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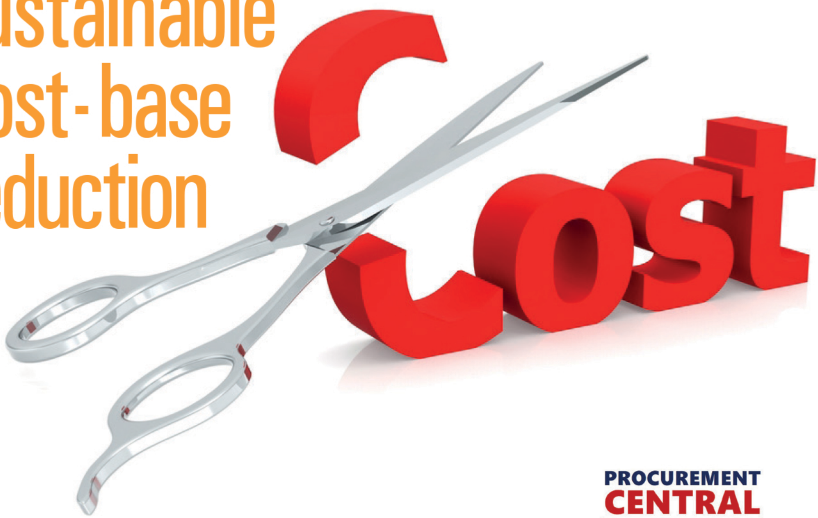
COST CUTTING

– a cultural shift to sustainable cost-base reduction



PROCUREMENT CENTRAL
CONTROL + PROFIT - RISK

Peter Sammons

Cost Cutting

— a cultural shift to sustainable cost base reduction

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Contents

Preface

As a seasoned Procurement Executive I have spent most of my career leading cost reduction programs. I have also seen a range of methods deployed to achieve them. Some have been effective, some were "slash and burn", and some were just cosmetic.

This "manual" provides Procurement Professionals with a strategic and sustainable approach to cost reduction that successfully manages to balance those objectives with value-add. It is recommended reading in any economic climate, but it is essential when companies are looking to maintain profit margins and find alternatives to flat line growth.

Change is part of everyday business life but when it happens it can send out seismic shock waves through an organisation, often causing panic reactions. By applying the effective techniques contained in this manual business leaders can maintain a balance between cost reduction targets and value protection. This is a more sustainable business model that protects your most valuable assets.

Procurement Central endorses the approaches contained in this manual and is pleased to demonstrate this with our clients and assignments. For further information please contact us on procurementcentral.net

Steve Wills MBA MCIPS
Director, Procurement Central
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Introduction

Learning points are clearly highlighted with our sweeping arrow motif. These encourage readers to review their current arrangements for cost-cutting programmes and consider whether adoption of the ideas outlined in this book are relevant to their business activity. By asking simple questions and opening up free discussion we can achieve two things:

- review our current cost-down activity and see whether any key cost areas have been missed
- think in a more end-to-end way about costs, and how costs can be sustainably reduced and controlled

There is a space in each Section for your own notes and comments, meaning you can come back to address those questions later, or detail someone in your organisation to take a second look. Unlike many 'business books' this does not aim to set out a detailed menu of do's and don'ts, but rather to encourage a review of cost-cutting programmes to ensure they are fit for purpose.

This symbol indicates a key 'learning point' or 'discussion starter'. You may want to use this as a kick-off point for your more detailed investigations.

1

The Problem

Thinking about costs

Business people everywhere, no less than managers in public sector organisations, are under constant pressure to cut costs. This is a ‘problem’ that is very easy to state! The question now becomes: *How do I cut costs without cutting corners? How do I cut costs without damaging the value that my organisation is able to deliver?* In other words, how do I cut costs in such a way that the organisation remains viable over the long term?

This short book is divided into three sections (1) defining the problem (2) evaluating the problem (one person’s problem is another person’s opportunity) and (3) looking at various practical strategies and tactics to achieve cost-down in a sustainable way. This first section, then, aims to assist us to think creatively and in-the-round about how costs accumulate, how they are categorised and how they can get out of control.

This first section is necessarily short as most business people will already have a good sense of these issues. Some aspects, in any case, belong in the area of accountancy and this is not an accountancy book. What this book tries to encourage is that we avoid a simplistic *slash and burn* approach to cost-cutting – an approach that may achieve short-term goals but incur long-term costs that often hamper ability to grow the business in the future.

Straight down to brass tacks, then . . . .

Fixed costs are costs that occur irrespective of the level of business activity, e.g. the cost of rent remains unchanged irrespective of the activity performed on the rented site. Capital equipment, capital depreciation, rent, rates, insurance and (potentially) salaries and associated social costs are fixed within time-bound periods. In the short-term, labour is a fixed cost, although over the longer term it can be adjusted (and in that sense is not fixed).

Variable costs are costs that change in line with business activity. Raw materials for manufacturing, energy use associated with business operations, travel and mail costs are all variable.

Semi-variable costs are those that have both fixed and variable elements. Telephone services are the obvious example: a fixed line rental must be paid, but the monthly call usage charge is entirely dependent on the number of calls made.

Sunk costs are those that have been expended and will not be recovered irrespective of outcome. So called *blue sky* Research and Development (R&D) can often represent a sunk cost, although R&D costs can often be written off against tax in many countries. We mention sunk costs, acknowledging that this is not a cost category that can be 'cut', because the costs have already been incurred. But there can be a case for accepting (and making the associated mental adjustment) that some costs will never be recovered and so must be written off. The classic example of sunk cost is that of an expensive 'pet' project of a senior manager, which has cost a lot of money but seems to be heading nowhere. Once we accept that the costs have sunk (like a ship!) then it can become easier – especially for a new manager – to kill the project completely. We cease to throw good money after bad and in that sense we 'cut' costs.

In considering cost-cutting, does your organisation typically think in terms of fixed, variable and semi variable costs?

Can you quickly obtain a breakdown of your revenue expenditure allocated to fixed, variable and semi variable?

Do you have crystal clarity about capital expenditure? What is your capital budget for this year?

Some organisations still do not use formalised business cases to justify and evidence approval of capital/ revenue expenditure. How robust is your organisation's expenditure approval policy? Do you use a business case format with which the entire business is familiar?

Does your organisation have projects that look as though they involve truly sunk costs? What are the prospects for an early termination?

My Notes

Note that a more sophisticated breakdown of cost categories has been argued by US business researchers Charles Ames and James Hlavacek into

- bedrock fixed
- managed fixed
- direct variable
- shared

They argue powerfully that many costs that we typically consider as fixed are in fact ‘manageable’. See (1) in the *Notes and References* section at the end of this book. A clear understanding of your true costs is vital. The Ames-Hlavacek article is highly recommended as a spur to thinking in this vital area.

Are all costs bad?

Costs that are caused directly by activity necessary for revenue earning – typically direct and indirect materials, direct labour, certain energy costs, and selling/marketing expenses are each a vital ingredient in revenue generation. Whilst these costs must be controlled and monitored, they are part and parcel of doing business.

Similarly, capital costs are a ‘vote of confidence’ in the future. If we are investing in capital, this makes a statement about our organisation and its longer term determination to be a serious player in our field of enterprise. R&D costs come in the same category.

Again, all these costs must be controlled and monitored, but if they support strategic objectives then they are ‘good’.

Non-discretionary costs, typically bank charges, together with other costs of finance and taxation – and legal fees – are costs that are generally resented, even if the necessity for them is well enough understood. It might be added that genuinely fixed costs are (to a certain extent) non-discretionary costs.

Not all costs, then, are intrinsically bad. It might be said that costs are good if they directly support revenue generation in an economical manner. But all costs are bad if they reduce profit – and any ‘saving’ in cost, whether fixed or variable, directly accrues to the bottom line. In other words all cost reduction theoretically assists profitability. And in that sense (alone) all costs are bad where profitability is our principle objective!

The problem for business and other organisations is to understand what costs are incurred by their business, and to work proactively to reduce those costs that yield least in terms of profitability. To achieve this we need to make a real effort to establish the nature of all costs incurred by the business.

Why, precisely, do you need to cut costs?

There are two basic situations that demand a reemphasis on cost reduction. Any cost reduction that you consider will be directly associated with these two, or a variation on the theme:

1. Emergency cost-down
2. Strategic cost-down

Let's look at them separately.

