ongoing special projects (i.e., reengineering, joint ventures, alliances)	14.6	25.6	23.1
Adopted or migrated financial applications on to intranet/Internet (i.e., e-G/L, e-reporting, e-AP)	18.8	23.2	22.3
Expanded/enhanced reporting to suppliers, shareholders, financial institutions	25	15.9	22.3
Adopted new FASB, IRS, or SEC reporting requirements	20.8	20.7	20.8
Used new valuation or analysis approach (i.e., EVA, CFROI, balanced scorecard, etc.)	16.7	17.1	16.9
Changed accounting practices (i.e., for revenue recognition, pooling of interests, tax shelters, etc.)	6.3	14.6	12.3
Revised how we analyze M&A candidates	6.3	2.4	3.8
Other	10.4	7.3	9.2

What are the best ways to improve internal financial reporting? Increase the speed of reporting, develop more meaningful reports, and deploy more state-of-the-art reporting technology.

Speeding It Up. One of the key goals of internal financial reporting is to alert management to problems that need attention. Of course, the sooner management is made aware of these problems, the sooner it can act to solve them. Therefore, increasing the timeliness of financial reporting can yield significant benefits.

"More timely financial information enabled management to make decisions based on actual numbers and get a sense of where the firm is going financially or where adjustments need to be made before it is too late," reports the controller of a 43-employee accounting firm. "Last year alone it saved the company money and time as well."

When increasing the timeliness of reports, do not think just about top management—think about the operating departments. They will be able to act quicker if something has to be done. "We implemented more in-depth reporting and reviews with division management weekly and monthly. This enables us to correct problems sooner," says a controller at a 400-employee telecommunications company.

Making Reports More Meaningful. Take a fresh look at the reports being sent out. Are some being generated just because that is the way it has always been done? Are they really necessary?

Of course, the trick is deciding what reports to keep and what reports to scrap. Often, you can do this by deciding yourself what reports to send to management, instead of having management decide. They often do not know what they want, so they just ask for everything.

"We scrapped some old reports we were doing just because they had always been done," says an accounting manager at a manufacturing company (75 employees). "Finance decided which direction to point them in. We began to develop easier-to-use reports, and we also began focusing on support functions, such as logistics and customer service, as a way of improving the bottom line."

As discussed above, the emphasis should be on reporting matters that are most controllable. Also, the way revenues and expenses are reported and analyzed can make a big difference. "We divided our product lines into subcategories and tracked gross profit. That has really magnified products that may need to be discontinued or should be promoted to a greater extent," says a controller of a training materials supplier (28 employees).

Deploying Technology. Automated financial reporting and analysis tools have come a long way, and can yield significant benefits. "We use enhanced data mining tools, which enable us to obtain data which was previously unavailable," reports a vice president of administration for a 270-employee manufacturer. "The tools give us better data for analysis and decision making. The only trouble is verifying the validity of the data."

The use of Web-based tools has also transformed the reporting function. "We provide better information to management through a new Web-based financial reporting system that clearly identifies the drivers of the business and our performance against those drivers. The result has been better management decisions," says a CFO of a 7,500-employee auto supplier. "The only disadvantage has been the time and expense to launch and implement the new system."

New automated tools can be expensive. However, you do not always need to buy new software to leverage technology—you can use tools that you already have, such as e-mail or your corporate intranet. "We utilized an internal company Web-based network to store and make available several key types of financial and operational data, such as sales, orders, inventory, and production," says a controller at a 1,800-employee manufacturer.

Enhancing the Budget Process

The second most cited technique for enhancing corporate value was changing the approach to budgeting and analysis; 63.8% said this was the most effective tactic. A number of the ideas companies are using are particularly worth noting: namely, getting business units more involved, switching to rolling forecasts, and leveraging technology to help the process.

Getting Business Units Involved. Getting business units into the process involves pushing more responsibility for the budget down the ranks. "We enhanced our budget process by empowering business units to take ownership of their data," says a director of financial reporting at a 175-employee leasing firm. However, you cannot just drop this in their laps without giving them some direction. "We took steps to educate our front-line managers in the basics of budgeting—not only for labor but for all expenses," says a controller at a 55-employee agricultural company. "We show them how their area affects the bottom line of the business."

There are definite benefits in giving front-line people a key role in developing their own budgets *and* the responsibility for performance to budget. A cooperative approach can cut the amount of time needed to develop the budget in half. Driving the budget process down the line also increases accountability; all of the time and effort spent on creating the budget will be wasted if individuals are not held accountable for staying on budget.

When managers are involved and held accountable, they will be more apt to search out hidden opportunities for cost savings and to catch mistakes. "All directors are given worksheets to chart their expenses, which they could then use to verify expense amounts on their monthly financial statements," reports the financial director of a 118-employee service firm. "This makes the directors very aware of their expenses versus budget and also catches any errors on the financials in a more timely manner."

As an example, use a team approach when pushing the budget process down the line. "We looked at each department's budget as a team this year. We thought that the two-heads-are-better-than-one idea would be more effective," says an accounting director at a health care organization (900 employees). "Each person saw different things in the budget and helped us to cut some costs. It took a little longer to do but was very beneficial in the end."

Using Rolling Forecasts. Some companies report moving from the traditional annual budget to a more dynamic process, typically in the form of a rolling forecast. "We began a weekly forecast meeting where all managers forecast net sales and profits for the month," says a controller at a 430-employee engineering firm. "Now the managers can be proactive rather than reactive to changing times. We are also getting many more people involved, which improves morale as well as knowledge."

"The rolling budgets enabled us to track our success against our updated forecast, which replaced stale/outdated annual forecasts," says a controller at a public utility (82 employees). "Using rolling forecasts can require additional staffing to effectively run them and to continuously update the company's forecasts."

Leveraging Technology. There are several ways to capitalize on automated budgeting technology. "We started using Cognos' Analyst tool for budgeting analysis. It allows much more flexibility than spreadsheets," says a manager of finance/accounting at a water utility (188 employees).

Technology can also help push the budgeting process into the business units. "We implemented new financial reporting/budgeting software. The most favorable result is enhanced reporting to the firm and a hands-on tool for department managers to prepare budget activity," says a controller of a 500-employee legal services firm.

Benchmarking and Performance Metrics

Ranking third overall, more than half (57%) of companies cited success with implementing benchmarking and adding new performance metrics. *Benchmarking* involves identifying best practices, both within your company and at similar companies, and then comparing your company's performance with those best practices. A director of finance at a 75-employee human resources firm put the benefits of benchmarking in a nutshell: "Benchmarking our results versus the leaders in our industry flags potential revenue sources, as well as excessive cost structures."

In particular, improvements in productivity matter. "Production benchmarking is the most successful technique used. It gives real-time costs of production and alerts us to weaknesses in the process," says a CFO at a manufacturing company. "However, information submitted from production is sometimes erroneous and needs to be double-checked and verified."

In addition to potential problems with bad information, you may encounter some resistance when trying to implement benchmarking. "There was initial resistance to change, as some employees perceived this as a negative attitude about their performance," says a controller at a 40-employee service firm. "However, we used benchmarking to develop performance feedback for sales and operations. It helped increase productivity."

Benchmarking metrics should be as specific as possible. It may take some time to develop them, but it can be well worth the effort. "The initial research to develop and look up peer results and organize them into a reportable format cost some time," reports a controller at a financial services firm (30 employees). "But the initial cost should be absorbed over time. It has given our board of directors a better feel for the numbers and what we are trying to explain."

Enhanced Corporate Planning

The fourth most cited technique for enhancing corporate value was changing the approach to corporate financial/strategic planning; 48% said this was the most effective tactic.

One of the main ways to make overall planning more effective is to improve top-down guidance and to get everyone involved. This helps ensure buy-in. "We involved all the executive staff as well as key sales personnel, business unit corporate directors, and finance," says the controller of a 700-employee health care information firm. "The CEO established overall objectives. The general managers brought to the meeting their first draft as to how those objectives would be achieved financially. The team spent two days discussing and prioritizing key objectives. We used an interactive financial model to test different scenarios suggested by the group to arrive at the target. The final step of the process was to ensure everyone who participated agreed and bought in to the plan."

As with the budget process, empowering business units can go a long way in improving the corporate planning process. "We turned our divisions into semi-independent businesses, giving them more control over marketing, sales, and collections decisions. So far it is working rather well," says an accounting manager at a financial services firm (2,500 employees).

Planning at Divisional Level

Having the planning process reach down to the department or division level produces top results; 42% of companies said this is effective in enhancing corporate value. "Prior to last year, my company never forecasted down to the department or cost-center level. Due to this, there was no accountability for the numbers, which left little room for valuable analysis versus goals," says a manager of financial planning and analysis at a 1,400-employee distributor. "Since doing this, we have reached our expense target each month!" This also improves accountability, especially if compensation is linked to performance against plans.

COMPUTING THE VALUE AND COST OF A FLEXIBLE CAPITAL STRUCTURE

Even if your company is operating at its "optimal" capital structure, it may be losing value. How much value? A newly developed model can help you calculate it.

The Premise

Under the prevailing theory, a company's value will be maximized when it operates at its "optimal" capital structure. We were all taught that the optimal capital structure is the mix of debt and equity that minimizes the company's cost of capital.

The trouble with this notion is that at optimal levels of debt and equity, a company may not have the financial flexibility it needs. That is, it may not have quick access to financial reserves (such as cash or debt capacity) to respond to market or economic forces. For instance, if a new market opportunity arises, a company needs cash reserves to be able to move into the market before its competitors. Similarly, a company may not be able to fund efforts to prevent it from being a takeover target. True, the company could issue new equity to raise the funds, but this is risky. It dilutes ownership, and unfavorable stock market conditions could force the company to issue equity at a low price relative to value. *Key point*: To maintain financial flexibility, a company must have either excess cash balances or excess debt capacity. The trouble here is that too much cash is not good, because it earns below-market returns; excess debt capacity means that the company is not operating at its optimal capital structure.

Therefore, you might think that having financial flexibility reduces corporate value. But this cannot be true, because there must be some value to being able to move fast in response to market conditions—so-called strategic financial capability. But how can you quantify this value?

New Model in Action

Using the concept of real options, a new model seeks to quantify the value of strategic financial capability. The developers, Nancy Beneda, assistant professor of finance at the University of North Dakota, and Theron R. Nelson, a finance professor at the same institution, explained their model in great depth in a recent *Corporate Finance Review*. The valuation is done using the Black-Scholes option pricing model.

The amount that is calculated represents the additional firm value created as a result of the strategic option to invest funds that are available because of increased financial flexibility. Put another way, with financial flexibility, a company has the option to invest in future opportunities. This option has value.

To demonstrate, Beneda and Nelson selected a company, Toll Brothers Inc., a major home construction company. Companies in this industry are faced with highly volatile investment needs. That is why they require the flexibility to be able to fund these needs. Using the Black-Scholes model, Beneda and Nelson categorized Toll's strategic financial flexibility as an embedded call option and used these five inputs:

1. Expected investment needs in excess of internal funds for the upcoming year (the strike price)
2. Present value of expected future cash flows on expected investment needs, in excess of internal funds generated by the firm for the upcoming year (the value of the underlying asset)
3. Volatility of reinvestment needs
4. Risk-free rate of 5%
5. Time frame of one year (to keep the analysis simple)

Using data from company financial statements, Toll's current debt ratio is 43.25% (debt level of $1,121.86 million), and its weighted average cost of capital (WACC) is 7.169%. Doing the analysis of optimal capital structure reveals that the optimal debt ratio is 50% ($1,296.95 million), which yields a WACC of 7.04%. Therefore, the company has excess debt capacity of $175.09 million (optimal minus actual). Add to this amount $21.44 million in marketable securities, and you get a total excess financing capacity of $196.53 million.

The following sections explain the various inputs to use for the Black-Scholes option pricing model.

Strike Price. Exhibit 1.6 illustrates the computation of the investment needs in excess of internal funds over the past four years. Internal funds include net income, dividends, depreciation, change in target debt level, and change in regular equity financing. A target debt level of 43.25% is used because it is the current level. It is assumed that this is what the company wants to achieve over the long term. The target debt level for each year is determined by multiplying 43.25% by the value of the firm (book value of debt + stock price × number of shares outstanding). As mentioned before, the optimal debt level is 50%, so the target debt level incorporates excess available debt financing for the company.

The actual investment requirement for each of the four years is calculated as the changes in property, plant, and equipment (PP&E), changes in operating working capital, and changes in other operating assets. Excess investment requirements are computed as actual investment requirements minus available internal funds. If the available internal funds are greater than the investment requirements, the excess investment requirement is zero for that year. The average of the excess funding requirements over the past four years is $90.5 million (varies between zero and $207 million). The $90.5 million is used as the strike price in the option pricing model.

Exhibit 1.6 Average Excess Funding Required to Meet Annual Operating Requirements ($ Millions)

Computation of Internal Funds	2002	2001	2000	1999
Net income	$ 220	$ 214	$ 146	$ 102
Dividends	0	0	0	0
Depreciation	10	9	9	7
Target debt level	1,121	938	860	579
Change in target debt level	184	78	281	6
Regular equity financing	(10)	(16)	(18)	(20)
Available internal funds	404	285	418	95
Investment requirements	276	440	249	302
Investment requirements in excess of internal funds	0	155	0	207
Average excess funding for investments required	$ 90.5			

Source: Beneda & Nelson, 2004

Exhibit 1.7 Volatility of Investment Needs

Year Ending	Investment Needs ($ million)	Natural Logs (Investment Needs)
October 2002	$276	5.62
October 2001	440	6.087
October 2000	249	5.517
October 1999	302	5.71
Standard deviation of natural logs (investment needs)		21.5%

Source: Corporate Finance Review

Value of Underlying Asset. The value of the underlying asset is the present value of the expected future cash flows as a result of the expected excess investment requirements for the current year, which equals:

$$(\text{Excess investment needs} \times \text{ROC})/\text{Current WACC}$$

ROC equals the five-year historical average return on capital (11.14%) and the current WACC is 7.169%.

Plugging in these figures, the value of the underlying asset is:

$$(\$90.5 \text{ million} \times .1114)/.07169 = \$140.63 \text{ million}$$

Volatility of Investment Needs. Exhibit 1.7 shows the computation of the volatility of investment needs. The volatility as the standard deviation of the natural logs of the annual investment needs is calculated. The volatility for Toll Brothers Inc. is 21.5%. Consistent with option pricing principles, the higher the volatility of investment needs, the higher the value of excess financial capability.

Option Valuation

Exhibit 1.8 presents the calculation of the option valuation using the inputs developed above. The value of the financial capability as a real option for the upcoming year is computed to be $54.63 million. This amount represents the additional firm value from excess financial capability.

The cost of maintaining this excess financial capability also must be computed. When computing the cost of maintaining excess financial reserves, the focus should be on the opportunity cost or the value of additional operating income (cash flows) forgone as a direct result of holding the funds. The focus here is only on the cost for one year, as the option is valued for only one year.

Beneda and Nelson point out that estimating the cost of holding excess investments is difficult because the purpose of these types of accounts is to hold funds temporarily while the company waits for valuable investment opportunities. For

Exhibit 1.8 Real Option Analysis and Valuation

Value of Financial Capability as a Real Option*

		Number of time steps	5
Expiration in years	1	Time step size (dt)	0.2
Volatility	21.50%	Up jump size (u)	1.1009
PV asset value	$140.63	Down jump size (d)	0.9083
Risk-free rate	5.00%	Risk-neutral probability (p)	52.82%
Dividend rate	0.00%		
Strike cost	$90.50	Binomial approach	$54.62
		Black-Scholes model	$54.63
		Super lattice	$54.62

Cost of Excess Financing Capability

Cost of maintaining investments:	
Investments return	4.00%
Current WACC	7.17%
Return on capital	11.14%
Investments	$21.44 million
Cost of maintaining investments for one year	$2.378 million
Cost of excess debt capacity:	
Optimal WACC	7.04%
WACC	7.17%
Opportunity cost	11.14%
Operating invested capital	$2.263 million
Loss in firm value from maintaining excess debt capacity for one year	$4.656 million
Total cost of excess financing	$7.034 million
Excess of value of financial capability as a real option over total cost of excess financing	$47.596 million

*Real Options Analysis Toolkit (Mun, 2002) was used to perform the real option computation.

Source: Corporate Finance Review

simplicity, assume that the funds have an opportunity cost. The cost of maintaining excess investments is computed using this formula:

[Value of investments × (ROC – Return on investments)] × ROC/Current WACC

The amount calculated represents the value, created in one year, from the additional cash flow, which would have been achieved had the excess investment funds been invested in company operations rather than in a money market account. The opportunity cost is equal to the value created in one year by the difference between the return on capital, 11.14%, and the return most likely achieved by these funds (assume 4%). It is assumed that the additional cash flow created is reinvested in the company at the end of year one. It is also assumed that the reinvested cash flow earns the return on capital, 11.14%. These hypothetical earnings are discounted at the current WACC, 7.169%. The cost of maintaining investments for one year is computed at $2.378 million.

The cost of excess debt capacity is computed using this formula:

[Operating invested capital × (Current WACC – Optimal WACC)] × ROC/Optimal WACC

The cash that is lost from using a less-than-optimal WACC for one year is determined by multiplying the difference between the current and optimal WACC by the firm's operating invested capital of $2.263 million. Thus, if the firm utilized its optimal WACC, additional cash in the amount of $2.942 million would result. It is assumed that this amount is reinvested and earns the firm's average return on capital, 11.14%. These expected future cash flows are discounted at the optimal WACC, 7.039%, which is the discount rate for the firm had the optimal capital structure been in place. Therefore, the lost value from operating at a less-than-optimal capital structure is $4.656 million.

The total loss in value incurred by the company as a result of maintaining excess financial resources is $7.034 million, which is the total of the cost of excess investments ($2.378 million) and the cost of excess debt capacity ($4.656 million).

Bottom Line

In this case, the value of financial capability as a real option exceeds the cost of maintaining excess financial reserves by $54.63 million less $7.034 million, which equals $47.596 million. This figure, then, represents the value of strategic financial capability. Put another way, if this company had operated at its "optimal" capital structure—with no flexibility—it would have lost this value.

We hope this framework will help financial managers implement a strategy of financial flexibility. If one is not able to put a value on this strategy, selling the idea to the top brass will be tough.

PLANNING CAPITAL EXPENDITURES

Companies generally have a dim view of their capital expenditure planning and analysis process, reveals a new study. Fortunately, the study also examines companies that are very happy with their process. What these companies have done can help you improve your company's setup.

There have been many studies on the subject of capital planning, but they mostly focus on the application of formal financial methods instead of the actual process. However, it is the planning process itself that can cause problems with the overall operation. This is the focus of the new study, *A New View of Capital Planning*, which reveals the factors that most differentiate the best from the mediocre.

Sources of Trouble

On an overall basis, companies rate their capital investment planning process at 5.8 on a scale of 1 (poor) to 10 (best). Companies that are unhappy with their process cite the following problems:

- "Gaming" of the process
- Special treatment of certain capital investments (such as information technology projects)
- The effect of executive incentive bonuses on investment decisions
- The treatment of implementation and uncertainty risks by the project appraisal process

Also, only about half of the companies examined conduct postinvestment reviews. However, when such reviews do get done, the primary intentions are perceived to be to learn lessons from investment decisions and to improve forecasting. Fewer companies use the reviews to help improve their capital planning process.

Ways to Improve

Companies with the highest level of satisfaction with their capital planning processes use the following techniques:

- *Treat all proposals consistently.* Best-practice companies evaluate all capital spending proposals consistently. That is, they do not approach different kinds of capital investment in different ways. There is no special treatment for strategic investment decisions (i.e., top-down initiatives, as opposed to bottom-up proposals).
- *Assess risks.* Sound risk-management principles are an essential component of the capital planning process. Uncertainty risk (e.g., business cycle, commodity prices, foreign exchange, and interest rates) should be assessed using sensitivity/scenario (what-if) analysis. As for implementation risk, companies need to examine whether they are well equipped to deliver the projects.
- *Consider all stakeholders.* The capital planning process should address the wants and needs of multiple stakeholders, not just those of shareholders.
- *Use nonfinancial measures.* Factors such as customer satisfaction, employee attrition, and market share should be used along with traditional financial factors to support proposals.
- *Expand breadth.* The breadth of what is included in the capital planning process should be expanded, to include such elements as brand investment and other intangibles.
- *Do a postaudit.* Significantly more of the best-practice companies tend to conduct postinvestment reviews: 78% of these companies always or usually do them, as opposed to just 50% of the rest.

A postaudit can also help ease the gaming-the-system problem. For instance, these reviews can reveal who is being overly optimistic in cash-flow projections. This technique is better than, for example, setting artificially high hurdle rates to prevent gaming, because this may cause the company to miss genuinely favorable capital investment opportunities that add shareholder value.

ROOTING OUT CORPORATE FAT DURING THE CAPITAL BUDGETING PROCESS

Most controllers now have optimistic feelings about the economy. Nonetheless, many report contentious capital budgeting processes at their employers, with new funds often available only after money shifts from other projects in a zero-sum game. As a result, finding the fat in capital budget requests remains a critical responsibility for most controllers. *Key point*: In many companies, top managers focus on big-ticket investments—usually no more than 20% of the capital budget—that have strategic importance to their companies. As a result, they depend

Sidebar 1.2. Driving Waste from Capital Budgeting: Eight Fat-Busting Questions

Stage 1: Getting Airtight Budget Proposals

1. ***Is this your investment to make?*** Sometimes unit managers overstep their territories and request an investment that is the responsibility of someone else in the company—or even of some other organization. For example, an inventory manager that is shifting to vendor-managed inventory (VMI) may request funds to create a vendor-managed site in the company warehouse. Here, the controller can ask why the company, rather than the supplier, should make this investment. Observes Copeland: "By forcing unit managers to explain why they, rather than others, need to make particular investments, managers can head off unnecessary spending."
2. ***Does the equipment have to be new?*** When their production facilities are aging, managers use the budgeting process to advocate for the lease or purchase of new equipment. In fact, the alternative that is often less expensive (but that managers tend to omit from their budget requests) is to service existing equipment. Contends Copeland: "In most cases, the overall cost of equipment (including breakdowns) is 30% lower if a company continues servicing an existing machine for five more years instead of buying a new one." *Recommendation*: Make sure managers analyze the lease, buy, and maintain options when pushing for the replacement of existing equipment.
3. ***Is there a lower-cost way to meet our compliance obligations?*** In their budgets, many managers take a conservative approach to compliance with environmental, health, and safety regulations. They think it is smarter to be safe and overspend on inescapable compliance costs than underspend and be left holding the bag if something goes wrong. Says Copeland: "This sometimes-irrational fear prevents managers from thinking as clearly or imaginatively as they should about how to save money on compliance, so they gold plate their investment requests." *Recommendation*: To avoid unnecessarily conservative and costly compliance spending, ask managers to analyze and report on compliance practices at other companies.

(continued)

Stage 2: Rooting Out Redundancy

4. ***Will the budget request duplicate already existing capacity?*** Even smaller companies with minor operations away from headquarters can accumulate excess capacity. Today, this risk is especially acute with capital spending requests for new technology. Observes Copeland: "A company may discover that it has inadvertently created excess capacity in its server networks. How? Its field engineers, unaware that those designing the network had already built in a 30% extra server capacity, may install additional servers to ensure sufficient capacity." *Recommendation*: Here, the solution lies beyond the capital budgeting process, with controllers fostering communication among decisionmakers and making sure they share information. There will then be fewer requests for capital expenditures that accumulate needless and overlapping capacity.
5. ***Are managers shifting short-term costs to the capital budget?*** In some departments, executives "manage" their costs by shifting spending to capital accounts. Their knowledge of basic accounting tells them that short-term costs that run through the income statement diminish department profitability more than costs that are capitalized in the departmental budget and then depreciated. *Recommendation*: If possible, controllers should ask department managers to include analyses of after-tax capitalized costs in their budget requests.
6. ***Are there signs of budget massage?*** Budget massage is common when senior managers, instead of policing capital spending, merely compare a unit's spending to its forecast. In this environment, shrewd managers manipulate their budgets, shuffling expenditures between their capital and annual operating budgets, to achieve steady year-to-year capital budgets. This way, they avoid the risk of denied capital spending requests following years when their capital budget goes down. Further, they avoid visits from internal audit. Why? Often, top managers, who do not scrutinize spending detail, send auditors to investigate big or fluctuating requests for capital spending increases. Though the practice is well known, Copeland reminds controllers that one capital-budget game managers play is end-loading. For example, at year-end, a dented fender becomes a new delivery truck. When managers realize they are going to underspend an allocation, they start putting in unnecessary expenses to make up the shortfall. Suggests Copeland: "By going to the trouble during the year to query unit managers about small decisions of this sort, senior managers can discourage units from massaging their budgets."

Stage 3: Improving the Process

7. ***Are we using fixed assets fully?*** Slow-moving bureaucratic procedures or mediocre tracking of fixed assets will inflate the capital budget. How? Say a company is slow to compile information about computers that it is disconnecting and relocating. Because these appear slowly on the excess capacity list, managers will buy new computers to meet their needs, even though the company's current computer assets make the purchases unnecessary. *Recommendation*: In this situation, controllers may have to visit their company's paper trails—not just its extra capacity lists—to see if fixed assets are tracked and recycled, avoiding needless capital spending.
8. ***Are our capacity measures valid?*** Sometimes, overspending is a direct result of poor measurement. *Example*: Copeland did consulting work for a cable company whose measurements indicated that a cable was fully utilized if one in a bundle of optical fibers was carrying information. The problem was that the measure pushed the company to spend on new cable capacity, even though each bundle contained 11 fibers.

Source: Thomas Copeland, Monitor Group on their controllers to ensure that the remaining 80% of capital spending contains no profit-consuming corporate fat.

Though there are many approaches to this responsibility, eight simple practices can help root the waste out of the capital budget. These practices address the tendencies of engineers to insist on better-than-necessary parts and equipment, of managers to ask for more money than they need, and of low-level executives to be risk averse (for example, ordering extra parts to ensure no delays in the pet project of a senior executive). *Key point*: These fat-fighting practices look at expenditures that tend to be rubber-stamped in the budgeting process. As a result, they challenge spending that has built gradually into budget fat.

Sidebar 1.2 reviews these eight practices. Developed originally by Thomas E. Copeland, who is associated with the Monitor Group (www. monitor.com), these fat-busting practices share one valuable feature: they are easy to communicate in meetings. These fat-busters can be used in capital budget meetings to state clearly that “this year, we’re emphasizing two tactics to keep capital budget requests lean, three to eliminate padding from existing programs, and two to ensure that fat-eliminating processes are effective.”

Note that Copeland has framed these practices as easy-to-use questions. Further, he urges controllers to ask these questions in three distinct phases. In the story “Copeland on Capital Efficiency,” he says:

- “Put the first three questions to your operating managers as they assemble their capital project requests. The questions will help them submit airtight proposals.”
- “Put the next three question to yourself and your colleagues as you examine small-ticket proposals. These questions will help you root out much of the gold-plating and redundancy built into budget requests.”
- “Post the last two questions at the end of the process. They will help you improve next time.”

The following discussion provides more than 240 recommendations that controllers have said can help to reduce costs.

BENEFITS

Cut Back Health Benefit Offerings to Reduce Costs.

Challenge: Reduce health care costs while maintaining employee goodwill.

Action: We reduced the benefit offerings from our largest single medical plan—that is, the plan with most enrolled employees. At the same time, our benefit reductions were relatively small and we made a big effort to communicate to employees that this plan was still above “median value,” as defined by Hewitt’s Benefits Index product. Altogether, we changed 12 specific benefits and reduced our health plan costs by over $2 million. —*Controller, pharmaceuticals, 80,000 employees, New Jersey.*

Adjust Benefits Offerings and Funding to Seize Savings Opportunities.

Challenge: Improve benefits offering to sales force while lowering costs.

Action: We consolidated our HMO offerings in Illinois from three to two, while offering a nationwide PPO for our sales force. This helped us control rate increases in Illinois, since it gave us economy of scale. The PPO for sales was helpful as well, since it replaced a bonus we paid to these employees, who for geographic reasons previously had no way of participating in our HMO. We also self-funded our dental plan, saving us about $15,000 a year. The savings exist because many of our staffers are younger and mostly require only cleanings. —*Controller, manufacturing, 2,900 employees, Illinois.*

Adjust Service Provider Fees Downward for Our 401(k) Plan.

Challenge: Lower fees as our plan assets rise.

Action: We have renegotiated fees as our plan has grown. Here, the history is that competition first increased noticeably among service providers when our plan exceeded $20 million. Then, we were able to bargain for a lower fee schedule. When the plan hit $40 million, the provider agreed to drop some fees altogether. At the same time, our current provider is improving access to plan information, with Web access for employees so that they can shift assets, as well as Web access for HR to input employee changes. —*Controller, manufacturing, 2,000 employees, Michigan.*

Adopt a Mail-Order Drug Program to Contain Soaring Prescription Spending.

Challenge: Shift our employees to a mail-order drug program.

Action: We changed the prescription co-pay for employees. It was a flat 20%. We changed it to a minimum of $10 and a maximum of $40, or 20% if the cost falls between. We also adjusted our plans so that the cost to the employees is the same for a three-month mail order as for a one-month pharmacy order. This has been a major incentive for employees to use mail order and we have saved about $40,000. —*Controller, transportation, 1,200 employees, Washington.*

Combat Surge in Health Care Spending with Increased Cost Sharing.

Challenge: Keep managed care costs from going through the roof.

Action: Our medical enrollment is evenly split between PPO and HMO plans. To minimize cost increases, we reduced the out-of-network benefits on our PPO plan to a 70% reimbursement from an 80% level. We also increased the prescription drug co-pay from $5/$10 to $10/$15. Then, we used a heavy communication effort to encourage use of our mail-order drug plan. With a heavy concentration in managed care, the only cost-saving option left to us is increased cost sharing. *—Controller, wholesale/retail, 1,300 employees, Louisiana.*

Contain Health Benefit Costs with Simple Modifications.

Challenge: Modify health plan to combat cost increases.

Action: We looked for simple changes in our benefits plan that would keep costs from jumping 18%. Our principal move was to couple an increase in deductibles with a contribution increase. This saved the company roughly $150,000. Formerly, we also included dental coverage with the cost of medical. Now, we charge additional amounts for it. Finally, we increased co-payments for our drug program. To lessen the sting of these increases to employees, we supplemented our life offering, which was viewed positively. *—Controller, transportation, 400 employees, Connecticut.*

Decrease Company Health Benefit Expenditures by Raising Cost Sharing.

Challenge: Increase cost sharing for health benefits.

Action: We have been moving over the last several years to higher cost sharing with employees. Our goal is to reach 20% on medical and 40% on dental and retiree medical. We also increased cost sharing by employees who use tobacco products. Here, we used an honor system and offered a discount for nontobacco users. Over 47% of employees indicated that a covered person used a tobacco product. *—Assistant controller, services, 1,000 employees, North Carolina.*

Implement a Discount Program That Reduces Prescription Drug Costs.

Challenge: Contain costs without diminishing drug benefits for employees.

Action: Previously, employees paid full retail for their prescription drugs and then submitted their claims for 80% reimbursement. So, we set up a three-tier prescription drug program with an associated mail-order discount element. Now, the mail-order program fills all prescriptions that last over 30 days at a discount to both the company and employees. Although our total prescription drugs costs went up, they would have been higher had we not implemented this program. *—Controller, manufacturing, 550 employees, Wisconsin.*

Implement a Wellness Program as Part of Our Attack on Rising Health Benefits.

Challenge: Build lower costs into our benefits program.

Action: We started a wellness program, which includes events such as health fairs and breast cancer awareness week. By implementing this program, we were able to reduce our overall costs by 4%. This past year we also increased our employee's overall share of health benefit costs to 21% from 18%, largely by raising our deductible $100 per person and lifting premiums by about 10%. —*Controller, services, 400 employees, Illinois.*

Join a Business Coalition to Broaden Health Benefit Offerings.

Challenge: Stabilize health benefit costs without compromising employee coverage.

Action: We were self-funded for medical, dental, and vision. We decided to join our region's major health care alliance. Seven of the largest employers in our city joined to increase bargaining power with Blue Cross Blue Shield. This helped us stabilize costs and increase the plans we offer. For example, we have broadened from an HMO and have added a PPO. Cost savings are impossible in today's environment. —*Controller, services, 800 employees, Iowa.*

Lower Corporate Benefits Spending by Modifying Our Co-Payments.

Challenge: Keep the increase in our health benefit premiums near 10%.

Action: We adjusted our co-payment structure, raising the cost for doctor visits from $10 to $15, doubling co-payments for prescriptions, and raising the charge for hospitalization from zero to $100 per day for the first five days. This helped reduce the cost of renewing our insurance from a 20% jump in premiums to 12%. We did not really have a strategy for introducing these changes. We simply announced them as we announced open enrollment. —*Controller, services, 500 employees, South Carolina.*

Lower Medical Benefit Costs through Self-Funding.

Challenge: Boost cash flow while self-funding health benefits.

Action: We have switched to self-funding with stop-loss coverage from a traditional premium program. This is a tremendous boost to our cash flow, since there is usually a three-month lag between the service from the medical provider and payment by the carrier. Also, we are not "funding" reserve projections on a monthly basis, as with traditional premium programs. Altogether, we have reduced our monthly payments $15,000 on average. —*Controller, manufacturing, 500 employees, Pennsylvania.*

Lower Total 401(k) Plan Costs by Adapting a New Program from Our Vendor.

Challenge: Make the smart choice on pension program alternatives.

Action: Last year, our 401(k) providers pitched their new full-service program to us. Called 401(k) Complete, this program seemed superior to the plan we were using. We did detailed comparisons, liked what we saw, and switched. Altogether, the new plan will deliver more services, reduce time spent internally administering the plan, and cut total fees by approximately $57 per participant. —*Controller, distribution, 150 plan participants and $3.2 million in plan assets,*

Reduce Benefits Costs with a Cafeteria-Style Flexible Benefits Plan.

Challenge: Design plan structure to lower health benefit spending.

Action: We have begun to offer multiple health plan options—a PPO with various deductibles and company contributions—within a cafeteria plan structure. These options range from a very-low-deductible plan to a catastrophic plan. Within this context, we have increased employee cost sharing for the best plan option and have designed premiums for lesser plans to encourage movement into higher-deductible options. We expect employees to become better consumers as they share more costs. —*Controller, finance, 250 employees, Wisconsin.*

Reduce Health Benefit Spending through Employee Cost Sharing.

Challenge: Get greater employee contributions for health benefits.

Action: We had not increased contributions for dependent health coverage for the last five years, even though our premiums had increased substantially in the last three years. We evaluated our program and saw that norms for employee contributions were upward of 25% of costs. In contrast, contributions at our company were 25% of costs five years ago. We explained this situation and told employees they should expect an increase next year. Then, we announced the addition of a wellness benefit. —*Assistant controller, services, 2,100 employees, California.*

Reduce the Rate of Benefit Increases by Raising Employee Cost Sharing.

Challenge: Increase cost sharing without alienating employees.

Action: We began charging employees for single-coverage health benefits and increased the amounts paid by those with family coverage. This tweaking the plan will soon reach its end, however, since employees will stop perceiving the plan as a benefit if we tweak cost sharing any more. In the meantime, we shifted our dental plan to self-funding and started a wellness program, which we offer in addition to our PPO. —*Assistant controller, services, 5,000 employees, Texas.*

Renegotiate Fees with Our 401(k) Service Provider to Cut Pension Plan Costs.

Challenge: Get our 401(k) provider to renegotiate terms of a dated deal.

Action: We went to our provider and requested that it reduce certain fees, noting our ten-year history with the provider and the growing assets in our plan. It wasn't exactly easy but the provider reduced our costs by dropping the administration fee (it was $10 per account) and reducing the charges on different asset classes. Helpful to us in negotiations was this fact: We made it clear that if the provider would not budge, there were plenty of other companies that would like our business. —*Controller, manufacturing, 550 employees, New Jersey.*

Shift Costs from Overhead by Automating Benefits Functions.

Challenge: Move benefit systems and interaction online.

Action: We centralized some benefit administration functions and then outsourced. We now use our outsourced vendor to scan all benefit documentation instead of keeping hard-copy files. This centralization has also reduced the need for various regional HR benefit functions. Further, we began to offer online enrollment for benefits, which serves as an information source for benefit options. Now employees can access their accounts from work or home, make changes, and eliminate paper enrollment. —*Assistant controller, health care, 9,000 employees, California.*

Switch to Self-Insurance to Contain Rising Health Care Benefits.

Challenge: Find lower-cost alternatives to coverage from insurers.

Action: We are a fast-growing company and our HMO costs were increasing rapidly as we grew. So we switched to self-insured medical coverage. We calculate that savings will be around $80,000 to $100,000 yearly. We also added wellness benefits and incentives to keep employees and their spouses healthy. Other changes in our health care benefits since self-insuring include coverage for mammograms, prostate exams, and well-baby check-ups. —*Controller, manufacturing, 1,600 employees, Indiana.*

Capitalize on Young Workforce by Self-Insuring More Health Benefits.

Challenge: Switch successfully to self-insurance.

Action: Last year, a larger company purchased us. This company self-insured health benefits to a very high level. So, we went self-insured this year, switching from a fully insured approach. The move has reduced our overall insurance expenses by about 15%, largely because we are a young population and are having a good year. So far, there have been no claims over $100,000. —*Assistant controller, manufacturing, 2,500 employees, California.*

Stabilize Benefit Costs through Increased Cost Sharing with Employees.

Challenge: Undertake a comprehensive restructuring of our health benefits.

Action: We increased employee contributions for health care and dental benefits. We increased our co-pays for both medical appointments and medicine. We made sure employees knew about our opt-out policy, where we pay a small amount in each paycheck to those who get their medical coverage elsewhere. Finally, we decided to self-fund our dental plan. Altogether, we budgeted for approximately $300,000 in savings because of these changes last year. *—Controller, manufacturing, 600 employees, Illinois.*

Cut Health Benefits Costs through Self-Insurance.

Challenge: Finance benefits at lower cost without perceptible change to employees.

Action: We self-insured our health benefits, using a third-party administrator. We found that our actual costs are much lower than the premium we had paid in the past. I was the one behind this change, and pushed hard after the insurance premiums at one of our sites increased. At first, parts of the company wanted to self-insure with networks. But our stop/loss provider pushed us under the umbrella of one third-party administrator (TPA). Now, we are now considering self-insuring dental. *—Controller, wholesale/retail, 200 employees, Ohio.*

Use Self-Insurance to Cut Health Benefit Costs.

Challenge: Devise lower-cost self-funded programs that meet employee needs.

Action: We now partially self-fund our health benefits. What we do is rent a network of doctors. And, we have designed our own self-insured health plan to duplicate the insured products that we had previously. We have a PPO and now an HMO look-alike. We also have a strong professionally managed wellness program. While this approach moves costs around a great deal, it probably lowers total benefit spending somewhat while costs for most companies are rising. *—Assistant controller, manufacturing, 600 employees, Florida.*

Improve the Cost-Effectiveness of Our Mail-Order Prescription Drug Program.

Challenge: Shift more costs to employees who do not use generic drugs.

Action: We revamped our mail-order program. Specifically, we shifted from a two-tier structure—generic/brand—to a three-tier structure—generic, preferred, nonpreferred. This design will pass more expenses for higher-cost brand-name drugs and nonpreferred drugs to employees who use them. The program is new so we have not yet quantified any savings. But we anticipate at least 30% reduction in prescription drug costs. —*Controller, manufacturing, 1,100 employees, Tennessee.*

Shift Spousal Health Coverage from Our Medical Plan.

Challenge: Remove participants from our health plan when possible.

Action: We no longer cover a spouse who is eligible for coverage through his or her own employer. In making this change, we had to switch to a four-tier system, distinguishing "employee and children" from "family coverage." We now cover 225 fewer spouses than we did in the previous year. This produced an annual savings of about $450,000 per year. —*Controller, manufacturing, 4,200 employees, Illinois.*

Lower Mutual Funds Fees with Hard-Nosed Negotiation.

Challenge: Get provider to help us to reduce our 401(k) fees.

Action: We switched from a mutual fund that tracks the S&P 500 with an annual fee of 35 basis points to a common trust that the same provider offers that is priced at a fee of 20 basis points per year. We discovered this option only when we asked if any institutional pricing was available for a plan of our size. The provider told us only when we complained that its S&P 500 index fund was twice as expensive as Vanguard's. —*Controller, real estate, 1,600 employees, Maryland.*

Cut Back Health Benefit Spending by Fine-Tuning Managed Care.

Challenge: Make our PPO more cost-effective.

Action: We contracted a new rate directly with our hospitals, which brought us a small savings on this expenditure. We also implemented new health plans, using a national PPO that will give us discounted rates throughout the country. Before, we only had discounted rates with hospitals in Chicago, which is our largest location. —*Assistant controller, manufacturing, 850 employees, Illinois.*

Capital Expenditures

Minimize Capital Expenditures by Outsourcing Noncore Activities.

Challenge: Focus capital spending on mission-critical functions.

Action: We have downsized and outsourced noncore processes. As a result, we are focusing our capital spending on our core areas and are paying for noncore activities only as needed. Further, we do not have to spend time or resources training staff on tasks where our performance is mediocre, at best. Our cost per unit is now lower, and worker's compensation costs have dropped because we divested ourselves of activities that were accident-prone. —*Controller, transportation, 275 employees, Tennessee.*

Tighten Procedures That Contain Capital Expenditure Costs.

Challenge: Insure funds for authorized projects only.

Action: We have taken a basic step—improved control of our capital expenditures by insisting on use of budget authorization (BA) numbers. Now, no purchases can be made without a BA number. With this system, there can be no question as to the validity of the purchase of the general ledger account to which it belongs. We are also looking into software that will improve tracking of capital expenditures and assign responsibility for spending at the executive level. *—Controller, manufacturing, 250 employees, Kentucky.*

Improve Capital Spending Decisions in the Slow Economy.

Challenge: Tighten our approach to capital expenditures.

Action: We are applying new return on investment (ROI) and payback methodologies to our capital expenditure lists. And, we have decided to do more leasing. We now have deals with two financial institutions, where we get very competitive rates. This has reduced large cash outflows and kept the assets off the balance sheet. We have tried to instill a new attitude: unless we are generating hurdle-rate revenue or lowering costs, we will wait on a capital expenditure. *—Controller, manufacturing, 500 employees, Oregon.*

Lower Capital Expenditures by Delaying Special Projects or Sharing Their Costs.

Challenge: Make capital expenditures affordable.

Action: We have placed expensive special projects on hold until the third quarter. We will wait and see how the market develops, reassessing if we should restart, continue to hold, or cancel altogether. We are also looking into a joint venture with another company to see if we can share expenses. On the bright side, we are working closely with major suppliers to trim expensive parts from our designs and to use more standard components. Our goal is a 5% drop in capital spending. *—Vice president of finance, manufacturing, 500 employees, New York.*

Compensation

Stabilize Compensation Budget with New Merit Increase Policy.

Challenge: Keep the lid on the comp budget without demotivating employees.

Action: We widened the range of merit increases to better reflect performance, rather than simply giving everyone approximately the same annual increase. In addition, we reduced the company-wide increase-percentage slightly to better control costs. Finally, we used lump-sum merit payouts for those employees who are at the top of their range. We think, in this way, this tightening in merit increases will still motivate our people, since it forces more money into a risk-based bonus plan. —*Controller, wholesale, 350 employees, Indiana.*

Contain Compensation Costs by Expanding Use of Salary Benchmarking.

Challenge: Align our compensation with norms for our industry and region.

Action: We have expanded our use of benchmarking. As a result, we now have a better method for comparing our compensation costs to those of our industry and location and for determining merit-increase budgets. In formalizing our system, we also evaluated the performance review process and educated our managers on its link to compensation. Thanks to this program, our compensation costs were flat last year. —*Controller, trades, 600 employees, North Dakota.*

Stabilize Compensation Costs by Adjusting Merit Increases.

Challenge: Salaries of many employees had grown well above market.

Action: We decided to slow raises for employees whose salaries were above market, while helping those earn generous raises who were paid below the market. (We define market as 94 to 106% of salary range midpoint.) To achieve this, we made our increase guidelines richer for below-market employees and a little more conservative for employees at market. We also used lump-sum merits for employees over market. To contain the costs of these awards, we stipulated that only above-market employees who were outstanding performers qualified. Since we have many employees, we expect recurring low six-figure savings. —*Controller, manufacturing, 2,800 employees, Washington.*

Slow Compensation Budget Growth by Adjusting Mix of Salary and Bonus.

Challenge: Keep executives motivated but avoid overpaying.

Action: We revamped the mix of base and bonus and redesigned the long-term plan for executives and senior management. We also increased the cycle between long-term payments. Finally, we introduced lump-sum merit and bonus awards, coupled with the introduction of a market-based pay program. This has reduced the base pay increases for middle managers who are already well paid in relation to the relevant labor market. —*Controller, R&D, 1,000 employees, California.*

Raise Payback of Compensation Dollar by Instituting Skill-Based Pay.

Challenge: Build understanding and support for skill-based compensation.

Action: We implemented a certification process that allows employees to increase their pay when they increase their skills. This program is self-paced. Employees meet skill criteria on their own schedules and then earn more money. The company has gained through workforce reduction, increased employee flexibility, and cost realignment. We estimate a 5 to 10% savings. —*Controller, manufacturing, 150 employees, Minnesota.*

Contain Compensation Increases through Greater Use of Merit Raises.

Challenge: Change compensation options of staff at top of their salary range.

Action: Some employees had long service and were overpaid for their jobclass. In this case, we fixed their current base pay and redlined further increases. Here, we told them that they would have to expand or enrich their jobs in order to receive merit raises. Meanwhile, their raises would take the form of one-time bonuses—that is, pay for performance. We also developed a salary guide chart, which makes our new system fairer and easier to administer. We expect a small annual savings. —*Controller, banking, 400 employees, California.*

Contain the Compensation Budget in a Period without Revenue Growth.

Challenge: Implement a range of change to contain compensation costs.

Action: We have taken several actions. For example, we are not replacing all employees after they leave. Instead, we delay finding a replacement for up to six months. We have also delayed the awarding of merit increases by six months and reduced the merit budget by 1%. Finally, we are shifting to a company-wide review cycle. This will give us better control of the comp budget. —*Controller, manufacturing, 1,400 employees, Illinois.*

Limit Compensation Increases by Adjusting the Mix of Salaries and Bonuses.

Challenge: Reward performance while slowing growth of total salary base.

Action: We decided to shrink the merit increase pool (to 3% from 4%) and to offset this change with increased short-term incentive (STI) opportunities. What we did: We expanded STI opportunity to all salaried associates. Then we based the STI pool on a combination of company and business-unit performance. Individual employees received awards from this pool, based on personal performance. Now we reward top performers and contain costs at the same time. —*Controller, insurance/financial service, 3,600 employees, Massachusetts.*

Reallocate Funds in Compensation Budget to Combat Rising Employee Costs.

Challenge: Shift money in the comp budget to reduce long-term costs.

Action: Last year, we split out 1% of the merit budget (which is 5% of our compensation budget) and paid it as a lump-sum bonus, rather than adding it to base pay. This saved approximately $150,000 in base salary increases that would have continued to have a multiplicative effect as the years went by. We also restricted merit increases to 2 to 6%. Finally, we are working to get better market pricing capability to managers so that they can make better decisions and not overpay at the top of salary ranges. *—Controller, nonprofit, 200 employees, Michigan.*

Reduce the Size of Merit Increases to Combat Soaring Compensation Costs.

Challenge: Shift to a more performance-based compensation program.

Action: We adjusted the merit budget so that it fits within realistic affordability parameters. Now, increases that are outside these guidelines need CFO and business unit head approval, as well as HR approval. In addition, we modified the overall compensation program so that a greater percentage of the budget does not increase base pay. Here, our goal is to provide more bonus opportunity and to manage this budget more competitively. We are more closely monitoring merit increases. *—Controller, manufacturing, 400 employees, Massachusetts.*

Restrain Rising Compensation Trends by Adjusting the Mix of Salary and Bonus.

Challenge: Implement a company-wide bonus tied to performance.

Action: Two years ago, we shifted our compensation structure, reducing merit increases but offsetting this with a bonus plan based on corporate goals. This shift raised the percentage of employee compensation based on salary and slowed increases in our base, thereby decreasing expenses for the 401(k) match and future merit increases. At its implementation, we told employees this bonus was not guaranteed. This year we did not achieve the bonus. This enabled us to control direct costs associated with salary. *—Controller, manufacturing, 200 employees, Georgia.*

Slow Compensation Increase by Simplifying Administration.

Challenge: Get employees to accept cost-saving system changes.

Action: Last year, we switched to a common salary date. All employees are evaluated once a year and salary merit adjustments are effective on the same date. This has saved manager's administrative and processing time, as well as resources. This is more effective for budgeting, as all salaries are looked at at one time, with projections easier to cast forward accurately. *—Controller, finance, 725 employees, Florida.*

Expand Our Use of Salary Benchmarking to Contain Total Raises.

Challenge: Shift to a market-driven salary structure.

Action: We expanded our use of salary survey data and benchmarked salaries of key company positions. This more accurate information has allowed us to move toward a market-based compensation model, instead of paying employees according to longevity. Eventually, we think a system providing annual merit-based increases and competitive market wages will lower the annual growth in our salary budget by 2%. *—Assistant controller, manufacturing, 1,600 employees, Texas.*

Raise Performance Incentives by Redesigning Our Compensation System.

Challenge: Connect compensation increases to achievement.

Action: For salespeople, we instituted maximum base salaries, while providing more opportunities to earn incentive bonuses. Through the refinement of our sales teams and the individualization of incentives, we are now able to measure results more usefully. Meanwhile, we put more dollars at risk for managers. To do so, we froze base pay but increased bonus potential. The bonus is based on individual business units and company performance. Across the company, we are now doing a better job of paying our top performers. *—Controller, insurance, 1,600 employees, New York.*

Controllership

Squeeze Costs and Float from Finance by Implementing Electronic Data Interchange.

Challenge: Establish an electronic data interchange (EDI) system for billing and cash receipts.

Action: Establishing the system required the cooperation of customers. But now, everything runs smoothly. With the new system, we send freight bills electronically to eliminate mail time. Customers wire funds directly to our bank, which reduces the float, and send remittance information to us by EDI. The information updates in accounts receivable automatically, eliminating input chores. Altogether, we have reduced certain processing times dramatically. *—Director of accounting, transportation, 750 employees, Missouri.*

Establish New Channels of Distribution to Reduce Export Costs.

Challenge: Cut our international distribution costs.

Action: We have established new channels of international distribution. Now, we are supplying finished and component goods to five manufacturing locations around the world and six major distribution centers. In contrast, everything used to move through the United States. But now, only what is sourced here, moves here. Otherwise, only the documents come to the United States. We estimate this change in our distribution knocks 3% off our product costs. *—Controller, manufacturing, 3,000 employees, Ohio.*

Implement P-Card Program to Save Money on Office Supplies.

Challenge: Take full advantage of potential P-card savings.

Action: The company shifted to desktop delivery of office supplies, which we purchase over the Internet using P-cards. Clerks and administrative assistants who have a P-card do most of the ordering. If they place an order before 3:00 p.m., we have delivery on most items the next morning. Annual savings: $700,000 in negotiated pricing; approximately $1,000,000 in inventory reduction; $380,000 in transaction savings. *—Controller, technology, 5,000 employees, Utah.*

Reduce Corporate Costs through Downsizing.

Challenge: The company needed to reduce its costs by 15%.

Action: We did a top-to-bottom reorganization of responsibilities. Afterward, we were able to outsource certain support functions. In addition, we consolidated operations, thereby reducing rent and other facility maintenance costs. Finally, we gave every department head a mandate to cut by 10% in their areas. *—Controller, manufacturing, 3,000 employees, Utah.*

Cut Total Travel and Expense Spending by Modifying Cash Advance Policy.

Challenge: Adjust travel and expense (T&E) system to a lower-cost model.

Action: We rolled out a corporate charge-card program. Then, we reduced the petty cash fund in the office, deciding to give travel advances only to employees who do not have corporate credit cards. This reduced our need for petty cash, cut down on general ledger entries, and cut down on following up with people to hand in reports who owe money. Altogether, this reduced the average monthly cash advance balance from the $50,000 to $85,000 range to the $10,000 to $15,000 range. *—Assistant controller, services, 1,000 employees, Maryland.*

Use Web-Based Technologies to Lower T&E Costs.

Challenge: Implement an Internet-based expense management automation system.

Action: We reviewed the expense management automation (EMA) systems of several vendors, including Concur, Extensity, and Necho. Finally, we decided to go with Concur on an ASP platform, thereby avoiding implementation costs and an increased burden on our IT department. The system has certainly streamlined our reimbursement. Plus, the system has built-in policy monitoring, red-flagging spending that exceeds our policies. Altogether, this EMA system will save us substantially in travel administration costs. —*Controller, services, 4,000 employees, New York.*

Tap Staff Expertise to Find and Unleash Cost-Lowering Improvements.

Challenge: End knowledge compartmentalization in the company.

Action: The company has established "asset management" teams, with diversified membership representing different departments. These teams focus on specific areas, such as inventory, production, purchasing, health and safety, and communications, where we want to cut costs. We encourage each team to challenge current practices and develop cost-effective ideas, which they formally give as reports to upper management monthly. In the past year, these teams have generated savings exceeding $1 million. —*Corporate controller, durable goods manufacturing, 900 employees, New Jersey.*

Improve Back-Office Efficiency by Implementing Imaging.

Challenge: Use the Internet to cut processing costs.

Action: We used imaging to move access to our invoices to a portal on the Internet. This way, any person needing duplicate copies of invoices can get their forms by going to our Web pages. This has saved us the cost of several people at central billing who did nothing but print duplicates and invoices and about five full-time equivalents (FTEs) in offices throughout the United States who did the same. —*Vice president and controller, transportation, 10,000 employees, California.*

Use Bidding Process to Get a Better Deal from Our Bank.

Challenge: Reduce corporate banking costs by 10%.

Action: We moved the company's banking activities, 401(k) plan, loans, credit cards, and daily operations to a new bank. In doing so, we identified our five top objectives, solicited input from four banks, analyzed their proposals, negotiated with the top two bidders, and selected the best offer for our business. We have not dollarized the effects. But the results are better service, lower costs, and less administrative time. —*Controller, transportation, 400 employees, Wisconsin.*

Combat Budget Overruns by Strengthening Leadership of Product Teams.

Challenge: Develop new products on schedule and within budget.

Action: We assigned project managers to key projects and gave them responsibility for all functional resources, as well as making them responsible for coordinating project efforts. Further, we brought in seasoned program managers to mentor our project managers and assisted them with day-to-day management. We went from 30% of projects meeting budget, schedules, and performance criteria to 90% doing so. *—Controller, manufacturing, 400 employees, Wyoming.*

Improve Banking Procedures to Eliminate Needless Float.

Challenge: Squeeze float from check disbursement and reconciliation.

Action: We switched to a controlled disbursement system from a standard checking account. This gave us an additional day of float and increased our interest income by $25,000 yearly. We also arranged to get a daily download from the bank that indicates the checks that have cleared that day. This download reconciles checks in our accounting system daily, so we have current information to work with when we invest funds short term. This download also eliminated two to four hours of manual check reconciliation daily. *—Accounting manager, services, 700 employees, Minnesota.*

Human Resources

Save Back-Office Costs by Implementing Timekeeping Software.

Challenge: Implement timekeeping and automated payroll processes.

Action: Before implementation, employees completed paper time sheets manually and routed them to supervisors, who routed the time sheets to payroll after approval. Payroll then manually keyed the information into an ADP program for weekly processing. Employees now swipe a timecard, which eliminates errors from misreading. Supervisors log into the timekeeping system for a quick weekly sign-off. And, payroll downloads the information from four separate departments with just a few keystrokes. Now, hourly employees, supervisors, and payroll staff spend less time on payroll, while the system is more accurate. *—Controller, manufacturing, 200 employees, Wisconsin.*

Decrease Training Costs by Adopting Intranet Learning Modules.

Challenge: Develop system for training hourly employees at reasonable cost.

Action: We made sure our hourly workers had access to intranet-based learning modules that are self-paced. This reduces our costs for travel, trainer salaries, and contracted trainers. There are also intangible benefits in this approach, such as that the training in our modules is immediately usable on the job. Even so, there seem to be some drawbacks, with some managers not happy with the quality of staff learning. We are sticking with this approach, however, since the cost savings may reach $25,000. —*Controller, government, 500 employees, Texas.*

Streamline Back-Office Overhead by Automating the Benefits Function.

Challenge: Implement a human resources information system (HRIS) system successfully.

Action: Our new automated HRIS system allows us to process, track, and record information quicker, as well as to provide management reports faster. Since implementation, we have brought the preparation of employee benefits statements in-house. We have also reduced work we formerly outsourced to vendors. We estimate our approximate yearly cost savings at $15,000 to $30,000. —*Assistant controller, manufacturing, 1,300 employees, Wisconsin.*

Introduce e-Learning System to Lower Sales Training Costs.

Challenge: Use existing resources in our sales training programs.

Action: We implemented a program we call knowledge on demand. This is a collection of electronic files that we have created from existing product information and hard-copy training programs that we placed on our intranet for instant, searchable access 24 hours a day. This has substantially decreased the lost time we were experiencing in the field when information was needed but not available. Further, it has helped us bring existing resources into the sales program. Our sales force is able to close sales faster. —*Controller, manufacturing, 2,000 employees, Texas.*

Lessen Administrative Costs by Migrating HRIS Applications to an Intranet.

Challenge: Provide intranet-based self-service for human resource information.

Action: We moved human resource information to our intranet. Now employees can download various human resource forms, view upcoming events, schedule training, and so on. Meanwhile, management can view their schedules, employee vacation and sick-day accruals, enter attendance, and so forth. We have not formalized cost savings yet; however, we have saved approximately four hours plus per week across the various areas (payroll, benefits, etc.). —*Controller, services, 870 employees, Washington.*

Reduce Overhead Costs by Using a Less Paper-Intensive Human Resource System.

Challenge: Implement first phase of SAP human resource system.

Action: We selected and implemented this challenging program. Ultimately, this will lead to an integrated HR/benefits/payroll/training system that eliminates duplicate entry and massive paper movement. Now, data changes take effect immediately—not in a week, as before. We estimate our back-office saving to be $150,000 the first year. —*Assistant controller, manufacturing, 1,000 employees, Minnesota.*

Shed Overhead by Migrating Certain HRIS Functions to Our Intranet.

Challenge: Deliver human resource information less expensively.

Action: We provided online benefits enrollment via an intranet. This reduced our error rate by 95%, increased employee access to benefits data, and made them more informed consumers. Additionally, the new system executes confirmation statements immediately, not in two weeks as before. Altogether, we have saved between 400 to 600 hours of data entry yearly. —*Controller, services, 1,100 employees, Texas.*

Use Corporate Intranet to Streamline Labor-Intensive Human Resources Functions.

Challenge: Use our Intranet as a time-entry system.

Action: We implemented a Web-based time-entry system for employees. Now, we capture time-worked information throughout our multistate organization via Web-based panels. This information then loads—after review—into our time and labor system, which is by PeopleSoft. We calculate that we can reassign staffers in 12 data-entry jobs thanks to this system, eliminating about $200,000 per year in overhead costs. —*Assistant controller, finance, 10,000 employees, Kansas.*

Lower Information Expenses by Adopting an HRIS.

Challenge: Shift information management away from human resources staff.

Action: We are in the process of implementing a new HRIS system that will provide employee and manager self-service capabilities. We will provide 24-hour access to human resources information with this system and reduce employee reliance on human resources staff. The system will link facility locations in several cities and also provide access via the Internet to employees who work out of their homes. This is a major money-saving investment, but we are anticipating almost immediate ROI. —*Assistant controller, manufacturing, 1,400 employees, Minnesota.*

Reduce Human Resource Budget by Centralizing Training Management.

Challenge: Get more bang for the buck in training.

Action: We investigated our training programs and found that we could outsource some programs while making better use of our trainers.

We also centralized our registration, billing, and purchasing. The final numbers are not in, but we expect to save at least 40% of last year's costs. Note that the training program was in a unique situation, in that this was the first year all company training was unified in one "corporate university." *—Controller, manufacturing, 10,000 employees, Ohio.*

Implement Benchmarking to Assess Training Program Effectiveness.

Challenge: Reduce training costs while raising trainer productivity.

Action: We began to benchmark employee performance "before" and "after" training. We then modified training to increase its effectiveness, all the while monitoring our progress. As a result, we were able to cut unnecessary training hours and materials. We have experienced a 12% reduction in total training cost, with a 7% jump in trainer productivity. *—Controller, government, 750 employees, Iowa.*

Inventory

Reduce Inventory Levels by Shifting Ownership to Suppliers.

Challenge: Create a win/win situation that lowers our inventory costs.

Action: We negotiated long-term agreements and then shifted ownership of our inventory to suppliers. A specific example is the program we developed with our glass supplier. Here, we agree to a longer-term contract and buy a larger quantity of glass (maybe up to a year's worth). Then, the supplier warehouses the stock for us and bills us only after use. As a result, inventory levels are down and our glass prices are less, because of the higher order quantity. Meanwhile, the supplier has higher sales. Estimated annual savings: $100,000. *—Controller, furniture manufacturers, 350 employees, Wisconsin.*

Reduce Inventory Levels by Upgrading Our Control Measures.

Challenge: Shift to a more effective system of inventory control.

Action: We have implemented a monthly review process, where we count inventory levels by cell. The process of cell review identifies usage by item, improving our planning. This monthly mandatory count is a key practice, saving our company thousands on shipping costs and rush charges applied by vendors to our own orders. For the next year, we have these goals: a full cellular manufacturing process in a pull system, with three-day lead times, and a 95% on-time ship rate with finished goods. *—Controller, high technology, 250 employees, Maryland.*

Use Hurdle Rates to Fight Production of Slow-Moving Inventory.

Challenge: Establish an effective system for discontinuing inventory.

Action: We are implementing an item rationalization model. Here, we recommend hurdle rates for an item, which it must surpass to remain on our price list. After two years, every item must now attain a critical mass and profit potential or we discontinue. So far, we have dropped 17 items out of 101 evaluated and have 800 more items to evaluate. Overall, we expect to reduce our inventory value by $4 million by the end of the year. —*Controller, pet food, 1,000 employees, California.*

Standardize Inventory to Lower Purchasing Costs.

