10Minutes on Sustainable Cost Reduction*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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An approach that sticks, in bad times and good

Highlights

- Traditional methods of cost reduction often fail over time.
- A strong foundation for cost reduction activities must be established before introducing game-changing transformational initiatives.
- There is no accountability, accuracy, or way to evaluate cost reduction efforts without clarity of operating cost drivers and linkages to financial plans.
- There are a number of steps companies can take immediately to move to sustainable cost reduction.
- If the spend culture isn't addressed, cost reductions won't be sustainable.

Companies are justifiably anxious to reduce costs. But the problem with many cost-cutting measures is that they are put into practice without considering their sustainability. Often, cost savings achieved in the short term eventually leak away. The failed cost reduction initiatives wind up damaging corporate infrastructure and culture, leaving companies struggling well after the recession ends.

Faced with a protracted period of sluggish demand and tight credit, companies are now asking, "What has to fundamentally change so our cost reduction efforts work today as well as in the future?"

Why do most cost reduction attempts fail?

1. **Lack of a strong foundation.** Companies lacking financial discipline, stable cost management practices, and an in-depth understanding of their cost baseline will have difficulty identifying and tracking cost reduction opportunities.
2. **Dipping into the same well.** Companies tend to repeatedly focus on low-hanging fruit and SG&A back-office activities. They often fail to address baseline operating costs and third-party spending where significant opportunities also exist.
3. **Failure to address cost management and control.** Companies regularly focus on reducing costs without addressing their spend culture—who can spend, how they spend, and how it's tracked.
4. **Inability to measure results.** Cost reduction activities often get lost within annual operating results. Without a strong monitoring process, it's difficult to know whether cost reduction plans are achieving desired results.

At a glance

Cost reduction strategies and practices

Value killers

- Setting reactive and arbitrary cost reduction targets
- Lack of transparency of cost drivers
- Building financial plans on a "last year plus" basis
- Lack of financial discipline with accounts, such as managing the budget as a single pool of costs rather than as line items
- Trying to save every possible cost from every possible part of the business, plus time wasted analyzing a perceived "best possible solution"
- Operating managers receiving weak cost information from financial analysts

Value builders

- Strong direction and support from the C-suite for cost reduction initiatives, with clear scope and objectives
- Having a strong foundation in place before introducing transformational initiatives
- Ability to assess and challenge the company's spend culture
- Bridging the silos: frequent interaction between finance and operating managers for better cost reduction decisions and tracking of results
- Effective communication regarding cost reduction plans to lessen resistance among staff and create more buy-in from managers

01

Challenging times call for thoughtful measures

Companies have always been under pressure to look for efficiencies and reduce costs, but never more so since the US slid into recession at the end of 2007. The latest macroeconomic forecasts indicate a protracted period of weakness, which will challenge companies to dig even deeper.

The US economy is expected to contract at a 3.5% rate in the first quarter and continue to contract through at least the first half of 2009, leaving real gross domestic product growth for the year at only 0.1%—even with a substantial stimulus plan.[1]

In this challenging business environment, knee-jerk reactions can do more harm than good. Ad-hoc spending cuts can damage reputation and infrastructure and demoralize employees. For cost reduction measures to stick, companies must clarify the cost drivers of the business and use that knowledge to create a culture of cost consciousness, in both bad times and good. For example, at farm equipment company John Deere, bonuses are no longer tied to commodity boom-and-bust cycles. Managers are held accountable for not only profits but also the cost of assets they use, and their rewards are based on overall performance.[2]

What has to fundamentally change so the results of cost reduction efforts endure this time around? Companies will need to simultaneously tackle cost reduction and cost management and control.

- The cost reduction component would focus on identifying and delivering savings opportunities.
- The cost management and control component would focus on stabilizing cost controls and improving the way costs are managed to allow for continuous improvement and sustainability.

The essential elements of a cost reduction and cost management and control framework include financial management and control, procurement and supply chain, business process execution, and performance management.

1 Macroeconomic Advisers, LLC, December 8, 2008.

2 Jia Lynn Yang, "Reviving John Deere," *Fortune*, October 10, 2007.

02

Why do cost reduction plans unravel?

Frequently, companies swing between the two extremes of cutting short-term costs and placing big bets on transformational plans. Sudden measures driven by "We need to reduce costs now, and I don't care how" are reactive and unsustainable. Large-scale, ambitious plans executed during times of extreme stress are equally risky because they tend to implement a system the company may not need, may not be suited for, or cannot handle.

Here are three common cost reduction methods and the reasons they unravel:

Top-down approach. Senior management focuses on transformational opportunities to reduce costs. The company is hoping that a single solution (organizational redesign, IT system change, shared services, offshoring, etc.) will solve its long-term cost issues, without paying attention to the behaviors and decision-making processes that drive costs in the first place. If the existing spend behaviors at the company haven't changed, any new savings will not be sustainable.

Slash-and-burn approach. Organizations conduct business as usual, but departments are directed to reduce spending by a set target. The target is often arbitrary and reactive to market conditions. This results in cost cutting without long-term action, management, or tracking plans. And because of the random nature of the cuts, there's likely to be a negative impact on morale and culture.

