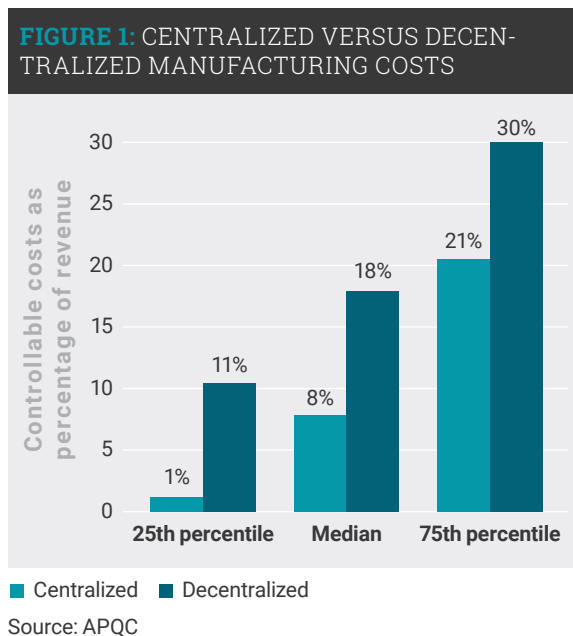


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# Centralization versus decentralization: what's right for you?

Organizational structure is notoriously difficult to design. One of the biggest questions involves which functions or units to centralize. Centralization can bring with it many benefits: cost savings, standardization, and sharing of best practices. For example, according to the American Productivity & Quality Center (APQC) (formerly, American Productivity & Quality Council),<sup>1</sup> controllable manufacturing costs are 10% lower at centralized versus decentralized manufacturing organizations (figure 1).



<sup>1</sup> APQC, "Manufacturing: Centralization vs Decentralization. Which Is Better?" Target magazine, Third Issue, 2010, accessed March 1, 2016, <http://www.ame.org/sites/default/files/10-26-03Benchmarks.pdf>.

At the same time, centralization, especially when it requires restructuring an existing business, often carries its own risks—in the forms of increased layers of approvals, slower decision making, and hierarchical disruption of important cross-organizational processes as employees adjust to new ways of working. So, how do you know whether centralization is right for your organization?

## CENTRALIZATION AND DECENTRALIZATION DEFINED

It's important to start by being clear about what we mean by centralization. Centralization refers to the concentration of management and decision-making power at the top of the organizational hierarchy for the purpose of coordinating financial, human, and other business resources. In centralized organizations, strategic planning, goal setting, budgeting, and talent deployment are typically conducted by a single, senior leader or leadership team. In contrast, in decentralized organizations, formal decision-making power is distributed across multiple individuals or

teams. It's notable that although centralization can involve the collocation of personnel, it does not have to; centralization is more about where decisions get made rather than where people sit.

## CENTRALIZATION VERSUS DECENTRALIZATION

Leaders choose to centralize or decentralize their organizations for a variety of reasons, and certain benefits are associated with both centralized and decentralized models (figure 2).

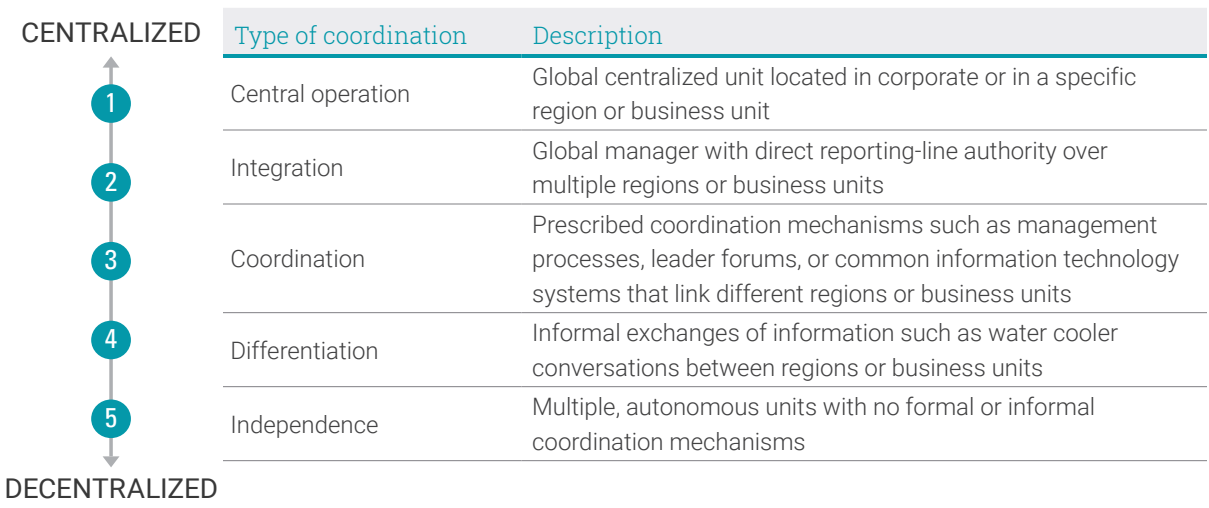
Centralization makes sense when scale or standardization is a major factor when it comes to costs, or when specialized production capabilities are necessary, or when manufacturing strategy is a strong component of business strategy. Alternatively, decentralization is more appropriate when different products for individual markets are needed or when the company must respond quickly to changing or regionally differentiated customer needs.