Challenge: We reduced purchasing costs through centralization.

Action: Senior management formed cross-functional teams and asked them to reduce the cost of particular commodities by 25% to 40%. The teams generated many ideas, including specification changes, redundant stock elimination, and better planning or requirements. We conducted approximately 20 sessions. Many improvements tie reduced product costs to our adoption of products with specs that are industry standards. This has led to improved availability and lower costs. Our estimated savings for one year is $6 million. —*Controller, manufacturing, 8,500 employees, New York.*

Reduce Inventory Carrying Costs with an Activity-Based Costing System.

Challenge: Streamline our inventory management operation.

Action: We implemented a modified activity-based costing (ABC) approach. We classified 6% of our SKUs as A items, 10% as B items, and the remaining 84% as C items. Then, we established a bi-level policy. With the C-1 items, we only place an order with a supplier when we receive an order from a customer. With C-2 items, we try to have one item on hand or on order at all times. This has reduced order review and processing time by over 70% and cut our slow-moving inventory. Overall, inventory costs are down 5% to 10%. —*Controller, medical instruments, 200 employees, Massachusetts.*

Reduce Inventory Costs with Pervasive Use of Competitive Bidding.

Challenge: Get better and cheaper vendors to bid for supply contracts.

Action: We now actively source new, best-class suppliers that do not yet do business with us. Then, we bring them into our competitive bidding process, where we buy key commodities. One recent initiative was for an electric part that is a commodity. Our system yielded actual savings of $3,000 on an annualized basis. We calculate a $22,000 future value. —*Controller, manufacturing, 2,000 employees, Indiana.*

Lower Inventory Costs by Making Production Schedules Available to Suppliers.

Challenge: Execute a concept we knew would free cash from inventory.

Action: We started a supplier integration program this year. This computer-based system allows critical suppliers into a "reserved office," where they can access our inventory and production planning screens. This helps us reduce inventory, lead times, and obtain schedule reliability. We are also providing less critical vendors with a 90-day forecast and 30-day production schedule. This helps to push inventory levels to a minimum. —*Controller, food industry, 500 employees, Pennsylvania.*

Reduce Level of Inventory Investment by Shifting Ownership to Suppliers.

Challenge: Get parts suppliers to sign on to our new management system.

Action: In the past, we have stored spare parts for every piece of equipment and never utilized our vendors to keep the cost down. Since we have a time-critical product—newspapers—we viewed our large spare parts inventory, which totaled about $3 million, as a necessity. But in the past two years, we have reviewed each part and then approached the appropriate vendors, asking them to stock certain items with the assurance that they could ship the inventory in 24 hours. The results: a reduction in inventory of over $400,000. We plan to reduce our stock levels another 20% next year. —*Plant controller, newspaper, 2,000 employees, Illinois.*

Cut Inventory and Logistics Cost by Consolidating Our Supplier Base.

Challenge: Get more bang for the buck from a smaller supplier group.

Action: In reducing the supplier base, we acquired more purchasing leverage, since we concentrated our purchase dollars. As a result, we were able to lower prices and to work with suppliers to improve quality and service. In many cases, we also shifted large-dollar purchases from distributors directly to manufacturers. This single move saved us $500,000. Altogether, reducing the supplier base enables us to use more blanket purchase orders, share annual forecasts, and negotiate better terms, while insisting on guaranteed performance and quality. —*Controller, manufacturing, 500 employees, Wisconsin.*

Lower Inventory Costs by Renegotiating Existing Supplier Contracts.

Challenge: Bring contract prices down to market level.

Action: We had multiple suppliers bid or rebid our existing demand. This allowed us to find the true market price for these materials. We then set up contracts reflecting these true prices to supply our manufacturing sites. Whenever possible, I tried to keep our contracts with our present vendors, since they know our specific needs. Altogether, the process took six months and saved over $200,000. *—Controller, manufacturing, 450 employees, Pennsylvania.*

Lower Supply Costs by Shifting Inventory to Vendors.

Challenge: Reduce inventory levels without hampering our manufacturing system.

Action: We are doing several things. For example, we installed a real-time inventory reporting system, which is readable via our intranet. We also altered payment terms and our system of supplier performance measurement. Most important, we shifted inventory assignments to individual suppliers with minimum levels to be maintained. Our estimated annual savings for these measures is $400,000 to $500,000. *—Controller, manufacturing, 225 employees, Arkansas.*

Scrutinize Inventory Closely to Ferret Out Extra Spending.

Challenge: Develop a comprehensive inventory-monitoring program.

Action: We set up inventory reduction teams by product and vendor and then reviewed each line item, its usage, our future needs, "blue light" sales potential, and scrap value. In addition, we reduced safety stock and lot sizes. So far, the program has been successful and we have seen a $1 million reduction in our inventory position, even as we are increasing output to meet new higher demand. Over the next 12 months, our goal will be to cut $2.5 million from our position. *—Controller, manufacturing, 300 employees, Virginia.*

Slash Throughput Costs by Implementing a Warehouse Management System.

Challenge: Eliminate excess operating costs from our warehouses.

Action: We implemented a warehouse management system. Savings are expected to be $100,000+ annually, due to labor reductions alone. This system will also allow us to better serve our customers by increasing throughput, reducing shipping errors, and meeting all customer labeling requirements. *—Controller, manufacturer, 200 employees, Ohio.*

Use Range of Management Practices to Lower Inventory Costs.

Challenge: Take cash out of inventory without affecting production.

Action: We integrated a just-in-time (JIT) buying process with vendor-managed inventory (VMI) to reduce our carrying costs by 50%. To do so, we took the top 20 items, which equal 80% of inventory dollars, and stocked them on site. Then, we put these stock items on consignment. The 80% of items that equaled 20% of inventory dollars were put on the JIT program and stored at the vendor's facility. *—Controller, manufacturing, 550 employees, North Carolina.*

Periodically Review Inventory with the Intent of Lowering Stock.

Challenge: Constantly refine and improve our system of inventory management.

Action: A program of periodic review has helped us to discontinue doggy items, introduce new items in hot product lines, and implement the economic order quantity order method. We also keep our sales staff posted. They, in turn, successfully sell down historically slow-moving products. Our buyers also spend less time cutting purchase orders, down to 3,000 per year from 7,000. In the last three years, sales have risen about 10% annually, while inventory levels have been stable. *—Controller, wholesaling, 200 employees, New Mexico.*

Reduce Inventory Costs by Improving Coordination with Suppliers.

Challenge: Communicate our production plans to suppliers.

Action: On a limited basis, we had made production plans/schedules available to suppliers. But we expanded the program. We expect differences in the piece price, since—by seeing future production needs—the supplier is able to combine runs and reduce this price to us. We have also addressed our internal costs by expediting express shipments, changing schedules, and experimenting with multiple line changeovers. *—Assistant controller, manufacturing, 500 employees, Ohio.*

Avoid Expensive Overhead Charges by Maintaining Accurate Inventory Counts.

Challenge: Maintain the effectiveness of our cycle counting system.

Action: We have an effective system of daily work-in-progress (WIP) cycle counts. Here, our WIP cycle-count process measures inventory accuracy of the work order and the piece count of each operation. To enhance this process, we utilize a hand-held barcode reader, which records the work order, operation, quantity, floor location, date, and time. We download these data to a spreadsheet, comparing them to baseline-system data. Our accuracy (95%) has eliminated the need to perform a wall-to-wall physical inventory for the past two years. Its cost: $150,000 plus two days of lost production. *—Controller, manufacturer, 520 employees, Ohio.*

Outsourcing and Professional Services

Employ Competitive Bidding to Force Vendors to Lower Prices.

Challenge: Conduct widespread bidding on outsourced programs to cut costs.

Action: We reevaluated our outsourced programs, such as payroll, benefits administration, and 401(k) recordkeeping. In doing so, we cast a wide net for vendors. Then, we gave vendors the opportunity to meet bids from competing vendors. Our total annual savings were just over $40,000. This demonstrates to me that all pricing for these outsourced human resource programs is negotiable. *—Controller, finance, 800 employees, Pennsylvania.*

Outsource Training Functions to Lower Human Resources Overhead.

Challenge: Use capabilities of nearby college to prepare staff for promotions.

Action: We outsourced our leadership development training instead of hiring a leadership development specialist. To do so, we partnered with a local college that provided 11 different leadership development courses. We saved 50% of salary in this function while meeting identified needs. We are now considering outsourcing some of our information systems training. *—Controller, health care, 1,500 employees, Illinois.*

Cut Overhead by Outsourcing Specific Human Resources Functions.

Challenge: Identify functions that service providers can do for less.

Action: We outsourced our 401(k) plan to a full-service provider. We save $13,000 a year in trustee fees and have less administrative work. Meanwhile, employees have daily access to fund balances and transfers, more fund choices, and the option of in-house investment training three-times a year. We also outsourced new-hire background checks and felony report searches. As a result, we can now downsize Human Resources, provide better 401(k) service, and cut back hiring mistakes. *—Controller, retailer, 400 employees, Indiana.*

Reduce Annual Accounting Fees by Shifting to a New Accounting Firm.

Challenge: Lower professional service costs while raising service quality.

Action: After seven years with a major national accounting firm, we shopped around among the Big Four and large local firms. We did so because we perceived a decrease in services without a decrease in fees. Eventually, we selected another Big Four firm and received an annual fee cap of 5% increases for the first three years, ensuring that the initial fee was not a teaser fee, just to get in the door. Bottom line, we have reduced accounting/auditing fees significantly—approximately $100,000 per year. *—Controller, manufacturing, 400 employees, Arizona.*

Tap In-House Talent to Tighten Spending on Professional Services.

Challenge: Achieve an across-the-board 10% cut in professional services fees.

Action: Our corporate counsel took the lead in fee/contract negotiations with our auditors, banks, and insurance brokers. This was useful, since friendships were having a cost-inflating effect on negotiations. In doing so, we traded overly close business relationships for black-and-white dollar discussions. We also reorganized the accounting department for the year-end audit. Because we are more efficient internally, we have reduced our audit fees by 25%. *—Controller, manufacturing, 800 employees, Michigan.*

Use Multiple Strategies to Reduce Annual Audit Fees.

Challenge: Reschedule and refocus auditor activities.

Action: Our fiscal year is the calendar year and auditors were working at our company in February and March. That is premium time for auditors when their fees are highest. As a result, we rescheduled our internal deadlines and moved some audit activities to one week before December and one week in January. We also assumed more paperwork preparation internally, reconciling, analyzing, and balancing accounts before year-end. Altogether, these changes lowered our fees by 15%. *—Financial officer, manufacturing, 280 employees, Iowa.*

Purchasing

Take a Tough Stand on Price Increases to Lower Purchasing Costs.

Challenge: Keep vendors from increasing their margins at our expense.

Action: We have implemented a cost-reduction program in purchasing, where each buyer is committed to saving $*x*. As a part of this program, each buyer nets each price increase against a cost-reduction commitment to our company. This way, we ensure that they meet their targets. Further, we are forcing suppliers to verify in writing the need for actual pass-along price increases. This stops proposed price increases for which there is no justification. *—Assistant controller, technology, 1,000 employees, California.*

Cut Inefficiencies via Electronic Commerce with Suppliers.

Challenge: Use electronic commerce to streamline accounting.

Action: We are a direct mail-order company that does a significant amount of drop shipments. Our new electronic commerce capability, which our CFO researched and recommended, gives us a new quick and efficient capability that updates orders, invoices our customers, and processes the invoices from our suppliers. Cost savings approximate the equivalent of one FTE. *—Controller, marketing services, 350 employees, Arizona.*

Clarify Supply Issues and Lower Costs with an In-Plant Store Program.

Challenge: Shift maintenance and repair operation (MRO) purchases to a supplier-managed program.

Action: We implemented a supplier-managed in-plant store program for designated categories of MRO material. This in-plant store program was very successful and resulted in an annual $100,000 cost reduction. Further, it eliminated the processing of 6,200 annual transactions related to purchase orders, receipts, and invoices. We should have done this a year or two earlier. *—Controller, manufacturing, 1,000 employees, Pennsylvania.*

Lower Purchasing Costs by Shrinking Our Supplier Base.

Challenge: Get our buyers to support this fundamental change in purchasing.

Action: We have started to leverage our spending with fewer vendors. Our goal is to have one major, one minor, and a third in the closet for each category of part or commodity. So far, we have been able to negotiate better discount/contract programs for our division, with costs lower by 10% or more for certain items. We have also received improved service and our suppliers are showing greater concern with quality. *—Division controller, medical devices, 1,100 employees, Arizona.*

Maximize Purchasing Power by Taking a Tougher Stand on Price Increases.

Challenge: Manage vendors so that they are reluctant to raise prices.

Action: We've been tougher on price increases. What we did is to set across-the-board reduction targets. We keep those suppliers who are working toward meeting these targets. Otherwise, we are changing suppliers, with the suppliers we drop basically not cost-effective in their own operations. We are also requiring vendors to document thoroughly the rationale for any increase. Finally, we are working with vendors to decrease their own costs, so that they can achieve their own margins without increasing their prices. Last year, we actually maintained our supply costs while increasing volume. *—Controller, drug manufacturing, 900 employees, Delaware.*

Consolidate Our Supplier Base to Lower Materials Costs.

Challenge: Join supplier reduction with better terms.

Action: Where we were using two or three suppliers for a particular commodity, we now use one. In exchange for the additional business, that supplier gives us concessions on price, terms, and sometimes freight, as well as rebates as incentives for additional business this year and next. By consolidating and leveraging our spending with fewer suppliers, we have produced a 5% price reduction, as well as improved our ability to integrate with e-commerce. *—Controller, manufacturer, 500 employees, Illinois.*

Contain Costs by Working Closely with Suppliers during Equipment Design.

Challenge: Build supplier expertise into the design process.

Action: Now we come up with initial design and performance standards. Then we share this information with our suppliers, asking for their input on improving the design or making it easier to manufacture. This has worked well for us. For example, we eliminated "overkill" on new equipment for certain high-volume work cells. For the two cells, this saved $215,000 on equipment, when the total cost was $1.6 million. *—Controller, manufacturing, 550 employees, Florida.*

Improve Purchasing/Manufacturing Coordination to Reduce Safety Stock Levels.

Challenge: Lower safety stock needs through better purchasing timing.

Action: Most of our accessories/consumables that come off the shelf to accessorize our made-to-order equipment were coming in far too early. This occurred because accessories/consumables typically have a two- to four-week lead time while the core equipment has a five- to six-week lead and we ordered everything at once. What we did is upgrade our logistics system, so that we break down demand by release date. Now, all this accessorizing stock appears when needed. *—Controller, medical equipment, 300 employees, Massachusetts.*

Lower Purchasing Costs through Revising Supplier Agreements.

Challenge: Meet senior management request for 10% lower purchasing costs.

Action: We reduced our materials costs $120,000 (15%) by restructuring agreements with suppliers and getting higher discounts in return for long-term purchasing agreements. We also ended one of our supplier partnerships, and are able to receive lower pricing for one commodity through a new bidding process. *—Controller, manufacturing, 325 employees, South Carolina.*

Lower Shipping Costs by Modifying Arrangements with Freight Forwarders.

Challenge: Make shipping less costly and more efficient.

Action: We have stopped relying on a single freight forwarder. Instead, we use different forwarders in different regions, usually those offering the best regional price. Now, we also pay in conjunction with a monthly retainer fee. The effect of these changes was to save 10% on freight forwarding, as well as to reduce the time spend on bill verification. *—Controller, distribution, 350 employees, North Carolina.*

Renegotiate Shipping Rates to Free Up Money in Our Logistic Spend.

Challenge: Get more bang for the buck in logistics.

Action: We reduced the number of our carriers by 40%. Then, we negotiated new freight agreements with our remaining carriers, saving us about $300,000. We also negotiated new rates with Federal Express. With this vendor, we also took about one-third of our next-day shipments and turned them into second- and third-day shipments. With FedEx, we are looking at a $90,000 to $125,000 reduction. —*Controller, pharmaceuticals, 100 employees, Missouri.*

Renegotiate Supplier Contracts while Raising Their Value-Add.

Challenge: Get more value from established suppliers.

Action: We told suppliers that we have worked with for many years that we were looking for new ideas and technologies and, therefore, new suppliers. This made them reexamine prices and products. Several came up with new products we could use for the same applications at cheaper prices. We also renegotiated some contracts by defining specifications better, insisting on different and less costly packaging, and specifying freight carriers with lower rates. Finally, we combined several programs for better purchasing leverage. —*Controller, nondurable goods manufacturing, 300 employees, Arizona.*

Tighten Travel and Expense Spending by Implementing Better Vendor Programs.

Challenge: Implement a cluster of new programs that lower T&E costs.

Action: We reduced T&E costs by 10% by implementing a new travel policy. This requires our corporate travelers to take the lowest fare possible and our agency to set up programs with major airlines to get free tickets based on mileage flown. We also implemented direct-billed corporate AmEx and set up automated reimbursement with Gelco. We expect further savings to come later as we issue fewer checks and we use travel expense information to negotiate rates. —*Controller, communications, 650 employees, New Jersey.*

Worker's Compensation

Act as an Agent for Subcontractors to Lower Worker's Compensation Costs.

Challenge: Change approach to worker's comp insurers.

Action: We require each of our subcontractors to maintain worker's compensation coverage while on our job sites. By mandating that all subcontractors obtain insurance through our corporate office, we, in effect, became the bidder for each area. Through economies of scale, we now are able to purchase insurance for less than what each subcontractor could contract for. —*Controller, professional services, 150 employees, Texas.*

Contain Worker's Compensation Costs through Improved Data Flow.

Challenge: Automate our system for monitoring worker's compensation issues.

Action: We purchased an OSHA/worker's comp software program to keep track of all accidents and worker's comp costs and generate OSHA reports. Our former system was manual and the new software has improved our efficiency and productivity, particularly our claims monitoring and the follow-up in our preventive programs. Now we are better able to manage the process. Across the entire company, we think there is a 25% savings in data entry and paperwork. —*Controller, retailer, 1,500 employees, Montana.*

Tighten Worker's Compensation Administration to Reduce Costs.

Challenge: Tighten worker's compensation recordkeeping and follow-through.

Action: We began to focus on the cost drivers in this program and to analyze the information we filed. We saved thousands by reviewing and correcting the classification of our jobs. We also implemented a new policy: Any employee who incurs a job-related injury must subsequently meet with and be interviewed by our general manager. We hope this will also impact our worker's compensation rates and the productivity we lose to injuries. —*Controller, manufacturing, 250 employees, Michigan.*

Use Multiple Strategies to Lower Worker's Compensation Spending.

Challenge: Implement self-insurance more effectively.

Action: The plant nurse worked with our third-party administrator to close many old claims. These were expensive, since our company allocates money to all claims, no matter how old, because we are self-insured. We also implemented a new plant safety committee that has raised the level of awareness for accident prevention. Approximate savings: $200,000 per year. —*Controller, trades, 400 employees, California.*

Employ a Range of Tactics to Cut Worker's Compensation Expenses.

Challenge: Get the entire company focused on worker's comp costs.

Action: We used a variety of programs to lower this cost. These were: give employee in-service training, modify work programs, create interactive safety committees, undertake postaccident drug testing, hold adjusters accountable for closing claims, involve our managed care network, gain the commitment of employees to lower this cost, improve screening methods, and revise our appraisal system. Overall, these tactics reduced worker's comp expense by 58%. —*Assistant controller, services, 2,000 employees, Iowa.*

Restructure Our Insurance Coverage to Lower Worker's Compensation Costs.

Challenge: Consolidate property and casualty insurance spending at subsidiaries under one policy.

Action: We combined all our subsidiaries in a master, paid-loss, retro property and casualty program. Altogether, this reduced our spending from close to $4 million to about $3 million, mostly through improving the management of our worker's comp programs. We also hired nurse-managers, whose job is to actively intervene early in all injury cases. This way, very few injuries become worker's comp cases. —*Senior vice president, finance, private practice, 4,500 employees, Texas.*

ENDNOTES

1. Harvard Management Update.
2. Harvard Business School Press, 2003.
3. Ernst & Young and the Institute of Management Accountants, *2003 Survey of Management Accounting* (2003) [hereinafter E&Y/IMA Survey].
4. *Id.*
5. *Id.*

Chapter 2

Human Resource Department Costs

COST-CONTROL STRATEGIES

Given the tough economic times we are forced to struggle with, resourceful human resources (HR) managers are asking staff to take on more responsibility, making do with less, increasing efficiency, and relying on technology to keep departmental costs under control.

IOMA's annual HR department management and cost-control study is a useful guideline for HR managers who are looking for effective ways to control costs in their departments. As always, IOMA cautions against relying too heavily on these benchmarks, as each organization is unique in terms of culture, workforce demographics, and economic demands. The following are highlights from the study, along with respondents' tips and tactics.

What's Working; What's Emerging

Asking HR staff to take on more responsibility (47.1% of all respondents) was the top cost-control strategy reported in the study. HR departments also continue to streamline their processes and procedures (41.2%), often in conjunction with a move to automated HR functions, the third most effective strategy (37.9% of respondents).

Size Differentials

Another sign of the times is the remarkable consistency among size groups by number of employees (see Exhibit 2.1).

Relying on HR staff to take more responsibility is the top cost-control strategy in small (up to 350 employees) and midsize (351 to 1,500 employees) organizations, and number two among large organizations (more than 1,500 employees), behind "renegotiated vendor contracts."

Small organizations also rely on technology improvements to control HR costs. Nearly half (42.2%) of respondents in this size group said they automated HR functions via HR intranet or Web-based HR applications. More than a third (37.8%) also use the Internet for hiring and recruiting, and more than a quarter (26.7%) have added employee or manager self-service applications.

An important component of the move to e-HR involves a close look at streamlining existing processes and procedures. Small-company respondents listed this as number three in their HR cost-control strategies.

Exhibit 2.1 Most Successful HR Department Cost-Control Categories, by Number of Employees

	Up to 350	351 to 1,500	More than 1,500	Overall
Asked HR staff to take on more responsibilities	42.2%	57.1%	44.7%	47.1%
Streamlined HR processes and procedures	40	42.9	42.1	41.2
Renegotiated vendor contracts	31.1	42.9	47.4	37.9
Automated HR functions via HR intranet or Web-based HR applications	42.2	28.6	42.1	37.9
Used the Internet for hiring/recruitment	37.8	33.3	42.1	36.6
Cut back on staff travel, conferences, etc.	31.1	42.9	36.8	36.6
Adopted/changed HRIS system/software	26.7	35.7	26.3	28.1
Set new HR staff performance goals/ increased HR staff accountability	28.9	19	23.7	25.5
Downsized HR staff	24.4	26.2	18.4	24.8
Added employee/manager HR self-service features	26.7	14.3	23.7	21.6
Outsourced one or several HR functions	11.1	11.9	21.1	15
Improved HR staff training programs	15.6	9.5	10.5	13.1
Used an automated applicant-tracking system	8.9	11.9	13.2	12.4
Benchmarked HR costs against those of competitors	8.9	7.1	10.5	9.8
Insourced functions that were previously outsourced	11.1	7.1	5.3	7.2
Moved traditional HR functions to line managers	8.9	4.8	7.9	6.5
Started an HR service center	4.4	2.4	13.2	5.9
Implemented an HR balanced scorecard	6.7	4.8	5.3	5.9
Other	6.7	14.3	15.8	11.1

Small-company respondents were also most likely to have insourced functions that were previously outsourced (11.1% of respondents).

Midsize organizations showed streamlined processes, renegotiated vendor contracts, and reduced staff travel and conferences as tied for third place in their successful cost-control efforts (42.9% each).

About one-third of respondents rely on Internet hiring (33.3%), human resource information systems (HRIS) improvements (35.7%), and Web-based applications (28.6%). Because relying on HR staff to take on more responsibility was far and away the most successful cost-control strategy (57.1% of respondents), it is possible that there was little budget for technology improvements among organizations in this size group.

Respondents in this size group were most likely to have downsized HR staff (26.2%) and cut back on travel and conferences (42.9%).

Large organizations were almost twice as likely as other size groups to have outsourced HR functions to save HR costs (21.1%), but least likely to have downsized HR staff (18.4%). HR managers in this size group also asked staff to take on more responsibility (44.7%), streamline HR processes, automate HR, and rely on Internet recruiting (all 42.1%).

Predictably, respondents in this size group were also most likely to use an automated applicant tracking system (13.2%), benchmark their costs against those of competitors (10.5%), and start an HR service center (13.2%).

Industry Differentials

Among *financial services* firms, the top cost-control strategy was moving to automated HR and Web-based applications (63.0%). This industry segment was also most likely to move traditional HR functions to line managers (14.8%).

Manufacturing firms in this study reported the biggest cost-control return from renegotiated vendor contracts (51.3%) and relying on HR staff (48.7%). This industry segment was also most likely to have downsized HR staff (35.9%).

Respondents in the *services* industry use the Internet for hiring and recruiting (47.6%), but were less likely to report other cost-control successes related to technology. For example, only 19% of respondents in this industry group said they had automated HR functions or added employee/manager self-service. Less than a third (28.6%) had adopted or changed their HRIS.

Respondents in this industry were also most likely to have experienced cost-control success from insourcing previously outsourced HR functions (19.0%).

Sidebar 2.1. What Do Respondents Say about Their Cost-Control Efforts?

- We were very fortunate to have wonderful employees who had the vision to take more on. They saw this as a way to cut costs and we/they are eligible for a bonus program based on profitability. *—32-employee services firm*
- Save approximately 30 staff hours per week now that we use an automated applicant tracking system. *—200-employee nonprofit organization*
- Developed processes and procedures that created accountability. *—200-employee nonprofit organization*
- Created a company intranet that provided resources to employees on a self-serve basis. Saved $15,000; cut HR time in half by allowing us to reduce staff by two. *—380-employee services firm*
- Renegotiated vendor contracts, saved $300,000 per year. *—Manufacturing company*
- Streamlined HR processes; improved privacy and reduced HR administrative burden by 25%. *—200-employee manufacturing company*
- Streamlined recruitment process resulting in reduction in time to fill jobs. Saved money by minimizing negative impact of turnover. *—250-employee governmental entity*
- Consolidated HR positions due to loss of headcount. Everyone took on additional responsibilities and is being cross-trained. *—430-employee Internet firm*
- Went to a single database system for HR and payroll data, saving input time and reducing errors. *—310-employee insurance firm*

Source: IOMA

Technology and communications firms, as expected, reported technology-related cost-control successes: adopted or changed HRIS (70%), automated HR functions (50.0%), and added employee/manager self-service (50.0%). This industry segment also turned to HR staff (50.0%) to pick up the slack by taking on more responsibilities. Companies in this industry segment also were most likely to have started an HR service center (20.0%).

Wholesale/retail respondents tagged Internet recruiting as their top cost-control strategy (55.6%). Other cost-control successes came from operational adjustments: relying on HR staff, streamlining HR processes, and reducing staff travel and conferences (all 44.4%).

HOW HR MANAGERS USE TECHNOLOGY APPLICATIONS TO CONTROL COSTS

Technology has become the mainstay of many HR cost-control initiatives—and with good reason. Even the simplest and least expensive applications save valuable HR staff time, increase efficiency, and provide better services to HR's many clients.

IOMA's HR department management and cost-control study revealed that the vast majority (88.5%) of HR managers in companies of all sizes and in all industry sectors now rely on HR automation (see Exhibit 2.2).

Technology has made inroads into even small organizations: 86% of respondents with 350 or fewer employees report that they currently use HR automation in their departments. As expected, the technology sector has the deepest penetration among large employers (those with more than 1,500 employees), where 92.1% report its use.

Exhibit 2.2 HR Departments That Currently Use Automation, Overall and by Number of Employees and Industry

	Use	Don't Use
Overall	88.5%	11.5%
By number of employees		
Up to 350	86.0	14.0
351 to 1,500	87.8	12.2
More than 1,500	92.1	7.9
By industry		
Financial*	88.9	11.1
Manufacturing	83.8	16.2
Services	90.0	10.0
Technology/communications	100.0	0.0
Wholesale/retail/distribution	88.9	11.1
Health care	100.0	0.0
Other	85.7	14.3

*Includes banking, insurance, and other financial services.

Some selected comments from study participants reflect this trend:

- Created an HR intranet Web page, which cost practically nothing but has allowed employees access to a wide range of information from HR, including all forms, benefits information, employee handbook, and the like. —*Assistant vice president, Iowa, 200 employees.*
- Automation of various HR functions, including benefits enrollment, improved productivity by at least 50%. —*Senior vice president of HR, California, 3,800 employees.*
- Automated employee status change forms and personnel requisitions made personnel information available to managers online. HR reports are also available online for managers. This eliminated data entry and clerical time. —*Vice president of HR, California, 4,000 employees.*

No significant variations were evident among industries. HR departments in all segments are embracing technology. In fact, in the industry with the lowest participation—manufacturing—its use is still at 83.8%. All respondents in technology/communications and health care reported that they currently use HR automation.

What Are the Most Common Applications?

Payroll (76.7%), benefits administration (57.1%), and benefits enrollment (41.4%) are the top technology initiatives, with recruiting and applicant tracking systems running a close fourth (39.1%) (see Exhibit 2.3).

With slight variations in percentages and placement, these top three HR applications (payroll, benefits, and recruiting) have led the pack for three years running—and with good reason, as vendors have made them inexpensive and easy to roll out. *Note*: Because of differences in respondent size and composition each year, these trends should be viewed as generalizations, not absolutes.

What was new to this study was the increased use of technology in training and development (31.6% of respondents overall) and manager self-service (18%

Exhibit 2.3 Most Common HR Applications, Overall and by Number of Employees

		Number of Employees		
	Overall	Up to 350	351 to 1,500	More than 1,500
Benefits administration	57.1	51.1	61.9	57.9
Benefits enrollment	41.4	35.6	35.7	55.3
Recruiting—applicant tracking	39.1	28.9	38.1	55.3
Personnel administration	39.1	42.2	38.1	39.5
Training and development	31.6	24.4	28.6	39.5
Employee self-service	24.8	24.4	19	28.9
Manager self-service	18	11.1	19	26.3
Other	3.8	4.4	2.4	5.3

overall). For the past two years, for example, only about 12% of HR managers reported using manager self-service applications. Only about one-quarter (24.3%) of respondents relied on technology for training and development in IOMA's most recent survey (2003).

Some selected comments from participants represent these trends:

- Used the Internet for hiring. Internet advertising is cheaper and available 24 hours per day. *—HR and corporate development coordinator, Minnesota, 38 employees.*
- Automated tuition reimbursement, leave of absence, open enrollment, 401(k), payroll via the Web; use self-service for deductions, address changes, etc. *—Vice president of HR, Georgia, 5,800 employees.*
- Obtained online enrollment product at no cost to department by downsizing medical plans to one carrier. *—Payroll/benefits manager, New York, 250 employees.*

What Is the Impact of Organization Size?

Payroll and benefits applications are in the top slots for companies of all sizes (see Exhibit 2.4). Even in the smallest organizations (up to 350 employees), 71.1% of HR managers report using technology to handle payroll.

Although use is less prevalent than in larger companies, more than a third (38.9%) of HR managers at small companies are taking advantage of online recruiting. Many post jobs on their own Web sites; others rely on large job boards, such as Monster.com.

HR managers in midsize organizations (351 to 1,500 employees) report greater use of technology for recruiting and personnel administration (both 38.1%) than even benefits enrollment applications (35.7%). This group makes an equal technology investment in employee and manager self-service (19%).

As expected, larger organizations (more than 1,500 employees) have larger budgets, and therefore the ability to invest in technology for their HR departments. Besides the top three applications (payroll, benefits, and applicant tracking), HR managers in this size group are most likely (39.5%) to use technology for training and development and employee (28.9%) and manager (26.3%) self-service.

The big three HR applications have penetrated all industry segments with the exception of health care (see Exhibit 2.4). Similarly, all sectors are using online recruiting or applicant tracking systems, with technology/communications reporting the heaviest use (70%) and financial services organizations reporting the lightest (29.5%).

Some selected comments from study participants underscore these results:

- We introduced several new technologies, including online enrollment, retirement self-service. We have saved the equivalent of two [full-time equivalent] employees' salaries. *—Law firm, Pennsylvania, 500 employees.*

Exhibit 2.4 Most Common HR Applications, by Industry

	Financial*	Manufacturing	Services	Technology/ Communications	Wholesale/ Retail/Distribution	Health Care	Other
Payroll	85.2%	79.5%	66.7%	90.0%	66.7%	66.7%	71.4%
Benefits administration	63	59	61.9	70	44.4	16.7	52.4
Benefits enrollment	37	46.2	42.9	50	33.3	16.7	42.9
Recruiting—applicant tracking	29.6	43.6	38.1	70	33.3	33.3	33.3
Personnel administration	37	33.3	52.4	50	33.3	16.7	42.9
Training and development	29.6	30.8	38.1	50	22.2	50	19
Employee self-service	22.2	23.1	23.8	60	33.3	16.7	14.3
Manager self-service	14.8	20.5	9.5	40	22.2	16.7	14.3
Other	0	0	14.3	0	11.1	0	4.8

*Includes banking, insurance, and other financial services.

- Went to a single database system for HR and payroll data, saving input time and reducing errors. —*Services firm, Maryland, 310 employees.*
- Use of Internet for hiring/recruitment purposes. Reduced recruitment budget by 50%. —*Nonprofit, Pennsylvania, 350 employees.*

HR TECHNOLOGY

HR technology is accomplishing its objectives, two studies show. The most important technologies for HR managers who are working their way up to business partner are applications that enhance employee acquisition and development, succession planning, and performance measurements and are valuable for more than just cost-savings features. Other e-HR initiatives have a positive effect on data accuracy and quality improvement, and more cost-effective HR department operations.

Research and results will help you make a strong business case for your own HR technology initiatives. Thus, here are hard data results from these two studies.

HR Department Operations

Fully 60% of HR managers report that Web-based employee self-service (ESS) has reduced their department's administrative workload, says the Towers Perrin sixth annual *HR Service Delivery Survey.* Manager self-service has eased HR's administrative burden for nearly half of respondents, shows this study of nearly 200 of the world's leading organizations. In addition, Thomas Keebler, a Towers Perrin principal and expert in HR service delivery solutions, notes that HR departments have been able to eliminate other HR service delivery "channels," such as voice response systems and paper-based transactions, boosting hard-dollar savings through productivity improvements.

ESS Rules. Increased use of the Web to deliver HR services is most apparent in the ESS arena, where 90% of respondents provide access to Web-based 401(k) information and transactions, and 73% offer online annual benefits enrollment. The study showed that nearly 90% of the corporations surveyed will offer online enrollment, with half making the Web the only enrollment option.

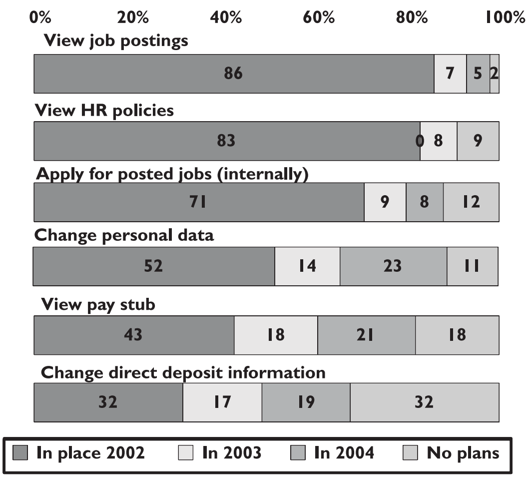
Communications. HR departments are also increasingly using Web-based self-service to provide employees with information about their benefits, including tools to help them select the best health plans, doctors, and hospitals for their needs.

The study showed that more than 90% of respondents allow employees to view HR policies online, and 89% let employees change their personal data on the Web, compared to 66% in the prior year.

Web self-service for employees is also expanding rapidly beyond benefits, the survey notes. Many employees can now update their personal data (e.g., name, address), review their pay stubs, and examine HR policies on the Web (see Exhibit 2.5).

There's More to Be Done. Unfortunately, some levels of HR self-service, involving tasks that you and your HR staff would be eager to be rid of, frequently

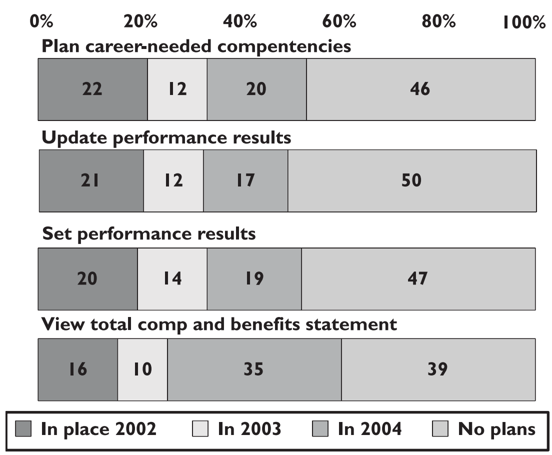
Exhibit 2.5 Availability of Web Self-Service (% Companies)



Source: Towers Perrin

are not available. For example, few companies currently provide access to compensation and benefit statements on the Web. Few organizations have Web-enabled areas for planning career competencies, setting performance goals, and updating performance results. All of these areas are ripe for deployment (see Exhibit 2.6).

Exhibit 2.6 Availability of Web Self-Service (% Companies)



Source: Towers Perrin

Manager Self-Service. Although deployment has been slower than for ESS, a broad array of manager self-service tools are slated to be on managers' desktops in about half of the companies surveyed. Towers Perrin expects this transformation in the way HR delivers services to continue as companies see a measurable return on their HR technology investments. According to the survey, HR departments are facing several key issues that will also drive this transformation. Respondents said implementation and expansion of HR self-service, including employee and manager self-service, is their most pressing issue, followed closely by upgrading HR systems (such as PeopleSoft and SAP) to support more self-service, and standardizing or streamlining HR systems and processes.

Cedar Looks at Strategic Technology Applications

Web-based HR initiatives are helping HR achieve a more meaningful role in the business and strategy of their organizations, the Cedar workforce technologies annual survey shows.

"This year's survey highlights a true turning point in the transformation of HR from an administrative to strategic function," notes Tom Rump, CEO of Cedar. "From 1997 through 2002, the trend has simply been that organizations implementing HR technology were saving on transaction costs. The 2003 survey findings show a significant shift toward strategic applications and a direct link between deployment of these applications and financial success." Strategic applications—those designed to attract, develop, retain, or measure performance of key talent—have grown significantly.

Use of some strategic self-service applications has experienced enormous growth, the Cedar study shows. Staff development via e-learning initiatives has grown by 103%, and salary management (including focal review, bonus award, and stock option granting) has grown by more than 80% (see Exhibit 2.7).

Note: Skills/competency management applications experienced the same level of use in the survey year and prior year; however, the 305 mostly North American respondents include skills management (38% of respondents) among the four applications of most interest for the next 12 months.

Exhibit 2.7 Strategic Self-Service Applications—North America, 2003

	2002 in Use	2003 in Use	% Increase
Recruitment services	53%	70%	33%
Training enrollment	48	53	11
Staff development	24	48	103
Salary management	20	38	84
Skills mgmt/competency mgmt	20	20	0
Succession planning	9	11	25
Workforce analytics	—	10	—
Workforce planning	7	8	11

Source: Cedar *2003 Workforce Technologies Survey*

Exhibit 2.8 2003 Expenditures Compared to 2002 Budgeted

	2003 Overall Use	2002 Budgeted	% Expenditures in Use Compared to 2002 Budget
Software	$ 399,744	$ 226,239	50%
Hardware	291,284	193,163	51
Implementation services (external)	267,290	206,346	30
Implementation services (internal)	267,117	178,394	50
ASP	235,065	145,245	62
Marketing (employee communication)	155,825	75,914	105
Total	1,556,325	1,025,301	52

Source: Cedar *2003 Workforce Technologies Survey*

Other applications generating the most interest for the next 12 months also reflect the strategic nature of e-HR: analytics (39% of respondents), succession planning (36%), and workforce planning (33%). "The expectation of organizations is that these solutions will enable HR to track employment trends against financial performance and thereby improve organizational performance."

HR technology applications were frequently 50% or more over budget, Cedar discovered (see Exhibit 2.8). The biggest budget discrepancy occurred in the marketing and employee communication category, over budget by 105%. This is in part due to HR managers overlooking the importance of change management in technology initiatives.

TOP STRATEGIES FOR IMPROVING HR EFFICIENCY

Consistently asked to do more with less, HR managers today are hard pressed to run their departments efficiently and cost-effectively. Asked to reveal their most successful techniques for improving their department's operations and staff productivity (see Exhibit 2.9), a group of HR professionals listed these three key strategies:

1. *Increase/improve HR automation.* Touted by some as *the* answer to shifting the emphasis of HR departments from paper pushing to policy making, HR technology played an important role in IOMA's HR department management and cost-control study. Respondents said the automation of HR processes was their most successful approach to improving their department's operations and staff productivity. These efforts covered a broad spectrum of HR services and products. For example:
   - A 7,500-employee mental health care facility in Virginia automated forms and published them on the firm's intranet. It also decentralized certain data entry functions, such as applicant tracking, license tracking, and training administration, and added a core benefits self-service application.

Exhibit 2.9 What Is the Most Successful Approach You've Used in the Past Year to Improve Your HR Department's Operations or Staff Productivity?

By Number of Employees	Up to 350	351 to 1,500	More than 1,500	Overall
HR automation	27.0%	25.6%	32.4%	30.6%
Set HR goals and standards	32.4	20.5	23.5	24.2
Streamline HR processes	21.6	12.8	14.7	16.9
Develop an HR strategy	5.4	20.5	14.7	12.1
Ask HR staff to do more	8.1	12.8	5.9	8.9
Other	5.4	7.7	8.8	7.3

By Industry	Business	Financial (banking, insurance, other financial services)	Manufacturing	Other	Overall
HR automation	40.0%	32.0%	29.0%	26.5%	30.6%
Set HR goals and standards	20.0	20.0	22.6	29.4	24.2
Streamline HR processes	16.7	20.0	9.7	17.6	16.9
Develop an HR strategy	10.0	8.0	22.6	8.8	12.1
Ask HR staff to do more	3.3	16.0	9.7	8.8	8.9
Other	10.0	4.0	6.5	8.8	7.3

- An integrated HR and payroll database has been the single most important improvement in cutting down time spent on administrative tasks, says the HR manager at a 200-employee nonprofit publishing company in the South. The key for future success, she believes, is getting more out of existing technology. "There are functions we can add to our self-service to further reduce 'drop-in' questions." Senior managers will be part of the equation as well, as automating some of their requirements will further reduce the time HR must spend on internal support.
- A law firm in the East established a firm-wide customer service center designed to assist employees in 13 offices worldwide. In addition, says the HR manager of special projects, the firm plans to upgrade and add new technology for historical reporting, more flexibility and options in creating reports, and better flexibility in security of data.

2. *Set goals and accountability for HR staff.* Also critical to improved HR departmental operations are established goals and standards for HR staff, along with accountability measures, this year's HR professionals noted. For example:

- "Improved communication has greatly enhanced productivity within the department," said the HR manager at a 25,000-employee financial firm in the East. "This includes two-way communication so that staff have an avenue to turn to that may not have been available before."

- Improved teamwork and cooperation, better communication, and less precisely defined responsibilities have improved HR departmental performance at a 2,200-employee financial services firm in New York City. More scheduled teleconferences and more sharing of information has improved team spirit at the global level.
- HR at a 400-employee hospital consulting company includes all staff in any decision making. "We used to think it slowed the process down, but now acknowledge that it assists with buy-in and implementation."

3. *Streamline HR practices and procedures.* Mundane as it seems, simplified, rational, well-thought-out policies and procedures are an important step in HR operational efficiency. Many respondents understand this well and are devoting the time and effort required to assess and restructure HR practices. For example:

- Moving to consistent and standardized HR practices allows a 12,000-employee services firm to leverage its HR technology. Formerly, business units with disparate practices forced HR to continually customize its human resources management system (HRMS).
- The director of HR at a 350-employee nonprofit in Pennsylvania "completely reviewed processes and procedures across all functional lines," looking for efficiencies or clarity in procedures.
- Another HR manager at a Michigan financial institution developed HR training manuals so "each of us has a resource to go to in order to more thoroughly assist employees."
- At a manufacturing company in the East, HR "does not just provide data to the organization; it first determines their needs and questions to be answered which are taken into consideration when developing reports."
- According to the president at a 600-employee service firm in Georgia, HR is documenting HR processes so they can be repeated, thereby delivering consistent results.

The quest for the hallowed business-partner status for HR managers is elusive. Nevertheless, several respondents "get it" and are revamping their HR departments accordingly:

- One VP of HR at a 7,500-employee manufacturing firm in Illinois reports that he is building an HR model and organization based on the HR partner-value added concept.
- Another VP of HR in a company with employees in 9 countries and 23 states works hard to "closely align HR staff to the operational needs of the organization."
- The HR director at a manufacturing company in Ohio has "moved everyone into goals and objectives that tie into the overall company direction."

HR METRICS: IS "ROI OR DIE" A MYTH OR A MANDATE FOR HR?

Measuring HR's results has become the rallying cry for those who support the HR-as-business-partner model. In today's "ROI or die" environment, the argument is that HR professionals can improve their value to the organization only by proving the bottom-line impact of their services and products to the same extent as their peers in other departments (e.g., operations or finance). However, as HR managers know well, it is often extremely difficult—if not impossible—to apply hard numbers to the intangibles of human resources. In fact, one expert believes that "this emphasis on measurement will surely fail to accomplish its goal: propelling HR chiefs into the inner circle of corporate decision makers." "Undue attention on measurement actually *diminishes* HR—it tends to minimize that part of the profession in which it is most unique and adds the greatest value: providing expert opinion on human behavior," says Michael O'Malley, an editor, consultant, and author.

How CFOs Are Different from HR Managers

To support his contention, O'Malley offers a comparison/contrast of HR's prospects for earning a seat at the table to the CFOs, for whom there is "no ambiguity" at all about why he or she has a seat. For example, CFOs:

- Oversee the finance discipline, which is "directly and unequivocally related to the primary purpose of a company's business—to make money." CFOs ensure the financial health and integrity of the organization so it is positioned correctly to take advantage of business opportunities.
- Are "instrumental in sustaining a sound capital structure and in regulating the business-investment activity of the organization—sales, mergers, and acquisitions—by weighing options and the financial consequences of different courses of action."
- Also serve as "an intermediary and information provider for many interested constituents of the organization—boards, suppliers, customers, and the investor community—by establishing financial terms, setting prices, forecasting earnings, and reporting financial results."

Not So for HR

As for HR professionals, O'Malley observes, "regardless of how informed HR executives are about the business—and they are uniformly well-informed—they will never be this kind of business partner. Whether the metrics are of high quality makes little difference. As it stands, HR studies and measurements that demonstrate efficacy to the business are unable to accommodate dynamic environmental and competitive conditions, nor does there exist a standard, concise, uniform approach in which to view and interpret the numbers that are generated." (Many will take issue with this.)

And so, O'Malley contends, "The tangible financial effects of HR on the business remain elusive, and statistical reports of dramatic findings that link HR practices to business outcomes are seldom persuasive." Referring to examples of how much turnover costs or whether a new reward program has improved quality, he concludes that such numbers are "useful, certainly, but hardly substantial enough to rescue HR from its chronic inferiority complex, lower executive salaries than in other functional areas, and the occasional indignity of indirect reporting to the CEO through Finance, Legal, or Operations."

O'Malley maintains that most people think they "get" HR already. In other words, all of the "specialized knowledge and vocabulary" you bring to the table is no more or less than what anyone knows almost intuitively. This view is wrongheaded, it is true—but is it prevalent? "Most managers are confident that they have a pretty good understanding of people based on their rich life experience and self-proclaimed keen powers of observation," O'Malley points out, adding that "[w]hereas few contest matters of law, for instance, everyone has his [or her] own theory on human nature."

HR as Behaviorist

What should HR managers do? Use their behavioral expertise—not their math skills—to protect their organization's decision makers from their delusions of HR competency, according to O'Malley.

To prove his point, O'Malley presents a quiz in his article that can separate the behavioral knowledge "haves" from the "have nots." *Caution*: It might well be a humbling experience to take this test, which demonstrates just how distinctive and specific HR expertise can be (for a sampling of his questions, see Sidebar 2.1). Besides demonstrating to those outside of HR that their understanding of human behavior is rudimentary at best, it can also nudge HR staff in the right direction.

Instead of focusing exclusively on metrics, O'Malley suggests that managers think about this: "What happens when people wield [behavioral] concepts without understanding them?"

It leads to organizational chaos, in his view. Unless HR's behavioral expertise is part of the decision making process, he concludes, "an organization can be swamped with assertions that are—to put it coarsely—just plain stupid." For example:

- "Option grants promote stewardship."
- "Removing a specified percent of the lowest-rated performers enhances organizational success."
- "Employees do precisely what is measured and rewarded."

The problem, as O'Malley puts it, is that such statements "are so full of exceptions and qualifications that it makes no sense to utter them at all." O'Malley also has little patience for a wide array of other platitudes, such as, "An empowered workforce is a productive workforce" and "Employees are our most important asset." He calls these "belief fragments that, if left unexamined, are devoid of meaning."

What is the HR manager's mission? "To tactfully challenge and refocus baseless conceptualizations of behavior, regardless of the status of the speakers and the seeming conviction behind their words. An appreciation for the intricacies and logic of human behavior—fostered and led by the HR function—can have a great impact on an organization's culture and direction."

No Place for Numbers

"Let me be clear," says O'Malley. "I'm not arguing against the quantification of HR, which, after all, frequently must combat assertions that it is soft and irrelevant. Indeed, there is plenty of room for more analytical and critical thinking in the corporate HR department. The argument is that even in an ideal world, in which the business consequences of HR could be perfectly specified and packaged, this is not the discipline's defining aspect."

O'Malley makes a good point; however, many heavy hitters in the HR business industry feel that unless you run the game, you must play by the existing rules. Hence, it is important for HR managers to continue to build metrics—meaningful metrics—that will demonstrate the results that those who *do* run the game (CEOs and finance) want to see.

Key point: Heed O'Malley's warning that HR's greater calling remains the same, but heed also the mandate to develop sustainable measures of the impact your HR department has on business and profitability.

Sidebar 2.2. Test for HR Pros (and Wanna-Bes)

1. In management theory, Theory X essentially maintains that people are motivated by:
   a. Internal satisfactions and enjoyment.
   b. Charismatic leaders.
   c. Extrinsic factors such as money.
   d. The need to achieve.
2. According to equity theory, people who feel under-rewarded and unable to be compensated further most likely will:
   a. Decrease their work effort.
   b. Rationalize the lower reward as necessary.
   c. Belittle others in the organization.
   d. Overestimate the rewards that others are receiving.
3. According to the over-justification effect, recurringly rewarding people for activities they already enjoy tends to:
   a. Reduce satisfaction with the activity.
   b. Increase the rate at which the activity is performed.
   c. Have no effect on motivation.
   d. Increase satisfaction with the activity.

Answer key: 1(c); 2 (a); 3 (a).

Source: Excerpted from the 20-question quiz, "How Well Do You Speak HR?" by Michael O'Malley, in *What Is HR Good For, Anyway?*)

Exhibit 2.10 Prevalence of HR Automation, by Number of Employees and Industry Sector

By Number of Employees	Up to 350	351 to 1,500	More than 1,500	Overall
Yes	82.9%	83.3%	100.0%	86.2%
No	17.1	16.7	0.0	13.8

By Industry	Business Services	Financial (banking, insurance, other financial services)	Manufacturing	Other
Yes	85.3%	92.3%	82.4%	87.8%
No	14.7	7.7	17.6	12.2

APPLICANT TRACKING IS A TOP HR APPLICATION

At last, technology has a firm foothold in HR departments in all industry and size groups, easing the administrative burden of HR managers and their staff. Indeed, 86.2% of HR professionals responding to IOMA's survey have automated at least one HR department function (see Exhibit 2.10).

Payroll and Benefits Administration Top the List

As expected, automated payroll is the most prevalent HR technology overall (71.7% of respondents), as it is the easiest to implement and most affordable HR service, even for small employers (see Exhibit 2.11). Also predictable, larger employers (1,500 employees and up) are more likely to have automated payroll services (84.2%) than small. Even so, in the smallest size group (up to 350 employees), about two-thirds (66.7%) have automated payroll.

Automated benefits administration, though popular, still is used by just over half (53.9%) of respondents overall. Again, the larger the organization, the deeper the penetration: 71.1% of large respondents automate benefits administration

Exhibit 2.11 Automated HR Functions, by Number of Employees

	Up to 350	351 to 1,500	More than 1,500	Overall
Payroll	66.7%	78.6%	84.2%	71.7%
Benefits administration	45.2	57.1	71.1	53.9
Recruiting—applicant tracking	31	40.5	52.6	39.5
Personnel administration	31	42.9	52.6	37.5
Benefits enrollment	26.2	26.2	60.5	35.5
Training development	7.1	23.8	44.7	25.7
Employee self-service	16.7	14.3	42.1	24.3
Manager self-service	11.9	7.1	13.2	11.8
Other	2.4	4.8	2.6	3.3

versus only 45.2% of small employers. Automated benefits *enrollment*, however—a time-consuming yearly operation for almost all HR departments—still has only about one-third (35.5%) of IOMA respondents on board.

Making Headway: Recruiting and Applicant Tracking

The demand for effective recruiting—more than putting bodies in seats—continues to draw HR managers to automated recruiting and tracking systems.

More than a third (39.5%) of respondents overall now rely on technology to assist in candidate selection and hiring. Large organizations are still the most likely to use such systems (52.6%), but there is only a small gap between that size group and midsize (40.5%) and small (31.0%) respondents (see Exhibit 2.12).

Also gaining ground, technology-enhanced training and development are now used by 25.7% of respondents overall. Penetration among small employers is still low: only 7.1% of HR professionals in organizations with up to 350 employees said they have e-learning in their organizations.

About one-quarter (24.3%) of respondents now have employee self-service applications. Again, larger respondents are more likely to have adopted this approach (41.1%). Less than a fifth of midsize (14.3%) and small (16.7%) organizations use employee self-service applications.

Industry Penetration

Among the four industry divisions in the study, technology has the lightest penetration in the business services division (all service firms except financial) and the heaviest infiltration in financial (banking, insurance, and other financial services) (see Exhibit 2.12). *Note*: Because of small sample size, transportation, technol-

Exhibit 2.12 Automated HR Functions, by Industry

	Business Services	Financial (banking, insurance, other financial services)	Manufacturing	Other	Overall
Payroll	62.9%	88.5%	73.5%	78.6%	71.7%
Benefits administration	48.6	61.5	52.9	59.5	53.9
Recruiting—applicant tracking	34.3	46.2	29.4	50	39.5
Personnel administration	28.6	46.2	41.2	45.2	37.5
Benefits enrollment	28.6	53.8	26.5	40.5	35.5
Training development	17.1	38.5	23.5	26.2	25.7
Employee self-service	14.3	23.1	23.5	35.7	24.3
Manager self-service	8.6	15.4	8.8	16.7	11.8
Other	0	7.7	5.9	0	3.3

ogy/communications, private practice firms, and wholesale/retail respondents appear in the "other" category.

Across all industry sectors, payroll is the HR function most likely to be automated, followed by benefits administration. Other interesting trends are also clear, among them:

- Financial service firms are most likely to have adopted automated benefits enrollment (53.8%) and some form of e-learning (38.5%). Business services firms are by far the least likely to use technology in training and development initiatives (17.1%).
- Firms in the "other" category are most likely to have adopted employee self-service (35.7% of respondents).
- Manufacturing firms are least likely to use automated recruiting and applicant tracking (29.4%); the largest penetration for recruiting technology is among respondents in the "other" division (50%).
- Although still in its infancy, manager self-service applications have made the most headway among "other" respondents (16.7%) and financial respondents (15.4%).

RECRUITING FUNCTION: PART OF THE HR DEPARTMENT?

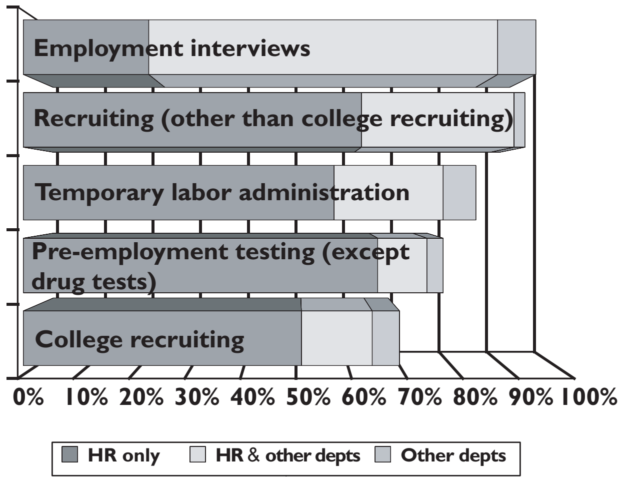
If you were hiring a recruiting professional, you would likely be looking for skills and expertise in sales, marketing, psychology, and general business acumen. If you were hiring an HR professional, you might focus on previous HR experience and other, very different, attributes. Now these questions: Can one person successfully execute these two roles? Should that person be in your HR department?

The latest research from the Bureau of National Affairs (BNA) underscores that HR is deeply entrenched in organizational recruiting and hiring activities (see Exhibit 2.13). In fact, BNA's study shows that most organizations give HR full responsibility for recruiting, preemployment testing, and contract hiring. As expected, HR is likely to be solely responsible for hiring in smaller companies, with shared responsibility with other departments growing as workforce size increases.

"It's likely that recruiting and retention will become the main focus of many HR departments," says Frank Heasley, Ph.D., president and CEO of MedZilla.com, an Internet recruitment and professional community that targets job seekers and HR professionals in biotechnology, pharmaceuticals, health care, and science. "There is a continuing trend that many employers are electing to outsource other HR functions, such as benefits. This is attracting more attention to the organization of HR departments, and whether HR professionals can make the transition into roles centered on recruitment or retention."

James Walker, president and CEO of Octagon Research Solutions, a life sciences solutions provider in Pennsylvania, says that his company went from a startup with fewer than 10 employees to more than 60 employees in less than four years. Octagon's growth has been dependent on the integration of the HR and recruiting roles into one position. "It's almost critical to have that person being one and the same because recruiting is the first step and retention is the goal," Walker

Exhibit 2.13 Employment and Recruiting—Who Handles It?



Source: BNA

says. "For us, the cost of recruiting is high enough, but the cost of turnover is even higher."

Whoever is doing the recruiting also has to be involved in the development and evolution of the corporate culture, which is an HR function. That line of thinking has allowed the company to hire the right mix of people and therefore prosper. "We've never lost anyone on the senior management team in four years, and we have less than 6% turnover," Walker notes.

Peggi Pranks, senior legal associate with Dharmacon, Inc., a biotech firm in Colorado, says that her to-do list as an HR manager for the company includes:

- New employee orientation
- Signing employees up for health insurance and payroll direct deposit
- Managing personnel files
- Management training
- Putting an employee handbook in place
- Revamping the existing mentor program
- Devising an employee award program
- Overseeing a monthly employee luncheon
- Researching and upgrading the benefits package
- Keeping current an employee bulletin board of staff photos
- Ensuring updates to an information bulletin board for communicating important information to staff
- Keeping the company organization chart and posting updates

When she was asked to recruit, however, her task list looked very different:

- Devising job descriptions
- Posting classified ads in the local newspaper and on the Web
- Screening resumes
- Scheduling interviews
- Lining up internal staff to interview candidates
- Conducting initial phone interviews
- Conducting reference checks

Recruiting and other HR responsibilities are very different functions, Pranks stated. Nevertheless, the two should fall under the same HR heading, she believes, and the HR manager/director should be able to perform recruiting functions. "I believe it takes a special talent to ask the nitty-gritty questions without making the candidate feel like they're being put on the spot and become defensive," Pranks says. "For example, especially in the current job market, a candidate may come in to interview for an [administrative assistant] position in marketing when what they really want is a [junior accountant] position in finance. . . . I've experienced candidates' outright lying about what they can do and the commitment they are willing to make to a position."

The ideal, Pranks suggests, is to have a skilled recruiter focus on bringing good, qualified candidates in and let someone else take care of all the post-hire functions to keep the employee. This concept works for companies that hire enough people to keep an in-house recruiter busy. If not, outsourcing the recruiting function or training an HR staff person to recruit might work, she says. "I have met HR managers/directors who admitted that, although they did recruiting, it was not their favorite thing. That is why I believe it is crucial to have someone perform this function that is stellar at it and a people-person; otherwise, a company will be looking to fill the position again in three months because the wrong candidate was hired for the open position."

HR and recruiting may be two separate functions, but that does not mean that recruiting is not an imbedded task inside HR—it means that HR assumes a much more robust role in the organization, from personnel development to compensation plans to resource allocation to medical benefit issues and 401(k) policies, says executive recruiter Chuck Pappalardo, managing director of Trilogy Venture Search (Burlingame, California). "In the last several years, the outsourced recruiting industry has grown substantially because we focus specifically on recruiting," Pappalardo says. "We don't focus on all the other things that HR people do to maintain a company's growth. We go out and find specific individuals that match specific criteria and we are highly specialized in what we do. An internal recruiting function would not necessarily have the ability to be as focused."

Although there are HR people in recruiting, Pappalardo notes, recruiting is not typically an area HR professionals move into. When it comes to conducting executive searches, in particular, recruiters need certain skills to be successful, among them the ability to attract people at high levels in a professional manner. Recruiters also have to have "global" versus company views, realizing what the possibilities, challenges, and trends are in the industry marketplace.

When hiring recruiters, Pappalardo looks for executives in specific industries who have marketing or sales experience. The recruiting environment, Pappalardo says, is very different from that of general HR. It takes the right personality to operate in the recruiting world, he adds.

Recruiting is often dependent on incoming revenue and features sales and execution demands that are very unlike traditional HR roles. As a former recruiter in science and health care, Heasley adds that these functions work better if differentiated whenever possible, and that coordination is essential for best results. "Employee retention, compensation and benefits, and other classical HR functions require a steady, day-to-day approach with the ability to focus on detail. From my own experience, successful recruiters tend more toward being entrepreneurs and risk takers with personalities more suited toward sales and marketing. It's nearly impossible to find these two very different sets of qualities in the same individual."

CUTTING COSTS IN HR DEPARTMENTS

HR managers are frequently called on to guide organization-wide cost-cutting initiatives. A good place to start is in your own backyard, leading by example to show other departments how to cut the fat and make the most of what is left.