Emergency cost-down

As its name implies, this is driven by some financial emergency – for examples, a severe shortfall in revenue (e.g. loss of key client, severe bad debts), unexpected additional expense, natural disaster that prevents normal business operations and so cuts-off revenue income, etc. Action must be taken quickly, on an emergency basis, and the key objective is to preserve sufficient funds to meet needs without official receivers being called in. In other words the intention is to avoid going bust! By establishing non-discretionary costs, fixed and variable labour expenses and other costs that must be met e.g. because of contractual commitments, senior management can estimate the shortfall and hence the immediate 'savings' target. A simple spreadsheet/tabular approach will also tell us the timing of bills and associated payments, as well as the anticipated time-impact of planned cost-down initiatives.

Strategic cost-down

This is a more considered approach, normally taking into account competitive pressures, current strategic plans and options, new market developments, and the demands of the current strategic plan. The time horizon is usually longer and the objective is to financially restructure the organisation on an on-going basis.

The techniques associated with Emergency and Strategic cost-down are explored in greater detail in the third section of this short book.

Slash and burn

There is a big temptation for organisations to ‘spread pain’ by taking costs out of the operation by a simple target percentage rate. Everyone is obliged to accept the same ‘cutback’ so that the ‘financial medicine’ is seen as being ‘fair’ with everyone suffering equal pain for the achievement of long-term gain. The weakness in this approach is easy to see: across-the-board cost reductions generally have unintended consequences. Such an approach takes no account of the reality that cutting costs in one area can easily load additional costs in another. The old truism that a cut-back in the area of QA (quality assurance) may lead directly to more customer complaints (= unplanned cost) in the marketing area illustrates this point neatly. Organisations need to recognise costs as being interconnected and to make efforts to calculate how and where a cut in one part of an organisation might re-load costs elsewhere.

The other key element in planning a cost reduction programme is to understand how a reduction in cost may lead directly to a loss of capability. Organisations may be able to safely cut *capacity* – but there is rarely a sound case for cutting *capability*. If a cut-back leads to a loss of capability we need to know whether that capability may be required in the future and if so, how easy it will be to replace. Some capabilities are relatively easy to reinstate, others may be near impossible to reinstate once that capability has been lost or dispersed.

Cost-cutting should be seen in context with the strategic direction/plan of the organisation, rather than directed towards a single tier of management or group of employees. So, cutting out for example, all middle managers, without some real effort to understand the longer term implications of that action, could be counterproductive. Middle managers represent tomorrow’s opportunity to promote from within, and they can represent a core element of the *intellectual capital* of the business. Once their brainpower (or corporate memory) is lost, can we replace it as and when we need to? If ‘yes’ then how much will it cost to recruit and train the replacement? If ‘no’ then can the loss of intellectual capital be remedied by changes to work practices – for example can we outsource the activity? The same issues apply to other skilled workers, such as specialist technicians.

Rather than start with a cost-cutting number, businesses/organisations should start with their key objectives. In your cost-cutting drive, what are your top 3 objectives – and how well understood are those objectives?

Have you cut costs before? Are you contemplating a further cut-back in the same area? Have the cost areas currently under review already been pared-back to a sub-optimal level?

Are you planning to reduce capacity or capability? How do you justify your answer?

If your cost-down plan involves cutting out layers of management, can your knowledge management system *guarantee that loss of knowledge in people’s heads will not adversely impact operations? Do you have a* knowledge management system?

My Notes

Senior managers are often in an ideal position to assess the options for departmental savings – they have access to relevant financial information which may not be visible to other managers. They also understand the corporate strategy most clearly and (should) have in view the various options available to meet that strategy. In principle then, they are best placed to understand what ‘cuts’ are sustainable and what are merely short-term or non-repeatable. Senior managers are in the optimum position to answer the question ‘what should we stop doing?’ Optimum cost-cutting is selective and focuses on where value is created – aiming to protect those areas appropriately. Since value creation, strategy and detailed financial insights are each in the province of the senior management team, so it is senior managers who have to be responsible and accountable for sustainable cost-down.

Some senior managers, however, rely too much on intuition, trusting their own insight to be sufficient to make robust cost-base decisions. It is vital for them to thoroughly understand where costs lie within their business before deciding where to make cuts. Whilst recognising that senior managers are often best placed to make the key strategic decisions, they must still research the issues and get a thorough ‘handle’ on the numbers. And here it is important for them to understand trends as well as absolute numbers. Industry ‘averages’ can be misleading and crude benchmarking can be quite inappropriate if we are making irrelevant comparisons. It is back to the old adage about ‘comparing apples with apples’.

Truism # 1 – if a cost reduction is not sustainable then it is probably not worth doing. It may even delay the achievement of other, sustainable, cost-base reductions.

Truism # 2 – understanding cost-drivers is more important than achieving short-term cost-down targets.

Slash and burn tactics can be driven (or energised) by unrealistic targets set by senior managers. Middle managers will be happy enough to hit short-term targets if they are told to do so, but the brighter ones amongst them may take that as a signal to begin to search out new career opportunities. They will be content to slash and burn if they do not see themselves as having a long-term future with this organisation. In the same way, external consultants may be very willing to set unrealistic expectations about cost-down targets that can be achieved, as they are typically 'here today and gone tomorrow'. They do not typically have to live with the consequences of their actions, yet senior managers often invest considerable faith in their consultancy advice.

Speed

Just how quickly should we cut costs? A key lesson from the experiences of many organisations that have had to cut costs aggressively is that once the decision has been made, then management must work quickly to implement. Delay allows rumour and uncertainty to take hold – this in turn damages morale and can quickly lower performance. Cutting costs across the board, sometimes called ‘death by a thousand cuts’ – making many tiny cuts here and there – rarely works. Once the decision to cut has been made, it is better to act promptly and aggressively.

What constitutes the ‘right’ speed will vary from organisation to organisation, and of course there may be necessary consultations with a range of stakeholders, but the essential lesson remains: it is generally beneficial to act promptly. This is always upsetting, but it does at least allow life to get back to some semblance of normality as soon as possible and for the organisation to quickly refocus on operations and revenue generation.

Revenue growth or cost-cut?

It is taken for granted in this short book that opportunities to grow revenue have been explored before a decision to cut costs is taken. For public sector organisations this will probably mean a bigger call on tax revenues. In the public sector there may well be political imperatives that make additional funding impossible, and hence a cut-back in capacity (and associated reduction in mission) may be the only option available.

In business the choice may be a little less restricted, but in recessionary periods, and/or in times of aggressive and uncompromising competition, then revenue growth may also be impossible, meaning that the cost-base must be reduced. Revenue growth implies new customers, new pricing, greater emphasis on marketing, and greater value delivered to attract more custom – or a combination of all these things.

As you embark on a cost-cutting exercise, are you satisfied that revenue growth opportunities have been adequately and exhaustively explored?

Can you cut cost and grow revenue simultaneously? If 'yes', is this part of your current focus?

My Notes

Cost culture

Do our managers and staff understand the true need for good cost control? This is a cultural question. During the 1990s and early 2000s in Western countries a whole generation grew up in economically 'boom' years. Sociologists refer to this as Generation X-Y. Many employees will have adjusted to new realities but some organisations have yet to ensure that cost control and cost reduction is seen as being a core business acumen, rather than an unwelcome diversion.

It is another truism that 'no organisation ever saved its way to success'. No commercial organisation ever became dominant in its market segment solely by cutting costs – although some will have achieved that through excellent management of costs. By contrast some organisations have allowed a culture of largesse to become the norm. In the second decade of the 2000s the financial institutions and media leap to mind, but no doubt there are others. Sloppy cost control inevitably means that when cut-backs become essential they will be more painful than necessary for these types of bloated organisation. Many public sector organisations also became bloated in the boom years (last decade of 20th Century and first decade of 21st century), taking on activities that might once have been considered peripheral, but in the boom years became considered as core activities. This was a form of mission-creep that very few complained about during those boom years but which now stand out starkly as the public sector, often funded on borrowing from the money markets, is forced throughout the Western world to rebalance budgets.

As organisations build their *vision statements* and associated *core values*, the judicious and proactive management of cost should be incorporated into the company's ethos. Cost control is everyone's business. On this issue leadership must, once again, come from the top.

