

## Cost Reduction Training – UK Consultant

### Costs – time for a rethink?

*With the recent credit crunch and its attendant liquidity crisis, increase in unemployment and liquidations; and loss of consumer confidence: this issue has once again been placed at the heart of Executives' concerns. In November 2008 alone: Mark One [a cut price UK clothing manufacturer and retailer], Woolworths [UK retailer], MFI [furniture retailer] and London Scottish Bank plc appointed administrators.*

### The perennial issue



One of the continuing issues for organisations is that there are constant and seemingly never-ending demands for expenditure (eg on IT and infrastructure) because of many factors – new legislation, changes in the market, or general issues) whilst at the same time they face downward pressures on margins and pricing from increasingly aggressive competition. The recent economic crisis has put these issues into sharp focus as banks withdraw finance and consumers stay home in droves. Many organisations fail to manage these problems satisfactorily or find it difficult to respond to revenue falls as they do not have a true understanding of the Cost/Revenue dynamics of the business.

This latter point is important as, typically, revenues change faster than costs (frequently in an adverse manner) and flexing costs to reflect such changes is very difficult without a deep understanding of those relative dynamics. A 10% fall in revenue does not necessarily mean 10% reduction in costs is necessary; it might mean a much greater decrease is required in some areas, and paradoxically might require **increased expenditure** in some areas to bring in revenue. It is also usually the case that a large cost reduction is difficult, if not impossible, to achieve in the very short term without having a detrimental effect on the business.

*‘We have focused on reducing our costs, improving gross margin and the business’s operational procedures. Establishing these retail disciplines is essential if we are to operate successfully in the highly competitive retail environment’.*

**Robert Walker Chairman W H Smith plc (Annual report 2005)**

There are many components of cost – and their relative importance varies between business sector.

-  For service companies [finance, holiday travel etc] – which are largely people based - staff costs often represent a major percentage of costs, along with items such as IT/telecomms and property;
-  For other sectors [eg retail] focus is more usually on working capital [Creditors, Stocks and Debtors] which can tie up vast sums of cash if not kept at efficient levels; or can result in unnecessarily early outflows if creditors are poorly managed.

## Cost Reduction Training – UK Consultant

- ✚ For some manufacturing organisations high levels of capital may be tied up in research and development costs eg pharmaceuticals; or in fixed assets to produce outputs.

**‘...At the same time we have a more accurate picture of the stock we have versus the stock we need and this has helped reduce our wastage and therefore cost’  
J Sainsburys plc (Annual report 2006)**

### Time value of money

Whilst in the long term all costs are variable, in the short term many are not; or at least are not easily changed. It is not generally a simple exercise to change or get rid of an IT system and there is often a large cost and effort (not to say risk) associated with it. Property prices are often the first casualty in a recession as fire-sales take place from distressed organisations – and what is the real value of the millions invested in specialist plant that is no longer required? Even reducing your staffing numbers has a cost – redundancies, notice periods, consultation, selection processes, outplacement, counselling etc.

How then can you ensure that your cost/revenue dynamics are in step without causing any deterioration in business effectiveness?

### Analysis is key

***In a 2004 survey of finance executives at more than 150 large companies<sup>1</sup>, 85 percent of respondents said their highest priority was cost reduction. Nearly 60 percent reported they want to reduce the cost of providing overhead services by cutting non-essential spending, restructuring costs and standardizing service levels. 97% said that they have not optimised cost reduction.***

To understand the nature of your costs and therefore to facilitate better control it is necessary to analyse the cost base by looking at *why* costs occur – ie what causes the expenditure to take place. These factors are known as ‘cost-drivers’.

Typical management accounting analysis breaks costs down into general across-the-board categories such as travel, IT, depreciation, staff etc. Whilst this can tell you that ‘travel’ cost US\$ x million last year and has increased by y%, it is, however, of limited use in controlling costs efficiently as it does not get under the surface and expose the real dynamics of the cost/income position; and often leads to actions that are indiscriminate and detrimental to the business.

## Cost Reduction Training – UK Consultant

### Why costed activities are important

| Cost type    | Function | Function | Function |
|--------------|----------|----------|----------|
| Telecoms     | xxxx     | xxxx     | xxxx     |
| Staff costs  | xxxx     | xxxx     | xxxx     |
| Premises     | xxxx     | xxxx     | xxxx     |
| Depreciation | xxxx     | xxxx     | xxxx     |
| IT           | xxxx     | xxxx     | xxxx     |
| Utilities    | xxxx     | xxxx     | xxxx     |
| etc          | xxxx     | xxxx     | xxxx     |

Traditional costing looks at cost type - gives no information except that telecoms cost £xx

| Activity               | Function | Function | Function |
|------------------------|----------|----------|----------|
| Develop product        | xxxx     | xxxx     | xxxx     |
| Market product         | xxxx     | xxxx     | xxxx     |
| Sell to customer       | xxxx     | xxxx     | xxxx     |
| Process administration | xxxx     | xxxx     | xxxx     |
| Delivery               | xxxx     | xxxx     | xxxx     |
| Sell insurance         | xxxx     | xxxx     | xxxx     |
| etc                    | xxxx     | xxxx     | xxxx     |

Activity based costing in its purest sense takes costs and allocates them across all relevant activities - thus enabling an understanding of what it costs to carry the activity out. We can then ask meaningful questions.