Four Core Strategies

Jonathan Tanz, associate principal with Mellon/Buck Consultants (Secaucus, New Jersey) provides four strategies for HR department cost savings:

1. *Look for costs over which you have direct control.* HR can achieve the quickest and most significant cost cutting by starting with areas over which it has direct control, Tanz advised, adding that 50 to 60% of HR department costs do not involve employee compensation and benefits. You can realize substantial savings by poring over outlays to vendors for training, temporary staffing, retained searches, and other recruiting activities.

   All HR departments can reap substantial savings by getting a handle on their use of vendors, Tanz said. One large printing manufacturer with about 25,000 employees found that it had small contracts for training scattered among more than 300 vendors, with more than 40 vendors alone providing training on Microsoft products. "Each division and each business unit was doing its own thing," he said.

   Solution: The company moved from a decentralized HR function to a shared services model to help get its arms around its vendors, he said. The best solution is to implement long-term vendor management controls that leverage procurement decisions, set clear criteria for vendor selection, and negotiate volume discounts with select vendors. Such a strategy must penalize managers who sidestep the established vendor selection protocols, he added.
2. *Improve HR service delivery.* HR can greatly affect costs at any organization, Tanz said, by improving service delivery, thus freeing employees to devote their energy to the business. "We find all too often in working with our clients that [HR departments tend] to be more fragmented in their service delivery."

For example, something as simple as scheduling training appropriately, so that it does not pull employees or supervisors away from the line, can help the organization avoid a slowdown in production or the expense of backfilling a position with temporaries.

3. *Streamline recruiting.* When recruiting, HR can better manage the applicant stream to hiring managers simply by sending them the top picks on a daily basis, rather than dumping 200 candidates on them once every couple of weeks. This simple change can dramatically reduce the amount of time hiring managers must spend on the task, Tanz said.

4. *Simplify the review process.* Similarly, HR can streamline and simplify the compensation and merit review process to allow managers to focus more on operational and strategic issues, such as developing the skills of their staff.

Look beyond "People Costs"

It is understandable that organizations turn first to employee rosters when trying to cut costs. People costs are the single largest and most visible expense, representing 50% of total operating costs for most organizations, according to Michael Rinehart, CFO of Nuera Communications, a San Diego-based telecommunications systems provider.

Conversely, nonpeople-related costs are the result of lots of little spending decisions of many different types. As a result, they are more difficult and time-consuming to address, and are often an "afterthought" to layoffs, Reinhart continued. Furthermore, although a CEO may be intimately involved in the people-related costs of an organization, other spending categories tend to get delegated further down the organizational ladder. Addressing these operating costs can significantly boost competitiveness, efficiency, and profits without sacrificing quality or customer service. It can also help you avoid morale-sapping layoffs and the potential talent drain therefrom.

HR managers should follow some general guidelines to ensure success when kicking off an organization-wide cost-cutting effort, Rinehart said:

- *Solicit input first*, and involve rather than accuse. Rinehart has found that when he asks employees at Nuera for ideas before implementing changes, 95% are fairly willing participants. When discussing the issues, he advised, avoid assuming that unnecessary spending is a conscious act. "They want to help," he said. "More often than not—60% of the time—people say, 'I didn't realize we were spending [that much].' "
- *Pick low-hanging fruit.* "Go for low-effort, high-impact opportunities first," Rinehart advises. He receives calls all the time from vendors offering to save him 10% on payroll. "But frankly, our whole cost structure for payroll expenses is not very high," and the payroll system feeds into six other systems, including the HR information systems. "I'm not interested in disturbing something that works, particularly for a nominal amount of savings," he said.
- *Set realistic goals and time frames.* "People end up giving up after a while because they are not seeing instant results," Rinehart said. He is continually surprised by how long it takes to reap savings, even after a plan is clearly established. "There's no magic way to approach this, other than keeping employees after it and having perseverance."

AVOIDING COSTLY LAWSUITS

The best way for your HR department to manage employment-related lawsuits is to avoid them altogether. Still, the time may come when you will feel that you have been pushed to the limit and you have no choice but to say, "So sue me."

Before you make that decision, of course, you want to have an entire arsenal of HR department practices and procedures that will stand you in good stead if the person to whom you throw down the gauntlet decides to call you out. One of the best preparation checklists comes from Jackson Lewis LLP (White Plains, New York; www.jacksonlewis.com), a national law firm that represents management exclusively and practices workplace law, including labor, employment, employee benefits, immigration, and workplace safety. The firm has a preventive philosophy.

Penny Ann Lieberman, a partner at Jackson Lewis, outlined these 12 critical steps to bulletproofing your HR department:

1. *Have you reviewed your policies?* A strong stance against discrimination, harassment, and retaliation, including policies that define inappropriate conduct, prohibit sexual or other harassment, and outline a complaint procedure, are essential to having a discrimination-free workplace and avoiding lawsuits and discrimination complaints or charges and defending them if they arise.

   Your policies should cover:

   - Examples of prohibited conduct and a disclaimer that the examples are not all-inclusive
   - Reporting procedures that include the name, address, and phone number for company representatives (both male and female) to whom employees can direct complaints
   - Encouragement to employees to come forward with complaints
   - Specific timetables for reporting, investigating, and responding to complaints
   - Discussion of possible disciplinary actions for violations of company policy against harassment, discrimination, and retaliation
   - A procedure to obtain a signed and dated receipt from each employee who receives the policy, which should be distributed at least annually and on which managers and nonmanagement employees should be trained

2. *Have you educated your supervisors?* Supervisors play a key role in your company's defense, Lieberman stated. Provide training on discrimination, harassment, and retaliation to all supervisors. *Key point*: Supervisors should be able to testify that they have been trained and understand the company's policy against discrimination, as well as the complaint procedure.

   You should ensure that it is you, the employer, that determines who are "supervisors" in your organization by identifying them and making them accountable for compliance with your antidiscrimination policies. *Key point*: The U.S. Supreme Court considers employers liable if a "supervisor" harasses a direct-reporting employee. Also include the phrase "commitment to equal employment opportunity" on every supervisory job description, Lieberman advises.

   Train specific managers or HR employees to investigate complaints. Train investigators to adopt a style that is nonaccusatory, sensitive, objective, and credible (see Sidebar 2.3). *Key point*: Case law says that courts look fa-

Sidebar 2.3. Ten Commandments of Conducting an Effective Investigation

1. Seek information—do not give it.
2. Be thoroughly prepared before starting the investigation or conducting an investigatory interview.
3. Maintain appropriate confidentiality.
4. Ask for detail—who, what, when, where, why, and how.
5. Interview all relevant witnesses—if in doubt as to relevance, interview.
6. Give both the victim and the accused a chance to tell their sides of the story in their own words.
7. Review all documents thoroughly, searching for inconsistencies and corroboration.
8. Do not mix your impressions with those of the witnesses.
9. Maintain neutrality throughout and do not make assumptions.
10. Write a thoughtful and careful report—the notes will be the centerpiece of the investigation.

Source: Jackson Lewis LLP

vorably on employers who promptly and effectively investigate complaints. Instruct supervisors and managers that all complaints must be brought to the attention of an HR manager or legal counsel. Attach disciplinary consequences to a failure to report.

3. *Have you educated your employees?* Train all nonsupervisory employees regarding discrimination, harassment, and retaliation, including your company policy and complaint procedure. *Key point*: Employee training enhances your position that you have made a good-faith effort to avoid discrimination in the workplace. It can also assist an employer in demonstrating that a plaintiff failed to take advantage of the employer's harassment complaint procedures.

4. *Do you tell new employees about the policies?* Distribute your policy to all new employees and inform them of the company policy. *Key point*: This procedure ensures that employees are aware of the policies and may strengthen your claim that you made a good-faith effort to prevent violations of the law.

5. *Have you documented your efforts?* Documenting your good-faith efforts to prevent violations will eliminate any disputes about the extent of your antidiscrimination efforts. Keep a complete record of prevention programs, publications, training, complaints, investigations, and actions taken. Also, if appropriate, note any failure by an employee to take advantage of your procedures.

6. *Have you done an EEO trend analysis?* Review your EEO-1 reports for the last five years. Also review your company's history of EEO charges to determine trends or similarities.

7. *Have you reviewed all exit interview forms?* Exit interviews can tell you employees' perceptions of supervisors and company decisions. Cross-reference possible opposing witnesses in lawsuits with exit interview forms.

8. *Have you obtained releases?* Employers can attempt to limit their liability by offering enhanced severance packages in exchange for a general release signed by terminating employees. *Note*: Check with legal counsel before using general releases, particularly if the employee is age 40 or over and the Older Workers' Benefit Protection Act applies.

9. *Have you performed appropriate adverse impact analyses?* Conduct adverse impact analyses on various applicable personnel actions. Review results with counsel.

10. *Have you checked to make sure there are no inadvertent violations of unrelated laws?* For example, are there wage and hour violations that could expose your company to class actions? Are there potential ERISA violations? For example, an exiting employee makes a written request for copies of applicable benefit plans, and the company fails to provide them within the required time period.

11. *Have you checked employee surveys for possible incriminating information?* If you have conducted employee feedback surveys, review them for anecdotal evidence that could hurt you.

12. *Have you reviewed diversity/affirmative action plans?* Were goals set? Were they met?

HEALTH PLAN SOURCING ON THE WEB

Moving time- and labor-intensive HR processes out of the department is one of the most effective HR strategic maneuvers. Take health plan sourcing and management, for example. If you have more than one plan option, or if your company has more than one geographic location, you and your HR staff must undertake a lengthy and complex request-for-proposal (RFP) process. This can entail a 15- or 20-page RFP plus the time and effort required to compare vendors.

Web Sourcing Way

A sign of things to come for harried HR staff is e-procurement. IE-Engine (Waltham, Massachusetts), a privately held software company, has since 1999 been providing online health care procurement to *Fortune* 1000 companies, among them Ford Motor, Dow, and Staples.

Nancy Lazgin, director of global benefits at Staples (Framingham, Massachusetts), described how the process works and how it has simplified health care sourcing for the company. Staples has more than 20,000 associates in eight geographical regions enrolled in its health plans. Researching and selecting health care plans used to be an expensive and onerous process for HR and benefits staff. "This is not like the paper process where you send out some sort of 15-page RFP, not including all the attachments, and then you end up with piles that are two or three inches thick lying all over your office floor." Using IE-Engine (www.ie-engine.com), Lazgin and her staff are able to source the company's health plans using regional variables and requests for quotes on both self- and fully insured plans.

RFP Process

Lazgin completes an online template describing the company's health care requirements—including population and claims data, which are imported into an

Excel spreadsheet from the company's HR system—and what the company is looking for from vendors. She identifies vendors ahead of time. IE-Engine then helps each one of the insurance vendors work with the system. Initially, some vendors had concerns about whether they would really be able to get their point across. That is no longer an issue, Lazgin says. "This having been the third year for us, it was a fairly easy and simple process because it's pretty much the same vendors." IE-Engine also added a scorecard this year that allows Staples to weight certain questions in the RFP, such as access to networks, discounts, customer service issues, performance guarantees, and the like, on which to compare vendors.

Vendors have a two-week window in which to review the Staples information and requirements. Staples also can design how it wants the vendors' responses reported to it, either individually by vendor or by all vendors in a certain area of the country, for example.

The company can also communicate with vendors during the two-week RFP process. "There may be questions about our data," explains Lazgin. "You can either respond to that particular vendor or you can do a broadcast response to all vendors."

During that two-week period, vendors have access only to the company information, and they can do their underwriting from that. During the last 48 hours, Staples opens up the bidding window so that vendors can enter their bids. They can see instantly where they are positioned among their competitors. Staples elects not to disclose vendors' financial information, although some IE-Engine customers do allow vendors to see each other's bids.

Results

There is a tremendous time saving from putting the RFP and sourcing process online, of course. "There's a lot of information that, having used the system for three years, you don't have to re-enter. You can update whatever you used in last year's RFP," Lazgin notes.

Online sourcing is also less labor intensive and less paper intensive, she adds. "There's an ease with which you can go to multiple vendors. You probably have more vendors involved in the process than you would typically have, so we're more confident and comfortable in our final selection. It does lend itself to getting you some dollar savings."

Lazgin believes it is easier to get comparable data as well. Unlike with paper RFPs, in the electronic RFP process, "you clearly define each element so you get comparable responses." Online sourcing also simplifies the process for vendors, Lazgin notes. "The whole idea of simplifying the process from our perspective and from the vendors' perspective—it was something we had to take a look at."

Costs

IE-Engine is an application service provider, so clients subscribe to its software on an annual basis. Vendors pay nothing. Fees are structured based on the number of covered lives and the complexity and volume of plans. The average annual fee for IE-Engine's current customer base is $250,000 to $500,000.

The company plans to expand into the middle market at some point, according to a company spokesperson. For example, Gerber Scientific, with only 800 employees, licensed the service to mitigate broker costs in the RFP process and achieved significant cost savings by doing so.

Return on Investment

Staples did not have specific ROI information for its contract with IE-Engine. However, Lazgin stated that the company would not have undertaken the process without a favorable ROI expectation.

IE-Engine says the general RFP time savings is 50%. One client performed an HMO vendor consolidation in 6 weeks as opposed to the expected 12 weeks. Dow Chemical realized a 6% cost savings from the process.

Leveraging Technology

Staples is very interested in how it can leverage technology, which is an important part of how it delivers goods and services to its customers. So, using the Web to source its health plans was a natural next step.

The company started out using the service for health plan sourcing and has expanded it to source life, stop-loss, and dental insurance as well. The next step is IE-Engine's vendor and plan management module, which Staples hopes will help multiple departments be more efficient. Its HR customer service center will use it to search plan documents and coverages, for example.

AVOIDING COSTLY EMPLOYMENT LAWSUITS

Nothing causes more teeth-gnashing among HR managers than the supervisor who slinks into their office—after the fact, of course—and asks, "Is it okay that I told Charlie he could keep his *Playboy* pinup calendar in his office as long as it's not visible from the front door?"

You can provide managers and supervisors with the tools they need to protect themselves—and you—from the most common employment-related slipups in about 90 minutes, says Jonathan Segal, partner in the Philadelphia employment law firm WolfBlock. The training essentials include EEO, discipline and firing, and harassment. The following 17 key strategies will help keep you out of the courtroom.

Equal Employment Opportunity

1. *Protected classes.* Review all EEO protected groups one by one: sex, race, color, age, national origin, religion, or military status. Why? If someone sues you and you have covered all but one group in your training, that is the gap opposing counsel will exploit.
2. *Culture.* When you talk to supervisors about nondiscrimination issues, be careful not to say, "Well, the law says . . . ." Supervisors might hear you say, "We would if we could, but we can't so we won't." Nondiscrimination must be part of your organizational culture and values. "It's morally wrong and economically stupid, not simply a matter of legal compliance," Segal stated.

Hiring and Promoting

3. *Impermissible questions.* Untrained supervisors will not know these, so provide them with a list of questions they cannot ask.

   Some common traps include asking "What do you do for fun?" Illegal? No. Dangerous? Yes. This question may encourage applicants to disclose personal information, or they may perceive that the employer is trying to find out personal information.
4. *Appropriate interview questions.* Provide supervisors with a uniform list of job-related questions that are okay to ask, including behavioral or situational questions, such as: "Tell me about a time when you were too aggressive with a customer. How did you handle it when you realized it?"

   A uniform list of questions is designed to ensure consistency in phraseology and avoid unconscious bias (e.g., asking young women if they are able to travel, implying that they would not be able to if they had children, and asking older workers about their ability to handle change, implying that they are rigid because they are older). Train supervisors to explain this uniform policy by saying that the company values consistency in opportunity and that is why interviewers ask the same interview questions of all applicants.
5. *Voluntary disclosures of personal information.* Train supervisors that if an applicant says, "I have cancer, but I'm in remission," supervisors should respond with: "I appreciate your telling me that. We only consider conditions that could affect the job. Can you do the job?" *End of discussion.*
6. *Résumé gaps.* Another typical question that can get your supervisors into trouble is "Tell me about this gap on your résumé." "Everyone always has a medical or other personal reason for gaps. That question, though legitimate, results in disclosure of information that you cannot use—but now that you know it, it can be used against you.
7. *Requests for an accommodation.* Train new supervisors that if someone says he or she needs an accommodation, the request goes straight to HR. The supervisor's proper response should be: "I appreciate your letting me know. I'll check with HR on it." Left on their own, supervisors could dismiss an accommodation that is easily made, or offer one that you do not intend to make.
8. *Questions about promotions and salary increases.* Supervisors should always speak in terms of possibilities, not guarantees.
9. *Note taking.* Train new supervisors to take lean notes. They should write nothing on the job application and never write EEO "identifiers"—age, race, and the like, even if they are doing it to help them remember who the candidate is. A court will assume that the note was made for an impermissible reason.

   Beware notations that reject a candidate for a lack of cultural fit, which can be interpreted as different from the group because of a protected class. Instead, supervisors should ask themselves what the applicant did or did not do that made them feel the applicant would not fit. "If they can't explain it, they're going to do no better in a courtroom."

   Include a warning about proxy adjectives, such as "too assertive" (women) or "lacks energy" (possible age bias). Train new supervisors that if a person is combative, they should write: "She argued with me; she told me I was wrong." Describe the behavior; avoid labels.

Discipline and Termination

10. *At-will employment*. Fairness matters, regardless of your organization's policy on at-will employment. Train supervisors to follow the verbal, written, final warning discipline process, Segal recommends. Here's why: Jane's supervisor fires her but never gives her notice. Jane goes to the EEOC and says, "I think I was fired because of my age." Without a reason for the termination, you end up unable to rebut an allegation of probable cause.

Two exceptions are:

New hires. If a supervisor fires an employee after a short period of time, the inference is that the firing was not discrimination and the employee is unlikely to file a claim.

Summary offenses. These are drug dealing; serious harassment; and, now, violations of the new Sarbanes-Oxley Act.

11. *Documentation.* If you train new supervisors to document employment decisions, it will show a finder of fact in a lawsuit that the justification for termination is not something you made up after the fact.

12. *Focus on workplace behavior or performance*. Train supervisors to focus on what is exhibited, not the underlying problem, and to avoid comments such as "you are not trying" or "you don't care." Expect resistance to this: Supervisors tend to be empathetic and will not like the discipline aspect of the job. Nevertheless, if the problem is personal and employee feels personally attacked, they may respond in kind.

Supervisors should say something like this: "This is your final warning. Failure to make immediate, significant, and sustained improvement will result in immediate termination without further warning."

13. *Voluntary disclosures.* Instruct new supervisors that if the employee says, "I have an anxiety disorder and I'm having trouble concentrating," the matter should be referred to HR immediately. The appropriate response from the supervisor to the employee is: "Thank you for telling me. I will report it to HR."

14. *Consistency.* The absence of consistency leads to discrimination claims. The nontermination today becomes the comparison case for future terminations for similar behavior (see Sidebar 2.4).

Train supervisors that when they make exceptions, they should consider individual circumstances and document the reasons for their decisions. This documentation can be used to defend against claims.

15. *Timing*. It is time for an employee to go, but the supervisor avoids the moment. The employee knows the axe is coming, so he goes to a therapist. When the supervisor finally gets around to talking with the employee, the response is something like: "I recognize that my performance has declined because I've had serious medical problems due to harassment at work from co-employees"; "the asbestos is poisoning me"; and so on.

Delay in implementation creates an opportunity for the employee to make a legitimate termination appear retaliatory. If delay is inevitable, train supervisors to document via e-mail something like: "As we discussed, when Joe returns from vacation, we will terminate him."

Sidebar 2.4. "But for" Defense for Nonterminations

There are risks in not letting a person go. For example, Martha has been with you for 20 years and is an A+ employee. She falls on hard times—a sick child or a divorce—and she is working long hours. When a big business opportunity comes along, the supervisor asks Martha to be in charge. Martha explodes and behaves inappropriately, but because of her long tenure and exemplary service, the supervisor does not fire her.

Then the supervisor hires Greg and, in a similar situation, tells Greg he wants help on a big project. Greg explodes and behaves inappropriately and the supervisor fires him. What do you do to prevent Martha's nontermination coming back on you?

The "but for" solution: HR confronts Martha and says, "But for the fact that you've been with us 20 years, you've been working hard, and you're under a lot of personal pressure, we would terminate you." Then the supervisor can tell Greg that when he has been there 20 years and has worked very hard the whole time, he too can explode without getting fired.

Source: Jonathan Segal, WolfBlock

Harassment

16. *Follow the Rs.* Train supervisors to follow the "Rs":

- *Refrain* from inappropriate behavior, broadly defined as sexual, racial, or ethnic discrimination or harassment, and the like.
- *Respond* proactively to inappropriate behavior (for example, a *Playboy* magazine on someone's desk or overheard racial slurs), even in the absence of a complaint.
- *Report* all complaints, even if the employee asks the supervisor not to do anything about it. HR must decide. When employees raise concerns, supervisors should report them to HR immediately.
- *Remedy* inappropriate behavior. When supervisors take corrective action, they should focus on inappropriateness, not illegality, because the latter could be interpreted as an admission. Use "offensive, inappropriate, unwelcome" in describing the behavior.
- *Refrain* from retaliation.

17. *Provide support.* Let supervisors know that HR and the company management will support them. Siegel says, "Sometimes we scare our supers to death about discrimination and harassment. If they do nothing and tolerate mediocrity, there are legal and business risks. It's important at the end of training to say: 'Look, I understand claims happen. We want you to follow the process. If you do that, and a claim is filed, we're going to stand behind you 100%. If you tolerate or ignore unacceptable behavior, there will be a problem.' "

SAVING MONEY FOR YOUR ORGANIZATION

Cost control, always in style, is particularly fashionable now. HR and compensation managers have long been experts at making the most out of the least resources. Further, those seeking the coveted "strategic partner" role wisely circulate their most effective cost-control ideas throughout the larger organization. The best managers are always on the lookout for new ideas.

In recognition of this fact, a list of 25 suggestions is provided to help you and your organization save even more. Even if some sound familiar, others should spark new areas to explore.

Health and Benefits

1. *Take steps to control health insurance costs, starting with the plan(s) you offer*.
   - Make sure employees want all the benefits your company is offering (always a good idea in these ROI-conscious times).
   - Consider the plans of the top-rated carriers.
   - Choose a plan that will be easy to administer and that offers good customer service on claims and coverage questions.
   - Shop online for the best rates.
2. *Save money on health insurance through auditing medical claims.* Periodic audits can reveal whether you are overpaying.
3. *Start a wellness program.* The costs for educational materials, onsite flu shots, and weight-loss programs are low—and the gains in productivity, reductions in illness-related absences, and better numbers in your employee pool for your next health care premium review will more than make up for them.
4. *Explore self-funded insurance plans.* Even smaller organizations can save money with this method, but if you are reluctant to try it with the general medical plan, experiment with a dental or vision plan.
5. *Control prescription drug costs through HMO or mail-order drug plans*. These can be especially useful for controlling the costs of drugs for chronic conditions. The advantages to employees of ordering by mail in bulk or getting lower rates from an HMO are obvious.
6. *Team up with other employers in your region or industry to shop for health plans.* A larger group gives you bargaining clout and improves rates for all the participants.

Pay Practices and Other Benefits

7. *Convert holiday bonuses into performance-based incentives.* Perhaps our favorite suggestion of the bunch, the idea is to set the criteria according to your desired goals, such as increased productivity, improved attendance, or reduced workforce injuries. Meeting such goals will save both time and money for the organization.

8. *Trim your company's 401(k) match percentage.* You can hope employees will not miss the extra contribution if the capital markets are performing poorly, and you can save the cash and plan to restore the benefit later on when the markets are better and such contributions are more valued.
9. *Make direct deposit mandatory.* You will save in accounting time for tracking and reconciling cash. If some employees resist, you can ask a bank to act as a pay station. The company e-mails a file to the bank, which then distributes the funds in cash. Banks will like this arrangement, as employees will probably open accounts there for the convenience.
10. *Control overtime through steps such as changing regular weekly working hours from 35 to 37.5* (which "buys" an extra 2.5 hours per week at regular rates), monitoring "casual overtime" (where there is no real need to work overtime, but the employee comes in an hour early or works through lunch to get more hours), and hiring part-timers to do work for which you formerly paid full-time employees at overtime rates.
11. *Offer flexible scheduling as a low-cost perquisite.* This may create more work at first for supervisors and HR, but the option can make workers much happier—and more productive, which is where the cost savings will come in. Offering such an alternative can also be helpful in softening the blow of smaller raises and bonuses this year.

HRIS/Technology

12. *Reconsider self-service HR applications.* As more people use these, they become more efficient and available for smaller organizations to consider. Trimming HR time for simple employee functions such as address changes and checking on health plan options can add up.
13. *Put the heat on vendors.* Competitive bidding will probably result in substantial cost savings for your organization. This applies not just for software purchases, but also for vendors that supply services such as payroll, benefits administration, and 401(k) recordkeeping.
14. *Seek out integrated software solutions.* This involves some detective work to verify the vendors' assertions that the new addition will work with other software. Make sure customer service is there to smooth the inevitable bumps in the integration process. It is worth the extra effort to have software and systems that work together.

General Cost Savings

15. *Form a cost-control committee* to review suggestions for savings on a regular basis.
16. *Assess the pros and cons of outsourcing various functions.* Perform your own mini-audit of various functions, based on the costs of performing them inside the organization versus outsourcing them.

17. *Train early and often.* The training you provide new recruits is critical, especially regarding the company's procedures and culture. This training can take many forms, including low-cost ones such as mentoring and online training. If necessary, you can limit it to the essentials.
18. *Set standards for your own department.* Establishing goals and budgeting time is not just for a production floor—it can work in every department, including yours. Not only can you save time and money, but you will also have demonstrable results of all that you are accomplishing.
19. *Use the Internet for recruiting.* It is popular, efficient, quick, and saves the costs of external recruiters and newspaper ads.
20. *Increase your reference and background check efforts.* When you were competing for workers, you may have been tempted to skip these checks, but now you should do them thoroughly. For all new hires, conduct a full reference check, a criminal background check, and a civil-records check (including all locations where an applicant lived or worked for a period of time).
21. *Put your organization's performance appraisal process online.* Keeping your appraisal and review processes on schedule and available to managers and supervisors is important to allow timely pay and promotion actions, to track the progress of workers, and to maintain high morale with regular feedback.
22. *Ask all employees to bring a written list of cost-saving ideas to the next performance review.*
23. *Thank executives and employees for cost-saving suggestions*, perhaps with a small gift or cash incentive to the workers whose ideas are implemented.
24. *Look for savings in the smallest places.* Suggestions:
    - Have people turn off lights in conference rooms, rest rooms, and computer rooms when they leave them.
    - Turn off equipment that is not being used, even during the day.
    - Open and close blinds to keep rooms warm during the winter and cool during the summer.
25. *Work on relationships with management throughout the organization.* This can ultimately be a cost-saver because it will develop respect for management's efforts to help the company thrive.

COST-CONTROL FORUM

Taking Advantage of e-Learning Saves about $100,000 per Year

Issue: Online learning is not new at this 1,200-employee technology company in Georgia, but taking full advantage of its opportunities has been an ongoing process since 2000.

Response: The company has been growing and promoting the use of e-learning, primarily for technical topics. It expanded this concept to a broader range of training topics, such as business and professional processes and skills, leveraging third-party support to build these strategies and courseware. The training department has also honed its internal skills—such as understanding and applying learning styles—to promote transfer of learning to the job.

Results: Reduced reliance on third-party, instructor-led training for technical topics and the increased use of Web-based training saved the company approximately $100,000 in one year. Still, the company's director of education and information services notes that she must continue to focus on making the most of existing technology, by increasing the skills of her staff while selectively leveraging third-party support to manage large learning projects.

Automation and Outsourcing Allow HR to Cut Its Budget by 2.5%

Issue: How to comply with management's mandate to reduce HR costs by 2.5% for the current year and 5% for the upcoming year (July fiscal year) at a 135-employee manufacturing company in Idaho.

Response: The HR department used a multipronged approach, relying chiefly on reducing clerical staff by outsourcing HR functions to a central agency (automation reduced the need for clerical staff); cutting back on staff travel and training conferences; and reducing headcount by attrition (with existing staff picking up the slack when people leave).

Results: To date, the HR department is on track with its cost-reduction initiatives.

Internet Recruiting Reduces Hiring Budget by 50%

Issue: A more streamlined HR function at a 350-employee nonprofit in Philadelphia.

Response: The director of HR began by completely revising HR processes and procedures across all functional lines, looking for efficiencies or clarity in procedures to assist him in achieving desired results. One area in which he was especially successful was recruiting.

Results: By using the Internet for hiring and recruiting, he reduced that portion of the HR budget by 50%. The initiative was so successful that it began an overall drive to provide information and HR management in an electronic format whenever possible.

Customized e-Learning Saves More than One Full-Time Employee Salary

Issue: How to provide training with reduced classroom time at a 350-employee private-practice firm in the South.

Response: Customized e-learning now provides all courses for new-hire training and software instruction. In the past, new-hire orientation was a huge drain on training resources. The firm also hired a trainer with significant experience in adult learning and education.

Results: Reduced classroom time leaves time for training staff to assume additional responsibilities. The e-learning package, which includes a management module, cost less than one full-time employee salary.

Prepurchased Monster.com Ads Reduce Recruiting Costs

Issue: A 1,800-member law firm in Pennsylvania places approximately 120 to 150 recruiting ads per year, an expensive proposition at newspaper-ad prices. The firm also needed to upgrade and make better use of HR technology to reach its several office locations.

Response: The firm now uses Monster.com for almost all open positions, prepurchasing ads in bulk. The HR department also launched a firmwide customer service center to assist employees in all offices (11 U.S. and two overseas). Technology upgrades will improve historical reporting, including more fields to track additional data, and result in more flexibility and options for reports and better security.

Results: Using Monster.com reduced per-ad cost from $400 to $500 for newspaper ads to approximately $120 for Internet ads.

Holding the Line on HR Staffing Saves Money

Issue: The HR department was reorganized to implement a more "service-deliverables" approach.

Response: Although the 1,200-employee manufacturer in the Midwest grew by nearly 30% in 15 months, HR staff size stayed the same (11 people).

Results: The senior HR manager has not quantified the savings, but this initiative is part of a larger transformation of the HR department from day-to-day HR to strategic business partner.

Is HR a strategic partner? The transition is in process. "Barriers include changing priorities of HR staff from traditional personnel and activity focus to strategic focus with priority of delivering customer-focused services that affect business issues; dropping 'nice to do's' that no longer matter."

Combining HRIS and Payroll Saves $5,000 to $10,000

Issue: A 245-employee manufacturing company in the East needed to streamline its HR data entry and payroll systems.

Response: The HR director researched and selected an HR information system that also included responsibility for the payroll function, reducing duplicate entry and time-consuming cross-checking.

Results: An immediate savings of between $5,000 and $10,000.

Revised Training Priorities Reduce Expenses by $700,000

Issue: A manufacturing company in Washington needed to focus on employee retention and ongoing staff development following a major corporate reorganization and staff reduction.

Response: The director of employee development designed courses that directly relate to corporate performance goals. Courses include goal setting for every employee, performance review training, coaching, development planning, and succession planning. The company also consolidated total training budgets into a single budget administered by the director of employee development, including travel, housing, and meal expenses. The company provided online learning and in-house training classes to supplement cuts in training expenditures.

Results: Training expenses were reduced by $700,000.

Integrated HR/Payroll/Benefits System Meets Its ROI Calculation

Issue: A mental health care firm in Virginia with 7,500 employees wanted to reduce transactional HR and related staff.

Response: An integrated HR/payroll/benefits/HR information and management system with self-service capabilities (Phase II). Automated forms are published on the company's intranet. HR also decentralized certain data entry functions, such as applicant tracking, license tracking, and training administration.

Results: The new HR system has already paid for itself. Next on the agenda: core benefits self-service implementation.

Reducing Travel for HR Staff Saves $4,000 to $5,000 per Trip

Issue: A short-term strategy for reducing HR department costs at a 500-employee transportation firm in the East.

Response: Cutting back on travel across all functions, including training, employee relations, benefits, and communications. Implementation consisted of requiring senior HR approval for all travel.

Results: Most travel requests were, in fact, not approved, saving the company between $4,000 and $5,000 per trip.

Renegotiated Vendor Contracts Save $100,000

Issue: Streamlining HR operations and reducing "administrivia" at a 420-employee financial firm in the East.

Response: The company's VP HR renegotiated all vendor contracts so that the company now works with high-quality vendors who assume a larger portion of the HR administrative responsibilities.

Results: The new arrangement increases service to employees and reduces the amount of administrative work the HR department is responsible for. Estimated savings in benefits administration cost: $100,000.

Insourced Recruiting Saves $100,000

Issue: Expensive recruiting costs at a 320-employee services firm in Chicago due to an overreliance on outside recruiting firms.

Response: Insourced recruiting function by hiring one person to organize and centralize the search process.

Results: Reduced the use of outside recruiters and saved $100,000.

Simplified HR Processes Produce Savings of $30,000

Issue: With her boss, the HR director, now joining executive-level staff meetings, the HR manager at a 1,250-employee manufacturer in Wisconsin incorporated the company's vision and strategy into the HR department. The first step was to overhaul and streamline HR.

Response: The HR manager simplified several HR processes by breaking them down into steps and then eliminating those that were nonessential or had no real strategic value. Streamlined processes were then automated wherever possible.

Results: A savings of $30,000.

Five-Step Plan Reduces Training Costs to Less than 1% of Operating Costs

Issue: HR at a 600-employee manufacturing firm in the South needed to be sure employees cost-effectively completed scheduled training.

Response: A training department overhaul. The company's training supervisor attributes their success to five improvements: (1) an in-house train-the-trainer program, (2) the use of instructional systems design for training, (3) networking with other firms for best practices, (4) close work with management to ensure that all training needs are met successfully, and (5) a Web-based delivery system.

Results: HR's training budget was reduced from 3.6% to 1% of plant operating costs.

Automating HR Functions Reduces Staffing and Positions HR for Workforce Planning

Issue: The need for HR staff to spend their time on change management and workforce planning rather than traditional HR transactional functions.

Response: Automation of basic processes at this 1,450-employee health care company in the East reduced the need for three HR support staff, as employees can now get information and conduct transactions online.

Results: A savings of $150,000.

Monster.com Recruiting Saves $30,000

Issue: The need for an efficient and cost-effective recruiting system at a 350-employee consulting company in Atlanta.

Response: Online recruiting at Monster.com.

Results: At a cost of $350 per posting, online recruiting produced about 10 usable résumés for each posting. Total savings: $30,000.

Combined HR/Finance Function Saves $40,000 in Salaries

Issue: Senior management's lack of awareness of the value of HR at a 300-employee manufacturing company in the West. Unfortunately, managers in the organization are "strictly autocratic," the company's HR manager reports, "managing like we're still in the

1960s." Nevertheless, the company sought a more streamlined HR operation.

Response: The company took the unusual approach of combining HR and finance functions to provide better customer service to employees. HR also moved into the main corporate headquarters, "quit wearing ties, and increased 'wandering' time," he said.

Results: The company saved about $40,000 in HR salaries by combining functions.

Internet Hiring Saves $75,000

Issue: A short-staffed HR department at a 650-employee services firm in Chicago.

Response: "We don't have enough bodies to do all the work, so we are outsourcing more," said the company's director of compensation and benefits. For example, the HR department reduced its reliance on recruiting agencies by 10% over the last year and is implementing self-service benefits and enrollment.

Results: Using the Internet for hiring has saved the company approximately $75,000. The good news for this eight-member HR department: "We are part of the senior management team. We have input on many of the overall strategic plans."

HR Reorganization Saves $200,000

Issue: The director of HR services at a large health system in the Midwest was charged with providing full HR services on a reduced budget.

Response: A three-pronged approach: (1) the redesign of HR to improve efficiency, eliminate unnecessary services, and move some functions to line managers; (2) HR restructuring to provide a full-service strategic organization, not just a compliance/processing role during budget reductions; and (3) reviewing and revising HR staff salaries.

Results: HR actually lost some ground on the "strategic HR" goal, the director of HR services admits. Nevertheless, improved efficiency and reduced HR services have reduced the HR budget by $200,000.

Online Advertising/Staff Referrals Generate the Best Recruiting ROI

This is especially important because recruiting budgets are expected to stay flat, according to the Society for Human Resource Management (SHRM) and Recruitment Marketplace, which provides an overview of research-based marketing strategies. "Internet recruiting has revolutionized the way organizations of all sizes seek new applicants," said SHRM VP of Knowledge Development Debra Cohen. "It has proven to be a cost-effective recruiting tool that complements newspaper advertising and other methods of attracting new recruits" (see Exhibit 2.14). More than two-thirds (67%) of HR professionals in the study reported that their organizations have annual recruitment budgets of less than $50,000. A majority (82%)

Exhibit 2.14 Sources Providing Highest Volume/Highest Quality of Applicants/ Best Return on Investment

Source	Volume*	Quality*	ROI*
Online advertising	37%	25%	36%
Newspaper advertising	46	16	24
Referrals	8	28	23
Headhunters/search firms	2	15	5
On-campus recruiting	3	4	5
Temporary agencies	2	2	2
Trade publications advertising	0	9	2
Radio advertising	0	1	1
Television advertising	0	0	0
Other	2	1	2

*Values denote percentage of respondents who selected each source as providing the highest volume, quality, or ROI.

Source: SHRM/Recruitment Marketplace

said their recruitment budget would either not change (59%) or would decrease (23%) in the coming fiscal year. There is hope: Just over half (52%) expect an increase in recruitment budgets over the next five years. Eighty-three percent of respondents said their organizations posted positions on the Internet, both on their own Web sites (85%) and on job boards such as Monster.com or CareerBuilder.com (77%).

What Will It Cost You if You Have a Problem Drinker on your Staff?

The federal government estimates that 7.4% of full-time American workers ages 18 to 49 have experienced serious problems, including alcoholism, as a result of their drinking. Hangovers and alcohol-related health problems have significant job cost implications. According to the federal government's 2000 and 2001 National Household Surveys on Drug Abuse, people with drinking problems say they call in sick or skip work twice as often as workers who do not have drinking problems. They are also more likely to be late for work or to leave early. So what do problem drinkers really cost your organization? George Washington University Medical Center's "Ensuring Solutions to Alcohol Problems" initiative has computed the prevalence of alcohol problems in the workforces of 10 major industrial sectors (see Exhibit 2.15). Go to www.alcoholcostcalculator.org/ and plug in your industry sector and the number of employees.

A Blind Request for Quote Cuts 401(k) Costs by 60%

Issue: Disappointed with the level of service it was receiving from its current provider, a small midwestern company decided to put its 401(k) plan out to bid—anonymously—to see how other providers' fees would compare.

Exhibit 2.15 In a Company with 100 Workers . . .

Likely number of problem drinkers in your workplace	4
Likely number of employee family members who are problem drinkers	13
Likely number of work days your company loses to sickness, injury, and absence because of problem drinking every year	3
Likely number of work days of lowered productivity associated with alcohol use by workers in your company	22
Likely alcohol-related health care costs that your company pays	$26,576

Response: Eight bids later, HR and financial professionals discovered that its current provider was charging an asset charge of $100,000 over and above its investment management fees. That priced its services far above the other anonymous bids the company received in response to its request for quote (RFQ).

Results: A wake-up call for the company's 401(k) provider, which, when confronted with the facts, dropped its asset charge by 60%. "If you haven't done it for some time, benchmark your plan," the company's 401(k) specialist recommended. "If nothing else, you can use it as leverage with your current provider." Note: Service is still an issue, and the company is continuing to analyze and interview prospective providers. Top-ranking vendors, as well as the incumbent, will be invited to make their presentations to the company.

Clear Link between HR Strategies and Corporate Profits

Companies that have people policies linked to a documented human resources strategy are more profitable, experiencing per-employee revenue that is 35% higher than at organizations in which no such strategy exists, says new research from PricewaterhouseCoopers (PwC). A documented strategy is also associated with more effective reward systems, better performance management systems, and reduced absenteeism. The global study surveyed more than 1,000 organizations in 47 countries, investigating the relationship between business performance, HR policy and strategy, and financial measures such as profit margins and revenue per employee. Worldwide, only 58% of companies have an officially documented HR strategy. The research also revealed clear and positive links between the "feel good" factor—HR people being satisfied with their contribution to the business—and profit margins. It was found globally that the profit margins of organizations in which HR people are very satisfied with their department's influence on business strategy are 46% higher than for those who are not satisfied with their contribution. The survey questionnaire was distributed in 47 countries to a predominantly HR professional audience, and therefore they reflect the HR view of organizations.

Chapter 3

Benefits Costs

BEST PRACTICES

CUTTING BENEFITS COSTS

With health care cost hikes continuing to take a large bite out of corporate profit margins, employers are increasingly relying on employee cost sharing to help soften the blow. For the past few years, employers have cited cost sharing as their most effective means to control benefits costs. However, there has been a trend toward increased cost sharing as opposed to increased copays, deductibles, or lifetime limits.

These shifts in emphasis and in the percentage of companies using this approach show that more companies are asking employees to pay for more of their coverage. In fact, in an IOMA survey, 78.7% of survey respondents cited increased cost sharing as their most effective means of controlling benefits costs, up from 59.9% last year (see Exhibit 3.1). Employers, both large and small, are using cost sharing. “All employees are now expected to contribute to the cost of their insurances, even for single coverage,” noted a respondent from a 95-employee agency in New Hampshire. “We implemented a three-tier system of contribution to insurance coverage across the board—the more money you make, the more you contribute to the insurance. We now offer a buy-out of the insurance plan if an employee can show [he or she is] covered elsewhere.”

Both of these changes, the firm’s HR director reported, took about a month to implement and were introduced during the benefit enrollment process at a series of structured meetings. The result was notable savings to the agency.

“In an effort to control annual increases, costs were shifted to employees,” reported the manager of benefits and HRIS at a 2,000-employee wholesale company in California. “Instead of maintaining the existing ratio of an aggregate 25% of premium, employees now pay from 20% to 40% of the total cost. Rates were published in our open enrollment materials.”

Copays, Deductibles, and Lifetime Limits

Increasing copays, deductibles, and lifetime limits garnered 62% of the vote as the most effective benefits cost-control tactic, placing it second in overall effectiveness. This represents an increase from 59.9% last year.

As the director of benefits of one 9,000-employee services firm reported: “We increased copays significantly on our CIGNA HMO plan (which 90% of our medical plan participants use), without increasing employee premium contributions.

Exhibit 3.1 Best Methods for Controlling Benefits Costs, Overall and by Number of Employees

Method	Overall	*Number of Employees* 1 to 99	100 to 500	More than 500
Increased cost-sharing by employees	78.7%	83.3%	81.9%	76.6%
Increased copays/deductibles/lifetime limits	62.0	70.0	63.9	59.6
Changed to a two-, three-, or more-tier prescription program	44.4	53.3	43.1	39.4
Added/enhanced voluntary benefit programs	28.7	30.0	40.3	23.4
Set up flexible spending accounts	25.9	50.0	31.9	16.0
Self-insured one or more benefit programs	25.5	33.3	25.0	21.3
Automated benefit functions	24.5	43.3	15.3	25.5
Adopted a mail-order prescription program	23.6	33.3	27.8	16.0
Started a wellness program	22.7	20.0	23.6	23.4
Reduced benefit offerings	20.4	20.0	20.8	21.3
Other	20.4	10.0	13.9	28.7
Added/enhanced employee health education	19.9	16.7	20.8	17.0
Implemented a disease management program	17.6	20.0	9.7	24.5
Offered a cafeteria-style flexible benefits program	13.0	30.0	16.7	6.4
Outsourced benefits functions	12.5	16.7	18.1	9.6
Added a managed care or preferred provider organization	11.1	23.3	11.1	8.5
Purchased health insurance through a business group/coalition	10.6	16.7	11.1	8.5
Added a point-of service plan	9.3	23.3	9.7	5.3
Introduced a consumer-driven health plan	8.8	16.7	8.3	5.3
Introduced an employee assistance program	8.8	16.7	6.9	8.5
Instituted a managed mental health care program	6.5	10.0	9.7	4.3
Replaced a defined benefit retirement plan	6.0	20.0	6.9	1.1
Replaced a traditional health plan with an HMO	5.6	16.7	6.9	2.1

Source: IOMA's *2004 Benefits Management and Cost Reduction Survey*

Management had given us a 5% maximum increase for this year. This is 'our' version of a consumer-driven health plan. It's clearly innovative, but a one-shot deal." The revised copays are:

- Office visits: from $10 to $15; $25 for specialists
- MRI, CT, and PET scans: from $0 to $200
- ER visits: from $50 to $150

- Outpatient hospital visits: from $75 to $150
- Inpatient hospital stays: from $150 to $300
- Prescriptions: from $7 and $14 to $10 and $20

"We've had very few complaints," the benefits director noted, "and it seems to be working." The company expects to save about $4 million.

Many companies reported in the survey that changing to a tiered-prescription drug program was their most effective benefits cost-control technique. Under these programs, cost sharing by employees increases if they choose brand-name drugs and decreases if they choose formulary or generic drugs.

Survey results also showed that adding or enhancing voluntary benefits programs came in fourth in effectiveness (28.7%), up one position from last year.

Setting up flexible spending accounts (FSAs) came in fifth (25.9%), up from eighth last year. FSAs are a win-win for employers and employees. Employees are not taxed on the dollars they put away to pay for medical or childcare expenses and employers do not pay payroll taxes on monies employees place in these accounts.

Although they did not rank in the top five, preventive care programs were instituted by more employers. These plans can go a long way toward keeping health care costs in check:

- 22.7% reported that their wellness program is effective, up from 14.6% last year.
- Almost 20% added or enhanced employee health education and cited its value, up from 10.9% last year.
- 17.6% noted the success of their disease management program in controlling costs, up from only 6.8% last year.

The number of employers citing the effectiveness of a consumer-driven health plan, touted by industry experts as a key way to control costs, increased more than 800% (only 1% last year compared to almost 9% this year). Smaller companies (1 to 99 employees), financial services, and the services industry (i.e., business, legal, engineering, etc.) were most inclined to report success in this area.

Approach Variations by Company Size

Smaller companies are leading the way when it comes to cost sharing, increasing copays, deductibles, and lifetime limits and modifying their prescription drug plans, the survey shows. In fact, across most categories, small companies are out ahead in citing the effectiveness of benefit cost-control techniques.

Companies with 100 to 500 employees listed the top five approaches cited above as their most effective methods of controlling benefits costs. However, when compared to other size companies, adding or enhancing voluntary benefits, starting a wellness program, and outsourcing benefits functions are most effective.

Large employers (more than 500 employees) said they rely on cost-sharing strategies and the other top five approaches mentioned. However, they are outpaced by other size firms in all categories, likely as a result of having already employed many of these approaches.

Industry Differentials

There are notable variations in the approaches different industries take to controlling benefits costs. Wholesale/retail firms are most inclined (90.9%) to increase cost sharing with their employees, followed by services companies (87%). Meanwhile, only 65% of health care companies cited this as the most effective approach.

About 76% of services companies and 69% of financial services companies heralded increases in copays, deductibles, and lifetime maximums as a successful cost-cutting tool, compared to only 45.5% of government institutions.

Tiered prescription drug programs are most often cited by wholesale/retail (54.5%) and services (54.3%) companies, and less by government (18.2%) and health care (35%) institutions.

DATA ANALYSIS CAN HELP CUT HEALTH CARE COSTS

Some employers fail to analyze employee health care and utilization data—which can be a costly oversight. According to an IOMA study, premium increases were 17% higher than the prior year for small employers that failed to analyze employees' health care cost and utilization data (see Exhibit 3.2).

Despite this significant savings, small companies are least likely (33%) to perform cost and utilization analyses on claims data. Midsize and large companies also steer clear of such analyses, although to a lesser degree (13% and 16%, respectively; see Exhibit 3.3).

Areas to Consider

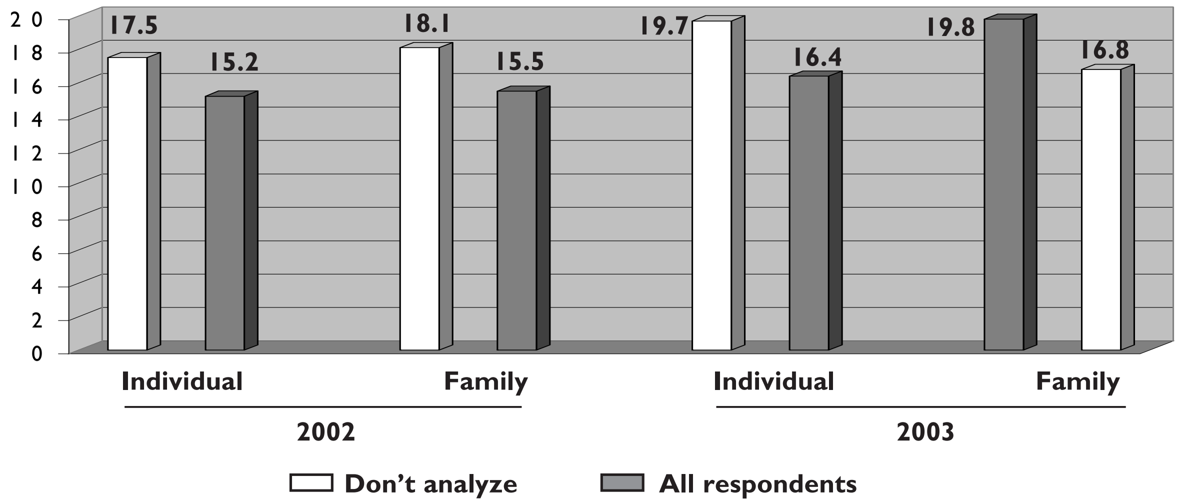
What areas can benefits managers examine more closely to better control their health care costs? With the aid of Ingenix (Salt Lake City, Utah), a company that helps companies extract and analyze claims data, IOMA's survey analyzed three areas in depth: (1) generating greater use of generic drugs, (2) minimizing the number of emergency room (ER) visits, and (3) identifying chronic conditions to properly plan for cost-effective disease management programs.

Analyzing the Potential for Greater Generic Drug Use

Many employees are unaware that there are generic substitutes for many of the brand-name drugs they take. Even if they are aware, some employees are reluctant to question the brand-name drug recommendations made by their physicians. Financial incentives can help employees make more cost-effective decisions regarding prescriptions without risking their treatment regimens.

The first step is to examine the current substitution rate of generics for brand-name drugs (see Exhibit 3.4). As the exhibit shows, 35.1% of this employer's prescription claims were for generic drugs. Nationally, this rate has held steady at close to 42% for the past few years, so there may be room for this employer to encourage generic drug substitution and increase their use.

Exhibit 3.2 Relationship between Analyzing Cost and Utilization Data and Average Individual Premium Increases for Small Firms



Note: Analyzing cost and utilization data is associated with lower premium increases for small firms (up to 249 workers)

Exhibit 3.3 Tools Used for Cost and Utilization Analysis, by Number of Employees

	Number of Employees			
Analytical Tools Used*	Up to 249	250 to 999	1,000 to 4,999	5,000 or more
Simple spreadsheets or database applications (e.g., Excel or Access)	40%	60%	47%	33%
Analysis and reporting software provided by our insurance vendor	4	20	15	33
More sophisticated analytical tools	3	5	8	25
Proprietary analytical applications	2	2	5	17
Don't perform this kind of analysis	33	13	16	6

*Multiple answers allowed.

Note: Small firms are least likely to perform cost and utilization analysis on claims data, but a significant portion of midsize firms use tools from their insurance vendors.

Another potential indicator is the 9.2% of total benefits paid for generic drugs. Nationwide, expenditures on generics account for almost 17% of total prescription spending.

Exhibit 3.4 Sample Analysis of Prescription Drug Costs and Utilization within an Employee Population

Pharmacy Type	Brand-Name Single Source	Brand-Name Multisource	Generic	Total
Mail-order				
Number of claims	17,523	2,776	7,658	27,957
Percent of total claims	8.0%	1.3%	3.5%	12.8%
Total benefits paid	$3,051,809	$208,637	$332,928	$3,593,374
Percent of total benefits paid	23.7%	1.6%	2.6%	27.9%
Average benefit paid/claim	$174.16	$75.16	$43.47	$128.53
Retail pharmacy				
Number of claims	105,025	16,671	69,045	190,741
Percent of total claims	48.0%	7.6%	31.6%	87.2%
Total benefits paid	$7,899,233	$551,645	$853,239	$9,304,117
Percent of total benefits paid	61.2%	4.3%	6.6%	72.1%
Average benefit paid/claim	$75.21	$33.09	$12.36	$48.78
Total				
Number of claims	122,548	19,447	76,703	218,698
Percent of total claims	56.0%	8.9%	35.1%	100.0%
Total benefits paid	$10,951,042	$760,282	$1,186,167	$12,897,491
Percent of total benefits paid	84.9%	5.9%	9.2%	100.0%
Average benefit paid\claim	$89.36	$39.10	$15.46	$58.97

Which Prescription Drugs Should You Focus on? "Often the biggest opportunity for increasing generic utilization," according to Bruce Schiller, consulting director of Ingenix, "is by lowering the use of brand name multisource medications. Most, but not all, multisource medications have a generic equivalent. Reporting can show the multisource brand name drugs that account for the highest costs." Exhibit 3.4 shows that the represented employer paid an average of $39.10 per brand-name multisource claim, at a total cost of $760,282.

Exhibit 3.5 shows brand-name multisource prescription claims sorted by dollars paid. Prozac generated the second-highest benefits paid ($274,172, or 5.1% of payments), even though it accounts for only 1.3% of total claims. The generic substitute, fluoxetine HCl, costs almost $83 less. If a generic equivalent were substituted for every Prozac claim, this employer would save $150,096. A similar analysis can be applied to Zantac and ranitidine HCl, its generic substitute, for a potential savings of $54,905.

Clearly, efforts aimed at increasing the substitution of fluoxetine HCl for Prozac are worth $329 annually for every claimant who switches. This benefit is less pronounced for Zantac, even though the generic savings per prescription are higher than those from the Prozac substitute ($101.30 versus $82.88, respectively). Why? Per claimant, the number of claims for Prozac is higher than for Zantac (3.9 versus 1.5). More employees are using Prozac, *and* they are consuming more of it. So, what are the data analysis implications for benefits managers?

Get beyond Firefighting. Not only must employers obtain data about their employees' drug costs and usage rate, as well as their health risks, but they must also interpret this data for cost-control purposes. Such an in-depth analysis implies a systematic benefits planning process, but the frenzy of the annual benefits renewal and enrollment cycle works against longer-term strategies.

According to Tom Lerche, senior vice president and a consultant with Aon (Chicago), although cost-management information is generally available, many companies lack the proper focus to use it effectively. "The planning horizon is too short," he said. "The annual benefits cycle has [only] led to incremental attempts to manage costs that don't really address root problems."

Adam Speck, vice president at Marsh USA (New York City), agreed: "Resources are limited to focus on [cost control] in a proper fashion," he said. "It's not so much a matter of money and staffing, but more a matter of time and attention. HR staffs and management are too focused on emergencies and the 'problem of the day' to engage in much long-term thinking about health-care cost control."

The best way to overcome this time and attention deficit is to focus your analysis efforts. A great deal of information is buried within claims databases, but you do not have to analyze it all to rein in costs. "A good rule of thumb for companies that must hire outside specialists," says Mary Harrison, associate principal at Mellon's Human Resources and Investor Solutions (Pittsburgh), "is to spend no more than 1% of your company's total health-care [budget] on data mining and analysis assistance." For example, employers that want ongoing access to claims data and analysis from aggregators such as Medstat and Ingenix should expect to pay $80,000 or more annually. Although such investments can make sense for large

Exhibit 3.5 Savings Opportunities for Two Brand-Name Drugs with Generic Equivalents

	Prescription Claims Data for Multisource Brand-Name Drugs								
	Benefits Paid		*Prescriptions*					*Potential Savings*	
Drug	Dollars	%	Claims	%	Total Claimants	Generic Equivalent	Generic Savings per Prescription	Total	per Claimant
Prinivil	$288,057	5.4%	6,965	5.1%					
Prozac*	274,172	5.1	1,811	1.3	456	fluoxetine	$ 82.88	$150,096	$329
Synthroid	166,768	3.1	21,644	15.9					
Xanax	147,819	2.8	1,169	0.9					
Neoral	131,369	2.5	427	0.3					
Prinzide	123,228	2.3	2,779	2					
Tamoxifen Citrate	110,327	2.1	1,029	0.8					
Nolvadex	108,003	2	490	0.4					
Zantac**	101,302	1.9	542	0.4	349	ranitidine	$101.30	$ 54,905	$157
Humulin 70/30	95,893	1.8	1,449	1.1					
Total savings								$205,001	$486

*Antidepressant

**Anti-ulcer prep (prescription strength) employers, small employers should consider budgeting for an annual claims analysis that identifies low substitution rates of generic over prescription drugs and the prevalence of such chronic but manageable conditions as diabetes and heart disease, to name a few.

Quantify Efforts and Results. Regardless of what you spend, says Harrison, "don't commit to data mining and analysis unless you are prepared to establish realistic metrics for financial returns that can pass muster with your CFO. You should be able to show a [return on investment] within three years with the initiatives you are able to design as a result of better data access and analysis." Fortunately, many vendors of wellness and disease management programs are willing to share this financial risk with you to help you achieve these returns.

GET EMPLOYEE INPUT TO REDESIGN BENEFITS PACKAGE

Many readers are currently on committees that are refashioning their companies' benefits programs. Interestingly, some of these committees are using surveys to help adjust their benefits packages. The advantage of this setup is that they can preserve the benefits their employees value the most *and* still reduce costs.

For example, Delta Airlines used employee surveys in 2002 and 2003 to reorganize its benefits package. *Background*: September 11 caused a sharp decline in Delta's revenue, of which one-third of controllable expenses are benefits. *Key point*: Following 9/11, Delta committed to a 28% reduction ($300 million) in benefits expenses by 2005. At the same time, it did not want to change the benefits package unilaterally.

So, the company used a Web-based survey to poll employees. Twenty-six percent of Delta's active employees, eligible retirees, survivors, and inactive employees completed a survey about Delta's benefits program. *Finding*: The most valuable benefits to employees are the pension package (23%), medical coverage (17%), and prescription drug benefits (15%).

Based on these results, Delta made several changes to its program. *For example*: To save money, the company converted its pension program from a traditional defined benefit plan to a cash-balance plan. It also instituted a seven-year transition to the new plan so that 30% of its employees could retire without a change in their pension plans.

In addition, Delta made significant changes to its health plans. *Background*: In 2002, Delta's health care costs per employee averaged $8,976. Further, its health plan had $10 copays and required no premium contributions from employees. *Key point*: According to Delta, the survey showed that its employees were willing to increase their contributions, provided their health plans remained "intact." Keeping this employee goal in mind, Delta felt it could raise copays to $20 for visits to primary care physicians and $25 for visits to specialists, as well as require contributions for hospital services. Delta also established a three-tiered prescription drug program without creating deductible or coinsurance provisions.

In addition to influencing its cost-reduction efforts, the survey helped the company communicate with employees about the cost of benefits. *Key point*: According to the *2004 Health Care Consumer Poll* from Towers Perrin, only half of employees understand that their employers cannot afford to absorb all benefits cost increases. Says Mark Schumann, a Towers Perrin principal: "We have to make progress in terms of employees understanding the context for change."

Exhibit 3.6 may also be helpful to benefits managers who want to establish a dialogue with employees about benefits costs. Developed by Watson Wyatt Data Services, this chart shows quartile and median benefits expense per full-time equivalent employee at for-profit organizations, nonprofits, manufacturers, nonmanufacturers, and financial services businesses. At many companies, employees can review this information and see that their employer has to cut benefits costs to remain competitive.

The definition Watson Wyatt uses to calculate benefits expense is: total company-paid expenses for medical, paid time off, pension and retirement savings plans, legally required benefits, other employee insurance (such as life and accidental death and dismemberment), and other benefits such as severance pay, for the past fiscal year. Watson Wyatt only includes the employer-paid portion of each of these items. It excludes payments made on behalf of retired employees.

Exhibit 3.6 Benefits Expenses per Full-Time Equivalent Employee

Type of Organization	First Quartile	Median	Third Quartile
For-profit			
Less than 500 employees	$6,672	$10,566	$13,414
500 to 1,999 employees	7,579	10,503	16,486
2,000 or more employees	5,890	9,302	15,472
All employee groups	6,744	10,268	14,770
Nonprofit			
Less than 500 employees	8,712	16,200	21,791
500 to 1,999 employees	9,384	18,311	22,538
2,000 or more employees	7,010	11,600	14,175
All employee groups	9,189	13,514	18,754
All manufacturing			
Less than 1,000 employees	7,757	12,050	14,709
1,000 or more employees	9,513	12,993	17,082
All employee groups	9,042	12,201	16,331
All nonmanufacturing			
Less than 1,000 employees	5,977	11,230	19,349
1,000 or more employees	6,009	9,354	14,175
All employees groups	5,995	9,384	16,791
Financial services			
Less than 1,000 employees	5,879	9,750	12,727
1,000 or more employees	7,669	13,549	18,051
All employee groups	7,572	10,580	14,331

Source: Watson Wyatt Data Services

CREATING A CULTURE OF WELLNESS

As employers look for more ways to cut their health care costs, preventive care is taking on new urgency. The logic is simple: Healthier employees are cheaper to insure and are generally more productive. Employers are also reaching the limits of cost cutting and cost shifting, the common ways to deal with rising health care costs, notes Stephanie Pronk, a senior consultant with the Group and Health Care practice at Watson Wyatt Worldwide (Washington, D.C.). *Key point*: The business case for investing in and taking care of people's health is quite clear.

Creating a "culture of wellness" may make it second nature for all employees of your company to think about health-related issues and take an active role in maintaining their own health. This is why many employers, including law firm White & Case (New York City), have introduced a staffwide, comprehensive program that includes wellness and nutrition seminars, health screenings and advice, exercise, and weight loss management.

White & Case's program offers an extensive menu of onsite seminars: cancer awareness, heart health, nutrition, cholesterol and blood pressure monitoring, flu immunizations, yoga and tai chi classes, and massages. It also provides discounts to local fitness centers and pays Weight Watchers fees for any staff member who successfully meets his or her targeted weight loss goal. The firm also plans to introduce other activities, including a walking program, a mental health workshop, and a golf clinic.