Can you articulate your organisation's cost culture? Does it need to be re-emphasised for the clearer guidance of all staff?

My Notes

2

The Opportunity

Low cost and cost leadership

In a competitive environment, cost is a key product/ service differentiator. Customers look for good quality at lowest cost – but generally are prepared to pay higher prices if the quality justifies the price differential. Within the public sector the equivalent pressure is that taxpayers as 'customers' of the State (central or local government and associated agencies) either as individual voters or as stakeholder groups – such as trade organisations, businesses or pressure groups – have growing expectations of service delivery [quality, availability] at affordable cost [whether through taxes, or service-use fees]. In most countries tax is resented as an intrusion and the consumer ethos tends to judge State services in the same way that it judges private sector provision. A low cost base is generally a key element of repeat business (competitive business environment) or repeat votes (competitive political environment).

Low costs can be achieved via four key, overlapping, strategies:

1. Operating efficiencies – old processes and methods of working give way to new processes and methods of working – aimed at greater efficiency. More can be achieved with lower support expenditure. Budget airlines are a good example of this. The main airline proposition – to fly passengers from A to B – remains core to the customer experience. But all other services (meals, drinks, baggage etc) are charged separately. Newspapers going online may prove to be the next big ‘thing’ in terms of providing the same service in an entirely different (cheaper) way.

2. Product/service redesign – a fundamental re-think of product design or service specification to find ways of providing the equivalent (or better) utilising fewer or lower cost inputs. This strategy is close to **operating efficiencies** (immediately above), but the key difference is the systematic breakdown of product or service into separately costed components to see how each can be provided more cheaply.

3. Standardisation – aligned with **product/service redesign** (immediately above) – the idea is to locate *standard* rather than bespoke components. We live in an age of customer-tailored products where sophisticated manufacturing/service provision is designed to bring greater customer satisfaction. But this still leaves open the prospect to use standardised sub-components. Auto manufacturers often use the same ('standard') sub-components as their commercial rivals – tyres, brakes, illumination, radio/ sat-nav equipment etc. Any manufacturing operation can benefit from standard sub-components.

4. Economies of scale – in spite of an increasing scale of operations, many fixed overheads can often remain contained at their original cost level. As a company grows, it should strive to delimit fixed overheads.

All of the opportunities described in this section of the book can be identified with one or more of the above strategies.

Cost-down as change management

The opportunity to cut costs should be grasped. After setting out to reduce the cost-base, it is rare for a business not to emerge, at the very least, with a better understanding of some hidden costs once a determined effort has been initiated to reduce unnecessary waste. But organisations should adopt a portfolio based approach in which projects are weighted (scored) against the business objectives (or strategy) of the company. Projects and activities that are least closely associated with business objectives are the ones that should generally be pared back first. After that it is easier to identify which personnel may be surplus to requirements and if redundancies are required, these personnel will be the obvious ones to consider for redundancy.

Do you typically look at cost-down opportunities in this portfolio manner? Do you link cost-down projects directly to the corporate plan?

My Notes

The cost-cutting opportunity is a function of the problem we have already considered in the first section of this short book. The opportunity can be simply stated: a company (or public sector organisation) seeks to gain competitive advantage (for public sector organisations, read *meet the public's broadening service delivery expectations*) by reducing its cost base such that revenue and capital can (first) be secured and (then) applied in an optimal way to meet its strategic plan and mission statement.

Cost-cutting should be seen as part of *change management.* This means that the people-dynamic of change must be considered as important as the technology and processes dynamics. Technology and processes are often the focus as these appear to be main drivers of cost, but if the people-dynamic is not addressed at the same time, then cut backs in technology and other costs will not deliver the anticipated benefits. We may introduce better technology, we may find cheaper supplies, we may amend work practices so as to achieve more with less, but if our team members are not properly briefed and engaged then they may inadequately implement the new technology, they may misunderstand the new work practices (and revert to the old, more expensive, ways of doing things). Planned benefits can be dissipated by our own people.

Swift action must be accompanied by good communication, and yet often organisations are reluctant to communicate because the cost base reduction may well involve people's jobs and pay – and that is sensitive.

There are two elements to effective communication in a cost-down initiative: (1) it needs to be clear and unambiguous. Many stakeholders, not least employees, will scrutinise in fine detail the message; and (2) communication should focus on positive messages. The communication should be less about the fear of competition and the difficult current trading conditions (however real those factors may be), and instead should be more about cost reduction helping to keep prices low and so retain existing customers and attract new ones. For the public sector the equivalent message will normally focus on the need to keep delivering front-line services at a time of constraint by reducing support activities.

In considering cost reduction, what thought has been given to the people-dynamic? How will jobs change? What new processes will need to be devised? When and how do we communicate? Who will communicate the message(s)?

My Notes

Cost-down as a cultural statement

Some companies are much better than their peers at constantly managing and continually reducing costs. This differentiator becomes a key factor in market success and market position. Cost management must become a clear and well understood element of our organisation's culture if we are to create a virtuous circle of constant cost-down pressure associated with revenue growth over the long term. Revenue growth may also be a dimension of market share, as low-cost providers over time tend to acquire greater market opportunities.

Two things are necessary: (1) senior management must from time to time re-emphasise their business objective of becoming a lower than average-cost provider as being a *key* objective; and (2) the culture of the company should be emphasised and re-emphasised as being one of cost consciousness. Where public sector, we need to talk in terms of taxpayers' money and delivering value for money. Where private sector, we need to remind ourselves of investor's funds entrusted. Whilst taxpayer and investor are not the only stakeholders, in many respects they are the foundational stakeholders and organisations 'owe it to them' to use their funds wisely.

Truism # 3 – All budget holders hold other people's money!

Critical success factors

The cost-down opportunity will best be realised if we keep in mind the following:

1. Involve senior managers – ideally the cost-cutting programme will be driven from the top.

2. Ensure we have good cost-base information.

3. Make linkages between cost reduction in one area and associated potential cost rise in other areas.

4. Take decisive and swift action.

5. See cost-cutting within the context of change management, and communicate effectively.

6. Work-up a benefits realisation measure so you can ensure you meet anticipated targets and clear away unexpected blockages.

When to stop

The opportunity to reduce the cost base is not a one-time opportunity, but neither is it realistic to think of endlessly reducing costs. At some point revenue growth must become the main element of the mission statement – especially for private organisations. Companies are not static – financially they are either growing or shrinking. Like a weight-watcher preparing for a marathon run, weight loss (read *cost-down*) is required for a specific purpose, but at some point the need for growth will return. Cost-cutting gives way to revenue growth. But like the wise weight-watcher, companies are careful on an ongoing basis about what they eat (read what *cost-growth* they allow).

Putting an emphatic line under cost-cutting should be done once the cost targets have been achieved. Indeed this will probably become the occasion for some public statement about the achievements of the team as a whole in meeting cost-down targets. We can congratulate ourselves momentarily for a good job well done, and then emphasise once again the need for continuous cost vigilance.

Using consultants to assist cost-cutting objectives

This book encourages a hands-on and do-it-yourself approach to reducing costs, but there are specialist consultancies that can provide cost reduction advice and associated delivery. If the cost-down pressure is caused by a financial emergency (e.g. we may go bust!) then it is likely that the client organisation will feel that the expense of hiring a consultant is inappropriate. However there are occasions when the use of a third party consultant can add real value:

1. Specialist niche understanding of particular market-places – such as energy or utilities procurement – where most clients will not have this depth of understanding.

2. Where in-depth experience is needed that is unavailable in-house (similar to [1] above).

3. Where a detached and clear view, unclouded by in-house politics, is required.

4. Speed: where in-house resources cannot be released quickly, an external consultant can kick-start a cost-down initiative.

If such a specialist is required, then good ‘procurement’ of the service is essential. The skills of hiring a specialist cost-cutting consultant are no different from hiring any other type of business consultant. The UK Institute of Consulting website has some good basic information available for free download. See Reference 4 in the *Notes and References* section at the end of this book.

If you do use an external consultant, pay special attention in the terms of reference part of the contract to knowledge transfer. *Ideally, you want to develop in-house expertise to be able to undertake future cost-down initiatives without the support of an external consultant. The consultant should help you achieve this as a by-product of the cost-cutting assignment. The consultant should be able to train your staff (within certain limitations) to pursue cost-cutting independently.*

Be wary of remuneration packages based on 'savings' to be achieved. Both sides – but particularly the client – need to have a good grasp of the numbers before embarking on this approach.