Boil-the-ocean approach. All departments conduct extensive interviewing, process analysis, and benchmarking in order to improve efficiencies, leverage technology, and identify cost savings. This is an unwieldy process with an open-ended time frame and typically results in a loss of momentum and focus. Departments become personally invested in their own budgets and rarely find waste. In the end, the process produces a list rather than creating sustainable cost reduction.

These ineffective approaches teach us that before attempting any type of cost-reduction activity, two important steps must be taken:

- The C-suite must supply clear direction.
- A foundation must be laid on which real, sustainable change can be built.

03

A strong foundation is critical

Establishing a strong foundation is essential to sustainable cost savings. The management team must understand its cost baseline and view cost as a result of the business decisions it makes on a daily basis. The journey to a strong foundation and sustainable cost savings involves the following:

- **Reducing non-essential spending.** Discretionary spend is typically the first area to get scrutinized—and rightly so, since it's not essential to business operations. Assessing and challenging this type of spend centrally will help reduce any resentment about cutting these expenses.

- **Clarifying business cost drivers and improving accountability.** Analyzing spend data to identify potential savings will work only if the operating teams are properly using the financial accounts. Managing a cost center as one big pot makes it very difficult to understand what actually drives cost. Defining operating cost drivers through a bottom-up analysis and linking financial plans to operating plans will provide transparency, improve accountability, and enable measurement of cost reduction activities.

- **Taking control of third-party spend.** Ensuring that sound agreements and decisions are being made with third parties can reduce spend and improve supply chain leverage.

- **Tackling the company's cost culture and behaviors.** Cost reduction gains can be sustained only in a culture that encourages individual responsibility for managing and controlling spend.

Make it sustainable: embed cost management and controls

Consider two companies: Company A identifies office expenses it wants to reduce, and tells managers to cut them by a set percentage. Company B targets the same group of expenses, but also digs into how spend decisions are made. In the process, Company B's employees develop awareness of costs and how costs directly relate to business choices. As Company A's overall results improve, its cost-control focus takes a backseat and spend will return to previous levels. However, Company B is able to sustain its savings because employees now understand the impact of their spending habits.

A culture of sustainable cost reduction: where to start

Many organizations have established a culture of sustainable cost reduction. For example, it has been reported that at General Mills, all divisions have a three-year savings goal and managers meet every week to discuss cuts. Ideas range from shrinking packaging and eliminating flavors to consolidating purchases of raw materials.[3] A culture like this cannot be built overnight, but here's a good place to start.

Set an environment for cost reduction. Confirm the cost reduction targets and process, agree on the in-scope cost base, and complete a preliminary reduction analysis.

Agree on cost ownership. Agree up front on who is responsible for challenging which costs. Working from a pre-allocation cost basis will prevent any costs from falling through the cracks.

Challenge the financial plan. Have operating managers clarify cost drivers, challenge operating cost assumptions, and reduce discretionary spend.

Look for contract leakage. A forensic review of suppliers may uncover recoverable claims, cost avoidance areas, and off-contract savings opportunities.

Gauge performance by measuring results. Do so by monitoring activities, capturing related spend results, and producing robust reports for senior management.

At the same time, focus on these cost management and control activities:

Rigorously control spending. Immediately establish a tighter span of control for spend approval to begin the spend culture transformation.

Stabilize cost controls. Complete a gap analysis of critical cost management and controls to identify immediate actions required to stop the bleeding and create a culture of cost awareness and ownership.

Using cost management and control processes, successful companies often strategically position themselves during downturns to emerge stronger after the economy recovers. For example, Cisco expanded its presence in Asia during the region's financial crisis as other Western companies fled, and Apple launched the iPod during the 2001 recession.

3 Mina Kimes, "Cereal cost cutters," *Fortune*, November 3, 2008.

Upcoming 10Minutes topics:

Health reform under Obama

Employer-sponsored health insurance could be in for a jolt as President Obama and Democratic leaders set out to reform the healthcare system as part of their economic recovery. The next 10Minutes will examine their proposals for a new public health insurance option and mandates on employers to offer insurance.

Why climate change matters today

The incoming administration promises that climate and energy policies will work together to breathe life into the economy, combat climate change, and strengthen national security. 10Minutes explores how to link business responses to climate change more strongly with business strategy and corporate performance.

Top concerns for boardroom directors

As a year of unprecedented challenge and change draws to an end, directors are revisiting their oversight of risk management and corporate culture. 10Minutes looks at how the ongoing credit crisis affects these and other corporate governance issues, sizing up the potential impact on your business.

Finance and accounting (F&A) shared services

Until recently, companies expected F&A shared services centers to reduce F&A costs by 20% to 40% over three to five years. Faced with the current crisis, however, executives can't wait. 10Minutes explores a number of downturn-capitalizing strategies for companies with centers either in place or under development.

Realizing enterprise resource planning (ERP) value in a downturn

Across industries, at one level or another, enterprise applications (and whether they're agile, efficient, and cost-effective) sit at the core of a company's ability to weather the current economic downturn—or capitalize on it. 10Minutes discusses how economic downturns can be the best times to undertake a wide range of ERP-related actions.

How PwC can help

To have a deeper discussion about sustainable cost reduction, please contact:

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