Although your company can provide the tools and resources, the employees must value the program enough to participate. Moreover, you must tailor its message to the individual, based on personal health risks and history—and you must provide information in such a manner that people want to receive it. This takes some work.

Pronk recommends first gathering the necessary information via health risk assessments. Offering an incentive such as a health care premium reduction or a gift certificate to a health and fitness center has been shown to prompt participation in such initiatives.

Next, use the information you gather to adapt the feedback given to employees so that each person receives tools and resources that fit with his or her readiness to change. This can be done via phone counseling, e-mail coaching, and Web-based modules. Ranging from $30 to $150 per employee, these are relatively inexpensive ways to tailor a message to the employee's needs and should be easy to justify, especially "when you are spending more than $5,000 for each employee's annual health care," Pronk notes.

Tread carefully with these issues. Although a healthier workforce seems a sound idea from all points of view, delicate issues are involved and benefits managers must make sure that the company addresses them properly. For example, if weight is a health issue for certain employees, be mindful not to discriminate against them, even as part of the quest to help them become healthier.

By far, the biggest concern involves health care privacy rules under the Health Insurance Portability and Accountability Act (HIPAA), says Charles Goldman, an attorney based in Washington, D.C., who specializes in disability law. Under

HIPAA, employers must inform employees in advance about how any personal health information collected will be used and must strictly maintain the privacy of the information. "Record handling has to be done with extraordinary care," Goldman notes. Invasion-of-privacy claims that can result from mistakes can be extremely expensive, because there is no cap on damages.

FEW EMPLOYERS ABSORB HEALTH CARE COST INCREASES

The business climate has changed considerably since 2000, making employers increasingly reluctant to pick up rising health care costs. In 2000, 52% of employers said they would absorb any health care cost increases. This year, that figure has dropped to 29%.

The change in attitude is understandable. Annual increases ranging from 13% to 18% have made health care costs double in the past five years. Although the rate of health care benefits cost increases slowed from a median of 13% in 2003 to 12% in 2004, increases of this magnitude would double costs in a mere six years; these were the findings of *New Reality, New Choices*, the ninth annual survey report of the National Business Group on Health (Washington, D.C.) and Watson Wyatt.

Forty-one percent of respondents reported that their health care benefits costs were over budget last year. As for 2004, median cost increases for different plans were:

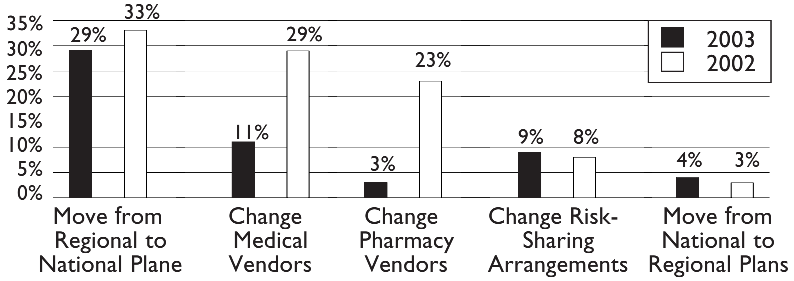
- All plans: 12%
- Point-of-service plans: 12%
- Preferred provider organizations: 13%
- Indemnity plans: 14%
- HMOs: 14%

This relative lack of differentiation makes it almost impossible for employers to reduce increases in demand by switching plan type, the report noted. This year's results clearly show that employers are retreating from tactics such as dropping one vendor in favor of another or allowing employees to choose from a wider array of plans (see Exhibit 3.7).

Employers are now focusing on:

- Giving employees financial reasons to take notice of information and program offerings, and to change their attitudes about their health care (see Exhibit 3.8).
- Providing employees with information and tools that will help them make better health care purchasing decisions, instruct them in the use of the health care system, and support them in their efforts to improve their personal health.
- Improving the definition, measurement, and dissemination of different components of value. In many industries, product information, such as reliability and safety, is readily available. Not so in health care. Some employers are considering how health care quality, in addition to cost, can be factored into their organization's and their employees' purchasing decisions.

Exhibit 3.7 Changes in Employers' Plan Management Programs, 2003 vs. 2002

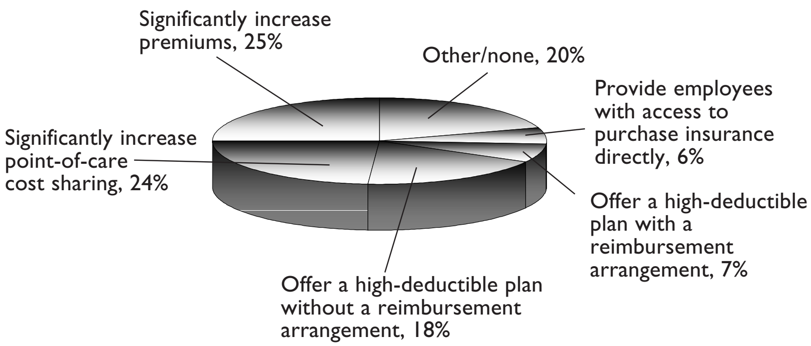


Source: National Business Group on Health & Watson Wyatt

The survey acknowledges that although the differences between high- and low-cost plans are diminishing, companies on the low end still enjoy a significant cost advantage over those with high-cost experience. The low-end companies:

- Use high-deductible plans with a reimbursement arrangement.
- Put money in FSAs to promote improvements in personal health.
- Implement lifestyle behavior change programs separately from the health plan.
- Provide information on specific health issues and concerns.
- Move to an employee self-service environment.
- Provide employees with access to tools to manage their health.

Exhibit 3.8 Methods Used by Employers to Increase Financial Tension, 2003



Source: National Business Group on Health & Watson Wyatt

GATHERING ENOUGH INFORMATION TO ADEQUATELY ASSESS HEALTH CARE COSTS

Looking for something other than cost sharing with employees to help stem the rising tide of health care costs? There are several supporting processes that benefits managers can introduce. Information gathering—both internal and external—is critical.

Which external data sources do employers find most useful? And how vigilant are they at gathering internal information? IOMA's *What Works Now: Employer Strategies and Tactics for Controlling Health-Care Costs* (2004) offers a new framework through which you can view your health care costs. This includes "soft factors," such as corporate culture, and "supporting processes," such as information gathering, data analysis, decisionmaking, education, and communication.

Use of External Information

According to the survey, respondents who consider themselves "heavy" users of outside research and advice have experienced lower individual premium increases than those who rate themselves as "light" users (see Exhibit 3.9). The difference in premium increases is greatest for users of purchased reports. When the rate of use is broken down by employer size, small and midsize employers benefit the most (see Exhibit 3.10).

Use of Internal Data

Employers that want to focus on their health care costs typically access and analyze cost and utilization patterns from past medical claims (administrative data). Not surprisingly, the smaller the employer, the less data is available from vendors

Exhibit 3.9 Relationship between Use of Outside Research and Premium Increases for 2002 and 2003

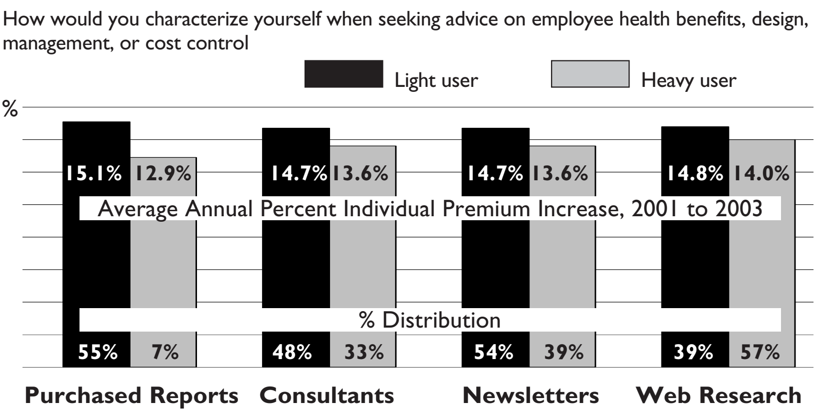
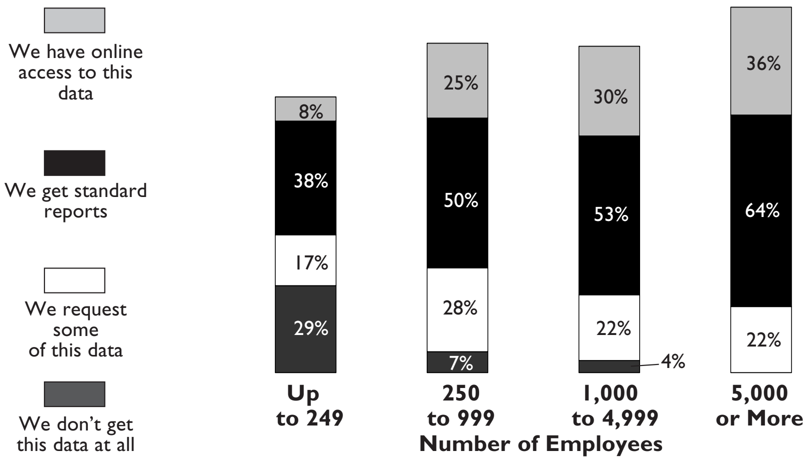


Exhibit 3.10 Use of Various External Information Resources and 2001–2003 Average Annual Individual Premium Percentage Increases, by Number of Employees

	Purchased Reports		*Consultants*		*Newsletters*		*Web Research*		
Number of Employees	Light	Heavy	Light	Heavy	Light	Heavy	Light	Heavy	Average Difference*
Up to 249	17.9%	7.0%	16.1%	14.8%	15.6%	15.2%	17.2%	14.9%	21.4%
250 to 999	14.0	12.0	13.3	13.1	14.4	10.7	13.7	12.5	12.7
1,000 to 4,999	14.3	15.4	14.7	14.2	14.6	14.7	13.4	15.3	–4.5
5,000 or more	13.2	12.2	14.9	12.2	12	14.9	13.2	13	0.8

*Difference between light users' and heavy users' increases as a percentage of light users' increase.

Exhibit 3.11 Access to Cost and Utilization Data, by Number of Employees



Note: Multiple choices allowed

(see Exhibit 3.11). Twenty-nine percent of small employers do not have access to this information, whereas all respondents with 5,000 or more employees do—and 36% of them have online access.

As Exhibit 3.12 shows, over the past several years vendors have improved their willingness and ability to provide this data. Still, smaller employers, which

Exhibit 3.12 Vendor Responsiveness to Cost and Utilization Data Requests, by Number of Employees

	Number of Employees			
	Up to 249	250 to 999	1,000 to 4,999	5,000 or more
Our vendors have improved their willingness and ability to provide cost and utilization data	3.4	3.8	3.8	4.1
The quality of and response to our information requests are mostly functions of our broker's abilities	3.4	3.3	3.2	2.3
We have recently switched vendors so we could gain better access to cost and utilization data	2.3	2.1	2.9	2.8
We cannot command the attention of our vendor or broker when we make such requests	2.4	1.8	1.8	1.6

Key: 1 = strongly disagree; 5 = strongly agree.

must rely more on their brokers to obtain it, have more difficulty getting their requests answered.

One way employers can gain better access to claims data is to opt for self-insurance. Although IOMA's survey found that self-insurance does not guarantee smaller premium increases, self-insured employers have better access to data. For example, only 4% of self-insured employers do not get any cost and utilization data (compared with 22% that are not self-insured), and 30% have online access to such data (compared with 14% that are not self-insured).

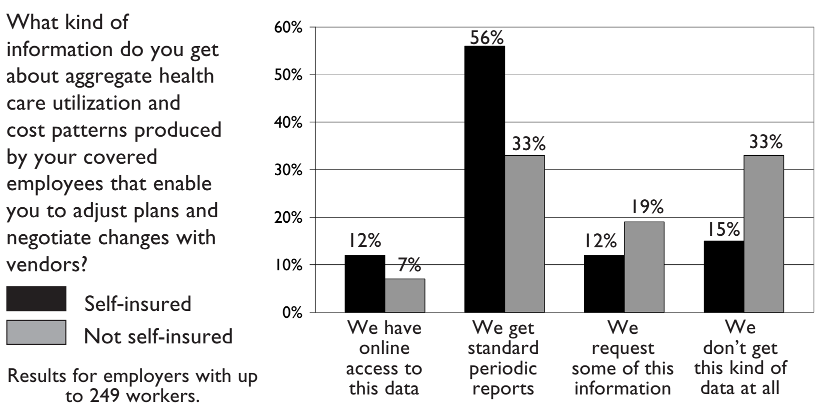
These results are somewhat skewed by the prevalence of self-insurance among large employers, but still show that self-insured small employers also have better data access than their fully insured counterparts (see Exhibit 3.13). For example, almost twice as many small self-insured employers (56% versus 33% of those that are fully insured) get periodic standard reports, whereas only half (15% versus 33%) report getting no cost and utilization data.

Lessons Learned

What lessons should executives and benefits managers draw from these findings on information gathering?

- *When it comes to containing health care costs, knowledge is power.* "It pays to do your homework. Reviewing benchmark studies, reading employer surveys, using consultants and other specialists where appropriate, etc., helps employers seize health care costs with more intelligence and confidence. While this advice seems intuitive, even trite, plenty of employers do not take advantage of these resources: 43% of respondents do not use or only lightly use Web research (which is free); 61% do not use or only lightly use newsletters; 67% do

Exhibit 3.13 Effect of Self Insurance on Access to Cost and Utilization Data for Small Employers



not use or only lightly use consultants; and 93% do not use or only lightly use paid reports and studies," the study noted.

- *Know thyself.* These words apply to organizations *and* to individuals. Knowing what other employers are doing, keeping up with premium-increase benchmarks, and researching a variety of external health care costs and trends do not generate enough information to create adequate cost controls. Organizations must look at their internal workings to determine how best to apply insights and tactics gleaned from their external research. Specifically, employers need to know their employees' aggregate patterns of health conditions and health risks. Armed with this information, they can then adjust various cost-control tactics to their unique circumstances.

  "Benefits managers need meaningful data about health care costs and utilization among employees if they are to target the right kinds of opportunities for cost reduction," says Mary Harrison, associate principal at Mellon's Human Resources and Investor Solutions (New York). "A solid foundation of data is required in order to convince skeptical CFOs of the returns [they can expect] from specific investments."

  Employers with large insurers such as Aetna or United Health Care have a good chance at getting such data. Those who cannot get this information directly from their carriers can hire third-party specialists. Such one-time efforts typically cost around $20,000, according to Harrison, but can be higher depending on the level of complexity.

  Pay special attention to coordinating your various data sources to assemble an accurate picture of health care costs and utilization patterns. For example, do not rely on pharmaceutical benefits managers (PBMs), health insurers, third-party administrators, and disease-management vendors to synchronize their distinct data sets across your organization. Assign this task to a detail-oriented individual who also knows how to deal with vendors in conflict. Even if you have a single vendor coordinating all this data for you, be sure you are comfortable with the reliability of the contractors and subcontractors the vendor uses to assemble it.

- *Start early.* Define what data you require and start gathering it as soon as possible during the annual benefits cycle. Assembling data from disparate sources always takes time, and analyzing it properly takes longer than most of us realize.
- *Consider or reconsider self-insurance.* Small, fully insured employers that are unable to get the data they need may want to revisit the pros and cons of self-insurance. While cutting out the middleman is a one-time financial benefit, the superior access to claims data provides long-term benefits for organizations that are willing to use the data and can withstand the volatility of paying claims from their own cash reserves.
- *Distinguish current costs from future risks.* Obtaining and using cost and utilization data is not the only way to "know thyself." Such administrative data provides a sense of *today's* health care costs, but containing *tomorrow's* costs requires assessing data about employees' potential health risks, which employers can obtain via periodic health assessments. "Companies that address

current health costs but ignore health risks that will impact costs in the future will not ultimately reduce costs," says Ronnie Bragen, product manager for Ceridian (Minneapolis). "Smart companies break down their planning and budgeting to address both short-term costs and long-term risk components."

Employers can typically get this data directly from employees. "While health screenings, wellness programs and other health status improvement efforts are good investments, they are not necessarily a good source of health status information," says Tom Lerche, senior vice president and consultant at Aon Consulting (Chicago). "Having employees and their spouses complete health status appraisals is a more effective way of identifying potential candidates for disease-management programs, for example."

CUTTING RISING DRUG COSTS

Coping with the high and rising price of prescription coverage continues to be a challenge for all plan sponsors. Prescription drug costs are expected to rise, on average, nearly 15.2% in 2004, the eleventh National Health Care Trend Survey of Mellon Financial Corporation (formerly Buck Consultants) revealed. Although this is somewhat less than last year, it still represents the fastest rising component of health care plans.

The pace with which these costs are increasing is reason enough for concern. But when you add in the fact that 85% of employees on average use this benefit, pharmacy management becomes critical.

Current Approaches

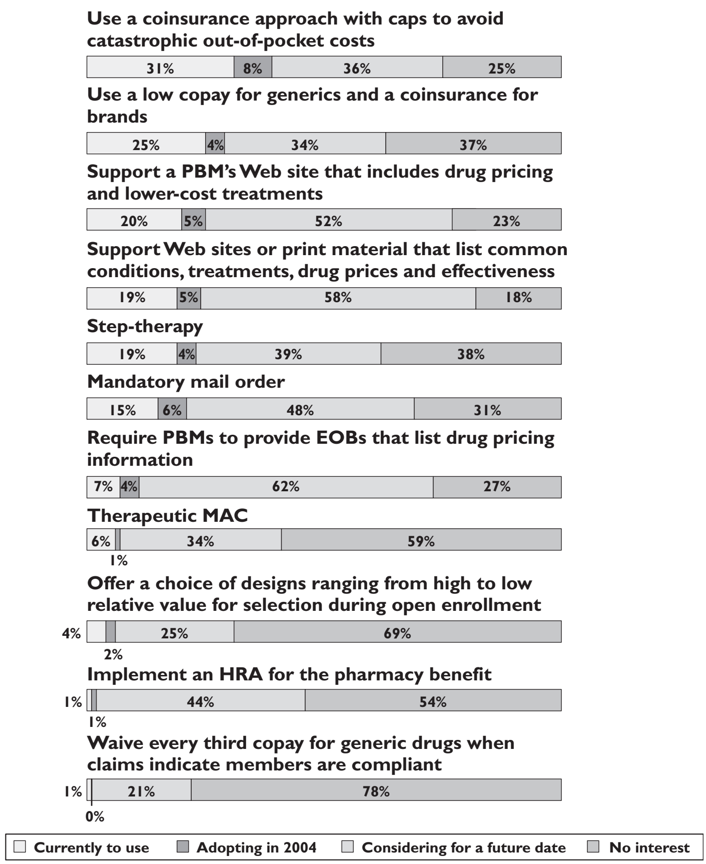
So what are employers doing to curb prescription drug benefit costs? "Employers are beginning to realize that even three-tier copayment structures inappropriately subsidize higher-cost drugs," a recent Hewitt Associates survey revealed. "As a result, they are turning to coinsurance, expanded differentials, and customized design options."

Looking toward the future, employers are considering a variety of options, including:

- Requiring pharmacy benefit managers to provide explanation-of-benefit statements (EOBs) that list drug pricing information
- Supporting Web sites and print materials that list common conditions, treatments, drug prices, and effectiveness data
- Requiring mandatory mail order
- Implementing a health reimbursement account for pharmacy benefits (see Exhibit 3.14).

More employers, the study found, are actively promoting utilization of high-value drugs (generics and low-cost brands) through the use of mail order (as noted above) and implementing low copays for generics and coinsurance for brands. But more can be done.

Exhibit 3.14 Which of the Following Apply to Your Prescription Drug Strategy?



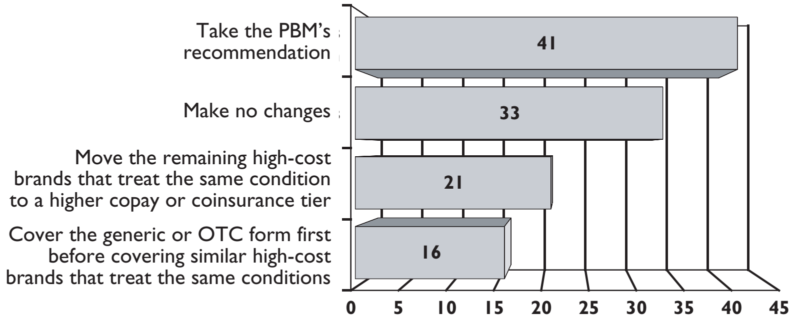
Source: Hewitt Associates LLC

Other Approaches to Consider

Data from Hewitt also shows that currently, when a popular brand-name drug becomes available in its generic form or becomes available over the counter, most employers either do not immediately change coverage or they look to their pharmacy benefit manager for direction (see Exhibit 3.15).

Some employers, however, are more proactive. Twenty-one percent said that they move the remaining high-cost brands that treat the same condition to a higher copay or coinsurance tier; 16% cover the generics or over-the-counter form first before covering similar high-cost brands that treat the same condition.

Exhibit 3.15 When a Popular Brand-Name Drug Becomes Available in Its Generic Form or Becomes Available over the Counter, What Strategy Is Your Organization Likely to Employ?



Source: Hewitt Associates

COSTS REMAIN ON AGENDA: HOW BENEFITS MANAGERS SHOULD RESPOND

Benefits managers face many challenges, most fueled by an improving economy, high health care costs, and legislative changes. Four key issues benefits managers will need to focus on are discussed in this section.

1. *Recruitment and retention.* Many experts contend that employers once again will begin to focus more on recruitment and retention and less on downsizing, which has been a constant in recent years. With that trend comes the need for an assessment of just how competitive firms' employee benefits programs are.

   "The war for talent will start up again," Pat Wright, director of Cornell University's Center for Advanced Human Resource Studies believes. With the economy turning around, employers once again will be embracing many of the strategies they used during the heavy recruiting of the 1990s. Wright commented that "so much of recruiting is driven by the economy." When companies were scaling back, they did not talk as much about becoming the "employer of choice," he said. But in the year ahead, they will be trotting out that slogan.

   Those companies that lacked sensitivity during the lean years may find their workers unforgiving, Wright said. Employers that did not treat their workers well "are going to see a relatively mass exodus from their ranks," he said. Moreover, they will find it more difficult to "attract new folks."

   Jobs will continue to go overseas, but the impact will be felt less as the economy continues to recover. "I don't think we're going to get away from the offshore issue," Wright said.

Jennifer Schramm, manager of the Workplace Trends and Forecasting Program at the Society for Human Resource Management, said that because "it's been quite a few years" since employers have faced a tight labor market, their recruitment and retention strategies will have to adjust to the times. For example, she said, the new labor pool, particularly Generation Y, is "much more diverse" and features a lot more women with advanced degrees.

2. *Flexibility and work/life issues.* Employers battling to attract and retain talent will need to ensure that they offer flexibility to their employees. "Companies will need to ramp up flexible options as a way to attract people," Wright said. Work/life issues, which sank into the background in recent years, will again move front and center, and employees will have more power and the ability to make greater demands on companies, according to Wright.

Ellen Bravo, national director of 9to5, National Association of Working Women (Milwaukee), notes that unfortunately many companies really scaled back work/life initiatives during the economic malaise. These companies will be at a distinct disadvantage in recruitment and retention; "They retreated in a way that will really come back to haunt them," she said.

"We think this is clearly a big workplace issue in the coming year," Bravo said of work/life initiatives. She noted that thus far, the employer community has yet to get in touch with the national zeitgeist, which favors a more balanced work/life equation. Since September 11, 2001, she said, people have made family life a much bigger priority. "On the other hand, there's been very little change in corporate America," Bravo said.

"Flexibility is very, very important for today's workers," added Joyce Gioia, president of The Herman Group, a consulting firm based in Greensboro, North Carolina. "Many people will choose to work for the employer who gives them that flexibility. That flexibility will definitely be a competitive advantage." Schramm also said that today's job seekers want the "flexibility to balance work/life issues." Family-friendly benefits have been on the decline in the past few years, she said, but employers will need to bring them back if they want to compete for talented labor. Moreover, Schramm said, because health care and other benefits remain costly, employers may view work/life benefits "as an easier way to promote job satisfaction."

Still, not everyone thinks employers will eagerly roll out work/life benefits in 2004 and 2005. Companies that are family-friendly will remain so, Jeffrey Berger, a Washington, D.C.-based attorney, said, but other employers will not necessarily be forced to adapt to employees' work/life needs. "Until it's difficult to hire people, companies will not feel the need to change," he said. Employers will push more work/life balance "only if the workforce becomes limited," Berger said, "and I think we're a long way from that."

Gioia said that an upswing in the number of older workers—caused by fewer employees choosing to retire—will fuel a push for more employment flexibility. "Employers are going to have to be more flexible if they want to hold onto their intellectual capital," she said. This means embracing such options as part-time work and job sharing rather than begrudgingly accepting them, she said.

Work/life balance is “a potential key issue” for older workers, Schramm said. If these workers decide to stay in the workforce past traditional retirement age, they may seek alternate work arrangements other than the full-time schedule, she said.

If baby boomers decide not to stick around and instead retire, employers may face a dearth of leaders and knowledge workers, Schramm said. Therefore, she said, “succession planning will be particularly important.”

3. *Health care costs.* One thing that will not change is the issue of health care costs. “It’s business as usual; costs continue to be a huge issue,” noted John Asencio, corporate health practice leader in the New York office of the Segal Company. However, with the economy rebounding and employers focusing on recruitment and retention, scaling back benefits and shifting costs to employees will become less appealing options to many companies. “I think that’s going to get a little harder to do as the economy improves,” he said. Employers, therefore, will start to look at other cost-cutting options, such as wellness and disease management programs, Asencio said. Health savings accounts, he said, “could open the door for employers to get out of the health business altogether.”

A Segal Company survey of insurers found that the cost of medical plans is projected to rise “at a slightly lower rate for all coverage types” except preferred provider organizations. This may “signal a beginning of downturn on the rate of increases from the prior three- to five-year period,” the Segal firm said.

In another health care survey, Mercer Human Resource Consulting reported that 25% of employers plan to increase employee contributions and 23% say they will increase cost sharing through plan design changes. More than 10% plan to reduce covered services, the survey said. The Mercer survey also found that 39% of employers say they are “promoting health care consumerism,” which it defined as informed and responsible health care spending by employees, as part of their benefits strategies.

Both employers and politicians will be thinking about what to do about benefits, “because the costs are getting so out of control,” Schramm said. She predicts that employers will move toward more consumer-driven strategies where more of the responsibility is placed on employees.

Benefits attorney Kirk Nahra, a partner with Wiley Rein & Fielding (Washington, D.C.), said that employers will once again be looking at “alternatives to traditional health care benefits.” Consumer-driven plans will be one of the major strategies they will be exploring.

4. *HSAs and HIPAA.* Asencio added that employers will carefully watch any developments relating to health savings accounts. “That will have a significant impact on how employers think about their health plans,” he said. Because of the tax advantages of HSAs, Asencio said, there likely will be “movement in that direction” by employers.

The new Medicare law—which could allow employers to shift more responsibility for retiree health care to employees—will have many employers reexamining their retiree health benefits. “It is going to be a huge year for looking at those issues,” Asencio said. For employers that offer retiree plans, he said, “this is one of the biggest things on their radar screens.” Nahra agreed that the new Medicare law will have employers "aggressively reevaluating the benefits they offer retirees." He added that dealing with Medicare will "be a different universe."

Looking elsewhere on the benefits horizon for 2005, Nahra said, "I expect there will be HIPAA problems and HIPAA enforcement next year." Employers will be at the center of Health Insurance Portability and Accountability Act issues, as problems with the handling of medical information are bound to come up, Nahra said. In situations in which it appears that the privacy of an employee's medical records has been breached, he said, the worker now has a solid legal basis for filing a lawsuit. "Now all of a sudden you've got something other than 'It's generally bad' as your legal argument," Nahra said. Further complicating matters, he said, HIPAA remains extremely confusing to both employers as well as the federal government. "Very few employers are completely compliant with HIPAA rules," Nahra said. "It remains an area of enormous confusion."

DIFFERENT STRATEGIES YIELD HEALTH CARE COST SAVINGS

When it comes to health care, employers are embracing as many different approaches as possible to keep a lid on costs. Logan Aluminum (Russellville, Kentucky), for instance, went to a consumer-driven health plan from a plan where the company picked up all health care costs but the 15% office copay. In contrast, CSK Automotive, a specialty retail automotive parts store that faced a 52% turnover rate, set up a separate, less generous health plan for its entry-level employees. Here are their stories.

Before January 2003, health care was basically free at Logan Aluminum. Howard Leach, Logan's HR manager, told attendees at the International Business Forum's Employers Summit on Health Care Costs: "Employees only paid a $15 copay when they visited a doctor. That was it. No employee monthly contributions." But in January 2003, that all changed when Logan Aluminum, a 1,000-employee self-insured plan, moved all its employees, retirees, and dependents to a consumer-driven health plan (CDHP).

Reasons for Selecting a CDHP

Logan, a manufacturer of aluminum can sheet metal, introduced a CDHP for several reasons. First, the company experienced a 23% increase in medical costs in 2001. "We had been moving along at a pretty good pace, experiencing anywhere from 5% to 7% average inflation on total health care costs," Leach said. "In 2001, that jumped to about 23%."

Second, the company had a history of talking about health care costs with employees. The company held quarterly face-to-face meetings where it would bring employees together and talk about the business. For the past few years, when talking about the business, Logan Aluminum would bring up health care costs because it saw them as a looming problem. Health care for 3,000 covered lives costs Logan Aluminum $7 million to $7.25 million a year. "That is a big number for us," Leach admitted.

Third, it chose CDHC because it was an appropriate fit with the company's culture. All 1,000 of the company's employees are team based. They work in teams of from 5 to 15 employees. Each day, the company holds team meetings to address problems in their particular area of the business. "The expectations that we set for all employees are that they are business partners," Leach said. "They determine to a great extent how successful the business is and that expectation is set and we expect employees to act as business partners in their daily performance of whatever work that they are doing."

Fourth, the company earlier went through a change to its prescription drug program in January 2002 and set up a three-tiered program. "That was the beginning of consumerism," Leach said. "When we made the decision to move to a consumer-driven health care model for the medical piece of our plan, we saw good results on the front end with the prescription drug plan."

Fifth, the company has had a wellness program in place for about 10 years providing health promotion, and it saw the CDHC model as a step in a natural progression.

Plan Design

For family coverage, the deductible is $2,000 under Logan's CDHP. For family coverage, the company places $800 in a health reimbursement account (HRA). However, employees are eligible to receive the full amount only if they undergo a health risk appraisal; otherwise, they only get $600 in the HRA. Nearly all (99.8%) employees completed a health risk appraisal.

If employees do not use the $800 available to them, the unused amount is rolled over to the next year. If they do use all of the dollars in the fund for family, the next level of responsibility, which is theirs, amounts to $1,200. "We acknowledged that our employees were not used to funding large amounts of health care, so we gave them some options. First, they could put dollars into a flexible spending account to help offset the costs by saving dollars on a tax-free basis," he noted. "We have about 32% to 34% of our employees enrolled in an FSA," Leach said. "We also have an on-site credit union. If employees don't want to put money into the FSA and face the possibility of not using that money and then losing it, we encourage them to think about putting some money in the credit union."

If employees use the $800 HRA plus their out-of-pocket $1,200, then health insurance picks up at 100%.

Communicating with Employees

Logan Aluminum started communicating early; it began talking to employees in April 2002 about the consumer-driven model. The company did not talk about specifics, though. It simply told employees that a CDHP was a model that it was exploring and that it thought would have some potential for employees at Logan Aluminum.

In July 2002, the company started talking about what the plan was going to look like, although it did not provide hard numbers at that time because it was still working through modeling of the plan. In September, Logan Aluminum had the final details of the plan together, so it initiated the next phase of the communications process. It brought all employees in, face to face, and talked to them about the reasons why it was moving to the CDPH, what it meant for them, and the mechanics of the plan, and gave employees an opportunity to ask questions. It also invited spouses and retirees to the meetings. “Not all retirees came in,” Leach noted, “but a good number of them did, as well as a good number of spouses.”

In October, the company then encouraged employees to complete health risk appraisals. The plan went into effect on January 1, 2003. At that point the company took another communications step and talked with local medical providers. Because all its employees are basically at the same site and Logan Aluminum is the town’s largest employer, it has some clout with the local health care community. It had two to three sessions with the doctors and hospitals about why it was making the change.

First-Year Results

Overall medical costs were down 19% in 2003 compared to 2002, saving Logan Aluminum $950,000. Sixty-seven percent of those insured used up all of their HRA and moved into the out-of-pocket deductible. Six percent of the population did not use any of their funds, so they rolled over all of their dollars into 2004. Overall, 83.7% of the dollars that were allocated to the HRAs were spent.

Office visits were down by 8%. Surgeries were down by 46% in 2003 and the average length of hospital stay down by 20%. The number of large claims ($25,000 or more) did not change from 2002 to 2003.

Lessons Learned

Without reservation, Logan Aluminum would implement a consumer-driven model again, if it had not already done so. In addition, Leach advised others interested in consumer-driven health that:

- *Communications are critical.* Communicating face to face is very important, he stressed, as is bringing in spouses and retirees. Communication with health care providers is also critical if your employees live in a rural area or small town. Once you go to consumer-driven health care (CDHC), employees are going to go to the doctor with a lot of questions. Communicating with doctors allows them to be a lot better prepared to answer those questions.
- *Focus on health care as a business problem, not as a health care problem or as an employee problem.* Most employees will understand and buy into a solution to a business problem—many more than if you try to present health care as an employee relations problem.
- *Integrate CDHC with a wellness program.* It provides employees with information and focus. Logan Aluminum provides both health education and health promotion. It also has a bonus incentive plan with two parts. In the first, the company will share up to $125 with each employee if health care spending targets are met. In the second, the company uses a third-party provider to assess health risk appraisals for tobacco use, annual wellness consultation with its wellness coordinator, body mass index, and exercise.

Aggregate results from the past year's health risk appraisals are compared to those from the current year based on goals set up by the company. If those goals are met, each employee can earn an additional $125. The potential maximum payout on the wellness side in 2003 was $250. Leach noted that Logan Aluminum was going to pay $218.75, less taxes in February to each employee, for 2003's excellent wellness results.

The average out-of-pocket expense for employees under the CDHP in 2003 was $650. That was about $400 more than they had paid in 2002. "With the wellness check, the net is that our employees will have paid about $200 more for health care per person in 2003 than in 2002," Leach said.

Health education and disease management along with good reporting are essential. "Keeping track of that, sharing information with employees as you go along aids in the buying process," he said.

A Separate Plan for New Employees

CSK Automotive Corporation took an entirely different approach in an attempt to cuts its health care costs. About seven years ago, the company decided that it wanted to spend more on benefits for long-time workers. The approach made sense. CSK has a predominately young workforce and a turnover rate of 52%. With a rate that high, it just did not want to dump a lot of its money into a benefits program for entry-level employees, Jo Ann Hinson, CSK's senior benefits manager, told attendees at IBF's Employers Summit on Health Care Costs. Therefore, the Phoenix-based company, with stores in 19 states, set up five benefits programs: one for entry level and the balance for those who had been with the company for a while. The nonentry-level programs include two union plans, one state-mandated plan for employees in Hawaii, and one for employees who had stayed for more than one year. The fifth was the entry-level basic care program.

For the entry-level employee, the company established a very simple program that was easy to understand and easy to communicate. The program is a self-funded indemnity plan that has a $10,000 annual coverage maximum per participant. "Ten thousand dollars in this day and age doesn't go very far," Hinson noted. "However, the plan is a very low-cost option for people who are mainly low-wage earners. We also have a very young workforce, which tends to be healthier. The average age in this basic indemnity plan is about 30," Hinson said.

The plan has a $100 deductible, 80% coinsurance, no preauthorizations and no case management. "Many have never had health insurance available to them. This plan makes it easy to understand and they can go to their provider of choice. Prescription benefits are handled like any other medical claim. There is no separate prescription card," she added.

For single coverage, CSK Automotive charges $17 biweekly for single coverage, as opposed to a PPO plan that costs $37. Family coverage is $44 biweekly for the basic plan; for a PPO plan, it is $126. "We developed this plan for people who are going in and out of our company quickly," Hinson said. "But what we have found over the years is that as we transition people into other plans after 12 months, many employees have chosen to stay with that basic program because of the cost." CSK passes on 30% to 35% of the cost of each of its plans to employees.

Particulars of the Basic Program

Employees are eligible for the basic plan on the first of the month following 90 days of employment. If employees in the entry-level program get on a fast track during the year and move into a management position in the store, the company automatically offers them the richer plan, although they can stay with the basic plan if they so choose.

Employees must be full time (defined as 32 hours per week) to be eligible for the basic plan. However, if their hours slip due to seasonal variations, they stay covered under the basic plan. Of CSK's 8,500 full-time employees, 2,000 are enrolled in the plan, along with 3,400 dependents.

CSK also offers dental, vision, and life insurance, but those are separate plans paid by the employees. The basic medical plan, Hinson noted, saves CSK approximately $2.5 million per year in benefits costs.

HOW EMPLOYERS FIGHT HEALTH CARE COST INCREASES

A Hewitt Associates survey found that companies anticipate an average health care cost increase of 14%, but can only afford to absorb an increase of 9%. The poll of nearly 650 major U.S. companies shows that this gap has become a major issue in the corporate suite at most organizations, with 96% of CEOs and CFOs either critically or significantly concerned with corporate health care costs, and 91% similarly concerned with the impact of health care costs on employees. In fact, as employee costs increase, employers are becoming more and more concerned about affordability and are considering lower cost-sharing levels for lower-paid employees.

"Senior management clearly sees the negative impact of double-digit health care cost increases, and, while there is no clear solution to the problem, this year's survey suggests an increased willingness to explore new options, such as more sophisticated purchasing strategies and consumer choice health plans," said Jack Bruner, Hewitt's national practice leader for Hewitt's Health Management Practice. "These major annual increases have forced organizations to put everything on the table to identify areas where change is needed to rein in costs."

Consumer-Driven Strategies Advance

Employers' interest in implementing consumer-driven health plans as a means to control costs continues to grow, according to the survey. The most common consumer-driven models currently in use or planned are customized design plans, which allow employees to purchase riders to customize their benefit options, levels, and contributions for physician, hospital, and pharmacy benefits (see Exhibit 3.16) (13% of companies surveyed) and health savings accounts plus high deductibles (12%).

Consumer-driven health plans that combine a health reimbursement account with PPO coverage after a bridged deductible are also growing in popularity, with 6% of employers offering this type of plan and another 6% intending to add the option in the year ahead.

Exhibit 3.16 Cost Sharing

One innovation in cost sharing is the use of a customized benefit design that allows employees to purchase riders to increase the level of benefits provided.

Base Plus Options

Basic Plan	$1,000 calendar-year deductible
	80%/60% coinsurance
	$5,000 out-of-pocket maximum
	$10/$20/$40 Rx copays
Rider	$25 copay for office visits/$50 for specialists
Rider	Rx copays: $10/$20/$30
Rider	$2,500 out-of-pocket maximum
Rider	$500 deductible

Menu of Options

Office visit	⊙ $15 ○ $25 ○ $25/$50	Prescription drugs	○ $5/$15/$30 ○ 80%/$250 deductible ⊙ $5 generic/50% brand
Annual deductible/ out-of-pocket max	○ $260/$6,000 ⊙ $500/$5,000 ○ $750/$5,000	Network options	○ Traditional PPO (80%/60%) ○ Multitier (100%/80%/60%) ⊙ Select (80%/60%)

Source: Hewitt Associates

Current efforts to control costs and drive consumerism include:

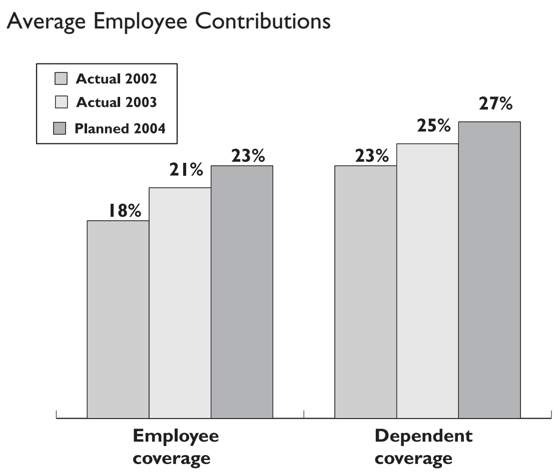
- Using a coinsurance approach with caps to avoid catastrophic out-of-pocket costs (39%)
- Adopting a low copay for generic and a coinsurance for brand-name drugs (29%)
- Supporting a prescription benefit manager's Web site that includes drug pricing and lower-cost treatments (25%)
- Promoting Web sites or print materials that list common conditions, treatments, drug prices, and effectiveness (24%)
- Implementing step therapy programs (23%)

Hewitt's survey also showed significant interest in multitier hospital coverage networks. Similar to multitier prescription drug coverage, these plans allow employees to choose from a variety of hospitals with small, moderate, and steeper copays at the point of service. More than 5% of employers will have this option in place by 2005.

Employee Contributions

The average employee contribution for self-coverage will be 23% in 2004, up from 21% in 2003 (see Exhibit 3.17). Employers say that their primary methods

Exhibit 3.17 Employee and Dependent Coverage Decisions



Source: Hewitt Associates

for influencing dependent coverage selection include implementing a higher cost for dependents than employees (34%), providing flexible credits for opting out of coverage (25%), requiring that employees pay an additional amount if working spouses do not accept coverage from their own employers (10%), and requiring that working spouses elect coverage from their employers (9%).

"While the number of employees and participants in consumer plans will grow exponentially over the next five years, employers recognize that there are barriers to consumer-driven strategies, including the need for infrastructure, decision support tools, price transparency, and extensive consumer education, which must be addressed before they move forward with fully implementing such plans," said Bruner. "This year's survey drives home the fact that employers have begun actively addressing these needs in their efforts to empower better employee health care choices."

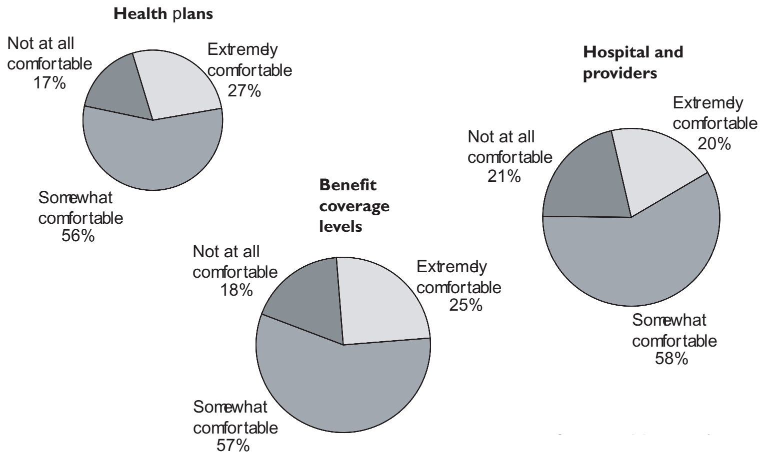
Employer confidence that employees can take greater responsibility for health care choices is growing, with more than eight out of ten companies reporting that they are either somewhat or extremely comfortable with employees' ability to evaluate and select health plans (83%) and benefit coverage levels (82%) (see Exhibit 3.18).

Selecting Health Plans

How do employers intend to manage health care costs and choose health plans? In addition to growing comfort over consumer choice and CDHPs, employers will

Exhibit 3.18 Health Plan Choice

How comfortable are you with employees taking greater responsibility for evaluating and selecting health plans, coverage, and providers?



Source: Hewitt Associates

continue to consolidate the number of health plans they offer in the absence of greater health plan differentiation and proven savings potential, the survey found.

Although still far from universal, the Hewitt survey also found that more employers are promoting quality, patient safety, and positive outcomes in health plans by using a variety of health plan assessment tools, like the Joint Commission on Accreditation of Healthcare Organizations, HEDIS, and Leapfrog (see Exhibit 3.19).

Influencing Choice of Physicians

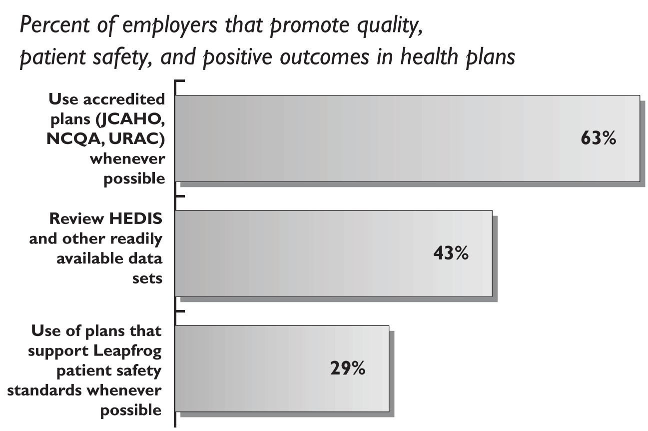
Employers primarily still continue to use the primary care physician gatekeeper concept to influence employees' choice of physicians. According to Hewitt, 44% of firms currently use this approach, with an additional 5% considering it for use in the future.

Additionally, 32% currently have adopted variable copays (i.e., $10 for primary care physicians and $25 for specialists). Although less widely used, some employers have started offering networks where care is provided only by the most cost-efficient physicians, or introducing a multitier network that provides access to all physicians with lower employee cost sharing for more cost-efficient physicians (see Exhibit 3.20).

Employers Look to the Government for Help

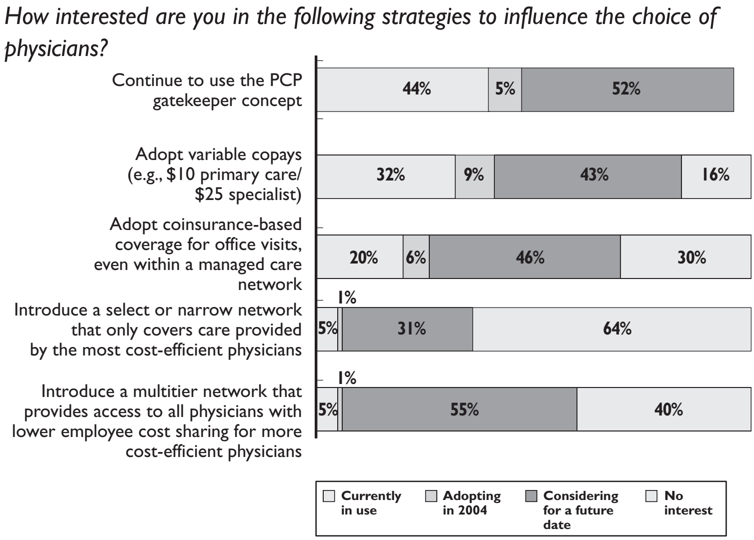
Though the overwhelming majority of employers do not support national health care, an increasing number feel that the government should play a limited role in

Exhibit 3.19 Health Plan Choice



Source: Hewitt Associates

Exhibit 3.20 Provider Selection



Source: Hewitt Associates

helping control skyrocketing costs and in making legislative changes to help drive consumerism. Steps employers would like the government to take include:

- Mandating quality reporting by hospitals and physicians (85%)
- Requiring providers to disclose prices publicly (70%)
- Mandating uniform provider data and payment reporting if long-term savings outweigh costs (64%)
- Allowing U.S. consumers to purchase prescription drugs from foreign countries (47%)
- Making Medicare available to retirees aged 55 to 64 at their own cost (58%)

Other Survey Highlights

Prescription Drugs. Employers are very skeptical of the current financial incentives in this industry and are looking for new models and management strategies. Nearly as many employers believe that the current pharmacy benefits delivery model increases their costs (34%) as those who believe it decreases their costs (43%).

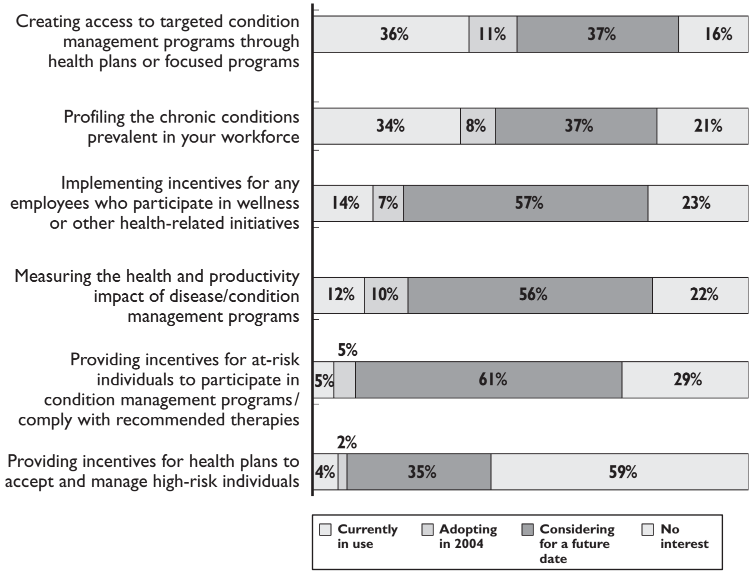
The emerging focus, the survey notes, is shifting from rebate sharing to clinical substitution and compliance management. In addition, plan designs are shifting rapidly to realign consumer incentives to use generic and over-the-counter therapies.

Condition Management. Lastly, Hewitt's study takes a close look at how firms have gotten their arms around health care costs with an approach called *condition management*. Employers are finding that by helping employees to closely manage chronic conditions, they ultimately come out ahead in their efforts to control costs. The study found that:

- Nearly three-fourths of employers offer condition management programs to their employees.
- Twenty-one percent of companies that will have condition/disease management programs in place will offer incentives for any employees who participate in wellness or other health-related programs, and 10% will provide incentives for at-risk individuals to participate in programs or comply with recommended therapies.
- Half of all respondents feel that cost incentives should be provided to those who make a reasonable effort to manage their chronic conditions, while one-fourth feel that those not making a reasonable effort to manage their health should pay more. (For a list of services that companies offer to improve condition/disease management outcomes and lower costs, see Exhibit 3.21.)

Exhibit 3.21 Condition Management

To deliver improved outcomes and lower costs, which of the following does your organization provide?



Source: Hewitt Associates

DISEASE MANAGEMENT PROGRAMS: HOW WELL DO THEY REALLY WORK?

Although more employers and health plans are using disease management for workers and enrollees with conditions such as diabetes, there is limited evidence of the programs' effectiveness in medical and economic terms, according to a study from the Center for Studying Health System Change (HSC). "Several studies have demonstrated that specific disease management programs can improve patient care and reduce service utilization, but the evidence varies widely across health conditions and types of interventions," the HSC study found. The experience of many health plans with disease management programs "is still too preliminary to assess how well they work, while plans that have made such assessments report varying results," the study added.

About 10% of patients account for 70% of overall U.S. health spending annually, according to HSC, which said research shows that "significant gaps exist between evidence-based medical practice—especially for patients with chronic conditions—and the care many patients actually receive." According to HSC, disease management "interventions" include sending patients educational materials about their conditions and reminding them to take their prescribed medications or seek preventive screenings. The interventions can also include educational efforts, treatment guidelines, and reminders aimed at physicians and other providers.

Employers are turning to disease management programs "in hopes of slowing double-digit health insurance premium increases," according to an HSC statement about the study. HSC said that most health plans are interested in programs that can produce relatively short-term reductions in health care utilization and costs, "because high membership turnover makes it difficult for plans to capture longer-term savings." However, employers may seek other outcomes, such as reductions in absenteeism and work-related injuries and improvements in worker productivity and satisfaction, HSC found. According to a statement from Glen Mays, an HSC consulting health researcher from Mathematica Policy Research and coauthor of the study, "The potential for both reducing costs and improving care helps explain why so many employers and health plans are experimenting with disease management and intensive case management programs despite limited evidence of effectiveness."

Who Does Disease Management?

HSC said hospitals and medical groups sometimes develop disease management programs for patients, especially if the providers bear financial risk for patient care through capitation of fixed payments per member, per month. As capitation has declined, development of disease management programs has fallen more frequently to health plans, third-party administrators (TPAs) that administer self-insured employers' benefit plans, and, increasingly, specialty disease management vendors. HSC said the disease management industry is growing rapidly, with specialty disease management companies' annual revenues increasing from $85 million in 1997 to more than $600 million in 2002.

Employers that purchase fully insured products typically rely on health plans to decide whether to offer disease management programs and what type of programs to offer. The health plans choose whether to develop these programs in-house or to contract with vendors who specialize in disease management services, HSC found.

Self-insured employers decide directly which disease management programs, if any, to offer their employees and dependents, HSC said. These employers can purchase disease management programs from health plans, TPAs, or specialty vendors.

Several state Medicaid programs are experimenting with various disease management approaches, and the federal government has several Medicare disease management demonstrations in progress, according to HSC's study. "The limited amount of evidence on effectiveness is likely to make public programs more hesitant to move beyond demonstrations than is the case for private employers," the study found.

WHY AND HOW TO INSTITUTE DISEASE MANAGEMENT FOR EMPLOYEES

To help stem the escalating spiral of health care costs, some innovative companies are adding disease management (DM) to their combative arsenal. IOMA interviews with companies that have offered these programs, new as they are, show that DM is usually coupled with wellness programs. Although many companies do not yet have cost data proving the economic advantage of disease management, on a gut level they are convinced it will pay off. A new survey, in fact, proves them right.

Pinnacle West Capital Corporation

Pinnacle West Capital Corporation, a very paternalistic company that generates, sells, and delivers energy, has a theory that it can affect two groups of people with both disease management and wellness programs. "The first group," Donna Thomas, Pinnacle's Total Rewards Manager said, "would be that 20% that causes 80% of your expenses. With that we believe that disease management is the best opportunity there to help control those costs." Because Pinnacle has a very low turnover rate of only 1% to 2% per year, it also knows that it behooves the company to have some wellness programs in place for its 6,500 employees so they do not get into the 20% that causes 80% of costs.

In 2003, the company did a request for proposal for disease management and selected Health Management Corporation (HMC) out of Richmond, Virginia. Traditional considerations, such as cost and availability, were at play. "But the one thing that made HMC a little different in our eyes is that they had the same disease-specific case manager on a case with the participants. So every time the participant would call in, they would talk to the same person," Thomas added. "That was really something that stood out with this company and it matched our corporate culture, which is built upon relationships."

The health conditions covered in Pinnacle's DM program, which was launched on January 1, 2004, are cardiac, asthma, and diabetes. "The reason we selected those three is that we looked at our data for all of our medical plans and it shows the diseases that were the most expensive and the most common for our own population," Thomas noted.

Pinnacle gives HMC all of its data from its medical vendors and from its pharmacy benefits manager. "They are using that data and identifying people they believe belong in the program," Thomas said. "We have also done a letter to all employees announcing the program and they are able to self-enroll as well. They don't enroll with us; they send the enrollment directly to the disease management company to avoid HIPPA complications."

Pinnacle also has an on-site health screening process, which it has had in place for several years. Following the screenings in 2002, it did a survey to find out why employees did and did not come. The biggest deterrent, the company found, was that they just did not know. So, in 2003, Pinnacle did its typical e-mail and letter communications. But right before the on-site screening, the company sent out a little tube that had a lottery ticket in it. On the outside, the tube said when the screening was going to be, where it was going to be, what the hours were, and how employees could enroll. Inside the tube was a lottery ticket that the employee brought to the screening. There were some instant winners. If someone was not an instant winner, he or she signed the back of the ticket and put it in for a drawing at the end of the screenings. "We had a 10% increase in participation in 2003. There were also some areas of the company that had 50% increases in participation," Thomas said. "We believe that the communication piece helped get the enrollment going."

The survey also showed that for incentives to be meaningful, they had to be in the $200 to $300 range. Thus, rather than giving a lot of smaller prizes out to many, Pinnacle West now gives larger prizes to fewer people.

Diamond Hill Plywood

Diamond Hill Plywood, a wholesale/retail company in Darlington, South Carolina, launched its disease management program in July 2002. The company started the DM program because it analyzed its health care costs and realized that 10% to 15% of its employees had chronic conditions that could be benefited by DM. As Dora Strickland, Diamond Hill's vice president of human resources, told IOMA, "We also have a wellness benefit with screenings for early detection to help control costs."

The program, offered to the self-insured company through its TPA, is run by Corporate Benefits Services and covers people with the catastrophic diseases of diabetes, cancer, cardiac conditions, and asthma. A nurse practitioner from the DM program contacts the individuals, provides follow-up information to them about their diseases, and makes sure that they are keeping their doctors' appointments and taking their medications. The program, which costs $4.50 per employee per month, also includes e-DocAmerica, an online program where employees can contact a nurse or a doctor 24 hours per day and get answers to their medical questions either online or through e-mail. In addition, the medical practitioner fielding their question follows up with the employee's physician.

Diamond Hill Plywood communicated the DM program through company newsletters, direct mailings, and check stuffers. Because the program is part of Diamond Hill's medical insurance coverage, it was introduced discretely as a new benefit, which is now part of the company's health insurance coverage. Announcements about the DM program, however, are also put in the company newsletter on an ongoing basis.

Strickland has received very favorable comments from employees about the disease management program. "It gives them a comfort knowing that there is someone out there that they can contact and who is monitoring what is going on with them," she said.

Usage of the DM program, she admits, was slow at first, but employees who have treatable conditions are using the program more and more. Strickland said that although the program is still too new to generate cost-saving results, she has a gut feeling that the program is really helpful. "Usually people have a tendency, when they are feeling better, to stop taking their medication or skip an appointment. It's human nature," Strickland told us. "When you have someone calling up saying that they notice you haven't been to the doctor in some time, it helps to keep people aware of their health."

Why DM Pays Off

Though little research has proven the cost-effectiveness of disease management, a study of 10 health plans and 25 different DM programs showed that enrollees in DM programs had fewer hospital admissions, fewer emergency room visits, and lower overall health care costs. The study, conducted by the American Association of Health/Health Insurance Association of America, even showed the return on investment of DM for different chronic conditions. According to the survey, *The Cost Savings of Disease Management Programs: Report on a Study of Health Plans*:

- *Asthma DM programs reduce total health care costs and show a strong return on investment.* One evaluation compared the cost of care for people with asthma with cost for the rest of the health plan population. In the year before the DM program was implemented (1996), the cost of care for people with asthma was 2.4 times that of the rest of the plan population. This number declined to 2.1 in 2001. The difference in pharmacy costs for patients with asthma declined from 4.5 times that of the rest of the plan population in 1996 to 3.6 in 2001. Another evaluation of a health plan's asthma program found that for every dollar spent on the program, the savings ranged from $1.25 to $1.40.
- *DM programs for congestive heart failure reduce ER visits and inpatient admissions by one-third.* A DM program for commercial and Medicare patients with congestive heart failure reduced emergency room visits and inpatient admissions by 33%. Given the high costs associated with emergency room visits, this finding has significant cost-saving implications.
- *DM programs for lower back pain provide a strong return on investment.* A DM program for commercial HMO and commercial self-insured plan members with lower back pain found that for every dollar spent on the program, costs were reduced between $1.30 and $1.50.

- *Diabetes DM programs reduce per-member, per-month costs, inpatient days, inpatient costs, and total costs.* One health plan that implemented a DM program for Medicare and commercial members with diabetes found that total per-member, per-month costs for diabetes patients enrolled in the program were 33% less than costs in a control group. Another plan found that its diabetes DM program for commercial HMO members and employer self-insured plans reduced total inpatient costs by 14.4%, inpatient days by 6.9%, and total costs by 6.4% during a one-year period. The plan estimated that for every dollar spent on the program, it saved between $1.75 and $2.00.
- *DM programs for multiple chronic conditions provide a major return on investment.* Health plans' DM programs often address multiple chronic conditions, including diabetes, coronary artery disease, asthma, and congestive heart failure. An evaluation of a plan with a multicondition DM program for its Medicare, Medicaid, and commercial members found that for every dollar spent, it saved $2.94. Preliminary analysis of the program also found a net savings of $.90 per member, per month. A similar program that another health plan established for commercial HMO and employer-self insured members found that the program saved between $2.25 and $2.50 for every dollar spent.

STEPS TO HELP CUT WORKERS' COMPENSATION COSTS

The most effective time to cut workers' compensation costs is in the first 24 hours after an injury. Given that, it is important for employers to intervene quickly, so the injured employee can be given reassurance, directed to proper medical care, and encouraged to immediately return to work in an alternate position, notes Martin McGavin.[1]

McGavin's compendium of articles and special supplements produced by the *Workers' Comp Report* gives many valuable techniques for cutting workers' comp costs. "The first 24 hours is the best time to conduct an investigation to determine compensability and appropriate preventive actions," the report notes. Although taking all these steps in the first 24 hours may seem arduous, they are critical to cost control:

Step 1: Get the employee medical attention. Take the employee to a quality medical provider. It is best to take the employee rather than allowing him or her to drive, he advises. It is also imperative to have made advance arrangements with a medical provider who is familiar with the jobs in your facility and with your return-to-work program.

Step 2: Take the employee's statement. Get a written statement from the injured worker immediately after the accident is reported and before important details are forgotten. This report, the compendium notes, will be the basis for corrective safety actions. "In claims that are not legitimate, it documents the employee's description of the injury and the extent of injuries. The employee cannot later change an accident account to improve the chances of getting benefits."

Step 3: Alert the doctor to suspicious claims. Physicians should be notified before the worker's office visit if there is anything suspicious about the reported accident or the circumstances surrounding it. "If you do not alert the doctor to suspicious circumstances, the employee certainly won't," the report notes. "Many diagnoses are based almost entirely on the subjective descriptions provided by patients, not on objective medical testing. The physician may reach the wrong conclusion if he or she is not aware of all the circumstances surrounding a reported accident."

Step 4: Get work restrictions from the doctor. "Get specific information from the treating physician on the diagnosis and any work restrictions. Make sure the doctor describes work restrictions—not just vague statements about a disability. A physician's role is to determine physical limitations such as restrictions on bending, lifting and standing," the report notes. "It's your responsibility to decide if that means the employee is disabled from performing available work. If an employee sees his or her own doctor, and the physician refuses to describe specific restrictions, consider sending the employee to a doctor of your own choosing."

