Cost Reduction
What Others Are Doing

By Garrett Cronin, FCA

The changed economic circumstances currently facing organisations provide an opportunity to focus on costs. Now is the time to concentrate on putting in place robust structures for the future.

I recently asked the CEO of a large Irish manufacturing operation, with multiple sites in Ireland, that given his manufacturing and sales model, in an ideal world, what his operational structure should look like. 'Not like this', he said.

The structure and model of most Irish companies has evolved over years, adapting to meet market demands, optimise revenue growth, integrate acquisitions, etc. They have become more stove-piped in their operational execution as each business unit and function sought to structure to the individual demands placed on their part of the business. In a growing market, this was accepted, but not necessarily acceptable. The dream was increased revenue, increased profit and higher market share and all else became secondary to this drive.

Fit for purpose

The world has now changed. Minimising revenue loss, cutting cost and conserving cash is what really matters. Analysing that 0.5% drop in margin, challenging that supplier for cost and service, struggling with that pricing decision, screaming for that cost analysis, and reducing headcount have all become the priorities of the day. Getting the structure right for future, not past, levels of activity is the real challenge and this involves a new culture of ownership, responsibility and accountability. Converting to an agile model with the appropriate mix of fixed and variable cost to meet market demands is key.

In supporting our clients as they address the cost reduction challenge, we have hosted cost reduction workshops for over 30 individual companies across all industries in the last 6 months. Some of the key challenges they face and the steps they're taking to address these problems are outlined below:

Know how much you make

In general, the cost to serve each customer is different. So how do you price the service you provide? Knowing the drivers of cost to serve each customer is key – these may include raw material costs, unique manufacturing processes, labour, stock holding costs, stock obsolescence, warehouse, distribution, invoicing, rebates, cash collection, terms of payment, customer service and support, etc. These need to be understood in the context of each product, each service, each customer and each channel you serve and a price needs to be set to generate a target margin to cover indirect costs and generate a profit. If existing product lines or customers are unprofitable, alternative options must be considered: drop the product, service or customer; change the price; or become more competitive.

As customers negotiate for more competitive rates, it's important to fully understand the dynamic of your cost base when pricing new business. If fixed costs are already covered by existing volumes and the contract is of a one-off nature, marginal pricing may be suitable. Otherwise, consideration must be given to striking a price that generates a yield against a fully loaded cost base.

Revenue leakage

Businesses constantly seek to optimise revenue, but what you collect may be poles apart from the list price. Discounts, allowances, rebates, credit notes, extended terms, early payment discount, returns, special offers, freebies, foreign exchange charges, all serve to offset list price. Many of these 'sales tools' are well intentioned, but unless correctly authorised and controlled can significantly impact net profit. An extra 5% discount on a 20% gross margin business reduces gross profit by 25%.

In-depth analysis of credit notes can often be insightful, identifying areas of inefficiency, poor process and customer service overload. The cost of investigating, justifying, approving and issuing credit notes is often up to

5 times the cost of generating an invoice and in addition often extends customer credit by an additional 30-60 days. Identifying and correcting the root causes of credit notes and improving straight through processing accuracy can generate positive benefits for any company.

Buckets of cost

Spend and cost need to be individually categorised and analysed. This sounds easy but can pose challenges in defining where a cost sits, how it is categorised, or what is a hidden cost.

Hidden costs may be significant and can include bad debts; obsolescence charges; shrinkage; un-recovered VAT; duplication of effort; unnecessary overtime; operational inefficiency; excess charges for premium services no longer required; over-claimed expenses, etc. Once these costs are identified and measured, they can be managed.

Understanding where a cost sits and assigning associated ownership is critical. A number of FMCG companies we spoke to had no owner assigned to inventory obsolescence, so inventory levels weren't monitored or managed, resulting in significant cost. Another company incurred research charges on behalf of another group company which accepted the charge without ever challenging its value.