In choosing between consultant practices, it is unwise to assume that one is ‘the best’ to the exclusion of all others. Try to identify a shortlist of firms capable of providing a suitable service, and focus on those whose culture, approach and scale most closely meets your requirements. Encourage any such consultant to consider this opportunity as a *performance improvement assignment*. Rather than say we want to reduce costs and then state a percentage reduction target, focus on the improvement to the bottom line, and on value-add to our customers. Consultants then may be able to help with growth of revenue, margin improvement or risk reduction. Each of these should be associated with cost reduction. But at the same time articulate clearly that cost is to be taken out, and taken out permanently.

Consultants may focus on simplistic cost measures to the detriment of the overall assignment objective. If the client has a poor appreciation of true costs and a lack of associated financial performance data then the consultant may find it relatively straightforward to present the client with estimates of costs that the client is not well placed to challenge. This may not be mischievous action by the consultant – simply that the consultant organisation will always try to identify targets that it is confident it can ‘hit’.

Caveat emptor! *Let the buyer beware!*

What is your organisation's past experience of using consultants? Are you good at managing them in practice? If not, then precisely what do you need to do differently in the future?

My Notes

3

The Solution

Having considered the problem and the opportunity, we now reach the most interesting bit! We look at basic techniques to track down, challenge and eliminate cost. At the outset we state clearly that not all of the ideas explored will be relevant to all readers. Some ideas may already have been successfully tried and implemented by the reader's organisation. But these are all key areas where costs can be ignored, misallocated, and/or not properly controlled. All these cost areas should periodically be reviewed and attacked once again.

Let's revert to the idea earlier in this book that there are two types of cost-cutting exercise, or two arenas of cost-down action: Emergency and Strategic. The techniques we are about to consider can be applied to either situation although some techniques clearly reduce expenditure more quickly than others. There is overlap between these two Cost Arenas, inevitably, but it is hoped the broad distinction will be useful to readers.

Cost Arena 1: Emergency cost-down

There are two types of emergency: a genuine financial emergency and an ‘emergency’ in the minds of senior managers! The two are different and it is as well to be realistic about this. We need to be clear: is this a real emergency (survival – a risk of bankruptcy) or is this a need to meet city expectations?

Other questions:

- What ‘saving’ must we make and by when? (Look at annual budget allocations – if our organisation uses them).
- What supplies are essential to meet existing commitments?
- What is discretionary spend?
- What is non-discretionary spend?
- Is there any obvious ‘low-hanging fruit’ in terms of costs that might be reduced?
- Which suppliers can we afford to offend? (what sort of customer are we to our suppliers? = importance x value).
- Would we be better to focus on chasing money owed to us?

In asking and answering the above basic questions, we should gain a better feel for what harsh and quick initiatives we can undertake. And we can prioritise them.

If our organisation makes use of contingent workers (i.e. contract staff/temporary workers) then we should consider terminating their hires early.

Spend Control

In many organisations corporate spending is decentralised. Individual departments are responsible for holding and managing budgets. All too often this activity can fall to administrative staff with no expertise in (and often no interest in) proper purchasing. This results in fragmented purchasing, no aggregation of demand to assure keen prices and little visibility, control or accountability. Spend control is not solely about purchasing, as it may encompass travel and subsistence, and sometimes other types of non-purchase cost. But today any spend with a third party which supplies a good or a service, can be considered as ‘purchasing’ in the broadest sense. Spend control, then, recognises what spend is, and then seeks to ensure it is approved and reviewed before action is taken which commits the organisation. These basic control mechanisms can act as a useful brake on spend.

There may be a good case – and almost certainly will be a good case for larger organisations – to progressively bring under control and visibility expenditure via a dedicated ERP system (enterprise resource planning) such as SAP, Oracle e-business, SAGE or Microsoft Dynamics (to name a few in the fairly crowded ERP market place). Most larger organisations have already adopted these automated control and management systems. Many smaller organisations have yet to catch up, but they do not have to invest in complex (and sometimes expensive) systems. Simple control loops and delegated spend authorities can assist.

Suppliers

Some supply contracts will have financial termination 'penalties' (for want of a better word) associated with them, if terminated early. Typically, suppliers have two objectives: (1) to recover at least the 'profit' they would have earned had the contract reached its natural conclusion and (2) to recover any out-of-pocket expenses occasioned by the early termination – typically any sub-contracts into which the supplier has entered and must now also terminate.

Truism # 4 – a contract is a contract is a contract!

A contract is a contract is a contract: we should not lightheartedly enter into contracts because of the difficulties in disentangling ourselves should circumstances change, and the damage caused to others. Lawyers and lawmakers in Western countries may unwittingly have rendered a disservice to society (and to commerce) in making it easier to find ways to break contracts. Having said that, circumstances do change and so it is only right that there should be clearly and carefully designed mechanisms to reflect changed circumstances in contracts for supply, including termination, in the event it is no longer required. In the event we do find we have to terminate a contract early then we should explore possibilities to offer the supplier first refusal on any future business of a similar nature. It may be possible to exit on good terms, or at least salvage some of the relationship.

In an emergency cost-down situation, third party supply is an obvious area to 'switch-off'. How do we go about this? Firstly we need to be clear about the terms and conditions of any existing contract/ purchase order and its associated termination provisions. We need a good sense of what 'rights' and obligations each party has. Termination periods should be established and mapped. In that way we can quickly decide how much notice is required and precisely when termination notices must be issued. With an eye to the future, we can then decide our negotiating agenda (supplier-by-supplier) and issue urgent invitations to discussions.

What supplies are essential to meet contractual commitments? Can we re-schedule deliveries or delay deliveries? And, if so, is there an on-cost? If there is an on-cost when will it 'hit' us? Bluntly, the supplier needs to feel the compulsion to work with us in a genuine emergency. If we go under, then the supplier becomes an unsecured creditor, so in principle it is in their interests to work with us.

Is the supplier better placed to shoulder financial 'pain' than we are? If not, are we prepared to risk driving our supplier to the wall? (For some suppliers the implications may be this serious).

My Notes

Contractual commitments – a problem shared is a problem halved!

After inviting the supplier to a discussion, and having briefed the supplier within the confines of commercial confidentiality and good sense, we establish the possibilities to re-schedule deliveries. Supplier may be able to support this and itself incur no additional direct cost other than delayed income.

Supplier may be able to offer a cheaper alternative, or may offer a discount in preference to termination. Each of these is a sensible response to a demand for emergency cost-down. If termination is the only suitable remedy from our viewpoint, then the termination Notice should be issued immediately – providing the contract terms allow us this escape route.

Contractual commitments – which suppliers can we afford to offend?

Bluntly, some suppliers will be less important than others. If full termination is not an ideal option then a price reduction may be achievable. We should demand a sensible price reduction in preference to termination but should always have an escape route – or a *best realistic alternative*. If the negotiations fail and we are compelled to terminate, then what alternative suppliers might we use? How ready are these alternative suppliers to deal with us and what due diligence do we need to undertake on new suppliers?

At this stage you should be able to target the supply reduction needed. How far does this take us to our overall cost-down target?

There are standard supplier surveys (question and answer format) to tease out the financial stability of suppliers, their technical competence and existing customer satisfaction. Does your organisation use these methods or do you appoint new suppliers 'blind'?

What price reputation? Although compelled to seek reductions or to terminate, can you assess long-term reputation damage? Will a significant number of terminations in short order send a bad signal to the market? (In the public sector, are there political ramifications arising from early terminations?)

Which contingent workers can you terminate?

My Notes

Delay purchases

There may be some purchases, either capital or revenue, that can simply be delayed. So, do we need to upgrade software now? Do we need to invest in new IT hardware now? If our organisation has a budgetary control system then a trawl through budgets can quickly uncover areas of incipient third party spend that can be delayed – or permanently deleted from the strategic plan.

Delaying maintenance is a classic risk of taking cost out in one area only to reload it in another area. But delay to maintenance might be possible. If so, are there any ways we can ameliorate the increased downtime risk? For example can we undertake certain maintenance tasks in-house?