Step 5: Decide whether to contest the claim. Within the first 24 hours, all the facts necessary to determine a claim's compensability ordinarily are available, McGavin notes. "If you suspect the claim is not legitimate and drag out the investigation, the employee may develop a negative attitude or hire an attorney. If the case is ultimately determined to be compensable, it will be too late to develop a positive partnership with the employee." He adds that if the claim is not compensable, you may have lost the opportunity to gather critical evidence and have to accept the claim anyway.

Step 6: Get employees back to work. For the sixth step, McGavin recommends that employers carefully review the work restrictions the physician has placed on the employee. The goal is to see if there is a job available that the employee can fill. "Unquestionably," the report notes, "returning the injured employee to work by his or her next scheduled work shift is the single most positive action an employer can take to minimize the cost of the claim." Employers must keep in mind that there are two types of employees: those who, when injured, will be worried about the future of their job and those who don't want to work. "A quick return to work assures the first group they'll be able to return to work and it demonstrates to the latter that a work injury is not the way to get out of work."

Step 7: Explain the workers' comp system. If you cannot find any job that the employee qualifies for given the injuries, make sure you take the time to explain the employee's rights and responsibilities under the workers' comp system. Make sure the employee knows what benefits he or she is entitled to and when to expect the first check. Also make sure that employees know whom they can contact at work if they have any questions. As an overlying message in all of this, make sure you stress that the company wants the worker to get better and come back to work.

Step 8: Prepare and send out an injury report. It is very important that employers be prompt in preparing the first report of injury and sending it, along with wage information, to the claims manager. You want to make sure that the employee's first check arrives on time. Consider it a matter of good faith. Often, McGavin notes, this detail is overlooked and creates a serious issue when the employee's benefit check is delayed.

Step 9: Develop a relationship between employee and adjuster. Make sure the claims adjuster contacts the employee and establishes a good relationship. If the employee has confidence in this person, it will help the employee recover more quickly.

Taking these nine steps within a 24-hour period may seem difficult, but doing so can go a long way toward establishing a good relationship with the employee and helping to control costs.

COST-CONTROL FORUM

HOW BENEFITS MANAGERS ARE CUTTING COSTS

The following list provides methods that benefits managers are using to cut costs.

Combat the Surge in Health Care Spending with Increased Cost Sharing

Issue: A 1,300-employee wholesale/retail company in the South was being confronted with galloping health care cost increases.

Response: Its medical enrollment was split evenly between PPO and HMO plans. To minimize cost increases, the company reduced the out-of-network benefits on its PPO plan to 70% reimbursement from 80%, its controller told IOMA. It also increased the prescription drug copay from \$5/\$10 to \$10/\$15. Then it used a heavy communication effort to encourage use of its mail-order drug program.

Result: More employees have now joined the HMO and are using the mail-order drug plan, resulting in decreased health care expenses.

Consider Local Managed Care Providers

Issue: A 230-employee manufacturing company in Ohio was experiencing uncomfortable health care cost increases, even with a self-insured plan.

Response: The firm moved from the self-funded plan for the entire company to several plans, its HR director told us.

Result: "The cost savings came from a very local HMO for the majority of our employees who live in White Lake, Wisconsin, a very remote location," he said. "The other cost savings came from combining [an HMO] with two locations in one plan."

Increase Cost Sharing and Consider Self-Funding

Issue: A manufacturing company in Pennsylvania was contemplating how to make its employees more aware of the real cost of health care.

Response: It has become more aggressive in sharing health benefits costs with employees. For example, last year it increased copays for office visits by 100% and increased employee contributions for dental coverage. "Even so," the company's controller said, "we still pick up 60% of our plan costs." The company also began to self-fund its dental plan.

Result: With all these changes, the company expects to save $150,000 this plan year.

Change Your In-Hospital Medical Cost Coverage

Issue: A large government agency in Texas sought to keep its health and prescription drug costs down.

Response: The agency changed to a three-tiered prescription program and reduced its hospital in-network coverage from 100% to 90%, its chief of benefits development and administration said.

Result: The medical cost trend was reduced 5.4% ($93 per member), and pharmacy claims per utilizing member decreased 2.7% ($12).

Negotiate New Contracts with Providers

Issue: A small manufacturing company in South Carolina was looking for ways to keep its health care costs down.

Response: It negotiated new contracts with providers and reaped substantial savings without lowering its benefit levels significantly. "In doing so, we redesigned our prescription drug program, shifting more costs to employees who use brand-name instead of generic drugs," the company's controller said. "Our biggest challenge was to find the time to do our homework properly."

Result: The 140-employee company now pays about $80,000 less.

Lower Corporate Benefits Spending by Modifying Copays

Issue: A 500-employee services company in the South was being pounded by rising health care costs.

Response: The company adjusted its copayment structure, raising the cost for doctor visits from $10 to $15, doubling the copayments for prescription drugs, and raising the charge for hospitalization from zero to $100 per day for the first five days.

Result: "This helped reduce the cost of renewing our insurance from a 20% jump in premiums to 12%," the company's controller said. "We didn't really have a strategy for introducing these changes," he admitted. "We simply announced them as we announced open enrollment."

Consolidate Your HMO Offerings

Issue: A distribution company in New York was searching for ways to keep its health care costs down.

Response: The 270-employee firm obtained proposals from three HMOs, bargained with all of the providers, and then signed an exclusive contract with one.

Result: By funneling more employees into one HMO, it was able to get better rates. It also received a free online enrollment package worth $10,000 because of its exclusive arrangement with the HMO, the company's payroll/benefits manager told us.

Make Employees Pay the Difference between POS and Traditional Health Plans

Issue: A midsize manufacturing company sought ways to steer its employees to a less expensive health care offering.

Response: The 330-employee firm added a lower-cost point-of-service (POS) plan to its benefits lineup and made those who did not select the lower-cost POS plan pay the difference in premiums between the POS plan and the firm's more expensive traditional health care plan, its benefits manager told us.

Result: The change yielded "significant savings."

Attack Rising Health Care Costs with Wellness Programs

Issue: A company with 3,200 employees was seeking innovative ways to lower its rising medical and prescription drug costs.

Response: "We're attacking medical costs with wellness communications and premature births with a new Healthy Mother-Baby benefit," the company's benefits manager said. It is also combating rising prescription costs through higher copays.

Result: The new programs have helped the company cut its medical costs.

Use Self-Insurance to Cut Health Care Costs

Issue: A 600-employee manufacturing company in the South was facing high health care costs.

Response: Now it partially self-funds its health benefits. What the company does is rent a network of doctors. It has also designed its own self-insured health plan to duplicate the insured products that it previously had. "We have a PPO and now an HMO look-alike," the firm's controller told us. "We also have a strong professionally managed wellness program."

Result: The controller admitted that although this approach moves costs around a great deal, "it probably lowers total benefit spending somewhat while costs for most companies are rising."

Adjust Your Long- and Short-Term Disability Coverage

Issue: A food service company in the South was experiencing substantial hikes in its health care coverage costs.

Response: Its long- and short-term disability plans are completely employer-paid, its payroll/benefits manager told IOMA, so it reduced the benefits from 60% to 50% to absorb a lot of the increase it had experienced with health insurance. The company also increased the office visit copay, as well as increasing employee cost sharing.

Result: All three steps helped cut the company's health care costs.

Employ a Range of Tactics to Cut Workers' Compensation Expenses

Issue: A 2,000-employee services company in the Midwest was being hit by rising workers' compensation costs.

Response: It got the entire company focused on the issue and introduced a variety of programs to lower this cost. These programs, the assistant controller told us, were providing employee in-service training, modifying work programs, creating interactive safety committees, undertaking postaccident drug testing, holding adjusters accountable for closing claims, involving its managed care network, gaining the commitment of employees to lower workers' compensation costs, and improving screening methods.

Result: Overall, the assistant controller told us, these tactics reduced workers' comp expenses by 58%.

Shift Spousal Health Coverage Out of Your Medical Plan when Possible

Issue: Last year, a Midwestern manufacturing company decided it was time to do something about coverage for working spouses.

Response: The 4,200-employee company decided that it would no longer cover an employee's spouse who is eligible for coverage through his or her own employer. In making this change, it had to switch to a four-tiered system, distinguishing "employee and children" from "family coverage," the firm's head of benefits told us.

Result: The company now covers 225 fewer spouses than it did the year before. "This produced an annual savings of about $45,000 for 2003," the firm's controller told us.

Stabilize Benefits Costs through Increased Cost Sharing with Employees

Issue: A 600-employee manufacturing company in the Midwest was experiencing medical and dental benefit costs that were just too high.

Response: The company increased employee contributions for health care and dental benefits. It increased its copays for both medical appointments and medicine. "We also made sure employees knew about our opt-out policy, where we pay a small amount in each paycheck to those who get their medical coverage elsewhere," the controller said. Finally, the company decided to self-fund its dental plan.

Result: Altogether, it budgeted for approximately $300,000 in savings because of these changes last year.

Improve the Effectiveness of Your Mail-Order Prescription Drug Program

Issue: A manufacturing company was looking for ways to cut down on its prescription drug costs.

Response: It revamped its mail-order program. Specifically, it shifted from a two-tiered structure (generic and brand-name) to a three-tiered structure (generic, preferred, and nonpreferred). "This design will pass more expenses for higher-cost brand-name drugs and nonpreferred drugs to employees who use them," the firm's controller told us.

Result: The program is new, the officer at the 1,100-employee company told us, "so we have not quantified any savings." However, he noted that the company anticipates at least a 20% reduction in prescription drug costs.

Use Self-Service for Open Enrollment

Issue: A 3,000-employee manufacturing company was looking for ways to cut down on paper enrollment during benefits open enrollment.

Response: It successfully transitioned its manufacturing population from paper enrollment to Web site-only enrollment during 2003. The decision was made to bypass IVR and the service center entirely, its benefits manager told us.

Result: Although the firm gave no specific dollar savings, it did note that the "outcome exceeded its expectations."

Put Money in a Flexible Spending Account in Lieu of Medical Insurance

Issue: An educational institution in Utah was trying to cut down on its medical insurance costs.

Response: It offered flex spending in lieu of medical insurance to employees with other medical insurance. "Rather than having to coordinate between both plans in lieu of our plan, they get half of what it would cost the district in a flex account to pay out-of-pocket expenses for their other plan. We also increased copays, deductibles, and lifetime limits," the benefits coordinator told us.

Result: The school district has fewer insureds to pay for and has increased cost sharing for those it cover, so it saves money.

Add Employee Health Education Programs

Issue: A small financial services company in the South was experiencing high health care renewal costs.

Response: The company implemented an annual wellness fair with free testing for glucose, blood pressure, cholesterol, and body fat. It also offers a monthly health/wellness newsletter on its intranet. "At our annual 'Employee Celebration Day,' we offer sessions on elder care, flexible spending accounts, and preventive health care," the firm's benefits administrator told IOMA. The company has also expanded the preventive/wellness items covered under its group health plan and sponsors Weight Watchers groups during business hours on site.

Result: A healthier workforce. The company has also seen its renewal rates drop.

Increase Cost Sharing and Explain Market Forces to Employees

Issue: A real estate developer and manager in the Midwest was faced with spiraling health care costs.

Response: It increased cost sharing with employees and communicated not only the changes to its plan design, but also external market data showing how and why health care costs were going up. "We utilized a quarterly newsletter, associate face-to-face meetings, and a special benefit newsletter," the company's director of compensation and benefits stated.

Result: The 1,200-employee firm saved about $200,000.

Change to a Three-Tiered Pharmacy Program

Issue: Until 2001, a wholesale/retail company on the East Coast had a two-tiered pharmacy program that charged a $3 copay for generics and a $6 copay for formulary drugs. However, prescription drug costs were increasing too rapidly and the 5,000-employee company needed to take some steps.

Response: In 2001, the company discussed the idea of going with the three-tiered program, but there was reluctance to move to it then, the company's insurance services manager told us. So it increased its two-tiered copayments to $5 and $10. "The total cost kept increasing, so we once again discussed the idea of a three-tier pharmacy plan," he continued.

Result: In 2003, the company successfully moved to a three-tiered plan with $7.50/$15/$20 copays.

Bid Early and Get Employee Input

Issue: A consulting company in Texas needed to keep a lid on rising health care costs.

Response: It began its health insurance renewal process early. "In doing so, we tried to get the best possible outcome in terms of cost/benefits trade-off," its controller told us. "We interviewed various brokers, evaluated the market, and polled our employees about their willingness to accept coverage reductions."

Result: In the end, the 400-employee company decided its best option was to pass higher costs to its employees while maintaining its existing benefits package.

Add a Specialist Copay

Issue: A technology company in Texas was looking for ways to cut its health care cost increases.

Response: The benefits manager at the 1,200-employee company took two steps. She increased copays, which "has heightened employee awareness of the cost of medical care." In addition, the company added a specialist office visit copay to its PPO plans "in an effort to drive employees away from specialist to primary care type physicians," the benefits manager said.

Result: Both moves have helped cut the firm's health care costs.

Change Carriers

Issue: A 240-employee nonprofit educational institution was, like many employers, facing health care cost increases.

Response: The firm changed its medical carrier and also changed its benefit consultant/agent/broker.

Result: By changing the carrier, it avoided a 12% increase in medical premiums and a 26% increase in dental premiums with no reduction in coverage. By changing its broker, it received more—and better—service with no cost increase, the director of HR told us.

Establish a Policy on Cost Sharing

Issue: A health care company in the Midwest wanted to create an atmosphere in which its employees would be more open to cost sharing.

Response: It established a cost-sharing policy and target, which it intends to adhere to, the company's controller told us. "This has given us a set approach for reacting to premium increases," he added.

Result: As the 900-employee company communicates its philosophy to employees, it also emphasizes that the company continues to pay by far the greatest share of health benefits costs.

Reduce Benefits Costs with a Carve-Out Mental Health Program

Issue: A health care company in the South was curious about steps it could take to curb its mental health care costs.

Response: The 920-employee company studied a carve-out for two years, comparing current utilization with what it would have cost using a managed care option.

Result: It now has a gatekeeper for mental health care, which is a program separate from its usual plan. "Overall, this approach lowered our annual premium by more than $160,000 from where it would have been without the carve out," the assistant controller stated.

Drop Your Family Plan Premium

Issue: An accounting firm in Texas was reeling from escalating health care costs.

Response: It decided to move away from a "family plan premium" and tier premiums more toward employee use. Now it charges a fixed premium for an employee, plus a premium for a spouse, plus a premium for each covered child.

Result: Those with more need for coverage actually pay a higher premium, and therefore costs are more equitably distributed.

Lower Benefits Spending by Adopting a Cost-Effective Prescription Drug Program

Issue: An 800-employee services company in the Midwest was being hit with large prescription drug cost increases.

Response: It implemented a mail-order prescription drug program and also adopted a more restrictive pharmacy program, requiring plan enrollees to use less expensive generic drugs unless there is a medical necessity for another product. "So that employees didn't complain, we implemented a 'no copay' policy for generic drugs when we implemented our mail-order prescription program," the firm's employee benefits manager told us.

Result: Thanks to this program, the service company reports that its prescription costs are up only slightly, despite sharp increases in drug costs for most plans.

Contain Workers' Comp Costs through Improved Data Flow

Issue: A retailer with 1,500 employees in Montana was looking for a way to better handle and track its workers' comp claims and reports.

Response: The company purchased an OSHA/workers' comp software program to keep track of all accidents and workers' compensation costs and to generate OSHA reports. "Our former system was manual," the controller told us, "and the new software has improved our efficiency and productivity, particularly our claims monitoring and follow up on our preventive programs."

Result: Now, the company reports, it is better able to manage the process and, across the entire company, it projects a 25% savings in data entry and paperwork.

Explain Medical Inflation while Raising Employee Share of Health Benefits Costs

Issue: A manufacturing company in the Northeast was facing high benefits cost increases. It increased employee deductibles and coinsurance, self-funded, and had a good claims year. Still, its health benefits costs rose nearly 40%, the controller at the 500-employee company told us. "This means we played our strongest cards but still didn't gain control."

Response: The company continues to adjust its coverage. For example, it added a deductible for in-network hospital usage, and it lowered its share of coinsurance from 75% to 70%.

Result: The company has also started to discuss health costs with employees, explaining why their share of this benefit cost has to increase. "For the most part, they've been receptive and resigned to higher costs," the controller told us.

Require Mandatory Mail-Order on Maintenance Medication

Issue: An entertainment company in Texas with 800 employees was struggling to keep its prescription drug costs under control.

Response: The company launched mandatory mail-order on maintenance medication. Communication was done through the benefits enrollment packet and e-mails prior to the effective date.

Result: The program saved the company $13,000 per year.

Use Trade Association Purchasing Power to Contain Health Benefits Costs

Issue: A 170-employee finance company was facing a midyear health care cost increase of 18%.

Response: It contacted a trade organization and began to purchase health care benefits through that group.

Result: This resulted in a midyear jump in cost of 9%, half of what the firm would have paid had it purchased solo. The new program also has a three-tiered drug plan, which "we think will be less costly than the two-tier plan at our former insurer. Further, this new association plan helps me with administration, freeing me to spend more time on the quality issues of our benefits package," the controller told us.

ENDNOTES

1. Martin McGavin, *Workers' Comp Best Cost Cutting Practices* (Boston: Quinlan Publishing, 2003).

Chapter 4

Compensation Costs

CUTTING COMPENSATION COSTS

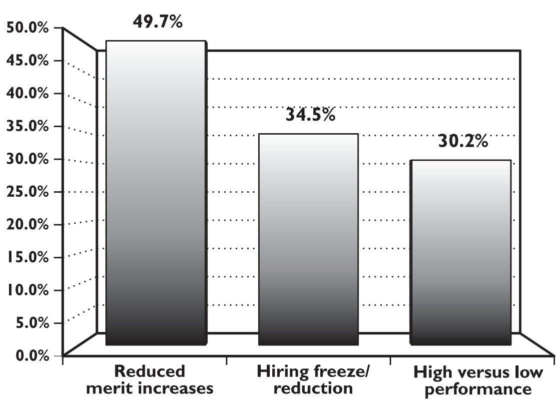
More than ever, controlling compensation costs is crucial to the fiscal health of your organization. IOMA surveyed nearly 500 compensation and HR professionals to uncover the best compensation cost-control methods they have come up with and actually used in their organizations. The top three approaches include reducing merit pay increases, implementing hiring freezes and reductions, and distinguishing sharply between high and low performance (see Exhibit 4.1). Survey respondents were allowed more than one answer because, of course, there are many ways to cut costs.

Reduced Merit Increases

Reducing the size of merit increases was the top method of controlling compensation costs for nearly half of the respondents (see Exhibit 4.2). At companies with 1,800 to 6,999 people, the number came to 53.5%, while at firms with up to 199 people, it was 41.9%.

Reducing merit pay increases was an especially popular move among business services firms (at 56.8%); wholesale/retail trade firms (54.3%); and transportation, communications, and utilities firms (53.6%). In many cases, companies combined

Exhibit 4.1 Top Ways to Cut Compensation Costs



Source: IOMA

Exhibit 4.2 Categories in which Companies Had the Most Success in Controlling Costs during the Past Year, by Number of Employees

	0 to 199	200 to 599	600 to 1,799	1,800 to 6,999	7,000 & over	Overall
Reduced size of merit increases	41.9%	51.9%	52.6%	53.5%	46.5%	49.7%
Hiring freeze/reduction	40.7	35.8	32.9	32.3	35.2	34.5
Created greater distinction	24.4	40.7	35.5	30.3	25.4	30.2
Altered benefits package	27.9	18.5	15.8	20.2	19.7	19.9
Instituted pay for performance	18.6	18.5	19.7	24.2	21.1	19.7
Reduced size of bonuses	17.4	17.3	13.2	15.2	18.3	16.3
Changed mix of salary and bonus structure	15.1	22.2	13.2	14.1	8.5	15.0
Pay freeze	16.3	16.0	10.5	15.2	11.3	13.1
Established/expanded salary	7.0	14.8	11.8	15.2	5.6	10.7
Hired more part-time temps	14.0	9.9	17.1	5.1	1.4	9.6
Instituted new incentive plan	5.8	14.8	10.5	8.1	5.6	9.0
Changed top executive pay	9.3	6.2	5.3	6.1	9.9	7.5
Changed bonus eligibility	2.3	4.9	6.6	10.1	5.6	6.2
Instituted broadbanding	2.3	3.7	1.3	6.1	2.8	3.2
Pay cut	3.5	0.0	0.0	3.0	0.0	1.5
Other	3.5	6.2	14.5	7.1	11.3	8.4

a reduction in merit increases with a new emphasis on performance and rewards for top employees. "We redesigned the bonus program to align with corporate financial targets. Payouts will only occur if target revenue, operating income, and earnings per share (EPS) are met. It could save $1 million," said the manager of compensation and benefits at a 1,379-person firm in the Northeast.

Of course, though lowering merit increases saves on cash, doing so has certain side effects, as one Southern nonprofit found. "We reduced merit increase from 4% to 3% and saved half a million but caused a lot of ill will!" said the manager at the 619-person nonprofit.

Other organizations attempted to emphasize the "merit" concept in merit increases. "We reduced the size of our merit increases without going to a full-blown pay for performance program. This rewarded staffers who are top performers and 'hit' average performers with zero increases," said the vice president at a 450-employee business services firm in the Midwest.

Hiring Freezes and Personnel Reductions

One of the quickest and easiest ways to reduce compensation costs is to lower the headcount, which is why hiring freezes and personnel reductions came in second. More than a third of the companies agreed it was one of the best ways to cut costs. "A hiring freeze helped to control money spent on wages, as well as a severance plan for long-term employees who wanted it, in order to save money over the next fiscal year," said a compensation analyst at a Southern educational organization with 3,500 people. Manufacturing, business services, wholesale/retail trade, and nonprofits were the most likely to enact a hiring freeze or lay off workers to cut costs.

Unfortunately, just as reducing merit increases can hurt employee morale, a reduction in force can really dampen people's enthusiasm. As one compensation analyst at a Northeast retail firm with 14,500 people said, "We had a hiring freeze and a reduction in staff and layoffs—we went through two rounds in the past year. I wouldn't say any cost control measure was successful, though, considering the loss of morale among staff."

To avoid firings, many companies opted to leave positions unfilled as employees left, counting on attrition to reduce the headcount. At the same time, they asked existing employees for fresh money-saving ideas, provided training, and required people to take on tasks from the unfilled positions.

Created Greater Distinction

One of the biggest compensation problems faced was how to reward top performers without having much money in the budget. Apparently, such rewards cannot only boost the morale of these top performers, but can also save money. The third most successful method of cutting expenses was to create a greater distinction between high and low performers. "We created a greater distinction between high and low performance by stressing to managers the need for differentiation. We are able to have a smaller budget but reward high performers (the 'keepers') very well," said a compensation analyst at a Midwest manufacturing firm with 12,000 employees.

Companies were careful to create a greater distinction financially, and also required managers to identify which employees were well above average and justify their choices. This method was especially widespread among firms with 200 to 599 employees; 40.7% reported doing so, compared with about a quarter of companies in the under-200 range and 7,000-and-over group.

Unlike other cost-cutting measures, a clearer differentiation between performers can help to improve employee morale. Top performers feel rewarded, while all employees get a better understanding of what it takes to be considered part of that group. "Creating a greater distinction between high and low performers is considered to potentially have the greatest influence on cost control. While we will be implementing a matrix for suggested increases, we will continue to allow managers the flexibility to reward their employees as they see fit within established guidelines," said the compensation analyst at a 5,000-employee financial firm in the Northeast.

Altered Benefits

Given the rising cost of health insurance premiums, it comes as little surprise that companies decided to alter benefit packages. In the past, altering benefit packages usually meant that companies found low-cost benefits to offer, to make up for smaller pay raises or a lack of bonuses. This year, it meant that more of the premium cost was shifted to the employees, along with higher deductibles and fewer costly offerings, such as retirement packages. "We increased the employee cost of medical insurance, saving the company about $75,000, or 0.75% of compensation costs," said the HR director at a Midwestern communications firm with 150 employees.

Small companies—those with fewer than 200 employees—were the most likely to alter benefits (at 27.9%), mainly by passing on costs to the employees. Northeastern and South Central companies favored this step more than other regions, at 25.4% and 24.6%, respectively. In contrast, only 12.2% of West Coast firms altered their benefit packages.

Pay for Performance

Trying to find the best way to spend compensation dollars meant that a number of companies revved up their pay-for-performance plans. "Linking pay changes to performance metrics provided an objective way of deciding where increases are warranted, based on good results achieved by individuals, in spite of an economic downturn. Although there may be fewer dollars to spend on compensation, it helps us decide how to allocate them," said the HR manager at a 140-employee business services firm in the Northeast.

The companies most likely to take this step were those with 1,800 to 6,999 people and those in the wholesale/retail trade field. A quarter of those in the business services or transportation/communications/utilities field also relied on pay for performance to curtail costs. "We moved away from 'entitlement' mentality into a true 'pay for performance' mind-set," said the compensation manager at a Southern business services firm with 5,000 employees.

Two key steps to making pay for performance work are communication and setting metrics. In organizations across the country, managers are being held responsible for those they deem high performers or those deserving a raise or bonus. "We require good documentation that is data driven to accompany increase recommendations," said the vice president of HR at a 460-person manufacturing firm in the Midwest.

Reduced Size of Bonus

With less money to give out, companies cut back on bonuses. A quarter of companies in the transportation/communications/utilities field reduced bonuses to control expenses. Some organizations eliminated bonuses altogether. "We reduced bonus dollars approximately 2% and by $200 per recipient," said the HR manager at a 175-person manufacturing firm in the Northeast. At the same time, the company distinguished more sharply between high and low performers and handed out bonuses accordingly.

In one company, a Northeastern pharmaceutical firm with 47 employees, bonuses are now reserved for top employees. "The bonus is based on performance rather than grade. It was always supposed to be this way, but no one wanted to take a stand and implement it. With a change in leadership, we are moving forward on this," said the senior manager at the company.

Changed Salary and Bonus Mix

Trimming back bonuses and taking a tougher stance on pay increases means that many companies have also reworked their salary and bonus mix. In some cases, it was a matter of taking the mystery out of who is qualified, as one retail company did. "The bonus structure was simplified so all managers at the same level earn the same percentage of base pay. All employees received new incentive programs. We expect payroll savings to be $200,000," said the HR director at a 230-employee firm based in the Midwest.

Other organizations switched to making more pay at-risk and temporary—offering bonuses instead of raises. "Previously, raises were given to those performing exceptionally well, thus we paid for these 'exceptions' year after year," said the controller at a Southern manufacturing firm with 100 employees.

Pay Freeze

A pay freeze was one of the top-10 ways to contain expenses for our survey respondents. Wholesale/retail trade firms are the most likely to freeze wages, at 21.7%. Interestingly, a number of companies that instituted some type of pay freeze specified that those with higher salaries were affected the most. "The pay freeze seems to be the most successful method. Employees were divided into three salary categories: less than $125,000, $125,000 to $150,000, and over $150,000. Those below $125,000 were eligible based on performance, those between $125,000 and $150,000 were exceptional only, and those above $150,000 were frozen, including executives," said the senior compensation specialist at an employee financial firm in the Northeast.

Established or Expanded Salary Benchmarking

Every company needs to know where its compensation offerings stand in comparison to others. If pay is high relative to market, money is wasted via an inflated payroll. If salaries are too low, firms run the risk of costly turnover. This is why establishing or expanding salary benchmarks made the list of top cost-cutting methods. "We started using market pricing to ensure [that] ranges were accurate. This has been helpful in curtailing the search for candidates that are overqualified or require too much money while still making assurances of proper salaries and effectively filling positions. The idea was implemented by first identifying the appropriate surveys and matching to those," said the compensation analyst at a Southern financial/banking institution with 1,100 employees.

Keeping track of compensation levels helps increase managers' awareness of what is going on in the market and what is appropriate for their organization, reported several HR professionals. This, in turn, helps managers to deal better with making hiring salary offers and setting raises.

Hired More Part-Time and Temporary Personnel

Small (less than 200 employees) and midsize (600 to 1,799 employees) companies were most likely to hire more part-time or temporary personnel to rein in expenses. "We had an increase in use of part-time staff—the retail end of our business is ideally suited," said the vice president of HR and training at a bank in the Southwest with 800 people. The bank workforce is now 40% part-time, whereas it was previously 100% full time. "It's being achieved through attrition: one full-timer leaves and is replaced with two part-timers," he said.

For some organizations, using temporary personnel solves a number of problems, such as how to fill a seasonal need and dealing with the hiring and managing of hourly workers. "The most successful cost-control idea was contracting out entry-level positions. This saved us physicals, drug screens, and orientation costs while turnover remained nearly constant," said the manager at a 110-employee manufacturing firm in the West.

Instituted New Incentive Plan

A small group of organizations found that enacting a new incentive plan—regardless of type—helped to save money. "Creating a skills/performance-based evaluation program has helped in both cost containment and retention of high performers," said the HR manager at a Midwestern health care firm with 1,000 employees. Far more companies in the South Central region installed a new incentive plan, whereas relatively few in the West did so. Also, organizations with 200 to 599 and 600 to 1,799 employees were more likely to do so.

Changed Top Executive Pay

Just as pay levels changed for many of the top executives at the biggest companies in the country, a number of organizations in the survey changed pay packages for their executives. Both the largest (7,000 and over employees) and the smallest (fewer than 200 employees) companies leaned more heavily toward this step. "We set an average percentage for salary increases and a specified amount for each department for bonuses. The vice president of each department determined who/what amount of bonus to give to staff, based on performances. It saved money in salaries for future years," said the HR director at a Southern nonprofit with 65 people.

Changed Bonus Eligibility

Reducing the number of employees eligible for bonuses was another option taken by some companies. Firms with 1,800 to 6,999 people were the most likely to follow this measure. Financial firms and business services firms favored altering bonus eligibility more than other industries. "We changed eligibility for the incentive bonus—only exempt employees are eligible now, which cut out almost half of our bonuses paid," said the HR analyst at a Midwestern financial firm with 1,100 employees.

Institute Broadbanding

Broadbanding, a former star in the compensation constellation whose shine has faded over the years, is still favored by some organizations. Done right, it can simplify the pay process and ultimately save money, as attested to by a number of HR professionals. "We are currently in the process of implementing a career banding structure that will streamline costs throughout base, bonus, and long-term pay," said the compensation consultant at a 10,000-employee manufacturing firm in the Northeast.

Pay Cuts

Relatively few companies decided to cut salaries, making this strategy last on the list for ways to curtail compensation costs. Only business services and manufacturing reported reducing salaries.

Several companies reduced pay levels only temporarily—one cited six months, for example. Other companies required employees to take unpaid time off. "We had two weeks off without pay for all staff at company headquarters. The weeks were at the employees' choosing. We saved $600,000," said the HR manager at a 100-person manufacturing firm in the South.

RECOGNITION PROGRAMS

When a strong economy exists, employee dissatisfaction increases, and corporations become increasingly concerned about how to get their best people to stay. Even if turnover is not a major concern, maintaining productivity and morale is. More than ever, organizations need to recognize and reward their top performers and inspire them to keep doing their best—and, perhaps, even get others to try harder. One major stumbling block is that past methods of motivating and recognizing top performers involved money, whether in the form of raises or bonuses, and companies just do not have all that much money to work with now.

Four Factors Plus Recognition

Inspiring employees to stay, or to improve their current performance, does not have to—and should not—involve money. Pay is and always will be an issue, but other things are just as important. There are four factors in engaging employees, according to Rosalind Jefferies, president of Performance Enhancement Group. One is pay and benefits. The three other factors are communication, learning and development, and work environment. Recognition of employees encompasses all of them.

Communication. Employees want and need expectations clarified. Otherwise, they feel as if they are working in the dark. "People want to know what's expected of them," said Jefferies. This means making it clear what objectives must be attained and what qualifies an employee as a top performer.

Learning and Development. Stagnation can be deadly to businesses; likewise, job stagnation is deathly boring for employees. When companies have little money to offer their people, creating a career path and learning opportunities can make up the difference. It often becomes a win-win situation, in which employees become more engaged and productive and companies benefit from employees' increased knowledge and satisfaction.

Work Environment and Managers. Much of the work environment hinges on the managers. They are the supervisors, the ones in close contact with employees, and they are the ones directly responsible for recognizing the quality of employees' work. "We teach managers all types of things, but not enough about the power of recognition," said Jefferies. The old saying that "people leave people, not organizations" holds true for a reason: because the individual boss greatly influences employees' work environments.

Managers need to be taught how to properly recognize employees and how to focus on performance results and outcomes, according to Jefferies. HR can start by asking managers what they already do to recognize employees, and then asking employees what matters to them. This information can be used to implement a performance management program (PMP), which is a process that fairly rates, recognizes, and rewards performance.

Be sure not to ignore your "steady Eddies and Edies," warns Jefferies. They are the 90% of your employees who work steadily, even if they are not the stars. It is this group who feels taken advantage of and could really benefit from strategic recognition. Surveying your employees about what matters to them will reveal what recognition opportunities were missed. "Employees will remember forever when they aren't recognized," said Jefferies.

Of course, companies need to determine exactly what they will recognize and reward. "Do you recognize people for showing up to work?" asked Jefferies. "No, because that's expected." Recognition should be linked to particular performances, and those specifics should be communicated to employees. Once those links are understood, employees will be much happier with the concept.

Communication Is Key

A study from Towers Perrin also finds that companies with successful incentive programs communicate more reward information to their employees, spend more time educating employees about the business as a whole, and focus on training managers to effectively communicate to employees about the link between performance and rewards. High-performing companies—those with an average five-year total shareholder return that surpasses the global average for their industry—combine heightened communication with the use of variable pay and differentiating the workforce. The survey covers 1,300 companies in North America, Latin America, Europe, and Asia, demonstrating that engaging employees is a worldwide issue.

The companies in the Towers Perrin study are focusing on three areas:

1. Segmenting the workforce by high-performing individuals and the functions with the greatest impact on business results
2. Designing customized programs for these groups
3. Introducing more variable pay into the mix

For 75% of the surveyed companies, rewarding top performers and retaining talent are major concerns. A poor relationship and lack of opportunities for advancement tied for the number one reason why employees leave. Even so, the majority of HR departments report that compensation budgets are tight. To deal with this, organizations are segmenting their workforces by identifying their top performers to focus their reward budgets on. Another tactic is to switch more compensation from fixed to variable—that is, to incentive pay. Even so, many of the companies in the Towers Perrin study reported that their incentive programs were not as successful as they had hoped.

Engaging employees requires more than just pay. Employees need to understand their role and their unit's role in relation to the company's objectives, according to another study from Towers Perrin. That study found that employees want strong leadership, personal accountability, autonomy, a sense of control over their environment, a sense of shared destiny, and opportunities for development and advancement.

Both studies found that communication and recognition are crucial factors in engaging and retaining employees. Just as Jefferies pointed out in her presentation, employees need to know what is expected of them, what opportunities are available to them, and how they can work toward those opportunities. To achieve this end, companies need to educate their managers so they can effectively communicate reward programs and objectives to employees. "How an organization implements rewards is just as important as what gets implemented," said Ravin Jesuthasan, coleader of Towers Perrin's Rewards and Performance Management consulting unit. "Successful organizations do the difficult things, such as effective communication/implementation, well in both good times and bad. Great companies build integrated reward systems, not disconnected, one-off programs."

PAY CAUSES HIGH TURNOVER RATES

It is no secret that many employees are becoming restless at their current jobs, either because of stagnant pay, more responsibilities, or simply greener grass on the other side of the fence. As the economy slowly improves, companies are likely to see a jump in turnover rates by as much as 8%, according to Sibson Consulting, which polled 1,100 workers and found that more than half were eager to switch jobs once the hiring situation picks up. At the same time, half of organizations surveyed by Talentkeepers reported an increase in turnover, with 74% saying it has become an increasingly important issue to the organization, according to Richard Finnegan, president of Talentkeepers Inc., a consulting firm.

If an impending pickup in hiring does not concern your organization, a change in demographics should. In the next six years, there will be 10 million more jobs than workers, predicts the Bureau of Labor Statistics. As baby boomers decide to retire, the following generations are simply not numerous enough to replace them. Organizations need to start now to figure out how they will retain the people they need. If your organization still dismisses the issue of retention, remember: Replacing departed employees always costs the company in lost business and productivity. In the long run, keeping the people you already have is less expensive and disruptive.

People Leave Their Bosses

Money is not always the issue in retention. The Sibson survey found that the majority of people who want to switch jobs would do so even if it meant no gain—or even a loss—in pay. Likewise, Finnegan found that people cared more about their job situation than the money itself. Finnegan also emphasized that people leave their bosses, not necessarily the company, although many view the two in the same way. "People leave companies for (1) leader factors, (2) job factors, and (3) organization factors," said Finnegan. Organization factors involve image, pay, and location; job factors include schedules, challenges, and learning opportunities; and leader factors involve the employee's immediate boss. Employees are attracted to companies for reasons ranked in nearly the exact opposite order: organization factors (such as pay), job factors, and leader factors.

Part of the problem in retaining employees is a disconnect between what employees want and what organizations offer, according to Finnegan. Organizations offer better health care, competitive pay, and salary increases. Although those things are important, employees still seek fair treatment, care and concern, and trust—factors that stem from the kind of relationships they have with their immediate supervisors.

How to Enact Change

A conventional company program uses organization-sponsored programs plus HR tools and resources to retain individuals. However, only one in five organizations believes its retention program to be effective, according to Talentkeepers. A truly successful retention program must involve immediate supervisors and managers, according to Finnegan, particularly as these people have such influence on how the corporation is perceived overall. Executives need to hold leaders accountable for retention, according to Finnegan. "All business-critical metrics are line-driven. Why not employee retention?" he adds. For this reason, companies should know the three Cs of turnover: costs, causes, and consequences.

Nevertheless, less than half of companies track turnover by department, and less than half track turnover by supervisor, according to research from Talentkeepers. Only 15% set turnover reduction goals by supervisor, and only 16% allow goal achievement to affect supervisor pay.

Only 34% of managers and supervisors have the skills required to retain good workers, according to Finnegan, and less than half of organizations have specific programs for building their retention skills. New employees value the following traits in their higher-ups:

- *Trust builder:* creates a sense of trust
- *Communication:* practices two-way communication by sharing and asking
- *Retention expert:* has knowledge and expertise to retain each team member
- *Flexibility expert:* considers needs and views of each team member

After training programs with a focus on retaining employees, companies have been able to improve retention by 20% in one year, according to Finnegan.

Sidebar 4.1. Five Keys to Improving Retention:

1. Research the three C's in your organization: costs, causes, and consequences of turnover.
2. Drive accountability for retention out to front-line leaders.
3. Select and develop leaders to build their retention competency muscle, knowing that trustworthiness matters most.
4. Train team members to become retention agents.
5. Work cross-functionality—with operations, training, and finance—then share knowledge, commitment, and execution.

Source: Richard Finnegan

PAY PLANS TO DEAL WITH FUTURE GROWTH

As the economic scene begins to change, companies are preparing to switch from survival mode to growth mode. Is your organization ready for things to come? IOMA surveyed more than 400 HR professionals to uncover what compensation plans, if any, are being put into place to deal with upcoming changes in the marketplace.

It is no secret that the number of dissatisfied employees is growing, and with it, the potential for key workers to flee once the hiring scene improves. Even employees who have little desire to leave are feeling the pinch. Lower pay increases have translated into lower morale (and lower productivity) for many. This may be why the number-one plan that companies intend to institute involves incentives and bonuses.

Incentive and Bonus Plans

Interestingly, the midsize companies (those with 600 to 1,799 and 1,800 to 6,999 employees) are the most likely to rely on incentives and bonuses in the future (see Exhibit 4.3). It may be that large companies (those with 7,000 employees or more) already have these programs in place.

The appeal of incentive and bonuses plans is cost-effectiveness. Unlike a raise, a bonus does not create a permanent increase in a salary. If applied correctly, it can have the desired effect of motivating and rewarding employees. "We plan on the institution of a new performance management that will make more accurate distinctions in performance and merit pay for high and low performers," said the compensation analyst at a 2,561-person health care company in the South.

Implementing a bonus and incentive program is especially popular among transportation, communications, and utilities firms, with 75% saying they have such plans in the works. "We will continue our quarterly cycles for salary increases along with our pay-for-performance strategy. Additionally, we are currently reviewing our bonus programs to ensure we are competitive from a total compensation perspective," said the manager of compensation and benefits at a 197,000 information technology services firm in the Southwest.

Exhibit 4.3 What Compensation Plan Does Your Company Intend to Institute to Help It Respond to Expected Future Growth? (by Number of Employees)

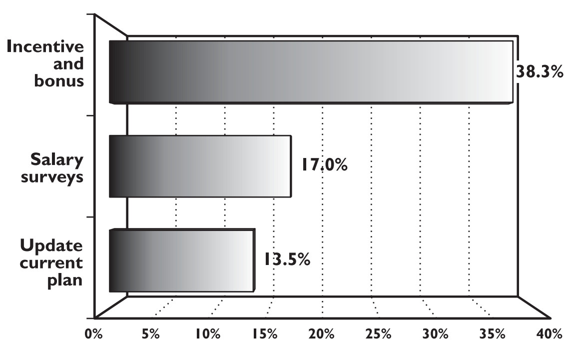
	0 to 199	200 to 599	600 to 1,799	1,800 to 6,999	7,000 & over	Overall
Incentives and bonus	35.0%	37.0%	40.7%	41.8%	27.7%	38.3%
Salary surveys	13.3	13.0	15.3	19.4	23.4	17.0
Maintain/update current plans	8.3	13.0	10.2	20.9	19.1	13.5
Less money/fire/hire-freeze	13.3	7.4	5.1	3.0	4.3	6.1
Attract and retain	3.3	0.0	0.0	0.0	6.4	1.9
Other	10.0	7.4	8.5	3.0	8.5	7.1
None/don't know	16.7	22.2	20.3	11.9	10.6	16.1

The issue of incentives and bonuses appears to matter the most to companies located in the Southeast, where 48.2% said they were counting on new plans to deal with the future.

Market Rates and Salary Surveys

HR professionals profess a new reliance on salary surveys, because ensuring that compensation levels are competitive is more important than ever before. Keeping pay levels competitive is a balancing act because salary budgets are still tight. Companies do not want to pay more than they should for a particular job title, while employees want to feel as if they are paid what the job is worth. Keeping frequent tabs on salary surveys is one way to ensure that both sides are satisfied. This is why using salary surveys is the second most important plan HR professionals have to handle compensation in the near future (see Exhibit 4.4).

Exhibit 4.4 What Compensation Plan Does Your Company Intend to Enact in the Future?



Maintaining competitive pay levels is of particular concern to larger corporations. "We are expanding our survey sources to ensure we have accurate information. We are also monitoring attraction and attrition numbers for signs of negative import and the need to respond," said the compensation manager at an 8,000-person research and development firm in the Midwest.

Keeping current with pay rates is also crucial if your organization deals with "hot jobs," which, at the moment, consist primarily of those for medical personnel such as nurses and technicians. "We try to update market data annually for our 'hot jobs' once or twice a year," said the director of compensation and benefits at a 4,200-person health care organization in the Northeast.

Regardless of what region a company is located in, the issues of market pay and use of salary surveys are important ones. This may be because region and location greatly affect pay. Also, for companies that felt compelled to offer ever-higher salaries in the past, cutting back to more reasonable levels became especially important. As the economy begins to change, companies once again need to know what the current rates are so they are not at risk of losing valued employees. "We will enhance our salary program to become more aggressive on conducting annual market surveys and study economic indicators more closely," said the HR director at a Midwest manufacturing firm with 135 employees.

Some companies used salary surveys to ration out limited compensation dollars to their top employees, as did one wholesale firm with 550 employees, located in the Midwest. "The installation of market-based compensation identified 'exceeded' performers below market. We channeled comp adjustments to high performers below market with a maximum of 11%. Overall, employees above midpoint did not receive an increase," said the director of benefits there.

No Change Right Now

Not every company has a plan in place for the future; for some, the crystal ball is still too murky to allow a peek at what may come. Quite a number of organizations said they expect little or no growth in staffing in the near future and have few expectations for growth in employee numbers—or business, for that matter.

On a more positive note, some corporations have already revamped their pay programs and are either satisfied with the results so far or the plans are so new that management needs to see the results before tweaking compensation further. "We made several significant adjustments to our performance appraisal process and bonus plan program several years ago, which should serve us well for the foreseeable future," said a compensation manager.

Likewise, another organization that recently altered its pay plans is taking a wait-and-see tack. "We are not planning any changes at this time—we revamped our compensation plan two years ago, and it seems to be working now," said the vice president of human resources at a Midwest manufacturing firm with 1,300 employees.

Maintain and Update Current Plans

Companies that have already put new plans into place—or were relatively satisfied with their old ones—predict that they will need only to make some alterations to adjust to future changes. Organizations with 1,800 to 6,999 people are the most likely to say their plans may need some updating in the coming months. “We are getting ready to review all of our sales compensation plans and try to get them consolidated into fewer plans as we gear up for growth,” said the senior compensation analyst at a 1,208-person retail firm in the Southwest.

A few organizations are in the middle of enacting change, such as one business services firm in the Northeast, at present employing 150 people. “We are currently working toward creating a firmwide compensation program. We are still in the investigative phase but expect to be completed by year-end,” said the vice president of human resources there.

Some are mulling over changes in theory but have no actual plans in the works . . . yet. Like so many other things, change depends on when and how the economy picks up steam. “We are actively considering a revamp of our incentive program to include nonmanagerial individual contributors and use funding throughout the organization,” said the senior compensation analyst at a Northeastern business services firm with 2,300 employees. His company is also considering broadbanding for the future.

No Money/Reductions

Unfortunately, some organizations simply have no cash at all for changes to their compensation plans. Even worse, some companies will be cutting back on employees—and pay—in the near future. “We are reducing the size of the merit budget to recognize the poor business climate,” said the vice president at a 285-employee manufacturing firm in the South.

A handful of companies are still suffering hangovers from the booming days of competing for talent, such as one insurance firm in the Northeast with 200 employees. “We are currently not proposing any increases—we are already scads above the competition and are in ‘rehabilitation,’ “ said the HR generalist there.

Small companies (those with 200 or fewer people) are the most likely to report a sheer lack of money to work with. In addition, nonprofits also appear to be strapped for cash, along with manufacturing firms.

Attract and Retain

Just a few years ago, the biggest problem facing HR was how to attract and retain enough employees. Although this problem has eased up somewhat, it has not disappeared entirely. The need for top talent will always exist, and there will always be certain titles that fall into the “hot jobs” category. Right now, those in the health care industry are struggling to attract and retain the right people. “Our industry continues to remain very competitive. Our future growth will be measured on our ability to build our internal organic growth. Compensation will be tied to this attribute,” said the compensation manager at a Northeastern medical firm with 25,000 employees.

Interestingly, the largest (those with 7,000 or more people) and smallest companies (those with fewer than 200 employees) are the only ones concerned about attracting and retaining employees in the future. The large organizations naturally need greater numbers of people, whereas smaller companies can find it difficult to offer competitive compensation, perquisites, and benefits.

Other Plans

A wide variety of plans fell into the "other" category, such as that of one 12,000-person manufacturing firm in the Midwest, which has a lot going on. "We have a task team analyzing retirement, the new workforce, and succession planning. Increased compensation training will allow us to hire new employees at more appropriate (often lower) rates," said the compensation analyst.

A number of other companies also mentioned compensation training—that is, educating managers and supervisors about proper compensation levels, pay for performance and bonus criteria, promotional guidelines, and more.

In addition, several organizations mentioned the desire to create career paths for their employees. This issue does have a strong compensation component, but it can also serve as a major motivational and retention tool, because many employees want to know how they can advance their careers and increase their pay. They consider advancement crucial to their satisfaction with their current jobs.

USING SALARY SURVEYS FOR MARKET-PRICING JOBS

When JC Penney decided to change its business model to continue to compete, the department store and catalog chain realized it was necessary to change its compensation program as well. The new pay program would be designed to help support the business and culture changes that were under way. Two of the key components of the new pay program included a focus on market pricing and job evaluations. JC Penney worked with the Hay Group to create a new compensation plan that would help to manage change. "JC Penney went from a compensation plan that gave people comfortable predictability to rewarding success and contributions," said Kevin A. Seaweard, a senior national retail practice consultant at the Hay Group.

In the old plan, merit pay had little meaning. Performance reviews rewarded tenure instead of results, fostering an entitlement culture. "Basically, we were paying for effort and not results. But we weren't getting the results we needed to achieve," said Donna Graebner, senior project manager of compensation at Penney. "We introduced a new performance management tool. To reinforce our new value system, [we sent the message that] you have to increase your value to the organization in order to get an increase in pay." Because determining job titles and compensation was an important step in moving toward a new business model, the HR department became a crucial component of the process, according to Graebner.

Using Market Data

Previously, JC Penney promoted from within, whether or not the candidate was a good fit for another job. Another problem with the old pay structure was that there were 29 pay grades, or position responsibility levels (PRLs). Employees could move through the many levels, but the movement did not translate into any substantial differences in their job responsibilities, titles, or pay levels.

Under the new plan, both external and internal candidates were considered for available positions, which necessitated a new emphasis on market pricing. "External hires needed to have market-based pay structures. This gave birth to our market-pricing project," said Graebner.

First, JC Penney had to select which surveys to use. For positions up to the management level, broad general-industry surveys were sufficient. Above that level, retail-specific salary surveys were more useful.

Comparing Job Titles

In taking a look at market data for the retail industry, it became clear that the company needed to figure out how to compare itself to other organizations in the surveys. It also became clear that the company could not simply rely on job titles from market surveys. Many organizations have a position with the same title, but the responsibilities and scope of the actual job can vary greatly. To remedy the situation, JC Penney added evaluations to the process.

"Job evaluation combined with market data to give us much better information. And that is what CEOs want, that is what line executives want," said Seaweard. Tying in job evaluations allowed the company to link the value of work to the market. This made it easier to communicate to people what they needed to do in their jobs to obtain a raise. "We want people to understand what creates value," said Seaweard.

When using a salary survey, "you need to understand the content of your jobs, as well as the survey models to get the best market data," said Seaweard. "We ended up matching our buyer's job to the higher level of the data. We realized the content of the Penney's jobs is bigger than the data's, so we've got to reflect that accordingly."

With a group of compensation-related jobs—such as compensation director or vice president of compensation and benefits—the approach was similar but slightly different. In one salary survey used by JC Penney, the compensation manager range is $50,000 to $100,000. "So what is the right amount? How big is your job?" asked Seaweard. He gave an example of two compensation managers, both at billion-dollar companies. "The first one administers the annual merit budget, the annual incentive plan, and market pricing and supervises a couple of analysts. But overall, HR is not a big player in the organization," said Seaweard. "The other HR does all of that too, but the department works closely in designing sales plans, works with boards, line managers, etc. So those jobs aren't the same and wouldn't be paid the same."

In looking at surveys, the organization then matched job titles and job content to comparable data—other companies that were of similar size and scope. JC Penney targeted the 50th percentile of the pay ranges for each job.

Career Bands

The jobs were then grouped by relative impact to the organization to create career bands, each with a maximum and minimum pay range. This reduced the number of titles while still maintaining logical career paths for employees. That structure meant that future promotions would have more real effect in terms of title, responsibilities, and salary.

This strategy also created a new emphasis on external competitiveness. Because the internal job titles were now comparable to outside jobs, it was easier to see whether an internal job candidate was a good fit for a new position or an outside candidate should be considered instead.

Another goal of simplifying the career bands—and the entire compensation process—was to create a consistent and repeatable methodology, according to Seaweard. "Is anyone really doing banding anymore?" he asked. "Less than 10% of organizations use a banding environment. So it is less common than before. So why at JC Penney? It made sense for them."

Market pricing had the side benefit of making it easier for managers to understand the value of work. "It answered a critical question of line management—what is a job worth?" said Craig Rowley, VP and national retail practice leader at the Hay Group. "When you pair job evaluations and market data, you get better results. It drives the company culture to know 'what is the right price for this job?' "

Communication Was Critical

Communication was also critical. The organization "educated and partnered with department leadership," according to Graebner. HR met with executive committees to get management buy-in for the new program and distributed a newsletter to management a month before it went into effect. HR also created a script for managers to ensure consistency in how they presented the changes to their staff, as well as videotapes for employees to watch and Q&A sheets. The video included messages from the top executives explaining the changes—why they were being made and what market pricing is—and emphasizing being the "best." In addition, HR posted project updates on the HR Website home page.

HR also contacted each employee individually. "We had prepared a personalized letter for every associate that told them what band they were in and what market data their job would relate to," said Graebner.

The communication blitz was so effective that one manager told them, "By the time we rolled this out we knew so much about it that it was second nature and a 'no brainer.' We were all wondering why we hadn't done this before." So far, JC Penney has had no major issues develop as a result of the changes, although Graebner says that ongoing communication is required.

GENEROUS WITH SEVERANCE PAY

In the last three years, nearly half of companies changed their severance policies, usually so the departing employees receive more money, according to a study from Lee Hecht Harrison. The majority of companies, 79%, have a severance policy or practice that covers full-time officers, executives, and exempt and nonexempt employees. At 39% of the organizations surveyed, part-time workers were also eligible for severance, but this is a decline from the 48% that offered it in the past.

Most companies use years of service as at least one measure of what the severance amount will be. At firms using that as the primary or only factor, employees at the executive level and above can anticipate a minimum payment of four weeks' pay; exempt personnel can expect three weeks. This is up from a minimum of two weeks' pay in past surveys conducted by Lee Hecht Harrison. Nonexempt employees still receive two weeks' pay for severance. Median maximum severance rose to 36 weeks for executives but remained at 26 weeks for all other levels.

In the Lee Hecht Harrison study, *nonexempt employees* are defined as hourly workers; *exempts* include managers and other salaried staff; *executives* encompasses vice presidents, department heads, and directors; *senior executives* are executive vice presidents (EVPs), senior vice presidents (SVPs), or the equivalent; and *officers* are the CEO, president, CIO, CFO, and COO.

If the payments are not based solely on years of service, the formula is typically a combination of years of service, salary/grade level, title, age, and other factors. Salary level at the time of termination is the second biggest consideration; for example, 45% of companies factor that in for exempt employees (see Exhibit 4.5). For executives and senior executives, 42% and 43% of organizations determine severance on a case-by-case basis. The higher the employee's level, the more likely it is that additional factors besides years of service will come into consideration.

One-third of companies surveyed said they enhance severance for employees who sign a release. The enhancements include more severance (offered by 45%), additional salary (22%), extended insurance coverage (15%), outplacement (14%), and additional benefits (13%). In addition, 36% of organizations enhance normal severance payments under special circumstances, such as downsizing, mergers, or acquisitions. Only 22% of firms have special provisions for change-in-control situations, and then mostly for top management only.

Most organizations make severance payments either by salary continuation or in a lump sum (47% and 46%, respectively); 13% allow the employee to make the

Exhibit 4.5 If Severance Is Not Based on Years of Service Only, How Is It Calculated?

	Officers	Senior Executives	Executives	Exempts	Nonexempts
Formula including years of service	43%	45%	48%	57%	60%
Formula including salary/grade level	34	36	39	45	40
Formula including title/level	34	34	36	28	20
Formula including age	8	8	10	11	12
Case by case	35	43	42	38	34
Employment agreement	35	30	17	3	0
It is negotiated	23	20	15	5	4
Flat amount	5	5	5	8	8

Source: Lee Hecht Harrison

choice (companies could select more than one method). Extensions are not granted. Most companies do not allow employees to appeal their severance payments, but 23% say they have a process to appeal severance benefits.

Almost all organizations (95%) continue medical benefits, and 37% continue life insurance during the severance period. Only a small percentage of firms continue benefits such as disability, tuition reimbursement, vacation accrual, use of company car, and office.

Outplacement Services

More than half of companies provided outplacement services to officers and senior executives, and 28% provided it to "some." Nearly half of organizations provide outplacement only if the departee signs a release. Roughly half of companies require employees to begin outplacement services within a specific time frame, typically within 30 days.

The more senior the position, the longer the outplacement services last. A third of companies provide departing officers with six months of services, while another 26% offer a year's worth, and 14% have no time limit. However, most regular exempt employees receive three months of services or less.

Industrial Differences

There are some differences among various industry groups. For example, medical products and pharmaceuticals firms are the least likely to have a severance policy, although the majority still do, at 71%. In comparison, 100% of those in the aerospace and defense industry have severance policies. The size of the severance pay also varies by industry. Among executives, for example, banking/financial services, hospitals and health care services, and wholesale/retail have the highest median minimum severance pay, at eight weeks. The maximum severance pay for executives is a median 52 weeks in the banking/financial services and the food, beverage, and tobacco fields.

Nonprofits, governmental units, and associations are among the least generous with their severance pay: for officers and senior executives, it ranges from a minimum of 2 weeks to a maximum of 20. For exempt employees, severance pay ranges from 2 to 15 weeks. Within this grouping, 40% report changing their severance policy within the past three years, with 29% saying it has become less bountiful. Even so, it could be worse: Within the industrial manufacturing, product, and services group, 45% said they have changed their plan, with 41% making it less generous.

Company Size

As usual, size does make a difference when it comes to severance plans. Only 64% of companies with fewer than 101 employees have a policy, compared with 100% of organizations with more than 25,000 people. The larger the company, the more likely it is to have a severance policy, award more generous amounts in that policy, continue medical coverage, and provide outplacement services.

An organization with more than 25,000 people offers a median of 4 weeks minimum and 52 weeks maximum to its exempt employees. More than half (54%) have changed their policies in the last three years, with two-thirds indicating that they became more generous. At a company with fewer than 101 employees, median severance for an exempt employee runs from 2 to 15 weeks. Slightly less than half offer outplacement to their exempt workers, with 20% offering it to all and 29% providing it to some.

Retention Bonuses

Overall, 46% of companies offer a retention bonus to ensure that terminated employees continue working until a specific date. However, there is no one set formula that most use to determine the bonus amount: 32% use a formula based on additional severance; 28% use a percentage of salary; and the rest use another formula, such as length of employment or job level.

By industry, the popularity of retention bonuses varies widely, from 64% of hospitality and travel firms offering one, to only 15% of those in the nonprofit, government, and associations grouping. Most other industries fall in between, with roughly half in each category using retention bonuses.

The larger organizations are more likely to use retention bonuses, with 67% saying they use them, and 85% of those reporting that they find the bonuses to be effective. Fewer than a third of companies with 101 to 500 people (34%) and with less than 101 (29%) use retention bonuses. Even so, three-quarters of those that do use bonuses find it effective.

Other Severance Plans

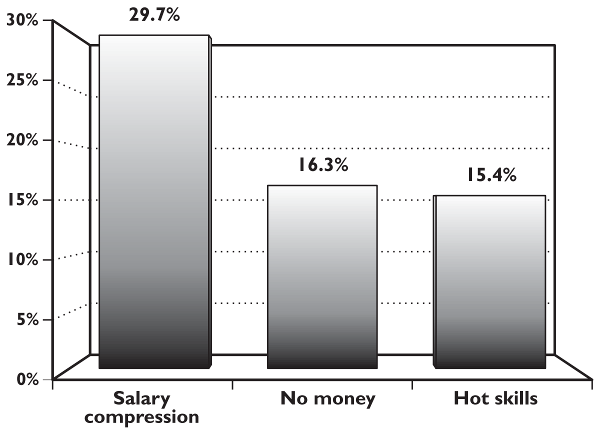
The study also examined severance policies for CEOs at 100 *Fortune 500* firms, finding, among other things, that more than a third offer 36 months of severance. In addition, the study takes a look at severance policies in 24 countries around the world. For example, companies in the United Kingdom are required by law to provide severance. Senior executives typically receive six months, executives and managers receive three months, and support/administrative employees get one month.

COMPENSATION CONCERNS: HOW TO HANDLE THEM

Money—or the lack of it—is the top problem facing compensation and HR professionals today. Simply put, there just is not enough to do what needs to be done, whether it is to bring pay up to market levels, end salary compression, or reward top performers. This is the finding of an exclusive IOMA survey of 500 HR professionals (see Exhibit 4.6).

The number one problem facing HR today is still salary compression, but now it is a hangover from former "hot skills" and the previously tight labor market. Just a few years ago, organizations were offering ever-higher salaries to attract the talent they needed, essentially creating a bidding war for certain employees. Now, those who won the bid may wonder if they actually lost out in the long run. "Our problem was people making demands for really, really high salary increases when

Exhibit 4.6 Top Compensation Problems



the economy was better. And now having to pay those salaries in the bad economy," said an administrator at a 32-person law firm in the Midwest.

An HR director at another company had a similar situation: "We made salary offers high in our range for hot skills. Several employees reached the max of their salary range, and they were not paid any more than the max, even though the merit increase warranted it," said the HR director at a Southwestern nonprofit with 99 employees.

Overall, 29.7% of companies said compression was the top compensation concern (see Exhibit 4.7). It is a bigger issue among small organizations, with up to 199 employees, where 40.3% said it was troublesome. It is less of a problem among the largest companies (7,000 or more people), with only 19.2% citing it as an issue.

There are companies that use pay raises to handle the issue. "We resolved compression by instituting modified steps in the lower half of the range as the minimum amounts for various lengths of experience in one's job. The result was improvement in compression at the lower end, where the problem was critical, but more above the eight-year level," said an HR professional in the health care field.

The situation is not easily fixed. In some cases, the employees' salaries are virtually frozen in an attempt to pay them no more than they already earn and hold their pay back so that other employees' salaries come a little closer. In other cases, organizations try to make the employees really earn their high salaries, such as one financial institution in the Northeast with 1,400 employees. "We are overpaying for IT skills no longer considered critical and are now trying to apply these employees to different applications. It's an ongoing problem that has not yet been solved," said the assistant vice president.

Another organization, a hospital in the Northeast, turned to creating alternative work arrangements for employees at the top of their pay range—again, making their job equal their pay in this dampened economy.

Exhibit 4.7 Biggest Compensation Problem in the Last 18 Months, by Number of Employees

	0 to 199	200 to 599	600 to 1,799	1,800 to 6,999	7,000 & over	Overall
Salary compression	40.3%	35.6%	30.2%	21.1%	19.2%	29.7%
No money	16.1	15.3	15.9	15.5	19.2	16.3
Hot skills	4.8	16.9	19.0	19.7	21.2	15.4
Market	6.5	11.9	11.1	8.5	5.8	8.6
Pay range/salary structure	9.7	6.8	9.5	11.3	3.8	8.3
Bonus	4.8	5.1	9.5	8.5	11.5	8.0
New compensation plan	4.8	1.7	1.6	9.9	7.7	5.3
Retention & recruiting	4.8	1.7	3.2	1.4	3.8	3.0
Sales	0.0	1.7	0.0	0.0	0.0	0.3
Other	8.1	3.4	0.0	4.2	7.7	5.0

Because many companies are reluctant to increase compensation costs by simply raising salaries, some try handing out lump sums to make up the difference. "Since we have not made salary adjustments in three years, we have about 18% of employees at the top of target. They do not receive merit increases, which causes morale issues. We have given them a lump-sum amount equal to the increase they would have received had they been awarded a merit increase," said the vice president of HR at a 282-person nonprofit in the South.