Procurement and spend

As certainty of business is crucial, a window of opportunity now exists to re-negotiate favourable contracts with all suppliers. In analysing procurement requirements, opportunity exists to reduce the number of suppliers, to consolidate spend across group or partner companies, to renegotiate both rates and terms, to challenge the service being provided for relevance and value, to solicit innovative solutions from 'supplier partners' where small investments can generate long-term cost savings, etc. One company, with significant security requirements, recently challenged their suppliers to suggest how new technologies could deliver a more efficient and effective solution. With some small investments, operating costs were reduced.

Is that overseas trip really necessary?

Spend is a factor of price and usage. While procurement tackles supplier pricing, don't forget to challenge internal usage: Is that extra shift required? Are operating processes efficient? Why are my internal experts buying in external support? Why are we printing single sided and in colour? Is that overseas trip really necessary? There must be a clear correlation between spend and value if proposed spend doesn't generate incremental margin, why invest?

Ownership and accountability

Unless every cost has an owner, it won't get managed. Common examples of ownerless costs include salesmen not measured on margin or bad debts, buyers not measured on stock obsolescence, procurement contracts not managed, treasury charges not challenged, etc. Every element of cost, every pricing decision, every contract, every resource needs to be challenged for relevance and value. The measure for each needs to be agreed by management ensuring alignment with the strategic objectives of the company. Aligning ownership and accountability for every bucket of cost to the performance measures of individual managers drives improved performance.

Identifying win-win situations can be profitable and motivational. An engineering group whose management challenged their own ability to reduce working capital to pay down group debt offered their company managers a 3% bonus for every €1 reduction in working capital. Some members of management earned the cap of €100k and, in doing so, the company not only reduced its debt, at a cost of 9% per annum, but also achieved a cultural shift in driving management innovation.

Shared Services and Outsourcing

Ireland's economic model has justified the establishment of over 100 international shared service centres (SSCs) in the country in the last 15 years. The fundamentals of agility, control and cost implicit in these investments are now being considered by indigenous Irish companies, resulting in a sharp increase in shared services activity.

The consideration of shared services models is also forcing companies to re-visit their existing operating practices, as SSCs drive standardisation of process. New disciplines are being introduced which force better operational and cost control, e.g. the need for purchase orders for all goods and services received, the standardisation of charts of account which facilitate like-for-like comparisons of performance, etc.

Outsourcing can offer flexibility

As companies look to control their cost base, outsourcing business processes like IT, Finance and HR are on the increase. Outsourcing companies can offer flexibility, expertise, innovation as well as reducing operating costs. The old adage remains – never outsource a problem – but there is clearly benefit in outsourcing inefficiency. Significant reductions in operating costs are achievable, even through outsourcing onshore, but experience shows that care is required in structuring such contracts.

Metrics

Our reviews indicated significant deficiency in the manner in which metrics are used to manage business performance. In many cases there were either not enough or too many metrics; they were not aligned to strategy; not every key cost driver was measured or had an owner; it was not possible to produce appropriate reports on a timely basis.

Significant investment is now being made in getting this right – management are focusing on a small number (< 10) of key metrics and red /

amber/green ratings are forcing them to address the problem areas. Aligning personal ownership with these metrics also retains management attention and focus.

The Role of Finance

As revenue and profit grew in recent years, the role of the Finance Function in many organisations largely reverted to a 'controlling' and transactional driven operation. However, now, more than ever, business insight is required to support operations in:

a) understanding their performance at a granular level; and

b) identifying and supporting initiatives to improve performance.

In a number of cases, we have seen examples where operating management were unaware of the information available to them from Finance. Investment in management reporting tools and finance skills may be required to adequately support this change in focus.

Culture

Without consistent and unequivocal leadership from the top, change won't happen – senior management need to maintain focus and momentum in taking out cost. Employee involvement is key for two reasons: a) they are at the coal face and often see opportunity not visible to management; and b) asking employees for input conditions them for the change that will inevitably follow. 'Sacred Cows' must be tackled – the first step is being honest in identifying those buckets of cost which are never considered, and then agreeing an appropriate approach.

Cost needs to be tackled from all angles within companies – no one area can be excused. Challenging the business model is the first step and getting an independent perspective on options is usually insightful, be it from a peer, a non-executive director, or an external expert. Agreeing a plan and ensuring there is ownership, responsibility and accountability is a great next step.

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