<sup>1</sup> Booz Allen Hamilton

For example – with people-related costs a better understanding comes from analysing the **activities** that take place during the processing of inputs and matching these with staff and other costs of those activities. Eg what do people actually do when a holiday is booked; how does a hospital deal with patients; who is involved in setting up a new mortgage and what do they do? Which of those activities adds value – and where and how much; to what extent is it automated; how many manual interventions are there (and therefore opportunities for errors, with consequent re-works and extra costs etc). This enables the real drivers of those activities to be uncovered and analysed after which options can be developed to attack them effectively.

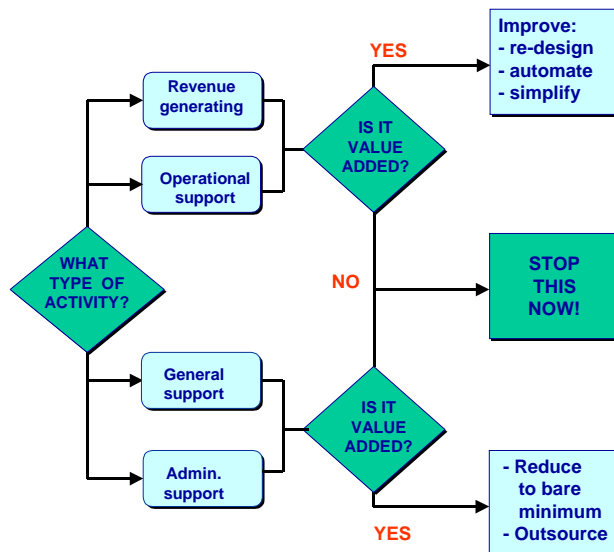
*A typical example – management expenses are distorting the cost/income ratio and in particular the travel budget is felt to be too high. As a result a 15% cut in travel expenses is initiated across the organisation - but how do you know that the travel costs in each area of the organisation are too high or too low unless they are set against the purpose and value generated. Carrying out an activity cost analysis will highlight those areas where travel expenditure really is too high and will also demonstrate which areas should possibly have their budget **increased** if it will generate more revenue (addressing the denominator as well as the numerator in the ratio). This will encourage revenue-earning areas, whilst delivering a message to the rest of the organisation.*

Once activities have been documented they can then be analysed and broken down into three main categories;

- **Revenue generating** – ie those activities which actually earn the income for organisation – dealers, business development officers, telesales, branch staff and so on;

## Cost Reduction Training – UK Consultant

- **Operational support** – those activities which are necessary to process the business (get it on the books), sometimes termed ‘back office’ eg inputters, payment processing staff;
- **General and Administrative support** – those activities concerned with other aspects of the business: HR, IT, premises management, preparing financial accounts, reporting etc – some of which may be necessary but often many of which are superfluous.



These can then be analysed for value, which helps focus the mind on what revenue is coming from which activities and where cost is consumed. Typically, general support activities do not generate any income at all but often represent the majority of activities in head offices.

### Driver analysis

Having established the activities that take place in the organisation it is then possible to analyse the things that cause them to occur – the *drivers*. These can be neatly categorised into the following in descending order of liquidity and timings:

- **non-value added activities** – typically where ‘things have always been done this way’ and no-one quite knows why or uses the outputs
- **process** – where inefficiencies in the process cause activities to be carried out that could be automated or dispensed with
- **system** – where the system drives activities due to inefficient configuration or poor training. Sometimes due to insufficient usage/understanding of system capabilities and more often ‘mechanisation’ of activities (transferring previous manual activities straight onto the system) rather than automation (taking the opportunity to re-design the process to maximise use of the system)

## Cost Reduction Training – UK Consultant

- **organisation structure** – where the working practices, culture, relationships and hierarchies drive activities to occur, and embed them within the ‘way things are done’
- **strategic/policy** where the organisation has stated that things must be done which may not be optimal
- **legal/external** – where laws, informal arrangements or stakeholders require activities be carried out. These require either negotiation or lobbying to change and that may not necessarily be successful

Typically many of the activities that require attention fall within the process, system and organisation areas and can, therefore, yield results relatively quickly.