**FIGURE 2:** PROS AND CONS OF CENTRALIZED VERSUS DECENTRALIZED ORGANIZATIONAL MODELS

	CENTRALIZATION	DECENTRALIZATION
Financial/ Customer	✓ Generates economies of scale	Can duplicate efforts or resources
	Fosters one-size-fits-all products and services	✓ Promotes experimentation and innovation
	Further from the customer; less responsive	✓ Closer to the customer; more responsive
Organization	✓ Aids in adoption of best practices	Slower to adopt best practices
	✓ Allows for common standards and metrics	Difficulty comparing performance across units
	Slower decision making	✓ More autonomy; speeds local decisions
	✓ Increased collaboration between departments	Risks organizational silos
	✓ Easier integration with external stakeholders	Harder to integrate other functions or third parties
Talent	✓ Flexible talent deployment	Difficulty deploying talent across disparate units
	Fewer career opportunities for employees	✓ Greater career options
	Reduced empowerment	✓ Increased empowerment

Source: AlixPartners

**FIGURE 3:** HYBRID ORGANIZATIONAL MODELS



Source: AlixPartners

**HYBRID COORDINATION APPROACHES**

An understanding of the benefits of each of the models is helpful, but most organizations are complicated, and usually, a hybrid model makes the most sense. Five different hybrid models can describe ways there’s room for adaptation (figure 3).

The models described in figure 3 have been laid out on a continuum from more centralized to more decentralized. But more than simply formal structures and formal decision rights distinguish the approaches, because there are other meaningful factors: informal coordination mechanisms such as management forums, use of common information technology systems, or even frequent water cooler discussions in which different groups exchange information, collaborate, and share best practices.

**FOCUS ON WORK FLOWS**

To determine which coordination is best for a given organization, it’s important to first understand the underlying, critical work flows that the structure must support. Put another way, form follows function. For instance, a business leader who sought to determine the best structure for the support of new product development (NPD) activities might first identify all of the functions involved in the NPD process. Next, the leader could consider the nature of the work that each function performs to determine which coordination approach is best suited for the given function (figure 4).

As shown in figure 4, organizational functions associated with NPD activities—such as research and development (R&D), marketing, and operations—are listed in the leftmost column. Alternatively, if the company were considering centralizing its human resources (HR) functions, those functions could be replaced with HR subteams such as compensation and benefits, talent acquisition, HR operations, and HR business partners.

The figure’s upper row lists the different coordination approaches—from more decentralized to more centralized. By considering the various requirements of each function—closeness to customers, standardization, economies of scale—leaders can determine which coordination approach is best for a given function. Once that analysis has been completed, the leader can then start to sketch out a new organizational structure with, for example, finance, operations, and project management more centralized and R&D, marketing, and sales more decentralized.

**A SHIFT TOWARD DECENTRALIZATION?**

Although centralization is in vogue, several trends foretell a shift toward greater decentralization. For example, millennials now represent the largest generation in the workforce. Millennials, in particular, seek flexibility and autonomy in their work, which are characteristics more compatible with decentralized structures. Keeping that growing segment of the workforce engaged may necessitate spreading decision making more broadly across the enterprise.