If a piece of equipment is due for replacement, can we delay its replacement and refurbish the ‘old’ equipment in some way?

Good purchasing

We mention this under emergency cost-down initiatives, but the lesson applies to the business at all times – and hence to strategic cost-down (see below). This is not a purchasing text book so we will not deal with the question in depth. Good strategic purchasing should:

- Optimise prices, and lower them over time
- Enhance quality and improve service levels
- Reduce supply-side risks
- Establish better/more strategic relationships with suppliers over time
- Reduce the supplier base, better rewarding the fewer suppliers that remain

Are you satisfied that your purchasing operation is fit for current demands? If not, what changes will you need to make to help it to up its game?

Do you have strategic commodity plans that fully understand the supply market with which you interact and do these plans link closely with the wider organisation's strategic plan?

My Notes

Turn-off your computer!

Surprisingly, more than half of workers do not turn off their computer at night, or indeed when they are away from their desk for long periods. A standard PC averages 1700 kWh and this can cost the equivalent of £250 a year for many computers. If they were closed down each night, cost would fall to £50 average. When did your organisation last remind staff to turn off computers and how do you 'police' the issue?

Don't pay for software you don't use!

Many computers have a full range of software bundled as a package, and yet many workers rarely use the packages. It should be possible to provide lower capability of software to workers who rarely need the more sophisticated stuff. When did your IT department last conduct an audit of use of standard packages? As many licence packages are annually renewable, this can be a source of a worthwhile 'saving'. What practical changes might you have to make to work practices if a reduced standard bundle of software was available?

There are specialist agencies that can evaluate software use. If your software/IT bill is large, there may be a case for using specialist diagnostics to uncover where the waste areas are. Google 'Software Asset Management' if you do not know where to start.

Pay bills early in return for a discount

In an emergency this may not be a realistic option – and may, in any case, be a more 'strategic' approach to business over the longer term. However, if a bill is due for payment in a short timeframe, then an offer to pay early in return for a discount may be worthwhile. The author has always been surprised that so many organisations think that by permanently delaying payment (e.g. stretching 30 day terms to 90 days without permission) they are acting shrewdly. Has no one ever reminded them that over time their poor payment practices will be recognised and their pricing attract the appropriate premium? If payment is delayed as a long-term policy in order to mask other financial difficulties, then this represents a failure to get to grips with that fundamental problem.

If the time-frame is short and the discount bigger than the current rate of interest, then an early payment may be worthwhile.

Laptops/notebooks and mobile devices

Does the mobility implied by notebooks justify their additional expense? If personnel need to be mobile on an occasional basis, is there a better case for holding a small stock of ‘roving’ notebook type computers and allocate these on an as-needed basis? We hear too frequently of laptops being left in hotels, on trains and in restaurants. Why (in effect) do your staff need to carry about with them a vast series of files and folders – far more than they are likely to need on any normal short-term period away from the office? What insurance premium do you pay for the privilege of allowing staff to carry around with them a vast and possibly needless series of losable files?

Many laptop devices are held on a rental basis. What are the prospects for terminating these rentals early?

Mobile devices should also be considered. On a rental basis some are very expensive. Just how important is it that your staff are permanently available? And when allocated a mobile device what value do they truly get from it? Does the existence of the device create the “need” to send e-mails so as to be visible? Do mobile devices feed an ego trip? There may of course be a trade-off between mobile devices and notebook computers. If staff have a simple mobile phone, can their reply to e-mails not wait for a few hours whilst they either access their notebook computer or reach their office and pick up/ respond to messages there?

Do you have a clear list of mobile equipment, who has what and on what rental terms? There may again be a case for having such devices available in a ‘pool’ and issued on an as-needed basis. This might have implications for the non-use of certain functionality, but in a financial emergency this may be a price worth saving!

Travel curtailment

Some organisations have a culture of travel and associated expenses. How justifiable is this? In an emergency, to put a temporary 'ban' upon all travel may well save a significant amount of money.

Beware of the 'exception to the rule'. Everyone thinks they are important and their travel vital. A travel ban should be precisely that – no one travels unless specifically authorised at a senior level. Video conferencing equipment and functionality improves year by year. This is becoming a viable alternative to at least some travel.

What is your organisation's travel budget?

What value are you now getting from video conferencing and other communications based technologies?

My Notes

Advertising and Marketing

This can be both tactical and strategic, as a cost-down arena. US businesses are reckoned to spend $20bn a year in advertising & promotion in the second decade of the 21st century. Other economic regions probably spend equivalent amounts – but the return on advertising can be extraordinarily difficult to measure. The following basic questions will be instructive:

1. *What do we want to be the outcome of an advertisement?* Do we want website visits, phone queries, e-mail responses, or direct orders?

2. *Do we expect customers to have a current need* (and so respond immediately) or do we want them to remember us at some future date when they do have a matching requirement?

3. *How much will this be worth to us?* Any advertising activity should have a corresponding income generation target, so we can sense-check the cost of the advertisement. The key elements of the calculation are these:

- The cost of the advertisement
- The likely number of resulting ‘enquiries’
- The percentage conversion rate from enquiry to customer
- Profit margin per transaction

E.g. if an advertisement costs £1,000 and is likely to lead to 100 enquiries that, experience tells us, will have a 12 percent conversion rate, and if margin on each product sold is £150 per product sold, then the margin income from the advertisement will be

12 X £150 = £1,800

A decision can then be made as to whether the advertisement is worthwhile. Whilst press, TV, direct mail, outdoor hoardings, radio and cinema are well known and expensive advertising mediums, there are other less expensive strategies. If your company is not already using them then these alternatives may prove suitable and cut costs dramatically:

- Viral marketing (marketing within peer groups by peers)
- Online display advertising – advertisements on websites where your target audience are likely to visit
- e-mail marketing (same as direct mail – but cheaper)
- Search engine advertising – using Google and equivalent search engines
- Blogs and podcasts

Because these mechanisms can often be more closely targeted, not only can they be less expensive in the long run, they may also be more effective.

- *What is your organisation's marketing strategy? How does this relate to current market realities and to changing advertising media?*

- *How closely do you monitor your competitors' advertising?*

- *Do you have ready figures for RoI on advertising? If not how quickly can you obtain that information?*

The astute and judicious use of public relations (PR) mechanisms can represent a "free" advertising mechanism. Editorial that contains news of your products and/or services, can be a helpful and often better-trusted mechanism to put across a positive message. This will require a sophisticated PR strategy, but over the longer term can develop to be a compelling advertising-communications medium. Good PR may also assist in customer retention. Customer retention can often represent a better investment than new customer acquisition.

How does PR link with marketing in your organisation?

Do you have a customer retention strategy *as a subset of the marketing strategy? If not, why not?*

There may be possibilities within your industry or sector to outsource selling. The cost of permanent sales forces can be daunting. But there are agencies (i.e. agents) that can sell at lower cost, as well as companies specialising in taking on sales and marketing. Once again a Google type search should provide leads on these sorts of companies.

When was the marketing strategy last reviewed? How has the market changed in the interim? Does our current strategy adequately reflect market changes?

My Notes

Recruitment Freeze

Employee costs are one of the biggest costs for organisations and carry an overhead beyond the basic wage paid. Employees require infrastructure (desk or working space, computers or other equipment), pensions, sick pay, insurance. The true cost of employment can be up to 4 times basic pay. It has been noted that most employees average 6 years with an employer, hence average turnover should be 15% a year – perhaps lower in a recession. But this means you can lose that percentage of headcount without the pain and cost of redundancy. If 'natural wastage' is insufficient to meet your cost-down target then a recruitment freeze will assist, but there are two key factors to bear in mind:

- ➢ Be prepared to re-train and redeploy other staff to fill 'gaps' caused by a recruitment freeze. There may be some personnel/HR type issues around this, but hopefully staff will be collaborative if they understand that the effort is to avoid redundancies.
- ➢ Identify key employees and nurture them so they do not become a part of your natural wastage 15%. Motivate, reward, promote, train as necessary to help them to feel valued and see their future in your employ.

What is your organisation's natural wastage rate at this time?

Do not rely solely on percentages: what sort of people are leaving your employ at this time and how does this impact your ongoing operations?

By recruitment freeze and anticipated natural wastage, how close do you get to your cost-down target? When will staff 'savings' begin to pay?