*‘You can only reduce staff numbers to a certain level and push them harder to a certain point. Structures and systems must also be changed’*

**Daive Croff MD, BNL (quoted in The Banker)**

### Costing the activities

Once activities have been collected and the initial value analysis has been undertaken then it is possible to input an activity cost to them. This highlights the:

- actual cost of those activities
- relative costs of different activities
- cost of non-value added activities
- fixed and truly variable costs
- costs of revenue generated
- (when aggregated) cost of processes
- cost of manual interventions
- costs of errors and re-works
- potential for savings when activities are changed/stopped.

These costed activities can then be used to form the basis of any business cases for action going forward to initiate change.

### Working Capital

For other sectors – such as retail, warehousing, or manufacturing – working capital is also critical. Here the key is to understand the *relative dynamics* between the major components:

- which are the largest **debtors**; what credit do they take [as opposed to being given]; what are the general terms of trade – are you more [or less] generous than the competition; are the discounts you give worth it?

## Cost Reduction Training – UK Consultant

- ✚ how much **stock** are you carrying [and why?]; how much is raw materials, how much WIP, what levels of finished goods or components; where are your vulnerabilities to sourcing issues? Do you use processes such as JIT?
- ✚ what terms do you take from your **creditors** – are you being pro-forma invoiced – are the discounts you obtain outweighed by financing costs?
- ✚ is your **financing** adequate or on sufficiently favourable terms; does the terms match the usage?

There are a lot of myths associated with working capital – often in the form of a golden ‘rule-of-thumb’ of 2:1 asset to liabilities cover. It is however impossible to generalise as sector patterns vary enormously. Often large retailers have negative working capital – as they have few debtors because most transactions are cash or cash equivalent – and travel companies are often paid in advance by customers – sometimes by as much as 12 months! For companies such as shipbuilders, however, work-in-progress may stretch over years.

### Fixed assets

Fixed assets too require analysis. Do you have the right level for your business? Are they financed in the optimum manner? [It is surprising how many businesses finance fixed assets with short-term monies!]. Are you encumbered with long leases that are difficult to break? Do you have freehold premises that could be developed to raise cash? Is sale and leaseback an option? What can be outsourced? Have you rationalised your property portfolio. [The recently announced LloydsTsb/HBOS merger means that the organisation will have at least four ‘Head Office’ complexes in its portfolio – and at a minimum two are wholly redundant!].

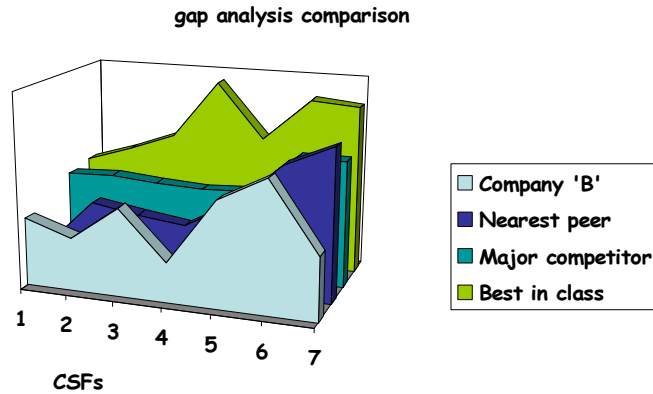
### Cost comparisons

It is not just enough for you to reduce **your** costs. You also need to know where they are in relation to your **Competitors**. If you reduce your costs by 7% - but they are still higher than the market – you will lose business or make lower revenue – or both! Cost benchmarking can yield useful results rapidly and enable you to understand just what the gap is that you have to close.

## Cost Reduction Training – UK Consultant

### Gap analysis

Illustrative data



### Summary

Costs and their link to revenue or value generation are an important factor in assessing organisational efficiency. Too often, however, the real dynamics and drivers are poorly understood resulting in general or across-the-board actions which can be detrimental to the business.

Carrying out analysis of the activities in which your organisation engages enables an understanding of the true cost/revenue dynamics and consequently the real drivers of costs, whether people-related, expenses, working capital or fixed. Subsequently attributing a cost to those activities can provide valuable evidence for a sustainable re-alignment of costs: which ensures that action is taken in the right areas to support revenue generation and that non-value adding activities are reduced across the organisation. Similarly for working capital – getting a tight grip on the components [Debtors/Receivables, Stock and Creditors/Payables] will enable costs to be reduced and cash flow management improved. Understanding the fixed assets and where they add value or erode revenue is critical for controlling your costs.

This means a well thought through and constructed programme, founded on in-depth analysis, that reviews the organisation holistically; so that all aspects are considered and relative internal priorities and strategic objectives are factored in. This will enable you to take short term savings, whilst also supporting sustainable longer term growth.