Nonprofits and wholesale/retail trade organizations reported pay compression to be their biggest concern, at 37.5% and 39.1%, respectively.

No Money

It is no surprise that one of the top compensation problems is the lack of money. Big companies considered it troublesome just as much as smaller firms did: 19.2% of those with 7,000 or more employees cited it as an issue, compared with 15.3% of firms with 200 to 599 people.

"Our biggest problem is being allotted a small merit budget and being able to compensate good performers with it. Turnover is very low, but it's getting difficult to get really good performers to take on bigger new responsibilities with such a small budget. We've been focusing as much of the budget on good performers as possible and either laying off or giving small or no increases to average or below-average employees," said the HR generalist at a Midwestern manufacturing firm with 8,000 employees.

Indeed, much of the concern focused on how to differentiate between top performers and others when there is so little budget to work with. Furthermore, although the job situation is tight for employees at the moment, that may change when the economy picks up again—and the frustrated top performers may leave for greener pastures.

Motivation is a huge factor, whether it is for top performers or average employees. Some companies resolve this issue by taking money that would otherwise go to the lower performers, through pay cuts, layoffs, or keeping pay levels stagnant. “The problem is how to motivate top performers in a pay-freeze situation. We reduced costs by converting overly generous pay positions to standard reasonable companywide accepted practices. Equal pay for equal work is ongoing,” said the manager of payroll and A/P, at a 5,000-person mining firm in the South.

Some companies turned to new incentive plans to combat the lack of money for more generous raises. One software company in the South implemented a bonus plan based on company performance.

Just as salary compression was caused by high-flying raises during the boom years, budgets created during that time are ill-suited to today’s business environment. “The bonus plan that was formulated and approved in the year 2001 for year 2002 performance was clearly out of sync with 2003 and 2004 performance prognoses. We paid a huge bonus just as the earnings were slipping deep into the tank,” said the director of compensation and benefits at a 620-employee manufacturing firm in the Midwest.

Hot Skills

Hot skills are not what they used to be; just a few years ago, there were not enough IT people to go around. Now, it is health care professionals who are in scarce supply. The added problem for many organizations is that the current economy means there is less money to attract and retain the people they need. “Meeting rising nurses’ salaries is our biggest compensation problem. In the last market adjustment, we raised start rates for new nursing graduates and increased the base salaries of all our nurses. We also enacted a shift differential for nurses having patient contact, as opposed to those focused on administrative research duties,” said the compensation/management analyst from a Southern health care firm with 2,561 people.

Indeed, more than half of health care organizations—54.8%—named hot skills as their top compensation problem. However, it is barely a worry for the wholesale/retail/trade field, with only 4.3% naming it as a major issue.

Market Level Compensation

HR professionals are concerned about keeping salary levels at market rate—whether they are too high (as in the case of recent hot skills) or too low. HR needs current data to counteract employees who look up their job title online and see higher pay than they are earning or managers who want to give their subordinates more. “The biggest compensation problem we’ve faced is managers wanting certain jobs slotted higher than the market value of the job. Many cases were resolved by educating managers on the consequence of overpricing jobs—that is, it could potentially create internal inequity, leave no room for future growth in job, and so forth. Once educated, managers understand that jobs are not arbitrarily assigned a job grade,” said the compensation analyst at a Southern retail firm with 1,050 people.

In other situations, checking valid survey data revealed that employees were indeed underpaid—but with tight budgets, this is difficult to correct. Once again, quite a few organizations turned to lump sums to make up the difference, rather than longer-lasting pay increases. One Midwestern-based retail company with 113,000 employees made up for geographic differentials by handing out cash instead of raises.

Out of the six industry groupings, nonprofits are the most troubled by keeping up with market data, at 17.5%. This is because nonprofits, even large ones, typically have less money to work with. "Paying competitively with the external market is a problem. It has not been resolved, but we are always recommending programs to help," said the HR supervisor at a nonprofit with 21,825 employees.

Pay Range and Salary Structure

It is no easy job to set pay levels, which is why this category came in fifth on HR professionals' list of compensation situations. It was a particular problem among financial, banking, and insurance firms, as well as manufacturing concerns.

One sticky issue is making sure there is uniformity among employees at the same level or even in the same job title. "Internal equity is an issue—a consistency in evaluating jobs across the organization. We are addressing this by researching alternative job evaluation methods and are considering implementing a new process," said the compensation analyst at a 2,300-person manufacturing firm in the South.

Interestingly, many companies found that their employees fell below the minimum of the pay range. However, not every organization had the money to grant large enough raises to bring up too-low pay levels. "Our biggest problem was how to move people through a pay range with a conservative merit budget. We resolved it by only moving pay if the duties and responsibilities are changed substantially," said the compensation manager at a Northeastern publishing firm with 1,421 employees. Working without pay levels, ranges, and salary structure can also be difficult, as attested to by several HR professionals.

Bonus and Pay for Performance

With the increased emphasis on bonuses instead of pay raises, some HR professionals had their work cut out for them. "The biggest problem has been the transition to the new bonus program. We resolved it by providing detailed communications to employees," said the manager of compensation and benefits at a 1,379-employee manufacturing firm in the Northeast.

Whether a bonus program is new or old, two consistent problems are getting employees to understand it and getting managers to follow the guidelines. Both require plenty of communication with employees at all levels. "With our variable pay programs, we refocused on efforts on goal setting, clearer metrics, and automated payout software to administer," said the compensation analyst at a Western wholesale/retail trade company with 39,323 employees.

In some cases, the trouble was finding the money for a bonus program. "Our problem was the funding of our management incentive plan. This was the first time that we needed to consider fully funding the payout pool. The funding decision was deferred for several weeks until more year-end financial data was available. This resulted in executives having shorter turnaround times to recommend bonuses. However, bonuses were paid on schedule," said the compensation analyst at a Midwestern financial firm with 2,257 employees.

If there is little or no money for incentive pay, companies struggle to keep morale from hitting bottom. "We have not paid incentives in two years. We are communicating about our competitive base pay position and educating on the financial links between performance and incentives," said the senior vice president at a 7,800-employee financial firm in the Northeast.

New Compensation Plan

Quite a few organizations were struggling through the growing pains of enacting a new compensation program. Most of the time, it came as the result of a buyout or merger, and a new plan was formed to encompass the new entity. This was the case at a 4,100-employee manufacturing firm in the Northeast. "We are bringing together disparate compensation philosophies after an acquisition. We resolved it through the development of a phantom stock plan and working with individuals to manage the pay transition," said the HR director.

In other cases, companies revamped an existing program or started fresh when the old one was found to be too flawed to work any longer, or, as one manufacturing firm found, the old pay plan no longer functioned in a poor economy. "We had ongoing discussions with managers and employees on changes in compensation philosophies, practices, etc., necessitated by poor economy/financial results," said the HR manager, whose company of 5,500 people is in the South.

Retention and Recruiting

Even in this sluggish economy, retention and recruiting are still concerns. Organizations may want certain individuals, but they are unwilling or unable to pay a great deal for them. "We need to recruit strong talent without spending significant amounts above what we believe is fair for the positions," said the vice president of HR in a Southern firm.

Sometimes the economy makes retention an issue. With forced salary freezes, fewer bonuses, and other pay problems, employees' morale is on the downslide. "With the institution of a wage freeze, we have experienced general morale issues among staff, which further results in retention issues of key talent. Performance management has also lost its focus," said the compensation analyst at a Northeastern retail firm with 14,200 people.

Sales Personnel

Sales personnel have always presented their own special set of difficulties. Balancing the right formula of base versus commission is an eternal issue. For some, it was a matter of finding the right percentage for commission. For others, it was how to handle sales positions in a poor economy. "The sales force is on commission plus base. All sales are paid the same hourly rate, but where they make their money is in sales commission. Retail sales have taken a drastic turn down since 9/11. It's hard to keep qualified long-term employees because of this. We started a bonus plan on a monthly basis," said the general HR manager at a 97-employee retail operation in the Northeast.

Other Concerns

Some of the other concerns mentioned include determination of who is exempt and nonexempt, dwindling stock plans, and employees who do not seem to realize that the economic boom is over for now. "Our problem is a weak market and many applicants with an expectation they could still command the higher strong-market salaries," said one HR director.

SETTING PAY RANGES

Pay ranges are a crucial component of the framework of compensation policies, but there is more than one way to create them. Companies need to create a range that achieves equity for the position and is appropriate for the organization's needs and characteristics. This was a topic on IOMA's Salary and Compensation Bulletin Board.

Establishing a Range

One visitor to the discussion group posted the following:

> Whether you're using a salary structure or some sort of market pay line to define your theoretical full-performance target pay, you're typically faced with the challenge of setting minimum pay ranges (and maybe pay maximums) to serve at least as the initial basis for determining entry-level and experienced-level pay relative to your minimum entry requirements.
>
> I know all the pretty much standard models and philosophies for setting pay ranges, most commonly as a set or variable percentage of the midpoint or market pay line, to recognize the anticipated complexity of the work and the amount of time it will take an average entry-level individual to progress to a level of full performance. My question is: Are there any other approaches or methodologies people are using to establish pay ranges—especially minimum pay ranges? Is that something that can in any way be derived from salary surveys, which would provide at least the appearance of a good empirical basis for setting pay ranges? What about any other approaches?

One responder to this post stated: "In my practice, I always work on setting up midpoint and range spread first and then use formulas for the minimum and maximum."

Entry Rate

Jim Brennan, of Brennan Thompson Associates, a compensation consulting firm based in Chesterfield, Missouri, suggests using the entry rate as a base for setting pay ranges:

> It is either reported by many surveys or able to be simply/swiftly calculated by application of the compound interest formula for current values projected to future values that applies to salary increases. The variables are: number of years from

> minimum entry level to average "journeyman" incumbent status and net rate of increase after the market movement each year. One then solves for either the market entry or the fully qualified journeyman "midpoint" target using the other as another variable. It is actually a basic time-value of money computation. If tomorrow's market norm for a journeyman will be $50,000 and that represents *X* number of years in which one gets an average merit increase that exceeds the market structure movement by, say, 3%, then the current entry rate must be *Y*.

Brennan continued: "Fixing the range at the minimum, one can more easily fix an accurate and market-appropriate entry rate (which tends to get lost in the conventional grade-range structures). And it's a lot easier to communicate the probity of an entry rate than a range midpoint; either it's the amount below which you can't find competent candidates or the minimum amount required to permit a proper progression in the average number of years from entry to fully qualified status." Brennan added that this approach will keep pay levels competitive, thus improving retention.

> Another big bonus/plus of entry-rate systems is that they are more durable than market-average-equals-midpoint approaches. Frequently, layoffs in a profession nationwide mean that market averages increase (because everyone has laid off their junior incumbents and only kept the older, higher-paid ones) despite entry rates remaining flat or even declining. And the opposite can happen in a thriving market: The market average/midpoint remains flat due to promotions drawing high-paids off the top, while rapid raises are required to keep scarce-skilled incumbents; although the market norm is flat, the entry rate will skyrocket in pace with actual supply-and-demand dynamics. Entry rates track these changes; midpoint systems miss them.
>
> The last excellent reason for using entry rate as your baseline foundation number is that it remains much more faithful to reality when applied for administration. Ranges tend to be built in one-size-fits-all style, which is patently ridiculous (junior accountants spend two years in their job, while senior technicians often spend 20 years, and the jobs are frequently in the same grade if they share the same midpoint). Using entry rates, you can classify jobs using identical current entry rates instead of ordinal labels like grades, which imply perpetual parity. For instance, "these are all currently $24,000 entry jobs," instead of "these are all Grade 12 jobs." Next year, they may both be "$25K jobs" or one changes to a $24,500 and another becomes a $26,000 entry job. Parity lasts only as long as the entry rates match. The only other component in the classification is the average incumbency period, where the junior accountant may have two years to go up or out, while the senior tech may expect to rise slowly but steadily for a dozen years from the common initial entry point. This clearly communicates a consistent and market-accurate norm point (the ever-escalating entry rate) that moves provably per the market and where no one has to look up an ever-changing table to discover what a job is worth and what one should be paid for normal merit progression. Overall, entry rate is a much more sensible baseline point than the market weighted average or median.

The Response and a Consideration

The person who first posed the question noted that this approach of using the entry rate is one that he considered at his organization: "We're considering whether there are sufficient commonalities to the work roles that we've associated with a particular market pay line that maybe the entry requirements are sufficiently similar that we could 'generalize' the entry pay rate to a variety of work roles, rather than trying to grind out entry rates for each separate role."

RESOLVING GENDER-BASED PAY GAPS

"Everywhere but here" could be the motto of most HR professionals when it comes to gender-based pay gaps. The overwhelming majority believes that such gaps exist in the general business world, but only a fifth think that such gaps can be found within their own company. This is the finding of an exclusive IOMA study, which surveyed several hundred HR professionals to find out what they believe about a gender-based pay gap. "Attitudes and mind-sets must change. Job assignments must be made without stereotypes," said an HR manager at a 400-employee manufacturing firm in the West.

Interestingly, there is a gender-based difference of opinion when it comes to pay gaps; far more women than men believe it exists. Overall, 87% of HR professionals say there is a gender-based pay gap in other companies. When it comes to their own companies, both male and female HR professionals maintain their denials: only 20.3% believe such a gap exists within their own organization.

Company Size

Breaking it down by size of company, HR professionals in the larger firms find more examples of gender-based pay gaps (see Exhibit 4.8). Of those who feel gaps exist in their company, nearly a third work at a large organization (those with more than 7,000 people), compared with 15.8% of those at midsize firms (those with

Exhibit 4.8 Perception of Gender-Based Pay Gap, by Company Size

		0 to 199	200 to 599	600 to 1,799	1,800 to 6,999	7,000 & over	Overall
Within your company							
	Yes	20.3%	22.6%	15.8%	20.7%	28.1%	20.3%
	No	79.7	77.4	84.2	79.3	71.9	79.7
Male	Yes	12.2	22.9	10.9	15	16	14.9
	No	87.8	77.1	89.1	85	84	85.1
Female	Yes	23	22.1	20.8	23.9	37.5	22.9
	No	77	77.9	79.2	76.1	62.5	77.1
At other companies							
	Yes	91.2	92.9	84.3	87.8	77.1	87.0
	No	8.8	7.1	15.7	12.2	22.9	13.0
Male	Yes	81.1	96.4	89.2	86.2	78.3	85.5
	No	18.9	13.8	3.6	10.8	21.7	14.5
Female	Yes	96.6	88.9	90.7	79.5	76.0	87.3
	No	3.4	11.1	9.3	20.5	24.0	12.7

600 to 1,799 people) and 20.3% of those at the smallest companies (those with up to 199 employees).

When it comes to a gender-based pay gap at other companies, 91.2% of HR professionals at small companies felt it existed, as did 92.9% of those at firms with 200 to 599 employees. HR pros at the largest organizations were the least likely to think that a pay gap exists in general, at 77.1%.

By Industry

Most HR professionals in the nonprofit field (91.2%) believe there is a gender-based pay gap at other companies. Interestingly, 100% of male respondents working at nonprofits feel that a gap exists at other companies, compared with 71.4% of female survey respondents.

Male and female HR professionals in the nonprofit field agree the most that a gender-based pay gap exists within their organization. Here, 27.3% of men and 20.6% of women agree. The results are similar in manufacturing: 27.8% of women feel it exists in their own firm, as do 20% of the men.

What Can Be Done: The First Steps

"The gaps should be validated against established criteria. If there is no justification for the gap, then it should be addressed with out-of-sequence increases to remove the gap. However, the senior management team must support the change, which I don't think will happen in many organizations," said a compensation supervisor at a 3,000-employee wholesale firm in the South.

That is part of the key to the whole situation. Not only does the problem have to be identified, but also little, if anything, can be done about it if senior management does not buy into the process. Again and again, HR professionals said that upper management had to play a major role in the change—and that too many refused to acknowledge when there is a gender-based pay gap. As one HR vice president explained, "It takes a top-down approach. The problem is that the 'top' is all men."

Assessing Experience and Pay

Most HR professionals said that the problem of a gender-based pay gap would disappear if management focused on paying for experience and ability. Again and again, the solution cited was to review the job requirements and then compare the employee's education, experience, and skill—without even considering gender. Current salaries should be compared to market data, based on the company's location, size, and industry. The vice president of HR at a health care company in the Midwest put it bluntly: "Identify what the job is worth to the company, then pay accordingly, regardless of gender. It doesn't take a brain surgeon to figure this out."

Closing the Gap

Once a gender-based pay gap is identified, the majority of HR professionals said it could be closed through pay corrections; that is, increase the female employee's pay gradually until it is equal to the male's. Some suggested it might take only one to two years, while others said it could take five years to phase in raises.

Both waiting five years to close the pay gap and doing it immediately can create new problems. It can be a financial shock to a company to suddenly offer several female employees much more compensation than they were paid the year before. However, drawing it out over many years may demoralize the female employees; though they might be receiving hefty raises, the whole process could be taking too long, and they may leave.

Ignore Salary History

One trap that many companies fall into is basing an employee's salary on his or her previous salary. Often, when employees are hired, they are asked to provide a salary history. If a woman had a low salary at her previous job because of gender discrimination, a new company that bases her next paycheck on this rate will simply be perpetuating the problem. "A company should make sure all future hires' salaries are based strictly on responsibilities and experience," said the HR director at a nonprofit in the Northeast.

At one company, a 3,000-employee financial organization in the Northeast, low starting pay is precisely what has created a gender-based pay gap. "We have been making some progress but not much. The gender bias resulted from entry salaries, and our current procedures don't allow for wholesale adjustments," said the HR division chief.

Ignoring an employee's job history is easier said than done; many companies use this as a strong measure of what they should offer as a starting salary. "When and where possible, an equalization should be made. However, I still think you need to take education, experience, salary history and market conditions into consideration," said the vice president of HR of a 1,500-person wholesale/retail firm in the South.

Educating Others

On top of everything else, some HR professionals are trying to help others overcome their biases. For example, a 1997 study by Catalyst on gender-based pay gaps found that some managers and supervisors still felt that women were not primarily breadwinners and thus did not have to be paid equally. This is counterintuitive to the growing number of single-parent households that are headed by women. Even in two-income households, women earn more 22.7% of the time, according to the Census Bureau. Regardless of the statistics, it is not up to a manager to decide who should earn more within a family.

Companies need to be aware of whether they have any gender-based pay gaps for another reason: fines. "One should determine individuals affected. You will need to also ascertain the maximum length of time the federal government would go retroactively for penalties and use this same time frame as the period for retroactive salary corrections," said a compensation analyst at a Southern health care firm with 1,000 employees.

Not everyone thinks that the law provides a sufficient solution. "Legal mandates are not the answer," said the director of compensation and benefits at a Northeastern nonprofit with 2,060 employees. "The education of upper management to the negative effects of disparity, along with 'group complaints,' may be more effective and less damaging."

In some companies, women are earning less, but mainly because they have lower-paying positions. "In my company, it seems that men have the top jobs but more women are reaching the executive level. However, within the specific jobs, I don't see much disparity. In our situation, maybe establishing a formal mentoring program or making an effort to identify strong female performers" would help to rectify the situation, said the compensation analyst at a financial firm in the North Central region.

Indeed, a variety of studies on general gender-based pay gaps find that women earn less because they are in lesser-paying jobs. Women are not moving up the ladder to leadership because they are not mentored or because they are in jobs that do not usually lead to higher-level positions.

CHOOSING THE BEST SALARY STRUCTURE

Salary structures are the backbone of compensation programs and the crux of your company's pay philosophy. Fortunately, there are many options to choose from when it comes to designing a pay structure, but it is not always easy to determine which one is best for your organization. Gregory A. Stoskopf, senior manager at Deloitte Consulting, says that the role of HR in creating a salary structure is changing. HR professionals are moving away from their traditional roles as administrators and acting more like consultants. With this change, it is even more important for HR professionals to understand the pros and cons of various pay structures.

Why Does It Matter?

Selecting a salary structure that suits your organization is crucial, because it can either support or inhibit the achievement of the organization's strategic compensation, human resources, and business goals and objectives, according to Stoskopf. A salary structure that is a good match can have a tremendously positive effect on an organization. It can increase the ability to attract and retain talent, allow the firm to be competitive in pay, provide more flexibility in moving people internally to meet organizational needs, and control costs.

An effective salary structure creates more flexibility for managers to reward performance and skill development by providing salary ranges that are wide enough to accommodate market ranges. A poorly designed salary structure is narrow, rigid, and restricts a manager's ability to reward.

A salary structure should also reflect the pay philosophy of an organization, said Stoskopf. To do this, companies must decide where they want to stand in terms of the market: Are they at the 50th percentile or the 25th? Even once this is established, organizations should review salary data once or twice a year to ensure that their pay levels remain where they were set. Likewise, firms should consider their total compensation target, which includes bonuses and incentives. "Too often, people are concerned that the salary structure will prohibit them from being competitive. But it should help—the theory is that there is a limit per job and the salary structure [provides] the appropriate range and prevent[s] over-paying," said Stoskopf. Organizations with grades that are too close render promotions nearly meaningless. However, a large gap between grades is also undesirable, as it creates too great a difference between jobs.

Options

There are several options to choose from. The most widely used pay structures are:

- Traditional structures
- Broadbands
- Market-based ranges
- Step structures

Traditional salary structures consist of ranges of 20% to 40%, with a midpoint progression of 5% to 10%. An estimated 75% to 80% of companies use this type of structure, according to Mercer HR's *Policies and Practices* survey. The narrow spreads allow companies to control variances in rates paid for jobs within the same grade, and also encourages internal equity. The disadvantage is that the narrow range makes it difficult to pay critical skills within salary ranges and can cause top performers to hit the top of the pay scale too soon. This means that managers can find it difficult to reward performance—they may feel pressured to promote people just so they can give them a raise.

The traditional structure, according to Stoskopf, is best suited for:

- Companies that need to control costs or internal equity
- Companies with a large number of incumbents in the same job
- Banks, insurance firms, manufacturing, health care, and nonprofits

Broadbanding is another type of salary structure that peaked in popularity several years ago and then fell out of favor as some companies struggled with it. Though it still can be a good fit for some, only about 15% of firms use it now. Broadbands typically consist of range spreads of 80% to 120%, with midpoint progressions of 20% to 25%.

On the plus side, broadbanding creates flexibility by having wide ranges to tie pay to the market and reward performance. The structure makes it easier to move employees among jobs, with less focus on job grades, possibly resulting in fewer requests for promotions or job reevaluations. The downside is that the broadbands may be so wide that it becomes necessary to develop zones within the bands—which makes it look more like a traditional structure. It also requires more complex and sophisticated compensation planning, and is more difficult for line managers to administer.

Organizations best suited for broadbands:

- Value flexibility over control
- Have little time or desire to make fine distinctions between jobs
- Are startups, professional service, and tech firms

Market-based structures have ranges of 30% to 70%, with midpoint progressions of 10% to 15%. The ranges encompass the 25th, 50th, and 75th percentiles of the market.

On the positive side, market-based structures both allow the flexibility to recognize differing market rates of pay based on performance, skill level, or market conditions and also maintain control over costs and internal equity, according to Stoskopf. Companies using this structure could also make use of pay for performance to reward top performers. The downside to this structure is that it can require more frequent market analysis to ensure that ranges are aligned with the market.

Organizations that would benefit from a market-based structure include:

- Those with resources to fund competitive salary rates, a desire to differentiate level of skill and performance, and the need to attract and retain top talent
- Financial services, pharmaceuticals, and professional services firms

Step salary structures have range spreads of 20% to 40%, with midpoint progressions of 5% to 10%. The ranges are divided into an equal number of steps, either by dollar amounts or constant percentage progression. This structure is easy to administer and automate, with predictable compensation costs, according to Stoskopf. There is a limit on the ability to reward performance with pay, however.

Organizations best suited for market-based structures include:

- Those with limited merit budgets and little ability to distinguish high and low performers
- Health care, nonprofits, and governments

Case Study

The Reading Hospital & Medical Center (Reading, Pennsylvania) currently uses a step structure for its registered nurses, nurse managers, and all nonexempt positions, according to Sharon Albright, who is the compensation manager. The hospital is facing a shortage of nurses and a very competitive environment for attracting and retaining the nurses it needs. The top step of the nursing salary structure falls slightly above the market median, and has a range of 25% to 30%.

In the hospital's situation, the step structure makes it difficult to compete for the "hot skills" employees in jobs such as nursing, particularly when those nurses are top performers or have critical skills. Pay for performance is also not part of the structure. As a solution, the hospital is implementing a market-based structure with wider ranges that allows more competitiveness and flexibility. The range midpoints will be based on a market median and pay increases will be based on performance rating and a merit matrix.

The new structure will take approximately six months to put into place, said Albright, and will take effect this summer. "So far, it's been well-received, especially among top performers."

Real-life examples have shown that companies need to allow sufficient time for new salary structures to be implemented, according to Stoskopf. Companies should conduct a cost analysis to estimate the cost of implementing a new structure, train managers on the new system, and communicate with employees about the changes. Companies that intend to keep their current structures in place should still do a market analysis every two to three years and adjust their structures if necessary, said Stoskopf.

Chapter 5

401(k) Plan Costs

CONTROLLING 401(K) PLAN COSTS

To control plan costs, 401(k) managers are still taking an active role in monitoring service providers. Rather than changing providers, though, as they tended to do last year, 401(k) plan managers' favorite approach is to keep their existing providers and renegotiate fees with them. A sizable 40% of the survey respondents listed renegotiating service provider fees as their most successful 401(k) cost-control technique (see Exhibit 5.1), according to an IOMA survey. This was up from the 32.8% who cited it the prior year.

As the plan administrator at a nonprofit firm told us, "High participation rates plus high contribution levels lead to high plan balances and high average account balances." That, in turn, allowed this 520-employee firm in New York to negotiate lower fees with its service providers.

"We were able to negotiate lower fees and revenue sharing arrangements with our third-party administrator and vendors," added a large government entity from Texas. "When we renew contracts, we do industry comparisons and either renegotiate it or send out a request for proposal. Revenue shares [i.e., for 12-b1 fees, which some fund companies levy to pay for marketing, etc.] from vendors are given back to the participants. This year," the benefits manager noted, "vendors opted to renegotiate their agreements, giving us better deals, which also saved the state time and money not having to go through the RFP process."

Coming in second on the cost-control effectiveness scale was changing recordkeepers, investment managers, and consultants. Nearly 33% of sponsors overall cited this as their most effective strategy, slightly less than last year's first-place response of 33.5%. "We switched to a new fund company with an overall reduction in fund expenses and a better plan and improved Web site access for participants," noted a small private-practice firm in Minnesota. A 544-employee finance company in Washington, D.C., went through the RFP process and changed recordkeepers, moving from Putnam to Vanguard. "Vanguard is less expensive," the HR manager told us.

Web-based changes occupied the third and fourth places for most successful cost-control strategies and tied for fifth place, according to the survey results. Web-based investment education (25.5%) came in third, Web-based loans (23.6%) fourth, and Web-based plan enrollment and charged/changed loan fees to participants tied for fifth place (22.7%).

A restaurant chain in Pennsylvania cited the value of implementing Web-based changes. "Our participants now complete all activities through the Internet," the human resources manager stated. "We moved our plan to a new provider with lower costs and better account performance. This greatly improved service and

Exhibit 5.1 Categories in which 401(k) Plan Sponsors Have Had the Most Success in Controlling 401(k) Plan Costs during the Past Two Years, by Number of Participants

	Up to 99	100 to 299	300 to 1,499	1,500 & up	Overall
Renegotiated service provider fees	27.3%	24.0%	50.0%	48.6%	40.0%
Changed recordkeepers, investment managers, consultants, etc.	63.6	20.0	34.4	35.1	32.7
Web-based investment education	0.0	32.0	25.0	27.0	25.5
Web-based loans	0.0	20.0	28.1	27.0	23.6
Web-based plan enrollment	9.1	20.0	31.3	21.6	22.7
Charged/changed loan fees to participants	18.2	8.0	37.5	21.6	22.7
Switched to a bundled service provider	27.3	20.0	15.6	27.0	20.9
Web-based deferral charges	9.1	20.0	15.6	27.0	20.0
Web-based investment charges	18.2	20.0	15.6	18.9	17.3
Set up plan to control number of loan requests	18.2	12.0	12.5	18.9	14.5
Charged recordkeeping fees to plan	27.3	4.0	18.8	13.5	13.6
Used index funds	18.2	16.0	18.8	8.1	13.6
Adopted a safe harbor designation plan	36.4	8.0	9.4	13.5	13.6
Reduced matching contributions	9.1	24.0	6.3	10.8	12.7
Switched to institutional funds (separate accounts)	18.2	4.0	12.5	10.8	10.9
Charged trustee fee to plan	9.1	8.0	12.5	10.8	10.0
Charged investment management fees to plan	45.5	4.0	3.1	8.1	9.1
Instituted automatic enrollment	9.1	12.0	0.0	13.5	9.1
Shifted QDRO costs to employees	0.0	4.0	6.3	16.2	8.2
Unbundled service provider	36.4	4.0	3.1	2.7	6.4
Negotiated performance-based contracts	9.1	8.0	3.1	8.1	6.4
Added/expanded company stock option in 401(k) plan	0.0	4.0	0.0	2.7	2.7
Shifted audit fees to plan participants	0.0	4.0	3.1	0.0	1.8
Went with front-end load funds	9.1	0.0	0.0	0.0	0.9
Other	9.1	12.0	21.9	16.2	16.4

administration. Internal administration time was reduced." "We used Web-based capability to reduce human resource administrative time to make changes for employees as well as improving consistency of educational information," added the CFO of a 200-employee manufacturing company in New York.

Tweaking loan charges also had an impact on the bottom line. "Loan fees were switched from company paid to participant paid," the benefits manager at a large manufacturing company in Illinois said. "We were the low-cost place to borrow, as all origination fees and maintenance fees were being picked up by the company. *Impact on the bottom line*: $100,000 in annual savings."

At a financial banking firm in Texas, the approach was slightly different. "We restricted the number of active loans that a participant may have at one time," the firm's benefits manager told us. "The employee pays for the loan origination fee." The result was a 50% decrease in loan volume.

Companies with 300 to 1,499 participants (50%) and those with 1,500 participants or more (48.6%) were most likely to renegotiate service provider fees. About 25% of smaller firms also exercised this option, all wanting to fulfill their fiduciary responsibility to ensure that fees and expenses paid by their retirement plan are reasonable.

Smaller companies with up to 99 plan participants were most likely to change recordkeepers, investment managers, or consultants (63.6%), a percentage that beat other size firms by either a three-to-one or two-to-one ratio. Smaller firms were also far more likely than their larger counterparts to charge investment management fees to the plan (45.5% versus the 3.1% to 8.1% of other size companies). In addition, they led the field when it came to adopting a safe harbor designation plan (36.4%) (see Exhibit 5.1).

"The implementation of a safe harbor match will eliminate the need for nondiscrimination testing (ADP test)," one benefits analyst from the Midwest stated. "Currently our highly compensated employees are limited to a 7% contribution. The new safe harbor match will eliminate monitoring highly compensated employee contribution rates (other than the plan limit)." Added a human resources assistant from Maryland, "Our safe harbor plan design has eliminated the need for additional consulting help and associated fees and reduced the staff time necessary to monitor and remedy discrimination test issues."

Firms with 100 to 299 participants, meanwhile, were most inclined to use Web-based education to keep a cap on costs (32%). They then looked to renegotiate service provider fees (24%).

Though most inclined to renegotiate fees and change providers, firms with 300 to 1,499 participants were far more likely than any other of their counterparts to charge or change loan fees to participants (37.5%).

TIGHTENING OVERSIGHT

Motivated, no doubt, by heightened government and public scrutiny of 401(k) plan management in the wake of recent financial scandals, plan sponsors are now monitoring investment performance more carefully and scrutinizing fees more closely than they have in the past, according to Deloitte Consulting's *Annual 401(k) Benchmarking Survey*, conducted by the Human Capital Total Rewards practice of Deloitte & Touche. "We expect this trend to gain momentum following recent trading misconduct activities by some prominent investment management organizations," notes Leslie Smith, director of the annual survey and a director in Deloitte's Total Rewards practice. "While few employers were asleep at the switch, it appears that their attention has been concentrated by recent events, which is a positive development," she adds.

Last year, for example, 47% of survey respondents benchmarked investment performance on a quarterly basis. This year, 55% do so. In addition, the number of surveyed employers that consider their plan fees "competitive" dipped to 83%, from 87% last year, suggesting that employers may be applying tougher standards in this area.

Survey respondents also appear to be more concerned about whether employees are equipped to benefit fully from their 401(k) plans. This is suggested by the finding that 12% more employers offer customized participant communications as opposed to generic programs. Use of customized communications has risen 25% since 2001, the year that the stock market and the economy went into sharp decline. "Clearly, employers are trying to do more to ensure that employees understand their options and are using their 401(k) plans appropriately," says Joe Kelly, a Deloitte principal and national leader of the Total Rewards practice. "This is not surprising, considering that even with [the recent] healthy stock market performance, most participants haven't recouped losses sustained in the equity portion of their 401(k) portfolios since 2000."

Nevertheless, the survey suggests that 401(k) participants have settled down in the wake of recent financial scandals and volatile equity market performance. Overall participation rates for the survey base were unchanged from 2002, hovering around 75%. "These steady enrollment figures show employers have met the challenge of keeping employees focused on investing for the long term," says Smith.

Employers overwhelmingly (96%) believe that participants are satisfied with their plans' investment options—up from 93% last year. But, perhaps consistent with the trend toward tougher scrutiny of plan performance by sponsors (see Exhibit 5.2), the proportion of employers expressing satisfaction with plan investments this year was seven percentage points below that of employees. "Even more interesting," notes Smith, "is that while 96% of the plan sponsors believe their participants are satisfied with the plan's investment options, 64% report that they made changes to their fund offerings this past year."

Exhibit 5.2 Employer's Approaches to Underperforming Funds

How do you handle an underperforming fund?	
Continue to monitor	53%
Replace fund	51
Phase out fund over a period of time	18
Hasn't happened	17
Freeze fund (no incoming money)	13
Other	4

When was the last time you replaced a fund due to poor performance?	
Never	32%
Within the past year	29
One to two years ago	14
Two to five years ago	20
Five or more years ago	5

Source: Deloitte Consulting

Fees

In general, the survey found, most 401(k) plan fees are paid by the company, with the exception of investment advice, investment management, loans, and other fees such as distribution, self-directed brokerage, and withdrawal fees. Fifty-seven percent of plan sponsors pay the recordkeeping and administration fees from company funds; approximately 24% charge these fees to the employees, whether as a line item on their statements or as a reduction to investment returns. Eighteen percent report that there are no direct recordkeeping and administration fees (see Exhibit 5.3).

Participant Communication

Customized communications, the survey found, are becoming increasingly popular, as employers try to vary communication to reach participants more effectively. In fact, 83% of those participating (a 12% increase from last year) said they offer customized communications for their plans; 42% offer generic communications programs and 42% offer personalized communications programs. Thirty-five percent say their program targets specific employee groups.

Meanwhile, the proportion of plan sponsors offering financial counseling/investment advice remained steady at about 40%. According to most plan sponsors, less than 25% of participants use the available advice services, and less than 30% of participants using the investment advice services actually acted on the recommendations they received.

Enrollment meetings remain the most effective means of increasing plan participation (21%), followed by a company match to the plan (14%) (see Exhibit 5.4).

Exhibit 5.3 Plan Fees—Who Pays?

	Company Pays Fee	Employee Pays Fee by Direct Charge	Employee Pays Fee by Reduction to Investment Return	No Fee	Service Not Used
Recordkeeping/administration	57%	8%	16%	18%	0%
Audit	84	4	7	3	2
Investment advice	28	5	5	18	45
Investment management (Other than normal fund operation expenses)	37	4	20	19	20
Legal/Design fees	86	2	5	6	2
Communication	62	3	8	27	1
Trustee	59	4	14	20	3
Consultant fees	69	2	6	10	13
Loan fees	8	71	8	7	6
Other	19	16	10	15	39

Source: Deloitte Consulting

Exhibit 5.4 What Was Your Most Effective or Original Strategy for Increasing Participation?

Enrollment meetings	21%
Company match	14
Auto-enrollment	12
Education	9
Targeted campaigns	8
Plan provisions	5
Good participation	5
Written communications	4
Passive/negative enrollment	3
Under investigation	2
Other	13

Source: Deloitte Consulting

Automatic Enrollment

Fifteen percent of plan sponsors surveyed have implemented automatic enrollment in their plans—a small (approximately 2%) increase over the past two years. Ten percent of respondents are considering adding this feature, while 1% have discontinued it. Key reasons for discontinuing the automatic enrollment program include: cost of providing match to disinterested employees, cost of administering small account balances, inability of the recordkeeper to accommodate the feature, and incompatibility with newly merged plans.

"The good news," notes the survey, "is that automatic enrollment works! More than two-thirds (71%) indicated that participants typically maintain the designated default rate, while 24% choose to increase their default rate. Only 5% choose either to opt out of the plan (3%) or to decrease their default election (2%)." Ninety-seven percent of plan sponsors that offer automatic enrollment are satisfied with this feature.

Additional survey findings include:

- Twenty-four percent of plan sponsors offer their participants automatic fund rebalancing, making it more convenient for them to maintain their target asset allocations.
- Account aggregation (the ability for participants to see their account balances in other employer-sponsored plans, outside investment funds, bank accounts, etc., through their 401(k) provider's Web site) is a feature offered by 29% of the survey respondents, and another 7% are considering it. Interestingly, 52% are not offering account aggregation because it is unavailable from their providers.
- More employers are offering both fixed and discretionary components to their matching contributions.

- A trend toward easing participation eligibility restrictions based on employment tenure and age remains in full force.
- Participant use of the Internet to access plan information is rising rapidly.

JUDGING THE SUCCESS OF THE 401(K) PLAN

How effective is your 401(k) plan? To help evaluate the strength of your plan, Roger Gray, head of client services for Scudder Retirement Services, provides some key comparison benchmarks. This section discusses the critical benchmarks that Gray culled from the Profit Sharing/401(k) Council of America's (PSCA) 46th Annual Survey, as well as his own experience with plan sponsors.

Plan Participation

More than three-quarters (80.3%) of eligible employees participate in a 401(k) plan when given the option (see Exhibit 5.5). Smaller plans have better participation rates overall than do larger ones, the PSCA survey showed, lending credence to the impact a more personal touch can have.

Highly compensated employees, Gray noted, who can better afford to make contributions and have more need for tax shelters, are significantly more likely than nonhighly compensated employees to participate in an employer-sponsored savings plan. In addition, he noted, participation rates tend to vary by industry, with the finance industry reporting the highest rate. Companies in the manufacturing and retail arenas, meanwhile, struggle more for participation.

Participant Contributions

For the most part, employers typically offer 401(k) plans on a pretax contribution basis only. According to PSCA data, on average, about 74% of 401(k) plans are designed this way, followed by about 19% that offer plans allowing both pretax and after-tax contributions (see Exhibit 5.6).

Exhibit 5.5 Rate of Employee Participation by Plan Size for 401(k) Plans

Plan Size by Number of Participants	Participation Rate
1–49	88.2%
50–199	83.0
200–999	80.5
1,000–4,999	70.9
5,000+	72.8
All plans	80.3

Source: PSCA, *46th Annual Survey of Profit Sharing and 401(k) Plans*, 2002

Exhibit 5.6 401(k) Plans Permitting Participant Contributions by Tax Basis and Plan Size

	Plan Size by Number of Participants					
Tax Basis for Participant Contribution	1 to 49	50 to 199	200 to 999	1,000 to 4,999	5,000+	All Plans
Pretax basis only [401(k)]	80.4%	80.9%	76.9%	65.5%	49.6%	73.8%
After-tax basis only [401(m)]	0.0	0.4	0.4	0.6	0.0	0.3
Both pretax and after-tax basis	10.2	10.1	16.0	30.7	47.8	19.2
No participant contributions	9.4	8.6	7.2	2.2	2.6	6.7

Source: PSCA, *46th Annual Survey of Profit Sharing and 401(k) Plans,* 2002

Matches

Approximately 26% of all plans permitting participant contributions use a fixed-match basis, Gray told conferees. Meanwhile, discretionary profit-sharing contributions are used in 75.7% of plans. For plans with fixed matches:

- 27.9% use 50 cents per dollar up to the first 6 percent of pay
- 8.4% use 50 cents per dollar up to the first 4 percent of pay
- 7.1% use 25 cents per dollar up to the first 6 percent of pay

As for frequency, matching provisions are most frequently made on a payroll period basis (56.5% of plans reporting in the PSCA survey). Gray advised attendees to remit matching contributions to providers as quickly as they can: "This is a big audit buster," he warned.

Vesting Schedules

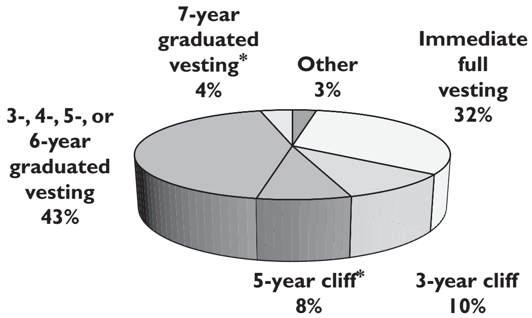
By law, Gray noted, all employee contributions to a 401(k) plan are vested immediately. However, the dominant vesting schedule for employer contributions to a 401(k) plan is five-year graduated vesting (see Exhibit 5.7). "At Scudder," he said, "we have seen plan sponsors getting more generous with their vesting." More, he added, are moving to a three-year graduated schedule.

Asset Class Distribution

As shown in Exhibit 5.8, actively managed domestic equity funds are the most prominently used investment in 401(k) plans, totaling 28.1% of holdings. These funds are followed by stable value funds, which hold 12% of plan assets.

Gray queried audience members as to their plans' usage of *lifestyle funds*, a premixed assortment of funds corresponding to a participant's age or investment

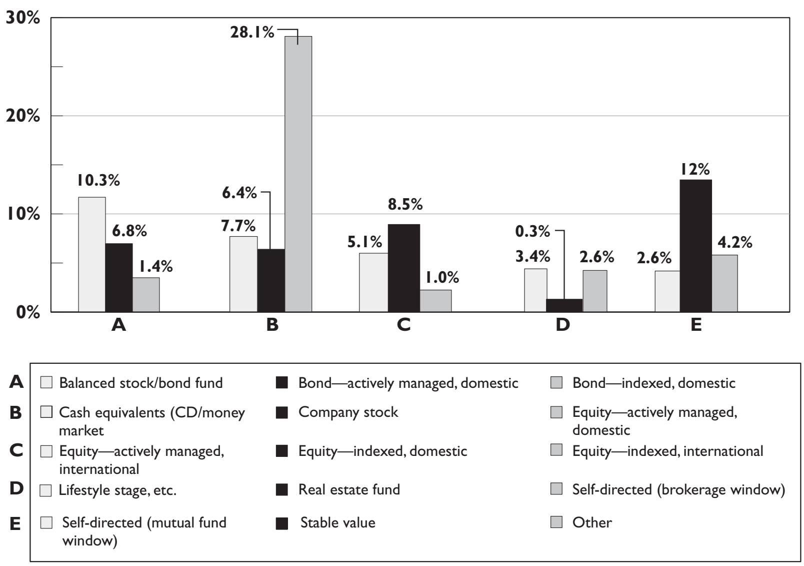
Exhibit 5.7 Vesting Schedule for 401(k) Employer Matching Contributions



*For plan years beginning in 2002. 5-year cliff and 7-year graduated vesting are no longer permitted in 401(k) plans.

Source: PSCA, *46th Annual Survey of Profit Sharing and 401(k) Plans*, 2002

Exhibit 5.8 Asset Class Distribution for 401(k) Participation Investments



Source: PSCA, *46th Annual Survey of Profit Sharing and 401(k) Plans*, 2002 style that takes the guesswork out of investing. PSCA tallies lifestyle funds as garnering only 3.4% of assets allocated, and many of those in attendance at the conference confirmed that they do not offer these funds. Of those that do, benefits managers explained that plan participants often invest deferrals in lifestyle as well as other funds, "completely diluting the purpose of lifestyle funds." However, one manufacturing company said it had had great success with these funds, getting a lot of usage from its plan participants. Gray noted that these funds are slowly growing in popularity and seem to be the wave of the future. "It's a great tool for the average person," he noted.

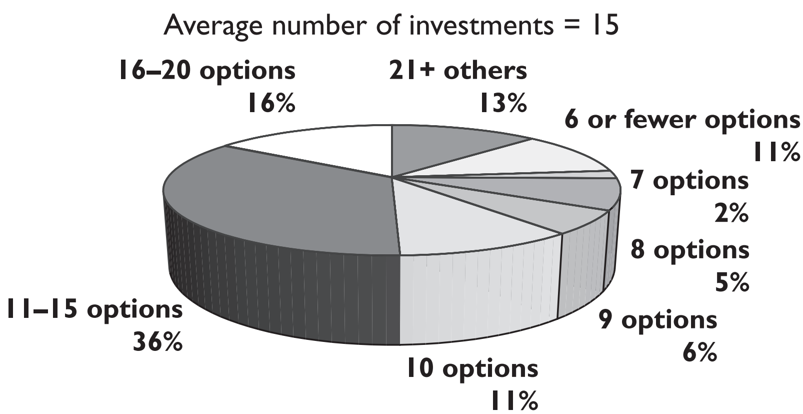
He also noted that sometimes sponsors offer a number of lifestyle funds to their plan participants. But in his view, three to five lifestyle funds is best. Otherwise, it is too confusing to participants.

As for self-directed brokerage accounts, plan sponsors that offered these accounts to their more sophisticated investors warned that they were seldom used. One sponsor with 200 participants noted that only 1 of its participants used such funds. For another plan, it was 7 out of 300, and for a third, only 1 out of 1,800. "Self directed brokerage accounts can be a solution for some plans," Gray said. "But you have to ask whether participants have the educational fortitude to use them or if you can educate them to do so."

Number of Investment Options

Funds being offered in 401(k) plans continue to increase, Gray said, citing more data from the PSCA survey. Nearly 81% of plans offer 10 or more funds for participant contributions, up from 69.8% that did so in 2001 and 61.5% that did in 2000. In fact, the average number of funds available to participants is now 15.3 (see Exhibit 5.9). However, Gray cautioned that when it comes to 401(k) fund of-

Exhibit 5.9 Investment Options Available in 401(k) Plans



Source: PSCA, *46th Annual Survey of Profit Sharing and 401(k) Plans*, 2002 ferings, "less is more." "One large cap growth fund is what you want to have, not two or three," he advised plan sponsors.

Replacing Funds

When sponsors replace a fund with another fund in the same asset class, how do they communicate the change? When Gray asked attendees this question, one sponsor revealed that it ran an extensive notification campaign, alerting plan participants to the change six months prior, three months prior, and then sending notification home to the employee and spouse two months prior to the change. If participants indicated no switch by the deadline, the sponsor then transferred funds from the old fund to the new fund that replaced it. Another plan sponsor sent a letter to participants 60 days before the fund was to be replaced. If participants did not make the transfer, the sponsor automatically made the switch for them to the new replacement funds.

Gray warned that sometimes sponsors fail to communicate to terminated employees when a fund switch is being made. One way to avoid this is to ensure that sponsors get the list of those to be contacted from the provider and not from payroll.

Waiting Periods

Gray noted that 90% of the respondents to the PSCA survey require a minimum waiting period before new employees are eligible to participate in the 401(k) plan. One year is the most common waiting period.

NEGOTIATING LOWER RECORDKEEPING FEES

Many sponsors have successfully negotiated both their recordkeeping and investment management expense ratios downward over the past few years. However, most experts now advise that sponsors not stop here—these fees should be negotiated annually. Indeed, with competition tightening in the recordkeeping business, many sponsors, particularly larger ones, have gotten further discounts on the fees they pay. When the recordkeeper also provides investment services, additional bargains can be obtained.

Investment Fees Fluctuate with Size, Type

When it comes to investment fees, expense ratios vary greatly depending on the level of assets, the category of investment, and whether the investment manager also is the plan recordkeeper. On average, plans pay 0.73% of their invested assets as expenses to investment managers, as can be seen from a CRA RogersCasey/IOMA study. This percentage is down slightly from the average 0.76% expense ratio paid the prior year, although John Flagel, director and chairperson of CRA RogersCasey's defined contribution practices committee, says the decrease is not indicative of what is happening in the marketplace. Rather, it is a result of a different sampling base in this year's survey from the one conducted in 2002.

Foreign Stocks Carry Highest Expense Ratios

There is a significant variance in the expense ratios by investment option category. The average expense on an international small-cap fund, for instance, is 122 basis points (see Exhibit 5.10). For fixed-income investments, however, money markets carry an average expense ratio of 42 basis points, stable value 37 basis points, and domestic bonds either 62 basis points (for active funds) or 34 basis points (for passive funds).

Domestic equity investments also carry varying average fees, with small-cap the highest at 103 basis points and large-cap the lowest at 78 basis points. U.S. equity index funds have an average expense ratio of just 31 basis points, according to the survey.

Greater Assets, Less Expenses

"As assets grow, generally, expense ratios go down," says Jeff Boyle, senior vice president of the Union Bank of California. The survey results clearly support that dictum. When $1 million or less is invested in a particular option, the average expense ratio is 0.91% of assets; when the investment rises to more than $100 million, the expense ratio is sliced in half, down to 43 basis points. If a plan invests $25 million or more in a domestic large-cap equity fund, the average expense ratio is 76 basis points; when less than $500,000 is invested into a large-cap fund, the cost goes up to 80 basis points.

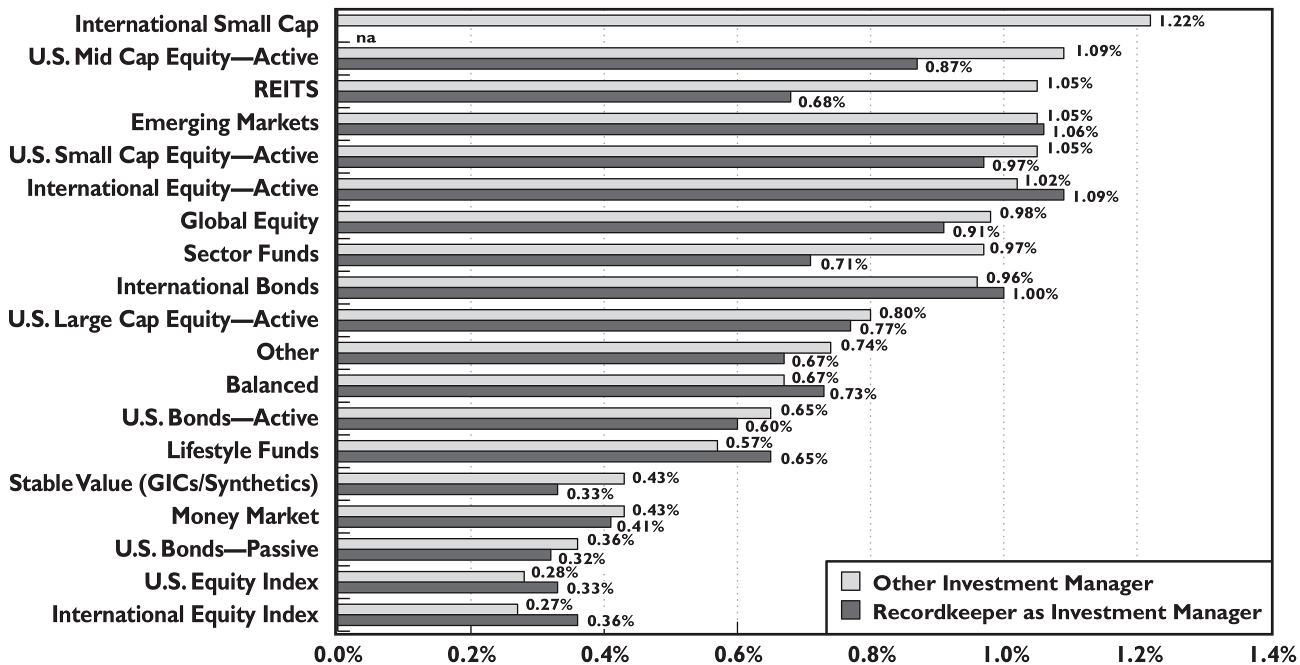
Retail mutual funds are typically more expensive than other investment arrangements. The average expense ratio for retail mutual funds, the survey found, is 82 basis points. For institutional mutual funds, the average is 67 basis points. For separate accounts, the average drops to 0.66% of assets, and for commingled accounts, it is 0.44%.

Recordkeeper Offers Best Fee Deals

Sponsors generally—but not always—can obtain lower fees when they also hire a recordkeeper to serve as their plan's investment manager. The survey found that for active domestic equity funds, U.S. bonds, stable value, money market funds, and sector funds, going through a recordkeeper results in lower expense ratios (see Exhibit 5.11). However, for emerging markets, international equity, international bonds, balanced funds, and lifestyle funds, recordkeepers do not always offer the lowest fees.

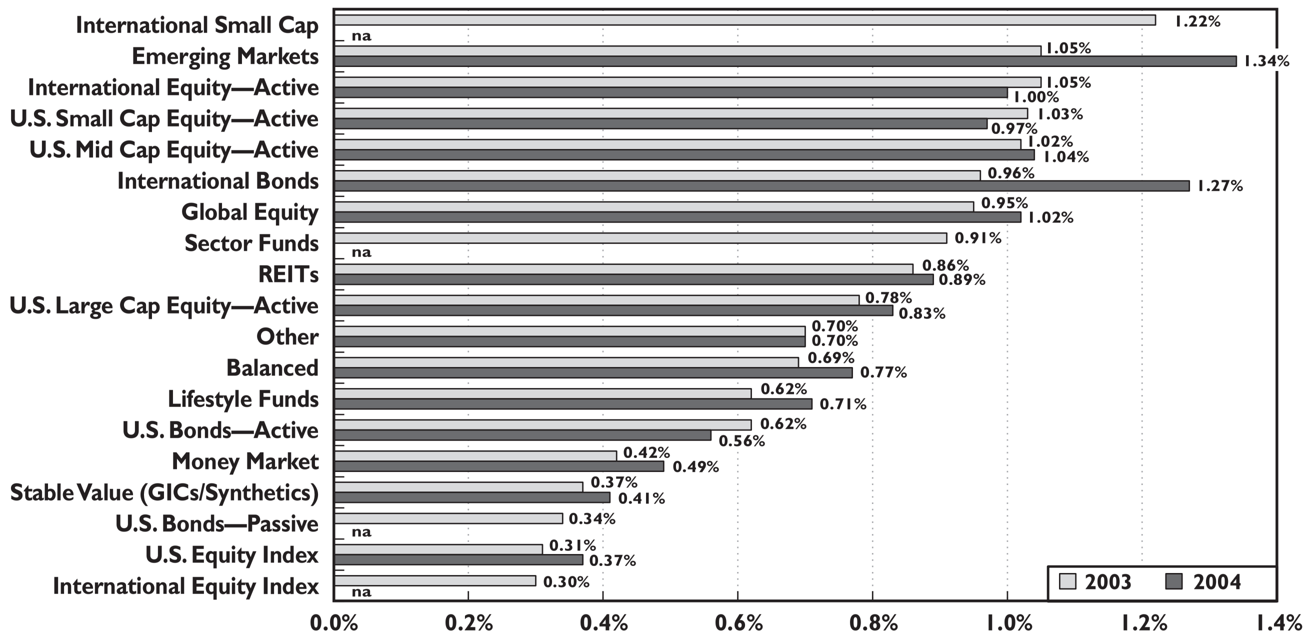
Often, however, when recordkeepers do offer lower expense ratios, the fee reduction comes with strings attached: The plan must purchase the recordkeeper's proprietary funds. For U.S. large-cap funds, for instance, the average expense ratio when invested through a recordkeeper is 77 basis points; when going through a different investment manager, it is 80 basis points. The difference is more dramatic for domestic mid-cap equity funds. The average cost is 97 basis points when going through the plan's recordkeeper, compared with 109 basis points for other investment managers. For small-cap equity, the average expense ratio is 97 basis points when the recordkeeper is the investment manager, 105 when it is not.

Exhibit 5.10 Average Expense Ratios (%)



Source: CRA RogersCasey/IOMA

Exhibit 5.11 Average Expense Ratios by Investment Manager (%)



Source: CRA RogersCasey/IOMA

With lifestyle funds, the reverse is true: The average expense ratio is 0.65% of assets when the recordkeeper is used, 0.57% when the investment is made through an outside investment manager. Similarly, with balanced funds, recordkeepers charge an average expense ratio of 73 basis points, whereas outside investment managers charge 67 points.

It is essential for 401(k) plan sponsors to keep a handle on the expenses they pay for recordkeeping and investment costs. Michael E. Falcone, vice president of Aon Consulting's employee benefit group, estimates that plan expenses can reduce gains by as much as 25 to 50%. Many providers today are willing to negotiate expenses and will not necessarily be restricted to a fee-basis arrangement. Most experts in the field advise sponsors to meet regularly with their providers to negotiate fees—at least annually.

PREPARE FOR AND RESOLVE A DOL PLAN AUDIT

Knowing what type of activities can trigger a Department of Labor (DOL) examination of a 401(k) plan, and understanding the examination process, are essential to preparing for and successfully resolving an audit, notes R. Bradford Huss, a partner at the San Francisco firm of Trucker Huss. Because the DOL does not generally conduct random investigations as the Internal Revenue Service does, plan sponsors should be aware that when they receive a notice of investigation, it means the DOL is looking for something specific, he said.

An investigation may be triggered by any number of sources, including participant complaints, government referrals, referrals from service providers, or even computer programs that "red flag" certain items, Huss noted. He gave as an example lists of investments that look like prohibited transactions might be involved. However, the department normally is very close-mouthed as long as an investigation is open, and an auditor normally will not disclose the basis of the source of an investigation. If asked, the investigators may informally disclose what is *not* the target of the audit, which may give the client some peace of mind, he added.

Investigation Areas

Huss said there are several potential areas of investigation, which may include one or more of the following:

- *Establishment of the plan and the trust.* Huss said the DOL will want to know the identities of the named fiduciaries, and to determine whether the plan has a funding policy procedure and procedures for allocating plan administrative responsibilities.
- *Fiduciary duties.* This is a "hot button" item, Huss said, and auditors will examine plan expenses to identify any that were not used for proper purposes or that are disproportionate to other similar plans. Examiners will look at plan operations to see whether loan repayments are collected in a timely fashion and whether tax-qualified status is maintained, and also will analyze investment diversification among types of investment and within each investment type.

Examiners will also look at whether the plan has an investment policy statement. Although this is not required under law, it is prudent for the plan sponsor to have such a policy, Huss recommended. Co-fiduciary liability is another area that will be examined to determine whether fiduciary responsibilities have been allocated in accordance with the plan document.

- *Prohibited transactions.* Huss said that the DOL will ask for a list of the parties in interest with respect to the plan and compare it with plan sponsors, managers, and service providers to see who they should be looking at in the investigation. Auditors will want to see whether plan fiduciaries have policies in place to prevent prohibited transactions. They will examine the plan's larger transactions to look for improper loans, ownership interest, or involvement between the fiduciaries and plan consultants, brokers, or agents.
- *Employer securities and real property.* Investigators will determine whether the plan holds employer security or real property in excess of 10% of the plan's assets.
- *Verification of financial data and claims procedure.* Huss said auditors will verify the accuracy of plan financial data reported on Form 5500 by determining whether the annual report and accountants' opinion for nonexempt plans have been properly completed and whether the plan's claims procedure complies with the requirements of Section 503 of the Employee Retirement Income Security Act (ERISA).
- *Bonding, reporting, and disclosure.* Investigators in a fiduciary investigation ordinarily will complete an ERISA bonding checklist and a reporting and disclosure checklist to see whether a plan complies with ERISA requirements in those areas, Huss said. If a violation is discovered, the DOL may try to resolve the violation during the investigation, he added.

There are several hot issues in DOL investigations, including timeliness of deposits of participant deferrals, employer stock issues, handling of demutualization proceeds, and allocation of plan expenses. Huss advised that plan administration in these areas be looked at carefully and potential problems identified and addressed in preparing for an examination.

Defense Techniques

When a plan sponsor receives a notification of investigation from the DOL's Employee Benefits Security Administration (EBSA), the notification is usually accompanied by a list of requested documents. Before doing anything else, Huss said, it is crucial to review all the documents that have been requested, attempt to identify the issues, and prepare responses. The sponsor should gather supporting evidence and organize plan records, he advised.

EBSA normally will request both an on-site investigation for document review and an interview with plan fiduciaries. Huss recommended that the document examination instead be set up at counsel's office, allowing counsel to control the investigation as much as possible and creating a buffer between the investigation and the fiduciaries.

Interviews with fiduciaries should be scheduled at a separate time and fiduciaries should be prepared for them as for a deposition, even though such interviews are not recorded and are not conducted under oath, he said. If counsel has identified specific issues or problems that will be raised, the plan sponsor should be prepared to respond. Huss also cautioned that interviewees should be educated to answer only the questions that are asked and not to volunteer information or give explanations that are not requested.

Procedural Prudence

The key to building a defense is procedural prudence, Huss advised. Plan sponsors should be prepared to explain how they did everything they did. The interviewer will use a checklist and ask for many routine items that are not the focus of the investigation and plan sponsors should be prepared to respond to those items as well, before moving to the real issues of interest.

Resolving the Investigation

When an audit reveals an apparent violation, Huss said the DOL will seek correction of the violation through full compliance. The DOL will issue a voluntary compliance request letter to the sponsor advising of the results of the investigation and the sections of ERISA that the DOL asserts have been violated.

This is the opening of negotiations, not a threat of litigation, Huss said. Because the focus is voluntary compliance at the administrative level, it is preferable to work something out at this point before it gets to litigation, he advised. Settlement terms that are acceptable to the DOL include full repayment to the plan within a year. If there are bonding issues or disclosure requirements, the DOL will want those resolved, Huss said.