My Notes

Reduce wage bill

Strategies that can make a rapid contribution to cost savings targets are these:

Freeze pay – generally this should first be applied to senior staff. If a 'saving' must be found among more junior staff then if a wage increase is allowable, a below inflation increase may have to be imposed.

Staff are often more prepared for reduced pay if a primary objective is to avoid redundancies. Unions also are more realistic today about the competitive situation in which many employers find themselves.

Introduce a shorter working week – again if the objective is to avoid redundancies this may be acceptable between employee and employer. It may be possible to avoid the proportionate wage reduction if other overhead costs are reduced thereby. But it may also be necessary to negotiate a proportionate reduction in wage.

Cut pay – if this is done then it will normally be in 'return' for some commitment to maintain employment levels. Here the reduction rate should be identical across the organisation, although very senior managers may be seen to take a higher reduction.

Shares in lieu of pay – this is a limited and short-term mechanism that simply may not be available for many types of organisation. It has the merit however of providing something of money's worth and ties the employees interests more closely with those of the company. It may also be seen as a 'vote in the future' by both employee and employer.

'Sell' holidays to staff – In the UK some employers have found this a mutually beneficial mechanism. Normally some sort of scheme will need to be launched with well understood rules. Employees can 'buy' up to a maximum number of additional days' holiday, above their normal leave entitlement. The benefit is offered via salary sacrifice, so both employee and employer can gain by a reduction on tax and national insurance contributions in addition to the reduced salary bill. Similar schemes are possible across the developed world, but need to be carefully planned via the HR department.

Some employees will genuinely value additional holiday, and especially so if it helps to stave off redundancies.

It is worth devising a scheme along these lines in good times as well as difficult, as this can speed implementation in bad times.

Slash dividends

Shareholders are generally willing to share 'pain' if it is for a good reason and especially if short-term pain leads to long-term gain. The case will need to be made that the reduction not only keeps the financial wolves from the door, but enables the firm to reinvest in a way that otherwise would not be possible. For both sides, the firm and the shareholder, once again this can be seen as a vote in the future.

What signals does dividend reduction send in the market?

Ultimately this must be a board decision, but what other stakeholders need to be engaged before this step is taken?

How close to our cash target will a reduction in dividend take us?

Swap debt for equity

Inevitably this dilutes the existing shareholders' percentage holding and may prove controversial for this reason. The lender will also need to be persuaded that their long-term prospects are enhanced by forgoing repayment of debt in return for an equity holding. Clearly that holding must offer the prospect longer-term of being a better 'investment' by comparison with today's debt and interest. But for both lender and borrower it may be the least-worst outcome in difficult circumstances, especially if it allows breathing space for a borrower that might otherwise suffer bankruptcy or a permanent reduction in its competitive position within the market place.

If this course is chosen then there will need to be planned and well-briefed discussions with lenders, and a realistic valuation of the share value to be swapped *vis a vis* debt. There will also be legal and other fees to be included, so a debt-for-equity arrangement needs to be worth everyone's effort in implementation. This means that usually the scale of the swap should be big.

From the lender's viewpoint there may also be short-term tax advantages in such an arrangement.

Cost arena 2: Strategic cost-down

In many respects this is the more interesting and satisfying area within which to work, as it implies a wider horizon of activity and expresses a vote of confidence in the future of the organisation.

Fixed to variable costs

In this book we approach the subject of strategic cost down by looking first at what fixed costs we can shift to variable costs, and then we list other promising avenues of investigation. As noted earlier in this book, fixed costs are those costs that remain unchanged irrespective of the business activity of the company/organisation. Rent and rates are two obvious examples, so we begin with these.

Fixed to variable 1: premises

If the organisation holds its premises freehold (i.e. no rental) then there may be opportunities to improve space utilisation and to offer space 'saved' to third parties on a rental basis. So the property becomes an opportunity to open a fresh income stream. Clearly there are many difficulties, obstacles, challenges to saving space and to rental to third parties. None, however, are insurmountable and it should be relatively straightforward to assess the current rental market and so assess the income that might be earned.

Rates may be more difficult to manage down if the overall building footprint and amenities remain unchanged. As noted above, some of the rateable obligation might be offset by renting-out some space. Beyond that if it is possible to improve space utilisation then there may be opportunities to offload some areas of the property and so reduce rateable values.

Fixed to variable 2: cloud computing

Some of the bigger computing firms offer certain hosting services, such as e-mail, for free. The cloud now represents a good opportunity to shift the fixed costs of e.g. servers, in-house maintenance/support, IT staff and software rental costs, from fixed to a variable fee based on usage. Such arrangement is a significant strategic change and there are additional risks to be considered and managed, but over the longer term this looks like a promising opportunity to transfer fixed to variable. We do not suggest here a particular ‘saving’ rate that should be sought; rather we suggest that organisations should undertake a business case analysis to establish current computer use, anticipated future use and investment requirements and then test the market (probably via a formal competitive tender). Some businesses, such as banks, may be debarred by law from hosting client information on third party computers, but even these may be able to find significant areas of non-sensitive business that might be able to benefit from cloud computing services.

What is your organisation doing about the cloud?

Not every cloud has a silver lining! Make sure you understand the risks for your business and have a suitable remedy plan in the event the cloud fails. The cloud has not failed yet, but the same could have been said of the financial services industry 10 years ago! Do not lose sight of the risks!

My Notes

Fixed to variable 3: telephony

A larger business should keep under review the telephony market and periodically market review service providers and the prices it pays. For long distance calls especially to other parts of the world, some effort should be made to establish that the time we make calls is optimised. Even within the USA with its different time zones, judicious use of the telephone can yield worthwhile savings. In addition to this VoIP (voice over internet protocol) facilities are now readily available – e.g. Skype. Their quality is improving all the time. Significant savings can be achieved via these.

Rather than buy telephone equipment, there may be a good business case to rent from a service provider, but beware – there have been some ‘horror stories’ of small businesses becoming locked-in to contracts that turn out to be much more expensive than the original service provider. Even bigger businesses have been caught out. The best defence against scams is to invite formalised ‘bids’. This gives the client better understanding of the telephony market – and knowledge is power!

There are specialist consultancies that offer to assist you to find telephony ‘savings’. Google ‘reducing telephone costs’ to locate them. If you do decide to use a third party then properly market test them – probably by inviting them to submit a formalised ‘tender’ in response to an invitation to tender (or so-called “request for proposals”).

Again we resist the temptation to suggest savings figures as telephony markets are so diverse and increasingly complex. But be assured, savings are worthwhile and will reward the effort to secure them.

Fixed to variable 4: remote working

Linked to the above, knowledge workers can often be independent of location – they can work at home. Whilst there may be some on-costs associated with establishing a viable office at home, the benefits can be these:

- Happier/less stressed workforce. Travel time reductions are a real boon to most workers.
- Lower staff turnover – viable home working is definitely valued by many staff.
- Better space utilisation at the head office. This in turn may enable smaller office with associated savings.
- Lower wages – if people are not working/travelling to and from/socialising in big towns and cities, they may well consider a trade-off between work-life balance and salary.

The key point here is that the fixed costs associated with head office working can be shifted to variable and the cost base reduced accordingly.

Once again it must be stated that there are many aspects to consider if we are to make a significant shift to teleworking/remote working, but enough companies have experience in this area for organisations to have confidence that it is viable.

My Notes

Fixed to variable 5: outsourcing

Of all the cost-down mechanisms considered so far, this one has the power to make the most profound changes to our business or organisation. Outsourcing as a strategy has been around for 20 years and its scope has grown in ways not originally anticipated – in principle there are today no services that cannot be outsourced. The key difference between *contracting* for services and *outsourcing* is the extent of the dependence by the client on the third party service provider. Modern outsourcing encompasses activities that once might have been considered as core. Today a client organisation may well entrust to the third party outsourcer its interface (i.e. its public face) with the consumer/service user/customer of the firm.

Globalisation, technology and the global reduction in some types of politico-military tension means that outsourced services can safely be carried out half-way across the world. The typical call-centre located in India is a well known example, although today hardly representative of the increasingly sophisticated services that can be sourced in this way.

For the purposes of this book we merely note this: what once was a fixed cost and a service or activity undertaken in-house, can today be contracted-in, so the fixed cost can become a semi-variable or even totally variable cost reimbursed on service utilisation charge rates.