**FIGURE 4:** NEW PRODUCT DEVELOPMENT WORK FLOW ANALYSIS EXAMPLE

	Independence	Differentiation	Coordination	Integration	Central operation
Finance				Finance support for NPD	Establishment of corporate hurdle rates for new products
R&D		Concept design, prototyping, and development done in local business unit	R&D budgeting, technology search, and platform development	Interactions with regulatory authorities	
Marketing		Market research, product definition, product promotion	Marketing budgeting	Branding	
Operations	Product production in dedicated regional plants		Budgeting council, packaging development, pilot plant operations	Procurement	
Project management		Project management support for NPD		Lessons learned; project management methodologies and tools	Stage-gate process definition
Sales	Independent, business-unit-focused sales teams		Account strategies		Sales training and commissions

■ Primary consideration ■ Secondary consideration

Source: AlixPartners

In addition, many organizations are starting to collapse their distribution channels and interact directly with customers. In that context, companies cannot leave it up to regional distributors to customize marketing efforts or tailor products and services. Instead, they must empower their own employees to respond quickly to changing customer needs. For example, Zappos, the Web-based shoe and clothing company known for outstanding customer service, recently announced it's done away with bosses altogether.<sup>2</sup> Similarly, the employee handbook for Valve Corporation's successful software Steam states:

"We don't have any management, and nobody 'reports to' anybody else. We do have a founder/president, but even he isn't your manager. This company is yours to steer— toward opportunities and away from risks. You have the power to green-light projects. You have the power to ship products."<sup>3</sup>

Finally, digital technologies are transforming business everywhere we look. Even the Indianapolis Zoo has digitized its business model.<sup>4</sup> As companies digitize back offices, interactions with customers, employee communications, and products and services, they pave

<sup>2</sup> George Anders, "Gurus Gone Wild: Does Zappos' Reorganization Make Any Sense?" Forbes, January 9, 2014, <http://www.forbes.com/sites/georgeanders/2014/01/09/gurus-gone-wild-does-zappos-reorganization-make-any-sense/#2ec042eb3b67>.

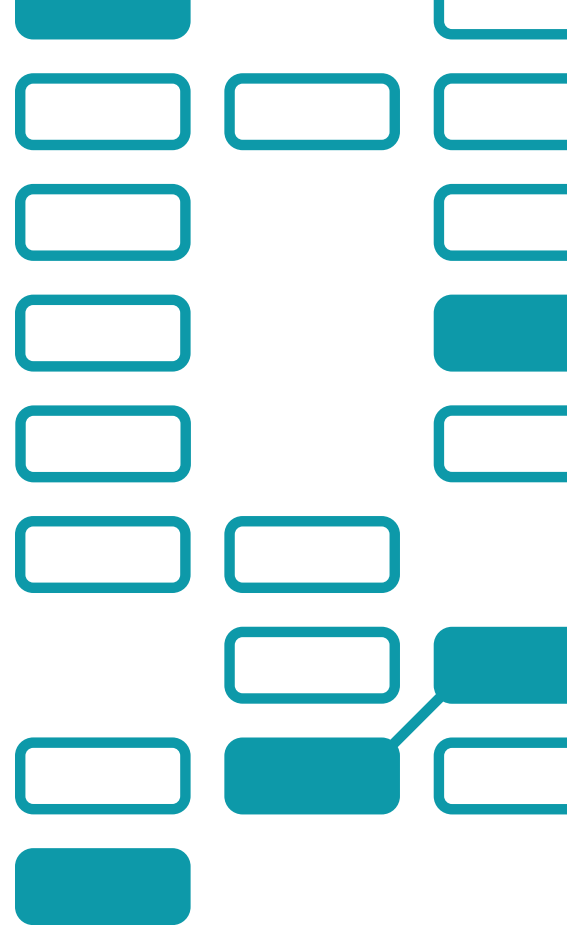
<sup>3</sup> Henry Farrell, "How Valve Demonstrates Democracy in the Workplace," Washington Post, November 21, 2013, <https://www.washingtonpost.com/news/monkey-cage/wp/2013/11/21/how-valve-demonstrates-democracy-in-the-workplace/>.

<sup>4</sup> Jack Nicas, "Now Prices Can Change from Minute to Minute," Wall Street Journal, December 14, 2015, <http://www.wsj.com/articles/now-prices-can-change-from-minute-to-minute-1450057990>.

the way for decentralization. Digitization addresses many of decentralization's traditional limitations by fostering common standards and metrics, collaboration across departments, and integration with third parties.

## CONCLUSION

Although the pendulum may be swinging back toward decentralization, centralized structures still could offer potentially significant costs savings. Determining which model is right for your organization is critical to any restructuring effort—the decision has the ability to impact not just your organization's costs and efficiency, but also customer satisfaction and employee engagement. Take time to understand the pros and cons of centralization versus decentralization, consider the various hybrid models, and determine which supports your most critical business processes. By applying this analytical approach, you can build the business case and make your restructuring decisions with confidence. **A**



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