He noted that the DOL's enforcement manual sets out five ways an audit may be resolved:

1. No violation detected
2. Violation detected but no further action warranted
3. Full correction through voluntary compliance
4. Partial or no compliance without referral by EBSA for litigation
5. Partial or no compliance with referral by EBSA for litigation

If a plan audit is referred for litigation, it does not necessarily mean the case will be litigated, Huss said. If it does go to litigation, there will still be an opportunity to settle.

Correcting violations involves making the plan whole, restoring losses of plan assets and lost investment earnings, Huss added. The DOL uses the IRS quarterly interest figure to calculate interest. In cases of violation of fiduciary duties, it is looking for the amount that would have resulted if funds had been prudently invested all along.

AVOIDING POOR 401(K) PERFORMANCE

In the past few years, specifically since the Enron scandal and precipitous declines in the stock market, claims under ERISA have increased as 401(k) participants who have lost significant portions of their balances seek recourse. Consequently, fiduciary liability has become of greater concern to employers, according to Gregory Long of the American Bar Association Members' Retirement Plan. A plaintiff's burden of proof is much lower under ERISA than it is under securities law, as ERISA is a watchdog-type statute that looks out for employees generally, but in particular for non-highly compensated employees with respect to their pension and retirement plans. This means that a plaintiff need not prove that a fiduciary in a 401(k) plan had evil intent, but only that the fiduciary did not do his or her job, Long said.

Savvy benefits managers will educate themselves on the issues, understand the concept of fiduciary duties, and provide adequate education to the average participant about retirement saving and investing. Consider these crucial questions:

- Who are the fiduciaries in your plan? Some are defined, while others may not be, Long says.
- When you set up your company's 401(k), profit sharing, or ESOP plan, were decisions made that affected you, to a certain extent, as the company's recordkeeper, investment manager, or trustee? What were those decisions, and what were the reasons behind them?
- What are the ongoing fiduciary responsibilities? According to Long, the biggest risk of a fiduciary breach is not active negligence but a lack of awareness of what people should be doing as fiduciaries.
- Are you aware of the processes and responsibilities and whether they are being fulfilled, as well as what the procedures are?
- How are your procedures documented? Long asserts that it is critical to create a paper trail to be able to defend against any cases that might be brought.

Duties of a Fiduciary

ERISA imposes a fiduciary responsibility on employers to operate their plans and manage their investments prudently. According to Shannon McLaughlin, an ERISA attorney for CitiStreet (Quincy, Massachusetts), a *fiduciary* is anyone in your company who has discretionary authority over the management of your plan—specifically, the decision makers or people determining how the plan will be set up. McLaughlin noted that fiduciaries are also those who:

- Have discretionary authority over the administration of your 401(k) plan by deciding who your service provider will be, what type of investments will be included, and who facilitates the reporting involved.
- Render investment advice for a fee (e.g., a registered investment advisor whom the person in charge of the plan hires to say, "These are the investments that are appropriate given the demographics for your plan").

According to McLaughlin, basic duties under ERISA hinge on the need for fiduciaries to act for the exclusive purpose and solely in the interest of participants and their beneficiaries. "That goes to the overall protection element of the statute, but it can often set up something of a conflict in terms of making decisions that are best for the company and best for your business versus making a plan-driven decision that's in the best interest of participants and beneficiaries." In addition, ERISA dictates that fiduciaries must:

- *Meet a high or "prudent expert" standard.* "As you're making decisions in terms of what type of plan or what type of investments to offer, you're not just acting in the capacity of decision maker, you're acting in the capacity of an expert."
- *Diversify investments and act in accordance with plan documents.* Setting up a 401(k) plan takes a lot of documentation. "You also need plan documents [and] summary plan descriptions—a lot of these things are communicated to your participants. As a fiduciary, you must be familiar with and operate the plan in accordance with these documents."
- *Refrain from engaging in prohibited transactions.* These can involve dealing with parties and interests or self-dealing. This requirement can make selection of vendors and things of that nature difficult.

ERISA allows fiduciaries to delegate some of the aforementioned responsibilities so that no one person or entity is held responsible for all of them. *Key point*: Your company may delegate by hiring service providers or investment managers, but you are liable for their actions, warns McLaughlin. "You are now co-fiduciaries. You are not stepping away from the process—you must remain engaged because it's a very dynamic, ongoing process." She adds that fiduciaries can be held liable if other fiduciaries to whom they have delegated a part of the process commit a breach by failing to meet their responsibilities.

Businesses are faced with a dilemma: how to make decisions that are in the best interests of the company when it is offering a benefit to employees that meets employee needs, while acting as a plan fiduciary whose actions must comport with the best interest of plan participants and the beneficiaries. McLaughlin explains: "Even though you may have a positive relationship with a particular broker or investment advisor, there may be some conflict there, [although using this person] may help your business."

Not everything that happens in conjunction with your plan, however, will rise to the level of a fiduciary action. It comes down to which hat you're wearing as you make these decisions and perform specific functions, says McLaughlin. Some companies appoint someone to coordinate the processing of forms and even to sit down with the employees and make sure the forms are correct. That type of activity is highly administrative and would not necessarily rise to the level of a fiduciary action, she notes. "If you are an authorized signer on the plan and you're addressing all plan questions, depending on the dynamic, the questions that may come up, and the guidance and information that you make available to the plan participants, you could be functioning more in the capacity of a fiduciary.

Generally speaking, the administrative side of it is just that, administrative- and business-related," she says.

Protecting Your Company and Yourself

Long advises benefits managers to take the following steps:

Step 1. Create a paper trail. The most important document is a policy statement that describes your plan's investment goals, identifies the appropriate investments, sets forth benchmarks, and outlines a review process. It might state, for instance, "Our goal is to set up a diversified line-up of 10 different investment options. Those options will be significantly different with regard to risk and reward."

Step 2. Define the review process. Long says that although there is no set time frame, you are required to take a look at your investment products and plan on a periodic basis (e.g., quarterly or annually) to assess whether they have met established benchmarks on a one-, three-, five-, and ten-year basis. "You need to see that your large-cap value funds, for example, are doing what you said they would do when you held them out to your participants," he explains.

Step 3. Evaluate fees. "What may have been an attractive fee schedule for a particular investment option five years ago might be very uncompetitive now," Long asserts. Fiduciaries have an obligation to mitigate expenses.

Step 4. Define the role of your service providers. Most companies retain someone to act as a trustee, investment manager, or advice provider—and these roles must be defined. "If you're hiring an investment manager who sees the job as simply providing administrative functions and not acting in a fiduciary role, and your idea is that it is a fiduciary role, you've got a disconnect that needs to be resolved," Long asserts. He recommends that you have your service providers define, in writing, whether they are serving as fiduciaries to your 401(k) plan.

Step 5. Remember your company's responsibilities. This holds even if you have retained a trustee, investment manager, or advice provider to assist with meeting your obligations. Your company's responsibilities do not disappear, according to Long. "You still have an obligation to monitor on a periodic basis the performance of the expert that you hire."

Step 6. Consider a 404(c). Firms' movement from trustee-directed plans to participant-directed plans was seen as a way to relieve plan sponsors of some liability. "You took the investment decision off the shoulders of the trustee and transferred it to the participants," says Long, "but the Department of Labor says the relief or actual transfer of control doesn't occur unless it's set up under a 404(c) design." If you have a 404(c) plan, no individual who is otherwise a fiduciary shall be liable for any loss that results from a participant's exercise of control over his or her account.

You still need to provide at least three investment options with significantly different risk and reward characteristics, Long told conferees. You also must make certain disclosures (such as the prospectus and information on performance) and, upon request, other disclosures, which Long says might include a detailed listing of all securities and past due voting rights. *Key point*: You need to verify that whomever your company hires to be the administrator can do these things and has the ability to meet the requirements of a 404(c). In addition, even though you can set up different funds that meet 404(c) requirements, your company will still pick those funds and is required to monitor its decisions. For more information, see Sidebar 5.1.

Sidebar 5.1. ERISA and Fiduciary Duties: What You Need to Know

These are the basics:

ERISA defines a *fiduciary* as any person so named in the plan and any person who exercises any discretionary authority or control with respect to the management or administration of the plan or its assets. With respect to a 401(k) or other qualified retirement plan, the following will normally be included: the plan sponsor, plan administrator, trustees, investment managers, and any other persons, including employees, who are involved with any aspect of handling the plan or its assets. *Key point*: If you are named as a trustee, helped choose the 401(k) provider, participated in the investment selection process, or had a part in making decisions about qualified plan operations, you are a fiduciary.

A fiduciary's basic duty is to act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. With respect to qualified plan assets, a fiduciary must act prudently, diversify the investments of the plan's assets, and act in a manner consistent with the plan's documents. A fiduciary must also act with the care, skill, and diligence under the circumstances that a prudent person, acting in a like capacity and familiar with such matters, would use. Fiduciaries must respond fully and accurately to all inquiries from a participant or beneficiary. Misleading communications, misrepresentations, or omissions may well constitute a breach of fiduciary duty. In selecting a service provider, fiduciaries must consider the quality of the service provided, not merely the costs thereof. Plan service providers should be reevaluated periodically.

Fiduciary liability exposure may result from the number of investment choices offered in a 401(k) plan, plan administration expenses, the investment selection process (or lack thereof), long-term investment returns of the plan, and merger and acquisition decisions (reflecting which plans are retained, disposition of investment funds, and so on).

Fiduciaries should carefully document their processes with respect to decisions on all aspects of their plan offering and its administration, particularly with respect to the items listed above. You should retain: the plan's investment policy statement; investment fund selection due diligence; service provider selection due diligence; ongoing investment monitoring reports; notes of investment committee meetings; plan documents, amendments, and board resolutions; discrimination test results, signed Form 5500s and all compliance documentation; memos distributed to employees concerning your qualified plan; and fidelity bonds.

Other steps fiduciaries can take to protect themselves include: Utilize appropriate legal counsel when necessary; seek assistance of independent, objective third-party experts with respect to qualified plan decisions; purchase adequate fiduciary liability insurance; and periodically audit your company's internal plan operation procedures.

Source: ABD Insurance and Financial Services; (www.insworld.com)

PROVIDERS OFFER SPONSORS PLAN EVALUATION TOOLS

Sponsors will increasingly find that they have the means to evaluate how well their 401(k) plans are operating. More providers are beginning to offer these plan assessment tools to help sponsors determine whether they are being adequately served by the providers themselves.

Such evaluations probably should always have been part of every provider's service package. During the 1990s, however, providers often ignored basic service functions. As long as plans were producing consistent growth for participant investments, sponsors did not have much reason to complain about the design of their plans.

Today, with the competition much steeper among providers, basic services can no longer be ignored if providers hope to retain business and pick up new clients. Thus, many are now virtually institutionalizing the idea of basic evaluation of services, giving it a spiffy title and marketing it as a new feature in the package of services they offer plan sponsors. The question, however, remains as to whether these tools are meaningful and credible or merely another handsomely designed marketing strategy in the provider's arsenal.

"In a lot of these report cards, the information being looked at is manipulative," says Ronald Eisen, president of Oregon-based Investment Management Consultants. "Wherever the provider sets the bar, it's virtually assured of giving itself a B or B+ grade." Eisen is quick to add, however, that many providers do offer meaningful evaluation tools that can be used to help sponsors make tangible improvements in their 401(k) plans. "There's a very real difference between the way measurements occur at one firm and another," he points out.

Watson Wyatt, as *Managing 401(k) Plans* has reported, offers a "401(k) Value Index," a vehicle to be used by plan sponsors to learn how well their plans were meeting expectations.

Fidelity Offers Diagnostic Program Online

Fidelity Investments has also announced the introduction of its own online diagnostic tool as a way for its sponsor clients to "compare their workplace retirement programs against the features Fidelity's research finds most beneficial for plan design." Fidelity's "Your Ultimate Plan Design" also provides sponsors with a report, after the evaluation is completed, that enables them to follow certain outlined steps to improve their plans.

"Sponsors have always made it a priority to improve their plans based on internal objectives and broad industry measurements," says John W. Callahan, president of Fidelity Investments Tax-Exempt Services Company. "This new diagnostic tool provides them with a valuable context in which to evaluate their plan's design and offers actionable steps that will help them maximize their programs and meet their key goals and objectives."

Schwab Enters the Field

The latest to join the fray is Charles Schwab, which has just initiated its "Schwab Service Scorecard" to help sponsors assess their plans. "The Schwab Service

Scorecard enables us to verify our service levels for plan sponsors and builds on our philosophy of client advocacy," says Ben Brigeman, senior vice president of Schwab Corporate Services. "We've always offered transparent plan pricing, and last year we introduced the online Fiduciary and Investment Report to help plan sponsors track and compare the performance of plan investments. Now the Schwab Service Scorecard provides insight into plan servicing."

If practice follows history, such evaluation tools soon will be part of every major provider's package of services. The 401(k) business is becoming increasingly homogenized. New ideas quickly become commodities included in the service platform of all major providers.

Schwab says it will assess how adequately it delivers its services to sponsors according to a set of criteria and then report its measured assessment via the Schwab Service Scorecard. Sponsors can use the Web to access the scorecard. The scorecard will include the following types of assessments:

- *Service experience:* Service levels will be measured for various plan activities such as contributions, distributions, loan processing, the plan's Web system and voice response system, education sessions, and call center performance. Some of the data will come from participant surveys.
- *Service score:* Goals that have been established as benchmarks for plans will be evaluated to measure the quality of service that is being offered. Part of the scorecard will determine how close Schwab comes to meeting the goals.
- *Service feature utilization:* The scorecard will determine how well a plan's various features and enhancements are being used.
- *Plan information:* Statistics will be offered for core plan activities such as participation rates, deferral rates, and IRA rollover data.

"By verifying service quality and tracking utilization of available features," says John Harabedian, a Schwab vice president, "we can help sponsors improve their companies' retirement plans as we continually look for ways to improve our service."

Different Evaluation Techniques and Issues

Fidelity's "Your Ultimate Plan Design" diagnostic tool looks at what it calls the "key goals" of plan design: participation, diversification, contributions, employee engagement (including online statements, participant Web site, targeted education programs, and the ability to offer personalized communications), and administration. Sponsors complete an interactive questionnaire on these issues and in return are given a report on both the strengths and weaknesses of their plans. They are then given a detailed set of steps they can take to enhance the operation of their 401(k) plans.

Fidelity's "Your Ultimate Plan Design" appears to cover the principal facets of plan design. But because a provider designs the evaluation tools—making these tools, in a sense, report cards on the services the provider itself offers—the tools obviously concentrate on facets of plan design that are the strengths of the particular provider. "You present the evaluation tool to the sponsor," says Eisen, "and say, 'Here are the things we need to evaluate, don't you agree?' So the sponsor looks at it and says, 'That looks pretty complete.' And then you say, 'The weighting should look like this, right?' And the provider says, 'Right.' And the provider says, 'Would you like a tool like this?' And the sponsor says, 'Yes, we would.' So it pretty much comes out exactly the way the relationship manager is looking for. And that will probably meet the demands of 95% of the industry."

Nevertheless, it is really up to the sponsor to determine whether the evaluation tools being offered by a particular provider are truly helpful or are simply a de facto means of endorsing the provider's own services. Sponsors have the right, as well as good reason, to decide precisely what methods should be used to evaluate their plans and also to determine what facets of the plan should be assessed. Eisen says the problem is that many sponsors do not know what to ask for. "The plan sponsors don't know enough to demand better measurement" in those cases where it is necessary, Eisen says. "As plan sponsors have the leverage, then they'll get what they want. It is still a business where sponsors must be the strong advocate on the participants' behalf. You're going to get out of your provider what you demand. And they'll do a much better job if you are demanding."

Shift in Priorities

The move toward diagnostic evaluations of 401(k) plans—and many other providers, besides the three mentioned in this section, now offer such tools—signifies a real movement in provider priorities in the 401(k) industry. Just a few years ago, the trend was to emphasize the number of investment options offered by providers or how many basis points were being assessed for services or funds. Now, however, such issues have largely been marginalized. There is relatively little difference in services and products offered from one provider to the next, in the realms of both fund manager and recordkeeper.

Providers are therefore looking to gain a competitive edge in other areas, and the innovation of the moment appears to be the evaluation of how well plans—as well as their sponsors and providers—are performing on behalf of participants. "That's where the field of measurement is taking business," says Eisen, "to see if the business is getting things done as it should. And ultimately, Congress might jump in, because this affects the social fabric of America. This probably wouldn't have happened if we hadn't had a crappy market, because the down market causes people to focus on the right things."

Genuine Help for Sponsors

Sponsors that are taking a serious look at the diagnostic services being offered can not only get help to improve their own plans, but also receive assistance in selecting their recordkeepers. Although many sponsors do not spend much time evaluating the services offered by recordkeepers, it is important for them to do so if they hope to find the ideal match. The evaluation tool can help shed light on a provider's priorities. Some, for instance, might have a diagnostic tool that emphasizes participant education and communication, whereas others might stress diversification of investments or contribution rates. A careful examination of what 401(k) providers themselves consider to be important plan components can help plan sponsors learn whether they are on the same page.

It is also useful to determine how accountable the providers will be if changes must be implemented. It may be that a plan has flaws that are the result of the provider's own platform, rather than anything going on within the plan itself. Eisen says good providers will respond to the results of evaluations and "recognize that their feet will be held to the fire."

DOL ALLOWS PLAN FEES TO BE CHARGED TO PARTICIPANTS*

It happens rarely, but the Department of Labor has changed its mind. It happened in a Field Assistance Bulletin. Because "the Department has determined that neither the analyses nor conclusions set forth in that opinion [Advisory Opinion 94-32A] are legally compelled by the language of the statute," the DOL concluded that plans may now charge participants for the costs of defined contribution plan distributions. What does this news mean for plan sponsors?

It may not mean as much as you might initially think. Keep in mind that defined contribution plans have already been charging for certain features for some time. ERISA §104(b)(4), for example, allows plan administrators to charge for copying plan documents, and §408(b)(1) allows charges for self-directed investment options and participant loans. What Field Assistance Bulletin 2003-3[1] has done is list specific examples of expenses that may be charged directly to plan participants or their plan accounts. Some specific examples from the Bulletin are:

- *Hardship withdrawals.* Plans may now allocate the expenses associated with a hardship withdrawal to the participant who seeks the withdrawal.
- *Calculation of benefits payable under different plan distribution options.* Defined contribution plans may now charge participants for calculations of benefits payable under the different distribution options available under the plan (e.g., joint and survivor annuity, lump sum, etc.).
- *Benefit distributions.* Expenses of distribution such as a monthly check-writing fee may now be passed on to participants.
- *Accounts of separated vested participants.* It is now permissible for plans to charge vested separated participant accounts the account's share (e.g., pro rata or per capita) of reasonable plan expenses, without regard to whether the accounts of active participants are charged such expenses and without regard to whether the vested separated participant was afforded the option of withdrawing the funds from his or her account or rolling them into another plan or IRA.
- *Qualified Domestic Relations Orders (QDROs).* 401(k) plans may now charge plan participants for QDROs.

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*This section was written by Jay Adams Knight. Mr. Knight is a partner in the Los Angeles law firm of Musick Peeler & Garrett, where he specializes in employee benefits law.

Caveats

Plan fiduciaries should realize by now that no boon from the federal government comes without strings. Conditions on participant charges include:

- Expenses must be proper plan expenses and not settler expenses (see Advisory Opinion 2001-01A).
- The expenses must be reasonable.
- The plan document should allow the plan expense to be payable from plan assets and set forth the allocation method.
- Summary plan descriptions (SPDs) will have to describe any plan provision that may result in the imposition of a fee or charge on a participant, beneficiary, or their account. Also, the SPD should identify any benefit offset.
- Fiduciaries must continue to act in the best interests of participants in accordance with ERISA § 406(b).

Final Note

The wise fiduciary will see this Bulletin as a way to recover the administrative costs incurred as a result of participants' and beneficiaries' abuse of the 401(k) plan features. This Bulletin also allows specific costs associated with a particular account to be allocated to that account and not underwritten by the whole plan. These are positive points.

However, some plan sponsors may see this Bulletin as an opportunity to save money by placing more financial burdens on plan participants, many of whom have seen their retirement savings dry up in recent years. Wise fiduciaries should use judgment in applying this Bulletin's provisions. They should resist any urge to view this guidance as an opportunity to fleece the 401(k) plan flock.

BEAR-MARKET PRICING STRUCTURE EMERGES FOR BROKERS AND PROVIDERS

The pricing system by which plan sponsors purchase defined contribution services is undergoing a number of changes, as is the relationship between brokers and providers, particularly in the midsize and small markets. Specifically, costs are going down, on the average, for hiring a provider through a broker, while the costs are going up when sponsors go it alone and negotiate directly with providers.

At the same time, the more traditional system of broker compensation through finder's fees is being replaced in the intermediate market by R-shares. This system spreads out the payments equally over several years rather than paying a big lump sum at the beginning.

Competition continues to intensify in the business, with the number of both providers and brokers dwindling as many of them find it difficult to keep their defined contribution businesses profitable. In fact, many providers are so desperate to keep the dollars flowing into their businesses that they are taking on new defined contribution clients that actually are costing them money. "We do know that, to a large extent, providers do not run a profit and loss on every prospect they get," says Warren Cormier, cochairman of SPARK Research, which has conducted research and surveys on the broker/provider relationship and on the pricing structure of defined contribution plans. "They don't bid on only profitable businesses. They need to get the assets into their coffers because that's their revenue stream. A lot of providers are taking on new business that only worsens their situation."

Fewer Differences, Fewer Deals

Another factor affecting the industry is that there are fewer differences in the actual services that providers in the intermediate market are offering sponsors. The result is that there is less churn in the industry. Sponsors interested in changing providers are discovering that the variations that existed between providers during the bull market, as to the services they offered, are no longer evident today. Therefore, once they have surveyed what is available in terms of new providers, sponsors often find it makes better sense to maintain the status quo.

"I believe that the demand for churn is as strong as ever, but actual churning is slower because they can't find a better place to go," says Cormier. "The major companies competing in the 401(k) industry have become better at cost control and services, so it's more likely that you're already with someone who's a better player." With fewer sponsors going to new providers, smaller providers are dropping out of the business, selling off their businesses, or outsourcing services.

Bear-Market Pricing Takes Hold

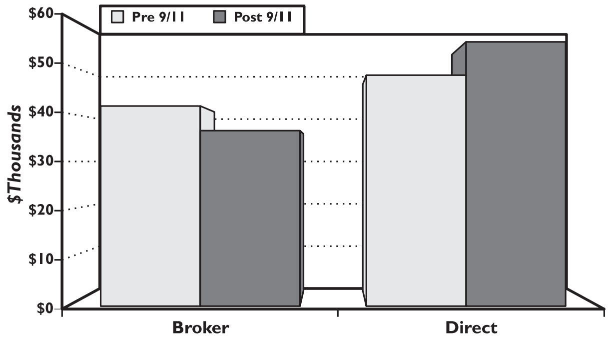
Much of what is happening with regard to the pricing structure in the 401(k) market is the direct result of the ongoing bear market and economic malaise. "It's causing price declines in the short term, and those price declines are coming in the form of people including administrative services in the annual base rate or including them in the expense ratios," says Cormier. Providers are saying that there is no charge for administrative services and that those services are included in the expense ratios, which are on the rise.

Pricing Down when Brokers Play a Role

An interesting phenomenon discovered in the cost of plans in the $1 million to $10 million market is that the average cost has gone down when brokers negotiate between providers and sponsors—but the cost has risen when brokers are not involved. In a survey conducted by the 401kExchange (see Exhibit 5.12) and SPARK Research, the average cost of a broker-negotiated deal has decreased 12.3% since September 11, 2001, from $41,500 per plan to $36,400. At the same time, when no broker is in the picture, the average cost has gone up 14.4%, from $47,900 to $54,800.

"The market has gotten softer after 9/11, with fewer and fewer sales opportunities," says Fred Barstein, president of the 401kExchange. "Providers are now willing to negotiate pricing." That willingness to negotiate works well when brokers who are familiar with the landscape are involved. They can barter with providers

Exhibit 5.12 Average Cost per Plan, $1 Million to $10 Million in Assets



Source: 401kExchange/SPARK Research

to get the best deals for their clients. However, small-market sponsors often are unaware of the potential negotiating power they have, so when they make deals on their own with providers, they frequently take what they are offered without trying to work out a better price for their plans. "Sponsors are on their own, and they don't know about negotiating," says Barstein. "So they're better off with a broker representing them. The broker is able to take advantage of the opportunities."

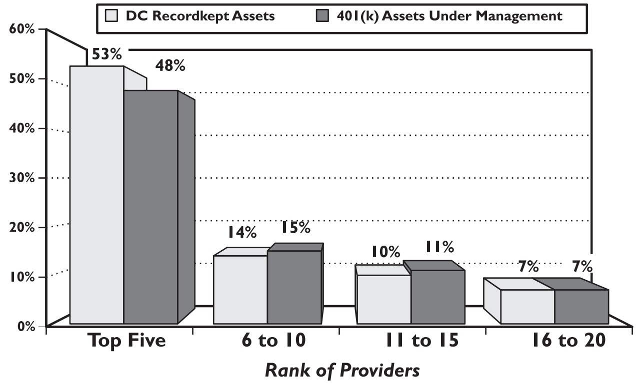
Cormier says the market already was on the decline prior to September 11, and the events of that day cut even further into the ability of providers in the intermediate market to make profits on their defined contribution business. Though some in the industry believed that the marketplace for serving 401(k) plans was about to bounce back three years ago, the terrorist attacks on the United States nullified any such potential rebound. "After 9/11, it was over," says Barstein. "The industry was on fumes anyway, and when 9/11 came, it was the reality. This business changed forever, and it's still changing. Bad business mistakes can't be hidden by a bear market."

The Big Stay Strong

Peter Starr of PH Starr Associates points out that about half of all 401(k) assets are under the management of the five top providers in the business (see Exhibit 5.13). "The big get bigger," says Starr, and as they do, they can invest more heavily in total retirement aggregate platforms. Meanwhile, the smaller companies struggle to survive.

About 90% of 401(k) assets reside in investment managers' proprietary funds, according to Starr, but these companies are losing some of their share of the market. The problem is that fees will not increase to make up the lost revenues, even though efforts will be made to increase fees to some extent, Starr suggests. The

Exhibit 5.13 Market Concentration



Source: Empirical Research

challenge thus facing recordkeepers, he says, is to control their costs in the face of increasing user demands and the spread of fast-evolving technology.

Starr sees a number of other challenges facing recordkeepers in today's defined contribution environment:

- The loss of asset-based revenues, as nonproprietary and lower-margin investment products—including institutional funds, index funds, and self-directed brokerage accounts—gain share
- Normalization of the equity markets
- Adequate fee compensation for recordkeeping services
- Increasing distributions to job-changers and retirees, and the low level of asset retention for the recordkeepers

Evolution of R-Shares

One technique used by providers to keep a hold on both their costs and their current clients is the growing reliance on R-shares as a mechanism to pay broker/advisors. R-shares, which were introduced by American Funds, eliminate the finder's fees paid to brokers in the intermediate market. The brokers are instead paid, typically, 50 basis points a year for four years. By reducing the brokers' up-front compensation, the R-shares "tend to reduce the possibility of [brokers] wanting to churn the account," says Cormier. It keeps brokers committed to the long-term relationship, and it nudges some brokers out of the business because they can no longer count on the big-hit payment they got in the first year under the finder's fee arrangement. The brokers might have gotten 100 basis points in the first year as a finder's fee, and then 25 basis points in ensuing years. With the

R-shares, they get a consistent 50 basis points over the first several years. That means, over the long run, the cost to participants might go up, with the continuing 50-basis-point fee, because sponsors prefer that the payments come out of plan assets rather than from their own benefits budgets.

Many brokers say that R-shares are becoming the industry norm. Some of them do not like the new arrangement because much of their costs come up front, and the finder's fees helped cover those costs.

Rollovers Rolling over the Market

The current pricing structures and relationships between brokers, sponsors, and recordkeepers are all in a transitional phase, as everyone is gearing up for the impending rollover boom that will reconfigure the direction of the defined contribution marketplace. By 2006, according to Starr, retirement assets, including dollars in defined contribution, defined benefit, and IRA plans, will reach $10.2 trillion. Defined contribution plans and IRAs together will account for 70% of all private retirement assets. Starr sees the growth in the 401(k) and IRA rollover markets as intrinsically linked, just as he perceives an intersection of the retail and institutional markets. By 2006, there is expected to be more than $2.5 trillion in rollover IRA assets and more than $4 trillion in 2011.

Like many others, Starr believes the key to retaining or capturing IRA rollover dollars is to create a holistic approach to all the financial service needs of participants. The winners, he says, will focus on service rather than products. They will maintain a closeness with individual clients and will offer a wide range of products that can compete on a retail basis. Most importantly, perhaps, they will have to be able to address a variety of the financial needs of their clients, from insurance to annuities to health care costs, as well as retirement savings. Furthermore, it is important for providers to begin addressing those issues *now* with individual clients if they expect to hold onto their more sizable assets when those clients reach retirement age.

ENDNOTES

1. http://www.dol.gov/ebsa/regs/fab_2003-3.html

Chapter 6

Training and Development Costs

BEST PRACTICES

TRAINING AND DEVELOPMENT COSTS

As training budgets get tighter, it is useful to have a look at what other training managers do to control training department costs. The results of IOMA's *Training Management and Cost Control Questionnaire* show that respondents are relying on a variety of strategies to rein in expenditures.

Variety Pack

In the past, one or two clear leaders typically emerged as the most effective cost-control tactics. This year, training managers are taking advantage of a variety of approaches to the problem, embracing everything from outsourcing to blended learning programs. Overall, online learning and video or teleconferencing joined pretraining needs assessments as training managers' top cost-control strategies this year (see Exhibit 6.1).

Nearly half (43.8%) of respondents included training needs assessments prior to adding training programs in their top five most successful cost-control strategies—an eminently reasonable strategy that eliminates unnecessary programs by identifying when, and if, training is the solution. Once the need for training is established, about one-third of study participants use either online learning (including custom, off-the-shelf, and hosted) (34.4%), video or teleconferencing in place of or in addition to instructor-led training (ILT) (32.8%), or reduced staff travel for conferences (32.0%). This trend was not unexpected given the general business climate and lingering lack of enthusiasm for travel in the wake of the 9/11 tragedy.

Nearly as popular for cost control (29.7% of respondents) is blended learning, which combines online and classroom learning programs. Interestingly, insourced (28.1%) was slightly more popular than outsourced training (25.8%) in this study.

Slightly more than a quarter (28.9%) of training managers developed a training department business plan and budget as part of their cost-control strategy. It was the number one strategy in the prior year's study; although it is difficult to draw comparisons because of sample size and composition changes, one hopes that the decrease this year is due to the fact that training managers have already incorporated that strategy in their business-as-usual operations.

Exhibit 6.1 Top Training Cost-Control Strategies, by Company Size

	Up to 400	401 to 1,000	1,000 & over	Overall
Performed training needs assessment prior to adding programs	52.2%	41.4%	43.5%	43.8%
Introducted e-learning (custom, off-the-shelf, hosted, etc.)	30.4	24.1	43.5	34.4
Used video/teleconferencing in place of/in addition to instructor-led training	39.1	24.1	32.6	32.8
Cut back on staff travel, conferences, etc.	32.6	48.3	23.9	32.0
Developed a blended approach combining online and classroom learning	21.7	24.1	39.1	29.7
Developed a training department business plan and budget	28.3	37.9	26.1	28.9
Insourced one or several training functions or programs	30.4	31.0	21.7	28.1
Partnered with line managers to support/pay for training programs	28.3	37.9	17.4	26.6
Outsourced one or several training functions or programs	30.4	17.2	21.7	25.8
Increased the use of coaching/mentoring programs	28.3	10.3	30.4	24.2
Began targeting training to key personnel only	17.4	17.2	26.1	21.1
Used on-the-job training initiatives	32.6	10.3	15.2	21.1
Eliminated or reduced repeat training	17.4	20.7	23.9	20.3
Improved effectiveness of training program marketing	10.9	20.7	26.1	18.8
Downsized in-house training staff	10.9	24.1	17.4	17.2
Adopted/enhanced training programs for new recruits	17.4	10.3	17.4	16.4
Set new training staff performance goals	13.0	20.7	13.0	16.4
Adopted adult learning styles measures to ensure learning transfer	6.5	10.3	19.6	11.7
Used ROI measures to ensure training program effectiveness	6.5	17.2	15.2	11.7
Introduced or changed training software/ hardware/technology	10.9	17.2	8.7	11.7
Launched a corporate/virtual university	8.7	13.8	6.5	10.9
Added electronic performance support systems to support on-the-job learning	0.0	6.9	2.2	2.3
Other	10.9	13.8	8.7	10.9

Results According to Size

Small-company (up to 400 employees) training managers relied on training needs assessments (52.2%), video and teleconferencing (39.1%), and—tied for third—on-the-job (OTJ) training initiatives and reduced staff travel and conferences (each 32.6%). Also effective for just about a third of participants in this size group were outsourcing and online learning (30.4% each).

In midsize companies (401 to 1,000 employees), nearly half of respondents reduced staff travel and conferences (48.3%), followed by pretraining needs assessments (41.4%), and training department business plans and budgets, the latter of which tied for third place with partnering with line managers (37.9%). Respondents in this size group were least likely to have reported cost-control success from focusing on training for new recruits (10.3%) and increased coaching/mentoring programs (10.3%).

Training managers at large organizations (more than 1,000 employees) found equal training cost-control success with pretraining needs assessments and online learning (each 43.5%). Nearly as many (39.1%) also used blended learning to control training expenditures.

Respondents in this size group were just as likely to insource as to outsource (21.7%), but least likely among all size divisions to partner with line managers (17.4%), reduce staff travel (23.9%), or develop a business plan and budget (26.1%)—again, because training managers incorporate that type of business planning as a matter of course.

CASE STUDIES, STRATEGIES, AND BENCHMARKS

OUTSOURCING

Training managers have been outsourcing parts of their programs for some time. In small organizations with scant staff, outside training programs and sometimes administration are essential to providing needed services. Some large organizations are now kicking the tires on what is known as business process outsourcing (BPO) for their training. Comprehensive BPO implies the transfer of responsibility and accountability for the entire training function to an outside vendor who will then deliver it back in a cheaper, better, faster form.

Outsourced learning is gaining momentum among major companies. Indeed, recent research by industry analyst IDC shows that training tops the list of functions that corporate executives are considering for outsourcing, "higher than sales and marketing, HR, finance, and accounting," says Michael Brennan, corporate learning program manager for IDC.

Is Training a Good Bet for Outsourcing?

Edward Trolley, co-author of *Running Training Like a Business*[1] and now VP of outsourcing for Knowledge Planet, believes that training shares the following characteristics with other successful BPO opportunities:

- The scope of training is easily defined, yet it is fragmented and dispersed in most companies.
- Training represents a large fixed cost for many companies. In most cases, training departments are unable to achieve economies of scale and leverage on these costs—a great characteristic for BPO.

- Training departments require a significant capital investment to stay current. Because training is not part of the main business product or service the company provides, it is difficult for training managers to secure the capital necessary to provide the best training. “Training is the last to get the budget and first to get cut. Why? Because there’s a big disconnect between cost and value.”
- Training can benefit from scale and aggregation. Nearly every training department needs vendors and administrators. “If you can manage these processes from a single ‘process center’ model, you can reduce headcount because you can leverage resources.”
- Training can benefit from highly defined systems and processes that reduce response time, cycle time, and improve quality. Paul Harris explains how organizations and suppliers are reaping the benefits of outsourcing in Outsourced Learning: A New Market Emerges.[2] Organizations can reduce fixed costs by taking advantage of vendor service centers, such as the Accenture Learning Content Development Center and others. Operations like this can provide training—“including blended learning opportunities and strategic alliances with e-learning firms—to fulfill an organization’s training requirements.”

Ultimately, training is not part of the primary business product or service of most companies, and therefore it is a good prospect for outsourcing.

Who Is Outsourcing Now?

To date, few major organizations have outsourced all or almost all of their training functions to a third-party provider. The more standard approach is to shift some part of the training function—training administration and vendor management, for example—to an outsourcing vendor, leaving internal training staff to focus on what they were hired to do: deliver training. (*Note*: In his assessment of more than 100 training organizations, Trolley found that, on average, 50% of training professionals’ time is devoted to administrative work.)

Will Outsourcing Work for You?

With outsourced learning firmly in the sights of corporate executives, you might be asked how, or if, this would work in your organization. “It all boils down to the business case,” states Trolley. As the head of training, you owe it to your company to consider all the options available to you and to look at the business cases associated with each of those options. “If you don’t, someone will do it for you,” he adds.

Here is what to consider:

- *Size and budget thresholds.* Achieving value from comprehensive learning BPO requires a workforce size of 7,500 or more and average per-employee direct training expenditures of $1,000, Trolley believes. This does not mean that smaller companies do not qualify; a smaller company that spends a lot on training could achieve cost savings as well.

- *Determine the business value of BPO.* In many organizations, "70% to 80% of resources are being invested in those things that are low value-added—like administration," says Trolley. "You've got to figure out how to do those things differently—and more cheaply—so you can redirect your money towards the high-value adding things like understanding the needs of your customers, delivering the right kinds of solutions, and ensuring results. Those are things that customers value and are willing to pay for."

  In the Boeing/Intrepid Learning outsourcing arrangement, for example, training design and development costs were reduced by 38% in part because Intrepid could and did produce several programs for Boeing using the same template. The Boeing outsourcing arrangement has expanded to include training delivery as well, and Intrepid plans to reduce training delivery costs by 25% by spreading the costs among multiple areas and clients and relying on flexible delivery capacity and lower overhead.
- *Look at transactions first.* If you are already using several outsourcing providers and you have a small training staff, "then maybe there isn't as big a return on outsourcing the whole thing." You could realize a substantial cost savings, however, by outsourcing the vendor management to someone who can reduce your overall vendor expenses. Likewise, by outsourcing the training technology platform, you could reduce the headcount associated with it or avoid a large capital investment. "If you have staff that are spending their time putting courses into a catalog, producing materials, taking registrations, you don't really need those people. These are generic activities that are suitable for leverage that you should be able to get from a company that provides that service to multiple clients."
- *Figure out what you control.* Do you have stewardship of all the processes? Do you have duplication of processes, activities, resources, and technology across your company? "If there are ways to bring those things together that are leverageable, you ought to do that."
- *Determine the cost impact of outsourcing.* Will economies of scale, technology infrastructure, and consolidated program and vendor management capabilities produce a cost savings?

If your business—and therefore training—model is highly volatile, outsourced training transfers the burden of appropriate staffing to someone outside your department. When a business contraction forces you to conduct fewer new-hire orientation programs, for example, it will be the training outsourcing vendor who will make staff adjustments, if any. "Outsourcing everything is a big decision to make. It's complex and involves lots of aspects of training. In this context, the corporation is saying, 'This is not a core competency—any of it—and I can't do it at the level of quality and value that I need to, and therefore, I'm going to have somebody else do the entire thing for me.' " Outsourcing of the so-called back office of training (for example, administration, transactional activities, and technology) occurs when training managers believe an outside vendor can provide the services better and more cheaply, leaving internal staff to focus on meaningful training issues.

GETTING A TRAINING BUDGET APPROVED

Planning a budget presents a dilemma for many training managers. Overestimate the cost of your training needs, and you lose credibility with the finance department. Underestimate, and you risk putting yourself in the undesirable bowed-head position of asking for more funding at a later time to meet those shortfalls—with no guarantee that the money will be available to you.

Gary Steinkohl, founder and president of The Lumin, offers his clients financial skills training, cost accounting, budgeting, and financial analysis expertise and experience. Steinkohl, a former controller with *Fortune* 500, shared with IOMA his five key strategies for preparing for the (dreaded!) budget process and getting the funding you need.

1. *Make budgeting a tool, not a game.* "Too often as business managers, we try to get approved what we think is approvable by taking last year's budget and adding *X*% and then building in cushions—sandbagging, cookie-jar reserves—all of those being extras that we don't necessarily need, but we include in anticipation of being asked to cut our budget at a later point."

   But that's the way the game is played, you say. It doesn't mean that you have to join in, especially if it means that you lose credibility. If you honestly quantify and request what you need to run your programs, you're adding real value to the organization, says Steinkohl. If later on you are asked to cut your budget, you can legitimately respond with something akin to "a 5% cut in budget will result in a 5% reduction in my training output since I only budgeted for what I needed to achieve our original goals." "Your budget is a tool. If you're asked to cut your budget by 5% and you can still deliver what you originally promised, then you have over-budgeted and that makes it a game."
2. *Budgets are never etched in stone.* A good budget is simply your best estimate and quantification of funding requirements for a period of time. "None of us has a crystal ball. Business will change; needs will change. Budgets by their nature must be living, breathing, dynamic estimations."

   Historically, actual spending differs from the budget. For example, your company expects business to fall off 10% in the next year so your training budget is going to be reduced accordingly. Partway through the next year, the business in fact does not contract, it expands by 15%. It would be unreasonable to expect you to deliver the same outcome based on the original budget. "This is a variable out of your control—hiring is going up, so you must ramp up to be able to provide appropriate new-hire orientation programs," Steinkohl explains. Finance people might not like it, he admits, but they would have to accept it. The alternative is that you will need to increase the number of employees per new-hire orientation session to stay within your projected budget. The question to pose is, "Is this in the best long-term interests of the organization?"
3. *Do variance analyses.* Performing variance analyses—looking at actuals compared to budgeted numbers—is a critical tool every business manager must have, says Steinkohl. First, it helps you understand what happens versus what you thought would happen: actual versus budget. Then—and this is the crucial element for any training manager—it uncovers why the variance, if any, occurred.

If the reason for the variance is due to something within your control, you are responsible and accountable for the variance. For example, you purchase a learning management system that you anticipated would cost $250,000 and it turns out to be $300,000. What was the reason for that? Was the original budget estimate due to your miscalculation, or something out of your control (such as changes in the marketplace)? If it is out of your control—for example, the phenomenon of business contraction versus growth—then you are not accountable for the variance. It is simply business.

4. *Go for the Big Three.* You have the greatest chance of budgeting success when you have responsibility, authority, and accountability: responsibility for achieving a goal, authority to carry out the steps needed for achievement, and accountability for success or failure. For example, if you are responsible for delivering an executive coaching program, but you do not have the authority to hire the outside vendor and you are accountable for the program's success, you will be in a difficult position. "You can only succeed in budgeting for this project by partnering with the person who has the authority to spend the money."

   In the new-hire orientation example, if you have the responsibility for delivering the program, but you do not make the decision about how many people are in each session, your accountability for the outcome is tarnished from the start.

5. *Learn the language of the CFO.* "I can't tell you how many times I have sat down with HR and training managers who could not communicate their business plan in the language of accounting and finance," says Steinkohl. "Since the CFO controls the dollars, training managers have to learn their language sooner than the CFO has to learn theirs."

What You Need

You need to be able to understand and communicate core accounting and finance concepts: what return on investment (ROI) analysis is and how it is done; how to quantify training projects; the impact of training on earnings; and the impact on the balance sheet of purchasing an asset and the depreciation impact over the following years. For example, you decide to purchase a learning management system (LMS). You need to know what it is going to cost, the annual financial impact of the purchase (including annual upkeep costs, maintenance costs, and depreciation), and the benefit you are going to realize—saving *X* number of headcount, being able to track training results, and the anticipated dollar impact on improved customer service through having a better-trained task force.

Where to Start

Contact colleagues in your finance department and find out what skills you need to deal with them effectively in your business environment, Steinkohl recommends. There are also myriad local and national financial training organizations that can help you get the financial skills you need to make better business decisions. (For a list of training options, see Sidebar 6.1.)

Sidebar 6.1. Financial Training Resources

- The American Management Association (www.amanet.org/seminars/cmd2/Finance.htm)
- Worldwidelearn (www.worldwidelearn.com), touted as "the world's director of online courses, online learning, and online education"
- Apples and Oranges, by Celemi, business finance for nonfinancial people (www.celemi.com/simulations)
- Balance Sheet Barrier, by AIM Learning Group (www.aimlearninggroup.com) (*Note*: Received four-star rating from *Training Media Review*)
- Finance for Non-Financial Managers, Wide Multimedia Ltd. (www.widelearning.com/website/02_e-library/non-financial.html)

CALCULATING THE ROI OF LEADERSHIP TRAINING

By now you are probably convinced that measuring the impact of training programs is something you absolutely need to do. But if one of your C-level executives asked you to do a return-on-investment study of, say, your leadership development training, could you do it? Would you know where to start?

That's what happened to Michelle Wentz, the assistant manager of training and associate development at BMW Manufacturing Corporation (Greer, South Carolina). She was new to training measurement and soon realized that she needed some help, Wentz told training professionals at an ASTD ROI network conference. Working with Toni Hodges, of TH & Company, an ROI consultant and author, Wentz developed a step-by-step process for selecting a program, applying the ROI process, and calculating the tangible business benefits of BMW's Leadership Mastery Program (LMP). Here is how the process works:

Step 1. Program selection. The LMP targets 18 leadership competencies by way of a 360-degree feedback inventory for managers, supervisors, and individuals with project responsibilities. The program entails three classroom days followed by eight hours of individual coaching.

Wentz and Hodges used a program selection decision matrix to home in on the LMP as a good prospect for an impact study (see Exhibit 6.2). There were challenges, because the program had already started, Hodges noted. Ideally, you would begin the ROI process in advance so that you would already have evaluation objectives and standards for data collection in place.

Step 2. Establishing objectives. Although BMW, with 5,000 employees, had compelling performance objectives for the LMP, it had no established business objectives for the course. Who better to trust to establish these objectives than the training participants, it decided. Through a series of focus groups among different functional areas (each was using the LMP in a different way), participants came up with a list of very potent business objectives.

Step 3. Collecting the data. Wentz and Hodges collected data for the training impact study in several ways:

Exhibit 6.2 Training Program Impact Study Selection Matrix

Criteria	Weighting
Tied to operational goals/strategic objectives	10
Able to measure behavior/skills before and after training	9
Known or identified performance gap	8
Competency-based program	7
Program has long life cycle	6
Program has a high cost	5
Program is high visibility/high impact	4
Program is conducted frequently	3

Rating scale: 5 = meets criteria completely
Weighing: 10 = greatest importance/weight

Source: Michelle Wentz

- Reaction data from 158 LMP participants using a written evaluation form.
- Job application data from a 360-degree assessment (pre- and posttraining data from 16 out of 34 participants).
- Business impact data from an LMP review survey of 128 participants. The survey instrument was designed to isolate the impact of coaching from the overall training program so it could distinguish the difference in results.
- A leadership mastery ROI survey (24 of 36 LMP participants responded) that identified tangible benefits and actual program costs.

Step 4. Data analysis. Hodges and Wentz used a return-on-training analysis team, with representatives from coaching and program design, to compile and analyze the results. Throughout the impact study process, they used the Jack Phillips Center for Research ROI Process™ (briefly, evaluation planning, data collection, data analysis, ROI and reporting).

Step 5. Calculating the results. Reaction and job application results were high:

- Participants saw improvement in 13 of 18 competencies. In four areas:(1) communicates with impact, (2) fresh thinking, (3) positive disposition, and (4) decisionmaking—the group reported significant improvement.
- Both training and coaching were perceived to have a positive impact on meeting business and performance objectives.
- Participants that received more coaching perceived a higher impact to business/performance objectives (20 to 50% higher impact with five or more coaching sessions). These results were based on a pre- and post-training 360-degree assessment that 16 participants agreed to complete.

Step 6. Calculating tangible benefits. Wentz and Hodges were able to isolate tangible benefits and convert them to dollar values based on participants' analysis of 10 business benefits that the earlier focus groups had identified (see example in Exhibit 6.3). The eight business benefits were:

Exhibit 6.3 Sample Calculation of Tangible Results, BMW Manufacturing Leadership Mastery Program

Question	Example
1. Identify the business benefit with the highest impact from the LMP	Fewer hours spent in meetings
2. What is the monetary value of each unit of improvement?	$30 per hour
3. What was the change in this unit over a 30-day period?	Four hours per month
4. To what extent do you credit the LMP for this change?	70% of change
5. How confident are you of this estimate?	80% confident

Source: Toni Hodges

1. Reduced number of issues (problems)
2. Fewer hours spent in meetings
3. Reduced time to full productivity
4. Reduced turnover
5. Fewer associate (employee) complaints
6. Improved customer satisfaction
7. Reduced minutes in rework
8. Improved vehicle quality measures

The highest tangible benefit the training produced was a reduced number of issues (BMW-speak for problems), producing a tangible benefit of $50,284. Fewer hours spent in meetings was the benefit most often realized, producing the second highest tangible benefit ($27,446).

Step 7. The ROI. Program costs (not including the cost of the ROI impact study itself, because it was a training exercise) were $103,392. (*Note*: Design and development costs were prorated over the five-year life span of the program times the number of participants per year.)

Program benefits assigned to all of the 8 business objectives were $124,008, an ROI of 19.9%. This is a conservative estimate, Hodges noted. (See Exhibit 6.4.)

Exhibit 6.4 ROI Calculation

Benefit Cost Ratio:

$$\frac{\$124{,}008 \text{ (training benefit)}}{\$103{,}392 \text{ (training costs)}} = 1.20 \text{ (every dollar spent on training produces a \$1.20 return)}$$

ROI Calculation:

$$\frac{\$124{,}008 \text{ (training benefit)} - \$103{,}392 \text{ (training costs)}}{\$103{,}392 \text{ (training costs)}} = .199 \times 100 = 19.9\% \text{ ROI}$$

Conclusions and Lessons Learned

Based on the estimates of the task force members and some LMP participants, Wentz and Hodges concluded that the program had improved leadership competencies that participants could apply on the job and that the LMP is leading BMW employees toward leadership with a financial return. Wentz and Hodges believe they can realize a higher ROI by making several adjustments, among them narrowing the field of LMP business objectives to determine which competencies to target in the program (strengthen the link to business results). They plan to replace fictitious scenarios with real BMW-based situations and enhance the coaching segment of the program. They will also incorporate action planning as part of the LMP and make the link between LMP and BMW business objectives an integral part of the program.

Next Steps

BMW plans to continue the Leadership Mastery Program. In the future, the training design process will include input from senior management that will link the LMP to business and organizational objectives. Wentz will also focus measurement efforts on learning and on-the-job application and performance impact.

Wentz also plans to prepare future participants for accountability, another important tenet of the ROI process. "Participants will know the program expectations—how they will apply it and the expected impact," said Wentz. "They will know that we're taking them off the job, investing in them, so we expect that to have an impact on the job."

When calculating ROI, three things to watch for are:

1. *Finance department resistance.* Hodges and Wentz met with resistance from the company's finance people, who believed that "nothing gets a 19% return." They settled the issue by changing "ROI" to "ROT" (return on training). Despite the initial skeptical reception of the study, ultimately the LMP ROI study received an honorable mention from the company's auditor as a company best practice.
2. *360-degree assessments.* These can sometimes be tricky, said Hodges. In this case, too much time elapsed between the pre- and posttraining assessments, so there were staff changes that affected results. In the BMW study, 360 analysis was used only as supporting data.
3. *Anticipate personal bias.* Parties with a vested interest may try to influence study results, Hodges noted. Therefore, the evaluator needs to remain neutral. (*Note:* This was not a problem in the BMW study.)

"ROI CAN'T" TO "ROI CAN-DO"

You might think you are slipping by unnoticed, rolling out training programs with simple evaluation sheets and seat counts as the measure of your success. That approach will not serve you well when it comes to budget allocations and credibility for your department. As John Coné, interim president and CEO of ASTD, said at an ASTD ROI network conference, it is no longer enough to be a workplace learning and development expert with an understanding of business. We must now be expert business people who understand learning and development.

Exhibit 6.5 Calculating ROI

$$\text{Benefit/Cost Ratio (BCR)} = \frac{\text{Program Benefits}}{\text{Program Costs}}$$

$$\text{ROI} = \frac{\text{Net Program Benefits}}{\text{Program Costs}}$$

Source: Jack J. Philips, Ph.D.

Feel the Fear

As much as training managers resist, return-on-investment (ROI) measures—on some, not all—of your initiatives is as essential as good learning design and performance support (see Exhibit 6.5 for a sample ROI calculation). Why do we fear it? Because it is hard to do. There are all manner of pitfalls. How do you isolate the impact of training? How do you assign a monetary value to results? How do you convince management to pay for an ROI study?

Why Do It?

You do it because there is a tremendous payoff, states Jack Phillips, of the Jack Phillips Center for Research (Chelsea, Alabama). Long a champion of ROI, Phillips believes that CEOs—and, in fact, management at all levels—want and expect these measurements. Consider this anecdote: One training manager Phillips worked with did not provide management with training ROI measurements because they had never asked for them. Why did management not require ROI data on training? Because they did not think the training manager could provide it. Training managers need to harness the ROI process in such a way that they can build respect for their training departments and build staffing and budget, Phillips said at the ROI network conference. For example, Black & Decker doubled its training budget as a result of its ROI process.

ROI measurements are also important because they force you to eliminate or restructure inefficient programs. “If you have a program that’s not adding value and it’s your program, who gets blamed?”

Getting Past “Can’t”

To get to a comfort level with the ROI process, it is important to understand some of the key issues and how to manage them.

1. *Organizational barriers.* Training managers have always had an angst-filled relationship with department managers. Training requires the sacrifice of productive employee time to attend training, even if it is intended to make them better at their jobs when they return.

There are two parts to dismantling this common barrier, says Phillips. The first is to create a sense of accountability among training participants. They are not passive observers in producing an ROI on training. Indeed, they are an essential part of analyzing and assessing programs, and then taking what is learned back to the job to be more efficient and productive.

At the same time, if you can show managers the value of the training—in business terms—they will be far less reluctant to support your programs. Think of the impact if you could say to your CEO, "Would you mind letting employees go to training if you knew that the results would offset the costs?"

Managers are accustomed to asking for ROI, Phillips noted, except when it comes to training. They have systems in place to report production results, for example, and they are likely to spend 5% or more of their budgets making these measurements. "Training must have the same reality." *Note:* Phillips estimates that 3% to 5% of your training budget will be needed for ROI measurements.

2. *Curse of high results.* It is not uncommon to produce an ROI of 100% to 700% on leadership, team building, or sales training initiatives, Phillips noted. For example, in 2003 IBM reported that it had achieved an ROI of 2,284% and a payback period of two weeks on its e-learning initiative. These kinds of results are so far beyond normal ROI expectations that management will refuse to accept that they are accurate. To build credibility, says Phillips, training managers must always be conservative in their estimates and show management what they need to see. That means that sometimes you leave intangibles as intangibles (increased job satisfaction, improved teamwork, reduced complaints, etc.) rather than trying to force them into some kind of absolute, Phillips stated.

   Tie training ROI targets to your organization's hurdle rate (the minimum required return on capital investments) or slightly higher, Phillips recommends (about 15% to 20% in the United States). In fact, your results may be higher. First-level supervisory training could have a 50% ROI in terms of its impact on turnover, absenteeism, and job satisfaction, for example.
3. *Isolating the impact of training.* Despite what some researchers will tell you, you do not need a control group study to isolate the impact of training on results. In fact, it is possible and plausible to use training participants' estimates to assess the extent to which training has influenced performance, says Phillips. "We tend to underrate participant data, but who knows best what's affected their performance? For example, most sales reps *know* why they have increased sales." That said, it is important to be conservative in these estimates and to ask participants to rate their confidence level in their estimate of training's impact on performance. (See Exhibit 6.6.)
4. *Converting data to monetary values.* There are a number of conversion methods, including converting output to contribution; converting employees' time; linking with other measures; and using participants', supervisors', and managers' estimates. Some examples include:

   - You can use an external database, such as industry data, to calculate the cost of turnover.
   - You can calculate the cost of one sexual harassment complaint by tallying actual costs from historical records, including legal fees, settlements,

Exhibit 6.6 Participant's Estimate of Training Impact

What Influenced Improvement	% Improvement Caused by	Confidence	Adjusted Improvement Caused by
Training program	60%	80%	48%
System changes	15	70	10.5
Environment changes	5	60	3
Compensation changes	20	80	16
Other	—	—	—
Total	100%		

Source: Jack J. Phillips, Ph. D.

materials, direct expenses, and the like, adding in the related costs of your HR staff and management time, and estimates of additional costs from HR staff. Divide by the total number of complaints in a given year and you will have a dollar cost for each incident. If your training initiative reduces the number of those complaints, you will have a dollar amount to include in the benefits portion of your ROI calculation.

5. *Making the dreaded cost calculations.* When costs go up, of course, the return goes down, so this part of the ROI calculation is difficult for many training managers.

   Phillips' rule for calculating costs: Include everything. This builds credibility with your CFO, even if you are more inclusive than he or she would have been. Phillips recommends that you include such things as needs assessments and development costs (prorated), program materials, instructor/facilitator costs, facilities, travel, lodging and meals, participant salaries and benefits, administrative/overhead costs, and evaluation costs.
6. *Managing the cost of ROI measurements.* Start early and build evaluation into the process, Phillips recommends. If your program is ripe for accountability, then set it up for a ROI analysis at the beginning.

The ROI process is appropriate for everything from e-learning to executive coaching, from global leadership to safety and health programs. To determine which programs make sense to measure, remember that an effective ROI process must be simple, economical, credible, theoretically sound, flexible, appropriate for a variety of programs, applicable with all types of data, and have a successful track record.

DEVELOPING ONLINE LEARNING IN-HOUSE

The United Way of America (UWA) has always relied on traditional classroom training to provide customized programs to its 1,400 local affiliates. A few years ago, the UWA decided to take the leap into e-learning, offering its audience a package of 51 off-the-shelf e-training programs ranging from management skills to conducting effective interviews.

Project Failure

Trainees showed little interest in the material, and the UWA eventually abandoned the program altogether. Training staff at UWA then took a hard look at their e-learning initiative. During this postmortem, they concluded that rather than generic prepackaged training materials, trainees wanted e-training opportunities that dealt directly with the unique nature of their work and the demands it placed on them.

e-Learning Redux

One year later, the UWA decided to make another attempt to integrate e-learning into its training agenda, but this time it would create its own content—on a shoestring. With a budget of only $10,000, not including staff time and outside consulting fees, the UWA created the technological foundation for its e-learning network. In less than a year, it successfully launched a pilot e-course that was well received and given high marks by learners.

The Process

"Our first step was to form an interdepartmental team to devise a strategy and oversee development of the e-course," said Kathy Napierala, a veteran UWA multimedia developer who was named e-learning project manager. Rather than attempt to create several e-classes at the same time, the team decided to focus on a single pilot course. For the pilot, it chose a condensed e-version of one of its most popular introductory training sessions, "United Way 101," which it renamed "Introduction to United Way."

The team reviewed the various e-training formats on the market and decided which approach would be the best fit for its audience. They decided on a self-directed model for the introductory course, said Napierala, who is now an independent multimedia and e-learning consultant headquartered in Silver Spring, Maryland. Once the pilot was finished, the team planned to introduce an advanced training course based on a blended teaching model containing such additional elements as instructor-led Webcasts and online interactivity.

Originally, the UWA intended to deliver its e-training exclusively on CD-ROM. The team later concluded that CD-ROM was too restrictive when it came to such considerations as the ability to update the course easily and inexpensively. The team also concluded that CD-ROM was not well suited to measuring user completion or retention rates. "Since we already had our own extranet, United Way Online, in place, we decided to make the Web the foundation of our delivery system," said Napierala.

After considering various technical issues, including the fact that the UWA did not own a streaming video server and did not have the budget to contract with an outside server, the team chose a blended distribution system. “At this point, we decided the initial content would be distributed and student usage measured on the Web using United Way Online. Meanwhile, media would be distributed on CD-ROM,” said Napierala.

Napierala also recommends that any organization considering e-learning survey and review the various kinds of technology and training materials that already exist within the organization that could be used to build on and deliver training programs. “We were lucky in that we already had video training materials that could be re-purposed and had an internal Internet structure to build on.”

Don’t overlook tech people. It is easy to forget this in the press of e-learning decision making, but including technology people in the planning and execution is critical. “It is important to cultivate the support of your technology people. So, be sure to include the IT department in the process from the start,” said Napierala. “Their input will be critical when deciding what approach and combination of technologies is best suited to your organization. Their insight will also be vital when it is time to draw up a budget and set timelines.”

Once a CD-ROM prototype was developed, the team ran it through a series of tests with potential users at the UWA’s annual local leadership conference. Although it was well received, several changes suggested by the testers were analyzed and incorporated into the final version of the course, which has been successfully implemented since then.

Lessons Learned

The following are Napierala’s lessons learned in the launch and relaunch of UWA’s e-learning initiative. These are valuable guidelines for those who are eager to join the e-learning revolution, but cautious about possible traps and pitfalls.

- Enlist an e-learning champion from the upper manager ranks to ensure that the initiative gets proper consideration within the organization and assistance when it hits a snag. A likely candidate is someone who is comfortable with and understands the advantages and possibilities technology offers.
- Assign a dedicated project manager to ensure that the project stays on track.
- Whenever possible, leverage any existing in-house database and computer resources to ensure that e-courses are compatible with the organization’s other technologies.
- Look for a blended training approach that is easy to use, interactive, and interesting, to achieve maximum student learning and retention.
- Remember to focus on the task at hand while trying to avoid personality and turf conflicts. Remember also that all the departments involved in the project need to feel they have an ownership stake in the program’s success.
- No matter how good the plan, it will take longer than originally expected to gather and design the right combination of e-content.
- Even after making the system as easy to use as possible, the odds are that trainees will require more “hand-holding” and technical support than anticipated.

- No magic formula ensures the formation of a successful e-learning strategy. Every organization has a different set of needs and cost structure, Napierala noted. “My best advice is, try to achieve a workable balance between the twin goals of cutting training costs and delivering the right combination of blended learning that meets the needs of your workforce.”

HOW TO SELL AN E-LEARNING INITIATIVE TO MANAGEMENT

In a majority of organizations, e-learning is still in its infancy, if it is even a part of the learning agenda at all. But maybe you have discovered that augmenting existing classroom training programs with online learning or support is just the thing to keep your budget on track and still provide the critical training your organization needs to stay competitive. How do you sell that idea to the people who control your budget and resources?