This is not a book on outsourcing and there is plenty of good material available to guide firms or public sector organisations in the nuances of outsourcing. The point being made there is that as organisations seek to reduce costs, they must be prepared to adopt more radical service delivery models.

Looking at your business model, are there any areas that could be undertaken via an outsourced delivery mechanism?

Note that some firms have had to reintroduce as in-house services some services that had been outsourced. There are pitfalls for the unwary. There are pitfalls for the thoroughly prepared! To justify any initiative to investigate outsourcing, what is the sort of cost base reduction that outsourcing might deliver to your organisation? Is it worth the effort and risk?

If a significant shift from fixed to semi-variable is possible via outsourcing, how might this affect your pricing and service delivery model?

Linked to outsourcing, but not necessarily the same, many organisations now have a *low cost country* sourcing objective. This means they recognise that low cost countries can provide good quality, value for money and service, without exploiting the local workforces and communities – which was a pitfall of early low cost country sourcing initiatives. Some organisations link outsourcing to low cost country sourcing. Accordingly this may be an option for your company.

My Notes

Strategic supplier cost-down

There are a number of elements to be considered. There is not much point in 'squeezing' suppliers if we have no clear vision for the future. The departure point for a third party (supplier) review is our own strategic plan. What investments do we make over the next few years? Who are our customers and are they changing? What are the dynamics of our market place? All these issues will inform our approach to reducing supplier costs.

Whilst supplier cost reduction is generally a desirable thing, we need once again to make a mental trade-off: if suppliers can deliver much better value and so improve our own market position in relation to our competitors, there may be a case for supply costs to rise, and not to be lowered!

It is beyond the scope of this short book to describe in detail the various project work-streams involved in a strategic supplier cost-down initiative, but broadly they will be as follows, and managers need to work out the sub-actions associated with them in their own organisational context:

- Market assessment
- Competitor assessment - intelligence
- Strategic plan

The supply/third party plan should be a component of the strategic plan.

- What 'selling price' are we aiming for?
  (what is the 3rd party / material component of the selling price?)
  (what is the 3rd party / services component of the selling price?)

- Cost engineering: what is the scope for re-engineering? (material changes, process changes, storage changes, packaging changes, sub-component changes, etc.)

Are you looking for a tactical or a strategic relationship with your key suppliers?

Do you know the supplier/supply component of overall costs?

If your organisation develops suitable long-term relationships with suppliers then there can be real incentive on both sides to explore ways together to improve quality, as well as reduce cost on an ongoing basis. Certainty in contracting provides just this incentive. All organisations must periodically review supplier relationships both with their *high-spend suppliers* and their *critical suppliers* (which may not be the same group of suppliers).

- *When was your organisation's supplier base last reviewed from a strategic perspective?*

- *At Board level, whose responsibility is it to 'own' supplier relationships and key supplier risk?*

Readers will want to consider the Appendix (Third party [supplier] cost-down work streams – Strategic) if they are undertaking a supplier cost-down initiative. This suggests a systematic way of looking at cost-down with key high-spend suppliers.

My Notes

The *make or buy* decision

With the growth of low cost sourcing options both for manufactured goods and for services such as IT support, there are an array of opportunities to buy-in goods and services formerly undertaken in-house. A number of considerations will influence the decision:

- ***Cost analysis*** – what are the costs of manufacture, ongoing contract management and quality assurance, and freight? And how do these offset 'savings' via buying-in goods or services as opposed to 'making' them in-house?
- ***Power/dependence analysis*** – an analysis of the future behaviour of the parties to the arrangement – essentially becoming too dependent on suppliers.
- ***Strategic resource perspective*** – a perspective on what resources are unique to a company or organisation and those that are less central.

These issues are well explored in standard purchasing text books (one is suggested in the Notes and References section of this book – see Reference 3) so we will make only two observations here: firstly some Western businesses have become *totally* dependent on their low cost country sources.

As business has shifted to low cost countries, so domestic suppliers have tended to exit their markets – essentially their former customers have driven them out of business. As freight, insurance and contract management costs rise inexorably, so the earlier ‘low’ costs can be offset in such a way not only to eliminate the earlier ‘price advantage’ but also to prejudice the customer’s long-term viability. Secondly, low cost country suppliers will inevitably secure higher wage rates for their workers over time – that is why their governments provide so many incentives to support these suppliers. Over time this will lower if not eliminate any price benefit. Whilst the *cost analysis* mentioned above is generally carried out satisfactorily, the *power/dependence analysis* and *strategic resource perspectives* are as often ignored.

Who in your organisation has the breadth of experience and gravitas within the organisational hierarchy to ensure that strategic issues are properly thought through? Is the make or buy decision tactical or strategic?

What is the strategic agenda discussion with your procurement head? Is the agenda narrow cost reporting or are supply dynamics, risks and strategic opportunities also discussed on a regular basis?

My Notes

Working capital control

Cash can become tied up in stocks and work in progress. For public sector organisations the equivalent downside may well be over-purchasing in the pursuit of 'discounts'. Improved control of working capital can genuinely save costs. Without going into these techniques in detail (which can be well enough studied in standard accountancy and purchasing texts), these are the techniques that all organisations should deploy:

Keep stock down

Optimising stock levels is a science – your company's approach should be well understood by the relevant managers.

Economic order quantities

Again, this is basic good purchasing. The relevant formulae should be developed and applied to your own business context.

Chase debtors

Nine out of ten businesses do not routinely send out reminder letters following missed payment deadlines. The cost of late payment is generally significant and on a cumulative basis can seriously dent profits.

Take credit or seek discounts?

Firms routinely ask for frankly unreasonable credit terms – 30 days frequently becomes 90 days. Whatever interest is gained will generally be small. Conversely, to offer (and deliver) prompt payment terms may enable discounts to be obtained that are more attractive than the apparent interest benefit of extended payment terms.

How often does working capital strategy get discussed at senior level in your organisation? Are you satisfied that this key subject has sufficient visibility at the relevant level within your organisation?

My Notes

Energy costs and utilities

All businesses need heat, light, telecoms, water and so on. The bigger the business, the more influenceable these costs tend to be. Many organisations will have proper and well-thought out utilities procurement strategies and the liberated energy markets within most Western countries – but particularly UK and US – means that there are genuine cost benefits to be achieved by exploiting those competitive markets. But savings can be illusory and energy costs will inexorably rise because of the difficulties of the energy market. Accordingly there is no option but to become more economical in the use of energy and other utilities. The following tactics will help and need to become culturally embedded:

Turn down – According to the UK's Carbon Trust, turning heating down by one degree can yield an 8% reduction in annual energy costs. Proper insulation and keeping doors and windows closed wherever possible – and even the bizarre act of heating and cooling simultaneously (it is easy to do in modern offices!) costs real money. Lower lighting costs by using natural light and repositioning work stations can lower lighting costs by as much as 10%. These are relatively simple tactics to adopt with a quick financial payback.

Voice over internet protocol (VoIP) – Free telephony is now a reality and can be implemented relatively straightforwardly. Skype is the obvious example here although there are other service providers.

When did your organisation last undertake a review of utilities costs at a senior level? How recent is your strategy document (or 'category plan') in this area?

What energy pressures will your business be exposed to in the foreseeable future?

My Notes

Audit costs

Large, global businesses must be audited and generally will have little choice as to who their auditors are – although it must be said that even these businesses are now becoming more energetic in seeking alternative styles of audit. Only four audit firms offer a truly global audit service and perhaps a dozen more can offer near equivalent services via a network of associated companies overseas. For smaller firms, however, there are thousands of accountancy firms that can quite satisfactorily provide the relevant services. There is a case for formally testing the market.

Once again this is a ‘purchasing’ type opportunity and a proper strategy should be developed. First establish your present audit fees and consider whether they are excessive in relation to the financial operations of the company. Secondly, draw up a schedule of services and timescales and initiate discussions with possible alternative auditors. Fixed and semi-fixed fees will be possible and this should enable accurate price comparisons.

Bank loans and fees

Banks remain the principal mechanism for most businesses to raise finance. The banking relationship is negotiable and the objective generally is to negotiate a rate of interest as close as possible to the bank base rate. A premium of 0.25 to 0.50% may be considered optimum for a listed company, whilst other private companies may pay from 3% to 9%. We should always keep in view that banks are in competition. Most are keen both to retain business customers and to work with them to mutual advantage. However, if in a competitive market they are unable or unwilling to meet your reasonable expectations then you should leverage the competitive marketplace – shift banks if you have to.