Sell the Benefits

This is the adage that guides all good sales presentations, but it is one that training managers often overlook in their enthusiasm about new training programs or methods. If a vendor comes calling with a fail-proof e-learning product, sit that person down and ask him or her how the product will address *X*, *X* being your most compelling business problem (*not* your most compelling *training* problem). For example, your company is about to launch a new product on a global basis. All employees—marketing, sales, support, and distribution—must be trained on the product prior to its launch. You are in charge of that. How will the e-learning product provide the required training faster, better, cheaper? *Tip*: Do not allow the vendor to focus only on cost reduction. You want to tell your C-level friends what the upside benefits will be: faster time to competency, which results in faster time to market, which results in increased profits.

Do not forget customers and suppliers. Where appropriate, think big picture for your e-learning initiative. Can you extend it to customers and suppliers so that they can understand and make better use of your services or products?

Speak the Language

Brandon Hall calls this “C-ese,” referring to the “chief” in management titles. For example, you say, “This e-learning program will enhance learning transfer and the simulations the systems offers will allow employees to actually practice the training online.’’ What the CEO/CFO/COO hears is: “Blah blah learning blah blah costs money.” Instead, try introducing your idea with a statement like, “If we add this new e-learning product I’ve investigated, it will reduce classroom training time by 25%, get employees on the production line in three months instead of six, and save the company about $30,000 in the first year.” The focus has to be on hard-data things like selling more products or services, generating higher profits, getting a return on investment, or lowering costs.

Make Friends with a Techie

A high-level manager in your organization who is a technology savant can be an invaluable asset in selling your e-learning plan. Use this person as a champion for your cause and as a sounding board for your e-learning sales proposal. You can also engage other "influencers" in your organization to support your e-learning mission—employees who have high credibility and to whom others, management included, listen and respond positively.

Prepare Your Case

Talk to associates who have already added e-learning to their training scheme. If you do not know anyone personally, go to local or national training conferences. Vendor demos are great, but remember that they are designed to showcase the product, not highlight its shortcomings. You want credible testimonials about how e-learning products work, how long it took to get them up and running, and, most important, the results. Be prepared to explain to C-level personnel what the costs will be (all of them: technology, infrastructure, licensing or host fees, implementation costs, support and maintenance, and so on).

Find Data to Support Your Plan

To add weight to your contention that e-learning is a viable business proposition, build an arsenal of statistics and case studies that show the importance of e-learning, its economic value, and the business results it produces. Some you can use include the following.

- International Data Center (IDC) shows that, although the majority of U.S. companies' training expenditures are for traditional training services and products, a clear shift is taking place. IDC estimates that U.S. employers will spend $11.4 billion this year on Internet-based training.
- So-called *human capital*—the combined value of workforce skills, knowledge, experience, and attitudes—is a top priority among CFOs. In fact, CFOs consider building leadership capabilities and raising workforce productivity top priorities, according to a study by CFO Research Services and Mercer Human Resource Consulting. A well-thought-out e-learning plan that can support those priorities is likely to find an eager audience.
- In a small (36 respondents) study by Corporate Universities International, more than half (64%) of respondents agreed or strongly agreed that employers will rely on synchronous (live) e-learning technology to deliver training and create opportunities for learners to interact formally.

  Here are some other examples of e-learning success:

- EMC Corporation (Hopkinton, Massachusetts) strives to get employees up to speed on a product concurrent with its launch. Using a combination of e-learning, instructor-led training, and coaching programs, the training department saved the company about $5 million in the first year in reduced costs ($2.5 million per quarter); salaries, travel, and facilities related to classroom training ($1.8 million); and faster time to reach sales quota (from 8 to 12 months to 3 to 8 months).

- At Captain D's Restaurant (Nashville, Tennessee) mystery shoppers test the outcome of computer-based, onsite customer service training. Posttraining results indicate that satisfaction levels have jumped from an average of 78%, to between 84% and 85%.
- Sun Life Financial (Wellesley Hills, Massachusetts) uses computer-based training, coaching, apprenticeship, and personal tutoring. Business results: Improved time to job proficiency by 67% and increased productivity by 38%.
- Avaya Communications (Basking Ridge, New Jersey) has increased online learning programs from 17% to 53% as part of a training and development overhaul. Avaya University supports the largest introduction of new products in the company's history.

Be Prepared to Answer These Questions

Typical C-level concerns about any business proposition that has costs attached to it include:

- What are the key business issues this e-learning initiative will solve?
- How much will it cost? How do you plan to fund it? What departments will help defray the cost? What is the payback and when?
- How will you measure success? (Dollars, productivity, profits, faster time to productivity, and the like.)
- Who will use the system? Where? How much time will it take?
- How will the technology aspect work? Will we be using internal systems?

USING RAPID E-LEARNING TO DELIVER COST-EFFECTIVE TRAINING

Recognizing the weaknesses of a training method often leads to the development of a better method. This is true for e-learning: Its inherent shortcomings—that it takes too long to develop courses, it can be costly, and many technologies do not work together—have led to the development of what the training industry calls "rapid e-learning."

Although rapid e-learning courses are developed quickly, they still deliver engaging content. Training managers can easily manage the content and use basic assessment and tracking tools to ensure that learners viewed and absorbed the content. The essence of rapid e-learning, explains Chris Howard, principal consultant at Bersin & Association (Oakland, California), an e-learning research and consulting firm, is that you need not be a "techie" to create the material. Rapid e-learning applications use software such as Macromedia Breeze and TechSmith Camtasia to convert existing, common development tools such as PowerPoint, Word, and Adobe Acrobat to Flash so that learners can view them via Internet browser. This process allows for interesting and interactive elements without the usual technology barriers.

When Does It work?

Rapid e-learning is useful for training that is information-oriented and that covers constantly changing content, Howard explained at a training conference (see Exhibit 6.7). For example:

- You must train 5,000 customer service reps and know who passed the quiz—immediately.
- Your company releases a new pricing model for one of its products or services. You must inform sales staff of its existence, how it will work, and how it is different from the previous model—immediately.
- You must certify all new employees on your company's safety procedures—immediately.

How Does It Work?

Here is a typical example of how this would work: You have new products and services that you announce several times each year to a busy sales force. Although

Exhibit 6.7 Applying Rapid e-Learning

Category	Example	What Learner Will Do	Tracking	Tools	Result
Information Broadcast	"There is a new pricing model being announced and here it is."	Read	None	E-mail, Web page PowerPoint **Rapid e-learning**	Perfect Fit
Critical Information Transfer	"Here is the new pricing model, how it works, and how it differs from the previous model."	Read, listen, and answer some questions	Who took this? Did they get it?	**Rapid e-learning**	Perfect Fit
New Skills and Competencies	"Learn how to price complex products so you can become a pricing guru."	Read, listen, and try out new skills	Did they really learn? What score did they get?	**Rapid e-learning** Courseware with assessments	Okay Fit
Certified Skills and Proficiencies	"Become a certified pricing expert in the regional sales office with authority to give discounts."	Read, listen, try new skills, and become certified	Did they pass? Are they certified?	Courseware, assessments, simulations, manager intervention	Probably Not a Fit

Source: Bersin & Associates

your workers are spread throughout the United States, you need to monitor their readiness to deliver these product updates.

Subject matter experts (SMEs) can create training modules using PowerPoint as their authoring tool, filling in templates and speaker notes. Using Macromedia Breeze, for example, just one of several applications that can produce rapid e-learning materials (for a more complete list, see Sidebar 6.2), the PowerPoint materials are converted to Flash and a professional narrator creates the audio from speaker notes. Breeze also tracks learner activity, including slides viewed and quiz results, allowing SMEs to adjust content over time as necessary. This approach, says Howard, can reduce training costs by one-third to one-half of traditional methods and requires no external learning management system (LMS) for tracking.

Who Is Using It?

BMW Group Canada (Whitby, Ontario) delivers about 40% of its training via e-learning, Brian Doegen, e-learning consultant, BMW University, told recent training conference attendees. The company used rapid e-learning to provide information to its international workforce on its BMW 5 Series automobile, which had been redesigned and was being relaunched. The company needed to increase overall training, but reduce the amount of classroom training, Doegen explained.

BMW Group used a blended approach, converting content into e-learning modules and then integrating e-learning with multiple learning management systems throughout the company. BMW Group employees completed the rapid e-learning program prior to (and as a prerequisite to) instructor-led training. The rapid e-learning program consisted of three elements: (1) the BMW brand, (2) the ability to distribute globally to the entire workforce, and (3) the ability to incorporate knowledge management in a global networking consortium.

1. *e-Learning style guides.* The product recognizes that each BMW brand has a distinct identification and presents materials with one face and one voice on standard templates.
2. *e-Learning technology guidelines.* Use of a standard authoring tool (in this case, Lectora Publisher) allowed the company to share the content globally. Lectora is simple for training staff to update, creates content that can be shared among BMW group companies, and integrates with multiple LMSs, Doegen noted.
3. *e-Learning knowledge exchange.* A global consortium to promote networking.

The results were a 35% reduction in the amount of instructor-led training. The company plans to use the same approach for new-hire orientation.

Potential Cost Savings

Rapid e-learning saves both time (in development) and money. Bersin & Associates estimated that development time can be reduced from several months to days or even hours using rapid e-learning tools (see Exhibit 6.8). Cost savings per instructional hour can be reduced substantially as well. Using Macromedia

Exhibit 6.8 Cost and Time Comparisons of Training Media

Media/Tool	Development Cost per Instructional Hour	Time Required
PowerPoint Alone	$50 to $500	Hours
Breeze	$100 to $1,000	Few days
Courseware	$1,000 to $35,000	Months
Simulations	$20,000 to $75,000	Many months

Source: Bersin & Associates

Breeze, for example, the cost per instructional hour is $100 to $1,000 versus $1,000 to $35,000 for standard courseware.

Some tips to remember are: Require the e-learning vendor to show you everything. "If they say they can do it, but do not demonstrate it, their score on that feature should be zero," said Howard. Rapid e-learning is one instance in which dealing with smaller vendors is a plus. Also look for integration capacity, bearing in mind that few learning management systems are integrated with learning content management systems because the technology changes faster than vendors can keep up with it. In addition, plan to restructure course material so it can serve as a job aid or reference tool as well as a training tool.

VIRTUAL CLASSROOM PRODUCES IMMEDIATE ROI

If you are thinking about launching an e-learning initiative, one of the first questions management will ask you is, "How much will it cost?" The second is, "How

Sidebar 6.2. List of Rapid e-Learning Products

Scheduled (Live Training Events)

- Centra
- HorizonLive/WebCT
- InterWise
- LearnLinc/iLinc
- Lotus Virtual Classroom/Sametime
- Macromedia Breeze Live
- Microsoft PlaceWare
- WebEx

Self-Paced (Asynchronous)

- Articulate
- Apreso
- Blackboard
- EEDO
- Macromedia Breeze
- Microsoft PowerPoint (with audio)
- RoboDemo
- OutStart TrainerSoft
- Trivantis
- Lectora

Source: Bersin & Associates

much will it save?" That all-important ROI calculation is the tool you can use to answer those two questions in a format that both finance and management appreciate.

The following is an ROI case study presented by T-Mobile USA (Bellevue, Washington) at a recent training conference. The technology at T-Mobile USA, an international wireless service provider, moves at wireless speed, making instructor-led training at multiple company locations a costly and inefficient way to provide training. Mike Bennett, manager of engineering and operations training, and his team provide training for T-Mobile's engineering, risk management (safety), and customer care staff. The engineering courses are generally delta classes—training that covers the difference between a current product release and an updated version.

Because it is impossible to keep its internal trainers up to date on product releases, the company relies on training experts from its product lines, such as Nortel and Ericsson, to provide the training. This adds to the expense because the instructor fee is approximately $2,000 per day and the trainers must travel to various locations. "The conclusion was obvious," Bennett said. "We had to figure out how to use technology to educate more people for less money." He began to investigate virtual classroom products and vendors with an eye to cost control, flexibility, and easy rollout. On July 1, 2001, T-Mobile USA partnered with Elluminate, Inc., to create an initiative called "Elluminate*Live!*" T-Mobile was Elluminate's first commercial customer; it had worked primarily in education in its former incarnation as TutorsEdge. T-Mobile's first virtual classroom went live in August 2001. By March 2003, the company had Internet access to "Elluminate*Live!*" By January 2004, with two additional licenses, Elluminate was providing training to 200 concurrent users on three servers.

The impressive part, said Bennett, was the nearly immediate return on the company's investment in virtual classrooms for training. ROI was particularly important for Bennett because the company's education budgets reside outside of his department, in the various markets and regional offices, and managers pay close attention to such things. To prove the cost benefits of the virtual classroom approach, Bennett made the following assumptions:

- The average salary for field technician and engineer trainees (excluding benefits) is $50,000.
- All ROI scenarios are based on actual classes and represent real training numbers.
- Travel costs are estimates.
- Program cost is based on the Elluminate contract, although Bennett cannot disclose the terms of T-Mobile's contract with Elluminate.

Two scenarios show the T-Mobile experience in developing the ROI for its virtual learning effort:

Scenario 1. Bennett's first ROI case study involved one-day, small-group training with one to ten trainees per location. Previously, training had taken place in nationally dispersed groups of 25 to 30 people, with the instructor traveling to students on Sunday, Tuesday, Thursday, and Friday nights after class (Bennett jokingly refers to this case study as "Kill the Instructor").

Using the virtual classroom, T-Mobile was able to increase the number of classes per week from three to five, eliminate travel and lodging costs, and reduce the cost per class from $7,208.33 to $2,400 (see Exhibit 6.9). Bennett reduced the total expenses for the training from $21,625 to $12,000, a savings of $9,625. He also received moderately good participant satisfaction ratings on the training.

Scenario 2. This involved the company's first virtual class rollout, to 125 technical staff, of a three-day training on a new mobile data solution the company was planning to deploy. Previously, trainees would have traveled to Richardson, Texas, for training that involved two travel days, with the company incurring overtime costs to cover the manhours lost to training. The virtual classroom training reduced the total course cost from $352,163 to $108,173, a total savings of $243,990 (see Exhibit 6.10).

Changing the class structure from three full days to five half-day sessions allowed trainees to continue performing their core job functions. Bennett trains half of the technicians in the morning and half in the afternoon class, so the company always has staff coverage. This reduced the course cost from $80,115 to $68,971.

Eventually, T-Mobile negotiated with Elluminate for a perpetual unlimited license to deliver its classes. T-Mobile is now a true capital partner with Elluminate. "With our perpetual license," Bennett explained, " 'Elluminate*Live!*' is considered

Exhibit 6.9 Scenario 1: Small Groups, High Travel

	Onsite	Elluminate*Live!*
Travel (per class)	$400	0
Lodging (per night)	$225	0
Travel nights	9	0
Total travel and lodging	$5,625	0
Instructor cost per day	$2,000	$2,000
Instructor cost per week	$14,000	$10,000
Total expenses for class	**$21,625**	**$12,000**
Number of classes per week	3	5
Cost per class	$7,208	$2,400
Total savings		**$9,625**
Percent of initial cost		**14.81%**

Notes:

- One-day, small-group training that might not have happened.
- One to 10 people per location needing class. Previous delivery methods yielded 25 to 30 people trained nationally.
- Assumes instructor travels to students. Travels on Sunday, Tuesday, Thursday, and Friday nights after class.

Source: T-Mobile USA

Exhibit 6.10 Scenario 2: Big Return

	Conventional Classroom[a]	Elluminate*Live!* Three Days[b]	Elluminate*Live!* 5-1/2 Days[c]
Class duration (days)	5	3	5
Travel	$750	$0	$0
Lodging	$625	$0	$0
Cost per person	$1,375	$0	$0
Cost for group	$171,875	$0	$0
Number of students	125	125	125
Daily student salary	$192.31	$192.31	$192.31
Cost of lost labor (per person)	$961.54	$576.92	$480.77
Total labor cost	$120,192.31	$72,115.38	$60,096.15
Virtual class cost (prorate of first 12 months)		$8,000	$8,000
Total course cost	$292,067.31	$80,115.38	$68,096.15
Total savings	**0**	**$211,951.92**	**$223,971.15**
Percent of initial cost		**140.54%**	**228.90%**

[a]Conventional classroom: These are the costs for the class had T-Mobile sent all students to Richardson, Texas, to attend.
[b]Elluminate*Live!* 3-day class: Reflects savings in travel and lodging as well as lost work days for travel.
[c]Elluminate*Live!* 5-1/2-day class: Reflects savings in travel, lodging, lost work hours for travel, and a small efficiency gain by running the class as a half-day session, allowing techs to perform essential duties.

ROI formula = (Total savings – total cost)/total cost

Source: T-Mobile USA

an asset the company can depreciate." You do not have to be a company the size of T-Mobile to take advantage of Elluminate's virtual classroom training, notes Rajeev Arora, vice president of strategy and business development for Elluminate. The company has one client using a three-month hosted contract for use with 25 concurrent users for $6,000.

FORECASTING TO PREDICT ROI TRAINING

Return-on-investment measurements can be a troublesome concept for training professionals, many of whom were, frankly, called to teach, enlighten, and motivate, not to do math. Fortunately the more ROI measurement becomes an imperative for training managers, the easier and more expeditious the process becomes. Indeed, ROI forecasting—which predicts the expected outcome from a particular program—is useful not only for securing budget approval, but also for testing the efficacy of your programs so you can make design or delivery changes if necessary.

Caterpillar University (CU), the training organization for manufacturer Caterpillar, Inc. (Peoria, Illinois), forecasts training ROI using an online forecasting tool developed by MetrixGlobal, LLC (Johnston, Iowa). CU's first global program was performance management (PM) training for managers. The training consisted of two-day classroom training plus follow-up and coaching as participants applied what they learned at work. The program was designed to address some changes to the company's PM process and the roles of managers in that process. The classroom work included instruction on process, skill building, and building a link between the PM program and other high-level HR initiatives, such as succession planning and market-based compensation plans.

Role of ROI Forecasting

Merrill Anderson, CEO of MetrixGlobal, met with the advisory council for performance management at Caterpillar, representing high-level business and HR people drawn from different business units in both the United States and Europe. Recognizing that it was important to build on the excitement and demonstrate the business value of the PM training, the team decided to forecast the ROI using the initial pilot training sessions to gather data. Benefits of conducting the forecast included:

- Increased accountability for managers to produce tangible business results with PM
- Improved ability and focus of managers to deploy PM on a global basis
- Increased likelihood that the change would be sustained

Collecting Data

Pilot participants identified one or more areas of potential business impact (such as increased sales, increased productivity, and increased job effectiveness), and then estimated in a conservative way what the potential monetary and intangible benefits of those business impacts would be (see Exhibit 6.11).

Isolating the Impact of PM Training

To isolate the impact of PM training on those business outcomes, participants were asked to decide what percentage of the monetary increase they would directly attribute to PM training. To further isolate the impact of PM training on out-

Exhibit 6.11 Sources of Potential Monetary Benefits from PM Training

Personal productivity	12%
Team productivity	57
Quality improvements	5
Sales (margins) increase	5
Cost reductions	21

Source: MetrixGlobal, LLC

comes, participants were asked to rate how confident they were in their estimates. Because not everyone would apply everything they had learned, CU also needed to make a realistic assessment of what percentage of people would apply what they had learned at work. The team used an estimate of about 65% based on research studies. (*Note*: Application rates tend to be higher when there is a specific tool that drives application, such as action planning or manager follow-up. In CU's case, both were in place for the PM training, so they knew 65% would be conservative.) The other discount factor is participation, because not all groups would participate in this PM effort. They estimated participation at between 60% and 80%.

Forecast ROI

After calculating the program benefits, fully loaded costs (including lost opportunity cost for time spent in training), and discounts for isolation (what percentage is attributable to training), error factor (degree of confidence), application, and participation, CU had an estimated ROI of 40% to 70% for the PM training (see Sidebar 6.3). CU considered this a very credible, informative, and relatively low-cost tool. CU now relies on an online forecasting tool developed by MetrixGlobal that is available to Caterpillar's learning leaders and managers around the world.

Actual ROI

After the training was complete, CU did a post-program ROI assessment on original pilot groups—a total of nine focus groups in four facilities that included about 80 participants. Participants went through a structured, step-by-step process of explaining what they have done differently as a result of the PM training, identifying the impacts (in areas such as sales, costs, and effectiveness) that were a result of applying the training. Based on that, participants estimated the benefits they believed they had achieved as a result of this training. The combined benefits and fully loaded costs from all focus groups produced an actual ROI of 120% to 180%.

Sidebar 6.3. Forecasting Training ROI

Forecast ROI = ((Benefits – Cost)/Cost) × 100 x Participation × Application: 130%
Participation (P) = % of people who participate in training
Application (A) = the % of program material that is used on the job

A range of ROI was estimated based on assumptions about the levels of participation (from 80% to 95%) and application (from 40% to 60%).

Maximum ROI	(P = 95%; A = 60%)	= 74%
Medium ROI	(P = 95%; A = 40%)	= 50%
Medium ROI	(P = 80%; A = 60%)	= 63%
Minimum ROI	(P = 80%; A = 40%)	= 42%

Source: MetrixGlobal, LLC

On-the-Job Assessment

As a third and final step, CU is designing an online survey that will go out to the front-line performers from managers who participated in the training. This is designed to validate the impact the manager participants described, as well as to gain some added insight on the impact of PM on the organization.

PREPARING FOR GROWTH DEMANDS

As the economy recovers, so will business in general, and with it the demand for corporate learning. If the market growth in e-learning companies is a fair indicator, demand is definitely up. So, how will training managers handle the demands of future growth in their organizations? IOMA asked training professionals that very question in its survey on training management and cost control. The following lists some of the strategies that are being used.

First is more training and more technology. Overall, a solid majority (74.8%) of respondents expect to expand their training efforts or programs in the next 12 months. Technology will play a big part in training outreach, with almost two-thirds (65.6%) of training professionals planning to leverage existing technology without additional expenditures, and about half (52.7%) prepared to purchase new technology or Web-based training applications (see Exhibit 6.12).

Results are surprisingly consistent across all size organizations, although there are slight variations worth noting:

- Small-company respondents (fewer than 401 employees) are slightly less likely (41.3%) than their medium (401 to 1,000 employees) (55.2%) and large

Exhibit 6.12 Five Key Training Strategies to Handle Organizational Growth (by Number of Employees)

	Overall	Up to 400	401 to 1,000	1,000 & over
Expand training efforts or programs	74.80%	76.10%	75.90%	76.10%
Get more out of existing training technology without spending additional funds	65.6	63	62.1	67.4
Purchase new training technology or Web-based training applications	52.7	41.3	55.2	65.2
Ask training staff to take on more responsibilities	48.1	28.3	51.7	65.2
Use outside training services or firms	40.5	37	44.8	47.8
Outsource some functions/areas of training	29.8	34.8	31	21.7
Add to full-time training staff	12.2	8.7	10.3	19.6
Use more part-time help in training department	12.2	15.2	20.7	6.5
Modify compensation plans to encourage growth	12.2	19.6	6.9	4.3
Other	25.2	19.6	27.6	32.6

(more than 1,000 employees) (65.2%) counterparts to be planning on new technology purchases. This is likely a budget issue, as the small-size group plans to get more out of existing technology to nearly the same extent as other size respondents (see Exhibit 6.12).

- Small-company respondents (37.0%) are less likely to use outside training services or firms than medium and large respondents (44.8% and 47.8%, respectively). Small-size respondents are more likely (34.8%) to outsource some areas of training than medium (31.0%) or large (21.7%) respondents.
- Large-company respondents are more likely to add to training staff (19.6%) to meet future growth needs than the other two size groups. Medium-size training departments are most likely to rely on part-time help (20.7%) to meet growth demands.
- More medium (51.7%) and large (65.2%) respondents plan to ask training staff to take on more responsibilities than small (28.3%) respondents.

HOW TRAINING MANAGERS CONTROL COSTS

Putting Supervisors in Charge of Their Own Budgets Saves Training Costs

Issue: How to encourage supervisors to be more selective in choosing external workshops and seminars for staff at a 220-employee government/education organization in the Southwest. The problem is compounded by the fact that management believes that training is the solution to every performance issue.

Response: Allowing supervisors to control their own training budgets. The organization has also added staff to manage clerical functions related to education programs.

Result: Supervisors are more discriminating in their spending for training programs, an appropriate response in an organization in which training funds are in short supply.

Insourcing Saves on Training Costs

Issue: How to reduce costs and minimize downtime required for training.

Response: The director of HR at this 400-employee manufacturing company in California insourced several training programs, developing the course materials in-house and then training her own HR staff to conduct the programs. She also arranged to have the courses delivered in Spanish to address the needs of a large Hispanic employee population.

Result: The in-house programs have minimized the expense of training and the cost of downtime from production for trainees who do not have to travel to an outside source for training.

Online Learning Saves More Than One Full-Time Employee Salary

Issue: Providing training with reduced classroom time at a 350-employee private-practice firm in the South.

Response: Customized e-learning now provides all new-hire training and software classes. In the past, new-hire orientation was a huge drain on training resources. The firm also has hired a trainer with significant experience in adult learning and education.

Result: Reduced classroom time and more time for training staff to assume additional responsibilities. The e-learning package, which includes a management module, cost less than one full-time employee salary.

Streamlined Training Procedures Help Small Company Provide Needed Programs

Issue: How to provide required training at a 104-employee Connecticut health-care firm with no official training department and only three employees to provide programs.

Response: The company added a formal new-hire orientation program that covers all OSHA and HIPAA training requirements (before this program, managers had to cover this training during work hours, taking away from management time and disrupting the work day). The firm also plans to outsource more safety training and conduct larger group meetings rather than multiple small meetings.

Result: Even with just one HR staff member (the manager) and three employee-trainers, a more efficient training process keeps the firm on track.

Training Goals with Teeth Increase Training Impact

Issue: Making managers accountable for training and training accountable for results.

Response: A 140-employee manufacturer in the South designed a more formal training program for employees, eliminating the "I'd like to go to that seminar" approach that had prevailed in the past. The HR manager also forced department managers to set training goals and budgets.

Result: The HR manager reviews training goals and budgets with line managers annually to determine if goals are being met, leading to accountability and improved training results.

Leveraged e-Learning Saves about $100,000 per Year

Issue: Although online learning is not new at this 1,200-employee technology company in Georgia, taking full advantage of its opportunities has been an ongoing process since 2000.

Response: The company has been growing and promoting the use of e-learning, primarily for technical topics. In 2004, it has expanded this concept to a broader range of training topics, such as business and professional processes and skills, leveraging third-party support to build these strategies and courseware. The training department has also honed its internal skills—such as understanding and applying learning styles—to promote transfer of learning to the job.

Result: Reduced reliance on third-party instructor-led training for technical topics and the increased use of Web-based training have saved the company approximately $100,000 in one year. Still, the company's director of education and information services noted, she must continue to focus on making the most of existing technology by growing the skills of her staff while selectively leveraging third-party support to manage large learning projects.

Accountability and Cost-Sharing Keep Training in Line with Business Needs

Issue: A mandate from the president and CEO of a 75-employee nonprofit social agency that employee training must support the company's business goals.

Response: With HR in charge of training and employee orientation, the HR director required managers and supervisors to justify the business need for training, including how the training being considered would benefit the employee in his or her present job and how it would benefit the agency as a whole. Employees who attend training must pay for part of the training—not a lot, but enough to prevent training from being "just a boondoggle."

Result: Training stays well within the agency's modest budget, and the CEO is comfortable that training programs meet the "business needs" test.

Training, Money, and Teamwork Produce Operational Improvements

Issue: How to get the people who do the work to solve the operational problems at BAE's Advanced Systems Unit in Greenlawn, New Jersey. Managers at the facility believe that the employees who use the processes are the experts and know best how to improve operations, explained Sharon V. Haase, manager of employee involvement programs.

Response: To kick off the involvement effort, the company's directors identified processes for possible improvement, and then established cross-functional teams of 15 employees, including engineers, administrators, assemblers, and HR managers. Senior managers formed their own team, to avoid intimidating workers with their presence, Haase said. The company trained everyone on problem-solving techniques, the desired outcome of the program, and the criteria for suggestions (must reduce cycle time, cut defects, save money, or improve safety). Managers were trained on the methodology of evaluating ideas. Fun is a big part of the program. One summer, BAE used a baseball theme, dividing the suggestion teams into two leagues. The team with the most implemented suggestions from each league at the end of five months went to the BAE world series, attended by the whole company.

Result: In just three months, a division of BAE Systems received 1,400 suggestions from its 600 employees on how to improve operations. On average, it adopts 62% of suggestions. For every $1 saved, its employee suggestion program earns $6 in return. The company pays $25 to $50 for approved suggestions, depending on expected savings. Last year, 71% of employees submitted at least one suggestion.

Train-the-Trainer Approach for New Payroll System

Issue: The high cost of training every employee on new technology systems at a 110-employee real estate investment firm in Illinois.

Response: Training key personnel and then requiring that they train their respective departments. “We started this idea based on the savings we realized with training only three key people on our payroll system and having them train the remaining three people in that department.”

Result: The company saved $4,500 in training costs for the payroll system and is now using the same approach for accounting software.

e-Learning Initiative Saves Millions in Training-Related Costs

Issue: A 15,000-employee engineering and architectural consulting firm in Colorado needed to deploy training in a more cost-effective manner.

Response: The director of professional development for the firm developed and launched an e-learning initiative, 95% of which was developed in-house by staff capable of “creating engaging, interactive training for the Web.” The system also allows employees to access manuals, newsletters, and other training materials from any computer.

Result: “We reduced costs and risks associated with vendor-created training. We also were able to customize content to the specific training needs within the company,” saving the firm millions in training-related costs.

On-Site Job Skills Training Saves Time and Money

Issue: A just-in-time training response at a 1,500-employee casino in the West. The HR director wants training in quick hits—one to two hours based on priority learning objectives.

Response: The organizational development and training manager assessed and identified opportunities to bring job skills training and certification on site by partnering with the local high school. Working with the high school shop teacher, the training manager now provides skills training for small engine repair, for example, eliminating the need to send machines and equipment out for costly and delayed repairs.

Result: The training has reduced downtime and is very cost-effective. Casino leadership is responsible for ensuring that learning goals are applied on the job.

Relying on In-House Trainers

Issue: The biggest training issue for the director of HR at a transit district in Northern California: money!

Response: The employee programs and development officer addressed the problem by identifying and using in-house trainers. "The idea gained momentum when the outsourced training bills became outrageous," she explained.

Result: A savings of almost $21,000 by using existing staff who were already teaching in one way or another. Cost-control strategies were successful, she said, "because we used existing resources instead of paying for outsourced new ones."

Regional Programs and Online Learning Reduce Travel Costs

Issue: For the VP of marketing at a 4,000-employee rental equipment company in North Carolina, the top training concern was completion of required training without breaking the budget.

Response: The company's training director increased the number of regional training programs to reach a dispersed workforce. Another successful strategy was an outsourced online learning and hosted learning management system. Courses include workplace behavior, safety, and operations training.

Result: Improved training completion rates. The online registration and database tracking that are part of the LMS have improved and streamlined the process of managing employee training.

e-Learning Provides "Expert" Training at a Fraction of the Cost of a Seminar

Issue: Controlling training costs and designing an organized approach to training development at a 175-employee state bank and trust in the Midwest.

Response: E-learning. "We purchased a one-year subscription to more than 150 online courses. The cost per course taken has been less than $20 per employee and is continuing to drop since we paid a flat fee," said the bank's training and development officer. The bank is also working on defining training plans for each position and will use this "library" of e-courses as a resource for training.

Result: "We receive 'expert' training at a fraction of the cost of a seminar. Documenting training plans also provides an organized approach to training development."

New-Hire Orientation via Teleconference Reduces Training Costs and Time away from Work

Issue: A nonprofit organization with 105 employees in four states, and a training staff of one, needed to develop an expeditious method to train new staff members that would eliminate travel and time away from work.

Response: In April 2002, the firm launched its new-hire orientation using Web conferencing. The company plans to schedule 12 sessions (one to two hours each) over a two-week period. "We feel employees will be able to participate without feeling totally frustrated by having to be away from their work for two to three days, which our previous orientation program required."

Result: A huge savings in time away from work, noted the company's affiliate director of training/recruiting. This type of program is a first for the organization, she added, and she estimates that they will save $3,000 to $4,000 in travel and accommodation costs as well.

Supervisor Training Self-Study Program

Issue: A holding company with approximately 1,800 employees needed to be able to train employees in new companies that are coming on board while continuing to support existing training programs.

Response: The regional training manager developed a self-study program for new supervisors that requires no travel and no lost work time. Participants meet via phone for feedback and subject matter experts assist with training reinforcement.

Result: This is the company's first step toward e-learning and alternative learning methods. Estimated savings from the self-study program are $103,680.

ENDNOTES

1. David van Adelsberg and Edward A. Trolley, *Running Training Like a Business: Delivering Unmistakable Value* (Berrett-Koehler Publishers, 1999).
2. Paul Harris, *Outsourced Learning: A New Market Emerges*, *T&D* (American Society for Training & Development, Sept. 2003).

Chapter 7

Accounting Department Costs

BEST PRACTICES

COST-EFFECTIVE CHANGE IN ACCOUNTING DEPARTMENTS

In IOMA's most recent reader survey, 200 respondents were asked to identify five areas that had yielded the most cost-effective change in accounting department management in the last year. Interestingly, controllers at both small (250 or fewer employees) and larger (more than 250 on staff) companies had roughly the same opinion about the value of these management tactics. The tactic that was most successful in improving accounting operations or reducing costs was to ask or require staff to assume more responsibility. Some 76% of respondents at small businesses had success with this tactic, compared to 72.6% of participants at larger operations.

New Processing Procedures

Overall, 54.6% of respondents acknowledged success from implementing new controls or procedures for processing accounting data. Even so, controllers at larger businesses were more likely to claim success with this tactic than at small companies. Here, the differential is 13.8%—60.7% versus 46.9%—the largest in the survey. What is happening?

In this case, there were sharp differences in the scale of the new processes that respondents implemented. Only respondents at larger companies, for example, mentioned the implementation of P-card programs, which obviously affect numerous employees. "This took a huge number of invoices out of our AP operation," explained the controller of a transportation company in Maryland. At the same time, these respondents tended to make procedural changes in their automated systems. Once again, the effects of such changes can be significant, especially when companies improve their high-volume functions. "We created a template for our bulk vendors," said a controller in education in Texas. "Now, they send e-mail files to us, which we upload into the AP system. This eliminates the need to key in multiple invoices."

Smaller respondents, however, tended to make policy changes that affected controls and procedures. The primary effect of these changes is to impose consistency on the management of purchasing, exception items, T&E, and so forth. They do not, however, yield major advances in efficiency or productivity. "We implemented a new purchasing policy," wrote a controller at a New York service business. "Now, our higher-ups know if they have room in their budgets for ad-hoc expenditures."

Accelerating the Close

"Expedited closing procedures" shows the second biggest ratings difference—13.2%—among the 10 tactics discussed in the survey. What is the explanation? Here, comments offered by respondents suggest that controllers and other accounting managers at smaller companies were implementing an array of best practices. Indeed, the changes in closing procedures mentioned by these survey participants included ending multiple approvals, automating recurring journal entries, ignoring small variances, and shifting routine work out of the close cycle.

Predictably, the effect of these and other best practices was to shorten the close, sometimes dramatically. For example, an accounting manager at a Florida-based food distributor said that implementing best practices shortened the monthly close from two weeks to three days. "Now, our information is timelier and aids in decisionmaking," she said. Similarly, an accounting manager at a small manufacturer in Connecticut claimed that a shift to best practices had shortened the close to 2.5 days. "Now, accounting has time to work on other projects," he added.

Likewise, managers at larger businesses were also implementing best practices to shorten the close. Their comments, though, also suggest that they already had a majority of basic best practices in place. As a result, the improvements they realized tended to have incremental effects, not the breakthroughs often seen at smaller businesses. For example, controllers at food distributors in both North Carolina and Virginia shortened their closes by roughly two days (from five days to three) by shifting routine accounting department work out of the closing period. "We moved some procedures to the period before the close," said the North Carolina respondent. "This frees up department resources to focus on closing activities."

Of course, only respondents from larger businesses made a connection between accelerating their quarterly closes and Sarbanes-Oxley compliance. An assistant controller at an importer in Tennessee, for example, said Sarbanes-Oxley forced a five-day quarterly close on his shop; in this case, best practices were not the answer. "We have to work much harder to get results in five days. Now, we're looking to move from Excel spreadsheets to new reporting software to enable us to meet this challenge."

More Training for Accounting Staff

Small and large participants in this survey also experienced different levels of success with staff training. In this case, the differential was 12.9%, with substantially more of the respondents at larger businesses (41%) having success with this tactic. On this issue, comments from several controllers and accounting managers at larger businesses tie this training to an enterprise resource planning (ERP) system. Such training is obviously indispensable if accounting is to derive maximum benefits from an always expensive ERP investment. Illustrating this driver behind new training for staff is the accounting manager at a Texas manufacturer: "We trained our accountants and require each to have a full understanding of the ERP system and its process flow, as far as it appears on their screens."

In contrast, the training that respondents at smaller companies considered successful emphasized cross-training or the clarification of job responsibilities. These are, in other words, training programs driven by the desire of managers to raise performance, not to keep pace with a new accounting system. Nonetheless, the success these managers achieved through new training was substantial. "By cross-training our staff," said a controller at a New Jersey distributor, "we reduced our need for overtime and our use of temps. Besides increasing efficiency, our cross-training also fostered team spirit."

Improved Accounting Reports

In general, there was substantial overlap among respondents at small and large companies when they discussed the successes they enjoyed through improving accounting reports. *Reason*: In both groups, managers did well when they modified report formats or streamlined their general ledger. At the same time, managers of the accounting function at larger companies did sometimes discuss somewhat more complex challenges when they improved their reports. "We refined our database and data verification process for project reporting," said a director of accounting who works in government in Florida. "Besides accelerating processing time and improving data accuracy, this raised the accuracy of our reports to federal project partners."

In contrast, the respondents at small companies discussed reporting improvements that went forward without database improvements and the probable involvement of a management information system (MIS). Indeed, these managers in accounting tended to focus on report consolidation. "We consolidated our reports to reflect a recent streamlining in our operations," explained a controller at a Washington-based manufacturer.

Obtain Better Accounting Data

Respondents were mostly silent on the steps they took to get better and timelier information from other departments. Altogether, IOMA received fewer than a dozen comments on this topic, with no discernible differences in the focus of small and large company respondents.

Regardless, one remark, made by a small-company controller at a New York service company, summarizes the forces driving success in this area. "Communication is the key," he said, "with accounting explaining its needs to other departments and then streamlining our reports so that other managers can respond efficiently."

CASE STUDIES, STRATEGIES, AND BENCHMARKS

REDUCE COSTS AND INCREASE PRODUCTIVITY? GIVE STAFF MORE RESPONSIBILITY

In its annual survey, IOMA asks managers who oversee accounting to rank 20 strategies for improving department performance and reducing departmental costs. This year, the big news is that managers gave an overwhelming endorsement to one strategy: ask or require staff to take on more responsibility. Altogether, 77.9% of the 250 survey participants rated this as one of their five top strategies, 10% more than in the equivalent survey one year before, when it also ranked first.

More with Less

The comment section of this survey showed that a wide range of circumstances lay behind the decision to shift more work to staff. For example, many companies have restructured, an activity respondents described as *downsizing*, *consolidating*, *streamlining*, and so on. The following are some comments from respondents that illustrate how this affected managerial expectations of accounting staff:

- "We went through a restructuring in April, eliminating a number of positions. Then, we raised our expectations for our remaining employees, asking them to perform at a higher level. To achieve this, we've done cross-training, increasing the skill sets of our staff." —*Accounting manager, insurance, 6,500 employees, New York.*
- "Our department took on additional work, following a decision to consolidate the accounting function at the corporate level. We added no new staff, despite increasing the workload." —*Assistant controller, distribution, 500 employees, Missouri.*

At other companies, managers asked staff to take on additional responsibilities after the implementation of new accounting software. In these cases, the software tended to channel more information to the same or fewer employees in accounting, making their jobs bigger. Here are a few examples:

- "Our new financial software (PeopleSoft) has streamlined our flow of accounting information. This has allowed us to shuffle responsibilities among a smaller staff, moving some former department employees to other areas at the company." —*Accounting manager, services, 1,400 employees, New York.*
- "We implemented a new accounting software system. Afterwards, we were able to move one A/P clerk to A/R, while managing the payables workload with a smaller staff. With this transfer, we also broadened the expertise in receivables." —*Controller, technology, 200 employees, Pennsylvania.*

Finally, some survey respondents were simply at companies that needed to cut costs. For these respondents, necessity was the mother of invention, forcing them to manage the flow of accounting information with fewer resources. These comments illustrate this predicament:

- "We reduced our staff and then cross-trained. This has not improved our morale. But we have saved money by allocating the work among fewer better trained people." —*Controller, manufacturing, 100 employees, Wisconsin.*
- "One accounting staffer left. Then, we eliminated a second position. Since we have a hiring freeze, we had to split duties among our remaining staff. So far, so good, thanks to some process streamlining and the elimination of special

projects. Altogether, this has saved us about $70,000." —*Controller, telecom equipment, 160 employees, Illinois.*

Making the Strategy Work

Certainly, the survey shows that managers are raising the bar for their staffs, expecting them to fulfill the accounting department's role with fewer resources. But this begs a critical question: What tactics do these managers employ to make this strategy work? Here, responses break into four broad, overlapping categories:

1. *Adjust the compensation.*

"We reduced our staff, cross-trained, and then raised the compensation for the accounting employees who remained. This has cut down on costly turnover, while creating a more motivated and productive staff." —*Accounting manager, services, 3,000 employees, Virginia.*

2. *Improve the tools.*

"We implemented automated Web-based T&E report processing. This has allowed us to reduce the accounting staff by three FTEs [full-time employees]. At the same time, our new system makes our T&E monitoring more efficient and effective." —*Controller, manufacturing, 900 employees, California.*

3. *Improve the procedures.*

"We eliminated repetitive nonvalue adding tasks, especially in accounts payable where we made a policy shift away from hard-copy to e-mail. This helped us reduce our headcount by two FTEs while giving our remaining staff more individual ownership of the work." —*Accounting manager, distribution, 400 employees, Massachusetts.*

4. *Cross-train.*

"We developed a very successful cross-training program, which relies on a small flying squad of accounting employees who move from job to job depending on the work flow. The result of this program is a 15% reduction in headcount and a savings equivalent to three mid-range accounting salaries." —*Accounting manager, services, 4,000 employees, Vermont.*

Change Is Not Easy

The strategy of shifting more responsibility to staff has its downside. In particular, several respondents in this survey said their departments now had fewer resources for new projects. Others mentioned how their staffs are "sometimes overworked," "run the risk of burnout," or suffer from "lower morale." Even so, the problems that managers faced after raising the bar in their departments are somewhat surprising. In several cases, for example, this strategy forced managers to confront what appears to be a tendency to under delegate. Two comments illustrate this peril clearly:

- "We streamlined procedures. Then I reassigned a range of daily duties, basically delegating more. But it's hard when you see staff making mistakes you wouldn't have made yourself." *—Accounting manager, transportation, 100 employees, Virginia.*
- "We modified our closing procedures. Now, I fully delegate the work on different subledgers so that their closing routines occur simultaneously. Nonetheless, it's hard for me not to jump in and do something myself. But I'm learning." *—Controller, manufacturing, 300 employees, Texas.*

Similarly, the decision to raise the bar in accounting made several managers confront subsequent and surprising resistance to change in other departments. Two examples are:

- "To make our accounting staff more efficient, we had to adjust our closing procedures. In this case, our strategy was to streamline the source documents we receive from other departments. Initially, we encountered a lot of: 'but we've always done it this way' opposition." *—Accounting manager, healthcare, 850 employees, New York.*
- "We created new procedures for groups that fed information into the accounting ledgers. We hoped this would shift responsibility for data quality to the people who originated the information. We expected this to free up time in accounting, allowing staff to do more analytical work. But we found our manufacturing and marketing groups slow to pick up our new requirements." *—General accounting director, manufacturing, 800 employees, Ohio.*

Finally, the decision to give more responsibility to staff does occasionally force the accounting department to cut corners. Two respondents described this challenge as follows:

- "Our company added a new division in an acquisition and did not add accounting staff. We've had to cut corners to get by, with salaried personnel bearing the brunt of the heavier load." *—Controller, manufacturing, 500 employees, South Dakota.*
- "We ask our staff to take on more responsibility as our IT department automates new tasks. This way, we handle more work at the staff level. But there are times when we are stretched to the limit, especially when there are absences or something extraordinary crops up." *—Accounting manager, distribution, 130 employees, Missouri.*

Why Less Is Often More

Even with these challenges, this survey suggests that managers that shift more work to accounting staff enjoy significant paybacks. We let three managers make this concluding point:

- "The company is growing but the accounting department is handling the workload without additional staff. The result is steady costs and the chance for staffers to broaden their knowledge of the business." *—Accounting manager, manufacturer, 100 employees, Minnesota.*

- "We restructured in finance, eliminating a number of positions. Yes: employees are expected to take on additional responsibilities and perform at a higher quality level. But this is also their opportunity to show management who 'can step up to the plate.' " *—Accounting manager, services, 4,000 employees, Florida.*

SHORTEN THE MONTHLY CLOSE AND REDUCE ITS COST

Actions that improve the monthly close fall into three broad categories. Stated as questions, these are: (1) How can we issue our financial statements faster? (2) How can we accelerate statement creation at minimal additional cost? (3) How can we increase the accuracy of our information? Fortunately, practical answers to these questions are now available from Steven Bragg, a prolific author of how-to manuals for controllers and other managers in accounting.

A Three-Step Process

To improve the close, Bragg urges managers in accounting to look at their closing process with a fresh eye, "as if they had just started at their jobs." With this fresh eye, he urges accounting managers to follow a three-stage close-improvement procedure:

1. *Just get the information out faster.* In this stage, the overriding concept is to push work out of the close period and into the previous month. Some of Bragg's recommendations include: the accrual of interest expense, unpaid wages, and vacation time; the allocation of rent; the calculation of depreciation; the compiling of commissions; and the reconciliation of prepaids.

   Note that Bragg has several innovative ideas that can help managers in accounting shift work out of the close period. For example, he urges them to develop a history of expense entries for suppliers that bill late. "Often, the billings of these suppliers fall into a certain range. Use this history as a basis for accruing the expenses."

   The watchword for this stage is to change the timing of work that might slow the close. "Since the close is the priority," Bragg says, "accounting departments have to adjust the timing of other work—even invoices, despite the cash flow issues."
2. *Streamline the process.* In this stage, managers in accounting make various internal changes that improve information accuracy but do not impinge on other departments. Overall, this streamlining will probably produce only minor improvements in speed, but its greatest achievement is more consistent information and increased staff involvement in the closing process. (See Sidebar 7.1, which discusses 14 close-shortening improvements.)

   Bragg also gives special attention and importance to streamlining the invoicing process, because invoices are the largest final-day item at most companies. His streamlining recommendations for this activity include: bill everything possible prior to the close; bill fixed-fee amounts prior to month-end; and create the invoice and then add rebills later, if you're waiting for re-billed expenses.

3. *Involve other departments.* In this final stage, managers in accounting face major challenges. To make these closing improvements, they need the cooperation and resources of nonaccounting executives. In this stage, the first category of challenge is, essentially, a battle over the financial statements. Says Bragg: "There's lots of information that slows the close. You have to get senior executives to agree, for example, that the close does not require operating data." Meanwhile, the second challenge lies in working with the MIS, which tends to place accounting department projects at the back of the queue and certainly behind those of sales. Here, the goal is to automate manual processes, with such IT projects as invoice imaging or Web-based timekeeping.

Final Thoughts

Two working days is today's world-class standard for closing the books and then issuing monthly financial statements, provided a company has multiple sites. The standard is a single day for businesses that operate from a single location. Although managers in accounting cannot perform at this level without broad

Sidebar 7.1. Best Practices That Shorten the Monthly Close

- *Create a closing schedule.* This is critical, as many steps in the close depend on the completion of prior steps. For example, staffers must close the accounts payable module before they can complete the fixed assets module. Last-minute additions to payables may require additions to fixed assets. Note that a schedule, in conjunction with a statement of task responsibilities, gives accounting a complete set of documents to guide closing activities.
- *Assign closing responsibilities.* Create a document that clearly states who is responsible for each task required to close. *What to do*: Have a short meeting, before each closing cycle begins, that reinforces the need for each person to complete each assigned task exactly on time.
- *Defer or reschedule routine work.* Many department tasks, such as invoicing customers or processing cash, are vital and cannot be delayed during the close. However, you can eliminate or shift other routine activities from the first week of the month. For example, eliminate the daily report of sales and cash receipts during the close, or push certain tasks, such as billing customers, forward.
- *Automate recurring journal entries.* Use the feature in your accounting program that automatically generates recurring entries every month. This avoids the time-consuming completion of several dozen journal entries (such as distributing occupancy costs) that you must include for accurate results. *Caveat*: Recurring entries will change at long intervals, necessitating periodic updates.
- *Complete allocation bases in advance.* Use information from the previous month as the allocation base when you, say, apportion telephone costs among departments. Then, you can update current costs outside the close and for use in the next cycle. *Caveat*: If outside auditors insist on a fiscal-year allocation base that uses information

from year-end, you will have one final hectic closing period when you bring your allocation bases up to date.

- *Eliminate the bank-statement wait time.* Companies often ask their banks to move the generation of bank statement forward. This eliminates the annoyance of waiting five days for the monthly statement and then blazing through the reconciliation in an hour.
- *Address document snafus in receiving.* At some companies, the freight department turns away deliveries that do not have an accompanying purchase order number. With such a system, accounting can generate a computer report that compares all inventory receipts to the purchase orders in the computer system, as well as to all received supplier invoices that match up against the purchase orders. *Advantage*: Using this procedure, accounting can quickly compile a complete list of all receipts for which there are no supplier invoices. This makes it a simple matter to accrue for missing invoices at month's end.
- *Eliminate small accruals.* Accounting might have to do 20 extra accruals, along with the attendant review, analysis, and approval, to generate financial statements when reported monthly profits rise or fall by 2%. Realistically, though, this slight change will not have a noticeable impact on managerial decisionmaking. *What to do*: In the close, do not bother with accruals that have an immaterial effect on the numbers.
- *Reduce investigation levels.* You can compare each line item to budget and thoroughly investigate each significant variance. This is admirable, as it catches errors and prepares you for questions from management. However, it also leads to the investigation of variances that are too small to affect management decisions. *What to do*: Make sure your investigation limits—a minimum $10,000—are tied to meaningful variances.
- *Limit the level of reporting.* Companies tend to add information to their closing statements over time, with the usual balance sheet, income statement, and departmental reports supplemented by numerous schedules (such as sales by customer or region, inventory level by type, and activity-based costing of major customers). *What to do*: Strip noncore reports out of the basic financial package and schedule them for some other date. This is especially important for reports that require staff to export and import data from spreadsheets.
- *Restrict the use of journal entries.* These are the bane of the general-ledger accountants, who may find new entries requiring investigation just as they are trying to close. *What to do*: Restrict input of journal entries (JEs) to these accountants. This creates a single, easily controlled point of entry, ensuring that general-ledger information has been verified in advance.
- *Use standard journal entry forms.* Create a standard set of JE forms where amounts vary but the account numbers stay the same. JEs suitable for this treatment include utility expenses and occupancy expenses for various departments, including accounting.
- *Write financial statement footnotes in advance.* Separate footnotes into two categories: (1) boilerplate information that rarely changes, and (2) footnotes that tie closely to current financial reports. Then handle boilerplate items before the close. It is also recommended that you highlight the footnote elements that do change from month to month, so that staff can spot them easily and make changes.
- *Document the process.* Look at employees or subledgers that are obvious bottlenecks in the closing process. Then write down detailed descriptions of what they do and flowchart their activities. Note that this is particularly beneficial at larger shops, where the controller may not know, for example, that an accountant is using a slow method to allocate occupancy costs.

Source: Steven M. Bragg, *Just-in-Time Accounting: How to Decrease Costs and Increase Efficiency*, 2d ed., John Wiley & Sons, 2001) company support, many close-shortening changes require minimal, if any change, outside the department.

At the same time, controllers and accounting managers who implement closing best practices show that they are more than competent; they show initiative as well. In addition:

- Top management usually appreciates the overall effect of closing best practices, because information generated in this way is timelier and has fewer errors.
- A monthly close is a carefully choreographed dance, with many people working together, often under intense pressure. Top managers recognize that the close requires good managers to keep the process in control.

AP COST AND PROCESSING BENCHMARKS

Many managers of the accounting function say that payables processing has hit a wall at their companies. By this they mean that their AP departments will improve their processing productivity only if their companies make major investments in high-tech processing solutions. Interestingly, new research from The Hackett Group's Purchase-to-Pay Business Advisory Service indicates that this high-tech wall may be illusory.

Major Differences in Performance

In general, IOMA's use of benchmarks in this section follows Hackett's standard format. That is, we show first quartile, median-, and third-quartile performance benchmarks for cost and productivity in a functional area.

In the associated Exhibit 7.1, we show Hackett's latest cost and productivity benchmarks for payables processing, drawn from what it likes to call its "research repository" for best practices. Managers of accounting who review this table will see that it shows broad gaps between the best-performing and average companies in both AP processing costs and productivity. Indeed, the table shows major differences in such critical performance measures as cost per invoice, cost per line item, and invoices per FTE. So that there is a frame of reference for this information, we point out that these benchmarks reflect practices at 50 large companies, with the smallest just under $1 billion in sales. Here, 25 participants in this sample were using an ERP system such as SAP, Oracle, or PeopleSoft. Eight used a legacy system and 17 used a non-ERP purchased system.

Moving to the First Quartile

When most managers of accounting learn about the Hackett sample, they immediately question the relevance of these numbers to their smaller shops. Many assume that Hackett's top-quartile performers have achieved high marks in low costs and high productivity through expensive high-tech investments in payables. Yet those who work with Hackett learn that world-class performance requires a mix of high-tech and low-tech strategies. Hackett Senior Business Advisor Cliff Struhar, for example, does advocate such high-tech solutions as:

- Requiring suppliers to invoice information electronically using EDI or Internet file-transfer applications
- Automating the workflow of electronic or imaged invoices

At the same time, Struhar and his colleagues at Hackett also advocate low-tech, low-cost processing changes that are within reach of every company. As summarized in the latest Hackett research, some of these include:

- *Centralize control of the vendor master file.* "Requests for additions, changes, or deletions to the vendor master file should be submitted to the central location via a Web-based application. This practice eliminates the possibility of multiple vendor masters and standardizes and streamlines the process for making changes."
- *Utilize procurement cards for high-volume, small-dollar purchases.* "Procurement cards have been available for over a decade. Yet many small companies are still processing hundreds of small dollar invoices every day. In many cases, the total processing cost (e.g., purchase order, receipt, invoice, payment, reconciliation) easily exceeds the cost of the item purchased. Early concerns about procurement cards (e.g., lack of flexibility, lack of control) have proven to be unfounded, yet few companies use procurement cards for more than 20% or 30% of eligible transactions."

Exhibit 7.1 Accounts Payable Processing Benchmarks

	First Quartile	Third Median	Oppty gap Quartile	Oppty gap Med-10	30-10
Cost measures					
Cost per line item	$1.41	$2.14	$3.53	1.5	2.5
Cost per invoice	3.54	$6.18	9.37	1.7	2.6
FTEs per $1 billion of revenue	3.50	6.10	10.90	1.7	3.1
Cost per $1,000 of revenue	0.27	0.55	0.86	2.0	3.2
Staff cost per FTE	37,968	$44,563	49,934	1.2	1.3
Staff cost per line item	0.66	$1.06	$1.79	1.6	2.7
Systems cost per line item	0.27	0.7	1.21	2.6	4.5
Productivity measures					
Line item per FTE	70,662	41,270	22,643	2	3
Invoices per FTE	23,460	14,588	9,948	1.6	2.4
% of paperiess invoices	66%	30%	11%	2%	6%
% of paperless payments	22%	7%	2%	3.1	11
Organizational measures					
Span of control	14	8	6	1.8	2.3

Source: The Hackett Group

Big Issues in Payables Processing

Needless to say, The Hackett Group, which helps "executives drive world-class performance in finance, purchase-to-pay, and shared services," also has strong positions on trends currently affecting AP processing. Some of these positions include:

- "What has to play out in the marketplace is whether the current trend toward outsourcing is going to allow companies to achieve better cost results than if they were to manage AP activities internally, once world-class performance levels are achieved. We believe that in-house processing of accounts payable will remain the preferred option."
- "By implementing best practices and taking advantage of low-cost processing locations on a global basis, the best-performing companies will be able to reduce their processing costs to levels equal to or less than outsourcers."
- "The requirements of Sarbanes-Oxley will cause CFOs to take a long, hard look at the trade-off between potential cost reductions associated with outsourcing versus control issues that could arise if an outsourcer 'owns' the process."

LOW-COST T&E AUTOMATION

Implementing an expense management automation (EMA) solution does not have to be a high-magnitude headache for managers who oversee accounting. This is the position of John Curran, an assistant controller at Stryker Endoscopy, a division of the Stryker Corporation, a manufacturer of medical and surgical products. Stryker has roughly 600 employees in multiple locations. Before its EMA implementation, only 60 of these traveled, but the travel they did do created a major reporting problem in accounting, which had not automated any aspect of its travel and entertainment (T&E) expense monitoring.

Curran describes this paper-based system at Stryker Endoscopy as follows: "We were using manila envelopes and paper format to write out expense reports." To address this problem, Curran examined four different EMA solutions. Three of them were expensive and geared for *Fortune 1000* companies. He adds: "One of the three had been in place for 18 months at one company and was still not fully up and running."

Automating T&E at Midsize Companies

Eventually, Stryker chose ExpensAble Premier to address its T&E reporting needs. This is an Internet-based (i.e., hosted) solution that shares critical capabilities with EMA systems from Concur, GEAC-Extensity, Necho, Captiva, and Gelco. Several of these systems are geared to big companies. Indeed, the rule of thumb for these systems (Gelco is the exception) is a base of 1,000 users (100 concurrent). Predictably, costs for such EMA systems are high. The ExpensAble Premier solution, however, shares capabilities with these big-company programs. Within the accounting department, for example, this EMA solution reduces paperwork and accelerates expense reporting. In particular, it:

- Reconciles receipts with card charges
- Prepopulates expense reports automatically with expense information
- Splits prepopulated expenses into subexpenses not visible in a single charge amount
- Analyzes data across categories such as department, merchant, expense type, and individual
- Interfaces with the general ledger, reducing rekeying of data

Similarly, this solution shares important workflow and compliance features with EMA systems geared for big companies. In particular, ExpensAble Premier:

- Flags submitted expenses with policy exceptions to expedite the review process
- Accelerates the routing process with self-service engines
- Requires users to submit and route expenses for approval online
- Provides real-time status views of submitted expenses

How Accounting Leads

An important fact about the ExpensAble Premier implementation at Stryker Endoscopy is that the solution was up and running in five days. "It only took that long because I couldn't give the install my full attention," Curran says. "We did it without the support of even one person from IT," he adds. Curran proved to be a sharp buyer, as he wanted a solution that would be "ready to go right out of the box and that didn't require heavy IT support."

Once this solution was operational, however, Curran faced a problem that affects all EMA installations. "The hardest part," he observes, "was switching the company culture from paper to the Internet." To address this problem, Curran trained a pilot group of 10 people on the system, using so-called quick-start guides (i.e., primers) from the vendor. The pilot group spent 30 days using the solution, making sure the installation had no kinks. Then, the pilot group worked within the company as proselytizers who sold the benefits of the new system to their colleagues. Says Curran: "Within three months, we had converted everyone from manila envelopes to the Internet."

Keys to Success

Managers in finance and accounting have to be aware of implementation issues, not only tech wizardry, when they consider EMA solutions. On this point, we echo the Aberdeen Group, which offers an abridged version of its report, "Best Practices in Expense Management Automation," on its Web site. This report observes that "EMA is even more challenging than most business applications [to implement] because it involves accounting for employees' personal time and money."

Interestingly, Aberdeen has developed what it deems to be nine best practices for EMA implementations (see Sidebar 7.2). These practices, however, have little to do with EMA technology. Instead, they address the human issue that controllers

Sidebar 7.2. Best Practices when Automating Expense Management Automation

Communication is critical. Although it may seem like a simple process to replace, manual T&E reimbursement is widespread and accepted within companies. As a result, they need to engage in major change management efforts to get people to adjust. A good start is to explain to employees how an EMA offering is going to make their work lives better (i.e., they will get paid faster). In this instance, many best-practice winners conducted internal marketing campaigns to make their employees aware of the benefits. "You can never do enough," said one deployment manager.

Assemble internal resources. Before kicking off an EMA initiative, a company should determine how EMA will affect employees and who will be responsible maintaining the system. Because EMA is frequently a hosted offering, IT often has little influence over the application. As a result, AP personnel are usually the day-to-day contacts. Be sure these front-line responders have the skills to support the application and employee problems with it.

Get management on board. Getting top executives to tout the system may be difficult. Some never worry about filling out expense forms themselves, because assistants do it for them. Nevertheless, gaining executive support—having them lead by example—is key to getting all rank-and-file employees to accept EMA.

Provide appropriate training. Web-based EMA solutions are designed to be user friendly, but not all employees are comfortable with the Internet. Indeed, some will have much longer learning curves as they adjust to working online. Here, a number of best-practice winners suggested providing training options, ranging from traditional classroom instruction to conference calls.

Ensure infrastructure access. To complete the submission cycle, these solutions require network connections. Work with IT to identify minimum access requirements, especially for road warriors.

Stop cutting checks. Shutting the door to other reimbursement options accelerates compliance and back-office process savings, while raising the value of T&E information the system generates. When AP stops cutting checks, employees cannot circumvent the system. This is an easy way to ensure full adoption.

Be prepared to address maverick expenses. Many companies are aware that they have maverick T&E expenses, but without detailed information on trips and travel compliance, they cannot prove it. With the information-capture and reporting capabilities of EMA, AP managers will have the data to go to managers and verify maverick behavior. Managers, in turn, have to help change staff behavior.

Plan for management challenges. EMA project teams train people to follow polices that were not enforced and overlooked in the past. This can take time as the company culture adjusts.

Information is the beginning. Once a company has detailed information on its T&E expenses in its accounting system, it needs to act on that information.

Source: The Aberdeen Group