But also be prudent and sensible about approaches for finance. Banks need suitable notice periods about when finance is needed, and too many business people rush to the bank when there is a shortfall in funding or when an investment project receives the ‘green light’ from senior managers. If money is available in such circumstances then it may carry a loan premium reflecting the ‘rush’ and the associated due diligence risks that the bank assumes. Better to approach the bank in a planned and systematic manner. Bankers generally think in terms of the five ‘Cs’ of credit analysis. If you present yourself well against these criteria then the price you pay should be minimised. The five ‘Cs’ are:

Conditions – bank attitude is influenced by market conditions generally and your own market sector in particular. They will look at your strategy and how it reflects market realities. A good business plan will assist your case considerably.

Capital – the bank will look at your net worth and in particular at the amount by which assets exceed debts.

Capacity – how readily can the borrower repay the loan? For a brand new business, naturally, the bank will focus on the business plan. Established businesses will need to provide financial operating statements and an analysis of business trends. Provide as good a picture as you can, to inspire confidence in yourself as a knowledgeable manager/ business owner, as well as the favourable dynamics of your industry. Astute bankers will quiz you closely in these areas, so be prepared!

Collateral – Banks look to an asset or assets that might be liquidated in the event a borrower cannot repay. Whilst this strikes somewhat against the spirit of limited liability it can help to keep costs down. Directors may make personal pledges to repay. If a borrower accedes to this approach then such a loan should be secured against *specific* assets only, and there should be clear conditions about when the guarantee comes to an end, for example when the loan is repaid. There is a slight danger, if there is a lack of clarity in this area, that personal or other guarantees may inadvertently become a permanent feature of your banking arrangements.

Character – last and not least! Banks want customers that are honest, capable, realistic and that have a sound credit history. If you can clarify your credit history and address any unfavourable issues (e.g. ensure other outstanding debts are cleared), then this will strengthen your case and should be reflected in a lower lending rate – or at least an optimised lending rate by comparison with other companies in similar circumstances.

Finally, if there are serious issues within your industry, the banks will already be well aware of that fact. They will be interested in the depth and sophistication of your analysis of your competitive position and how your company intends to navigate those difficulties and challenges in the foreseeable future. Prudent bankers tend to think of their lending funds as though it were their own money – Would I lend in this situation? Would I risk my own money in this situation? If you can satisfy them that their money will be wisely applied then you will assist your application considerably and minimise on-costs.

My Notes

Conclusion

Enough has been said in this short book to encourage a fresh debate within the organisation at various levels – certainly at senior and middle management levels – to uncover whether there are opportunities for cost-down that have not yet been addressed, or simply need to be revisited. But the title of the book indentifies *cultural shift* as being essential to sustainability. Cost consciousness among staff at all levels will lead to cost advantage.

We have *not* looked at all possible areas where cost can be contained or managed down. The biggest cost area not addressed in this book is that of tax, which is a specialist area in its own right and could easily have doubled the length of this book! But the principles suggested in this book can be applied to tax and other areas of cost. Those principles are: review, query and debate in a systematic way and ensure that cost issues remain on everyone's agenda.

In Section 2 of this book (The Opportunity) we also briefly considered cost-down as a cultural statement made by the organisation. Let us return once again to cultural shift. Cost advantage is not ultimately about a series of disconnected measures aimed to reduce today's 'price' to a lower one tomorrow. All employees must ultimately see cost control as part of their job responsibility – not to make the organisation penny-pinching (or risk becoming 'penny wise, but pound foolish') but to link all decisions that may have a direct cost implication to the broader economic objectives of the organisation. How does this decision affect our cost base and contribute to long-term cost advantage?

A cogent case is made in Colin Barrow's excellent short book *Cut Costs Not Corners* (see Reference # 5 in the Notes and References section) for all organisations to have a CCCO – a *Chief Cost Control Officer*, at a senior level. Too often perhaps, the responsibilities for cost control are assumed to be held by the Chief Financial Officer (CFO) but the linkage between finance, operations and strategy may be too broad a remit for the CFO who generally has many other agendas to attend to. Whether any organisation will in the end appoint a genuine CCCO remains to be seen but certainly the Board collectively make up the logical CCC team looking beyond the narrow area of spend control. It is the Board, then, that must take direct responsibility for mapping out the cost culture of the wider organisation and what this means in developing an identifiable cost-down posture. Most organisations know they have to keep working at costs in order to optimise them – and that is not necessarily the same as minimising them. Whole life costing should today be a key part of investment decisions, especially for capital investments.

To shift an organisation's culture means a conscious effort. It means understanding our historic or inherited culture and assessing the extent to which it supports or undermines cost consciousness as a corporate priority. Then the tools of vision definition, communication and practical controls must all be utilised in order to achieve an optimised cost base. We owe it to our customers (or taxpayers for public sector organisations), to our shareholders and to all legitimate stakeholders, as well as to our employees, to create a culture that sees cost control as everyone’s responsibility. Only in that way are our broader organisational goals met on a sustainable basis.

Notes and References

[1] Charles Ames and James D. Hlavacek, *Vital Truths About Managing Your Costs*, in *Harvard Business Review*, January-February 1990.

[2] Orit Gadiesh and James L. Gilbert, *Profit Pools – a Fresh Look at Strategy* in *Harvard Business Review*, May-June 1998.

[3] Paul Steele and Brian Court, *Profitable Purchasing Strategies* (McGraw Hill Book Company) ISBN 0-07-709214-7, 1996.

[4] www.iconsulting.org.uk
There are equivalent organisations in all Western countries, able to provide advice on consultancy practices involved in cost reduction activity.

[5] Colin Barrow, *Cut Costs Not Corners* (Kogan Page, 2010) ISBN 978-0-74945976-5.

The Author

Peter Sammons has worked for many years in the commercial field, focusing mainly on strategic procurement. His work has involved considerable emphasis on cost review and cost-down initiatives.

He currently acts as a panel member with the UK Institute of *Consulting Consultancy Purchasing Steering Group* and is a Member of the UK Chartered Institute of Purchasing & Supply. He is also author of *The Outsourcing R&D Toolkit* (2000) and *Buying Knowledge* (2005), both published by Gower.

Third party (supplier) cost-down work streams – Strategic

WS = Work Stream

WS1 - Establish top 5 third party spend areas

- This might be already well known. If not ...
- Use cost code info and associated spend reports

WS2 - Strategic review

Client market review)
Operations review)
Strategic review) stakeholder engagement
Income/finance review) (internal)
Supply market review) (external?)
Regulatory review)

WS3 - Options review

Can we consolidate supplies/suppliers?
Can we re-engineer the supply?
Can we re-scope/de-scope the service?
Is there evidence that fees/costs are out of kilter with the market?
Supplier innovation – what plans does the supplier have?
Vendor management/Supplier relationship management – can we align strategies?

WS4 - Options report and recommendations

WS5 - Third party supply plan for Top 5

Having completed the top five, then the organisation can repeat the exercise for the next five suppliers, and so on, to evaluate the relationship with all of the high-spend and/or strategic suppliers.

COST CUTTING

– a cultural shift to sustainable cost-base reduction

- Why cut costs? Why not grow revenue?
- Are all costs bad?
- When you set about cutting costs, should you slash and burn, wield a surgeon's scalpel or a lumberjack's chainsaw? Or all of these things, simultaneously?
- How does cost cutting link to your broader strategic objectives?

Businesses and public sector organisations are under constant pressure to cut costs. Rather than react to stock market pressure, sudden assaults by competitors, or public sector funding crises, is it possible to make cost-cutting a part of your organisation's cultural mindset? Can cost-base reduction become sustainable over the longer term?

This short book is aimed for managers and corporate decision makers, whether in the private or public sector. It poses a series of questions which are intended to encourage debate and action. Cost pressures are not going to disappear any time soon, so employees at all levels need to be focused on cost.

The author has spent many years considering cost, price and value – mainly in the commercial sphere. He has a knack of asking simple, but challenging questions. Readers can use these as a benchmark in pursuing their own cost-down agenda.

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