August, 2001

Making Cost Reductions Stick

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This article was published as the cover story in Charter magazine, the journal for the Australian institute of Chartered Accountants. It was published in the August 2001 edition, pages 22 to 25.

In tough economic times it is important to keep control of costs. Inappropriate and poorly executed cost reduction exercises can destroy competitive advantage and result in costs creeping back. This article outlines common cost reduction pitfalls and examines four popular approaches to cost reduction.

With current fears of a recession, many managers are already implementing cost reduction programs. Qantas, Alcatel, Cisco, Disney and Du Pont recently announced redundancies exceeding seventeen thousand workers in total due to the slowing economy.

Effectively executed cost reductions can position a firm to weather an economic slowdown and even win market share from struggling competitors. At their worst, these exercises can cause deteriorating customer service, lost customers, damaged long-term capabilities, and – to add insult to injury – “creep back” of costs originally targeted for reduction.

How then can managers under pressure to reduce costs achieve sustainable reductions without destroying the competitive position of their organisation? This article reviews why firms incur costs, outlines common pitfalls of cost reductions and examines the appropriateness of four prevalent approaches to cost reduction:

1. Budget cuts
2. Benchmarking
3. Activity analysis
4. Reengineering

Why Organisations Incur Costs

In order to examine cost reduction methods, we must first review why organisations incur costs. To put it simply:

Organisations incur costs in acquiring resources - such as labour, materials and equipment - to perform activities that provide valuable products and services to customers.

This statement is illustrated in Figure 1. While a simplification, this diagram highlights that cost reduction can impact on services to customers.

Overcoming Common Pitfalls of Cost Reduction Exercises

Table 1 describes some of the common pitfalls encountered by managers implementing cost reduction exercises.

<table>
<thead>
<tr>
<th>Pitfall/Constraint</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. People generally resist change.</td>
<td>-Managers should not underestimate the need to communicate and manage change. -The slowing economic environment may provide an opportunity for organisations to achieve significant change.</td>
</tr>
<tr>
<td>2. Cutting costs without changing the work will cause undesirable customer service surprises and a likely return of costs.</td>
<td>-Activities performed must be eliminated or their method of performance changed. -Care must be taken so critical capabilities and customers are not adversely affected.</td>
</tr>
<tr>
<td>3. All companies are not, and should not be treated as, the same.</td>
<td>-There is no panacea that suits all companies. -Numerical benchmarks must be interpreted with care. -Firm strategies, scale and investment in technologies must be considered.</td>
</tr>
<tr>
<td>4. Analysis in isolation does not reduce costs. Changing processes and reducing resources is required.</td>
<td>-Actions must occur to reduce resources to those required by redesigned processes. -Budgets, management reporting and incentives must be aligned with reductions in resources.</td>
</tr>
<tr>
<td>5. Many costs are “sticky” and difficult to reduce in the short term.</td>
<td>-Ensure the nature of all costs is well understood to determine which costs will be impacted by identified actions.</td>
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Employees almost universally resist change initiatives with “negative” connotations such as cost reduction. The crisis of an economic slowdown presents the dual opportunity to implement significant change through cost reduction and, if managed effectively, improved service. Managing change is vital to the success of any cost reduction program.
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As seen in Figure 1, costs are incurred to perform activities to service customers. Reducing resources without changing work may generate some benefits in organisations with excess resources. People may work harder for instance, but at some point without appropriate resources companies have different strategies, processes and systems. Hyundai can produce a car at much lower cost than Rolls Royce. The blind application by Rolls Royce of Hyundai manufacturing techniques will not, however, create products of appeal to Rolls Royce customers. Without massive system integration expenditure, a bank with fifty different IT systems is similarly unlikely to achieve comparative IT maintenance costs to a bank with integrated systems. The unique characteristics of an organisation must therefore be carefully considered before attempting to cut costs to match peer companies.

In order to realise cost savings, two critical steps are required. Identified process improvements must first be implemented, and then, as a second step, excess resources must be shed. Many organisations invest in changing processes, but fail to achieve costs savings because they retain excess resources.

Some costs are difficult to reduce in the short-term. The organisation may vacate a property subject to a lease, for example, and find itself unable to sub-let. Other costs may be non-controllable by a division or business unit as they are applied following allocation edicts from head office. It is therefore necessary to understand the behaviour of the costs to ensure cost reductions identified are really achievable.

APPROACHES TO COST REDUCTIONS

There are four prevalent management approaches to cost reduction - budget cuts, benchmarking, activity analysis and reengineering. Often a combination of two or more of these approaches is best utilised in practice.

1. Budget Cuts

A common approach is for senior management to mandate a reduction in the overall and divisional budgets. This budget cut can either occur as a constant “across the board” percentage, or target particular under-performing divisions heavily and successful divisions lightly to achieve the desired overall organisational outcome.

Senior management can implement top down budget cuts quickly. Unfortunately, guidance is rarely provided to line managers outlining how senior management foresees realisation of these reductions. This occurs because the corporate level may not fully appreciate operational efficiencies and “cost stickiness” at the divisional level, resulting in suboptimal or even unrealistic cuts. In turn this generally results in the cuts reducing resources available but not changing the overall workload or processes. This strategy often adversely impacts critical capabilities and customer service.

In some organisations, the planning process permits line managers to justify the degree of cost reduction in their division. This usually entails more detailed analysis (such as benchmarking or activity analysis) and the identification of how savings will be made. This “bottom-up” approach often requires several time-consuming rounds of discussion until consensus is reached between head office requirements and divisional imperatives. activity performance and therefore customer service will suffer. To achieve sustainable cost reductions it is therefore vital to determine how work will change and ensure impacts on customers are managed.

Independent of their identification, cost reduction opportunities need to be managed to ensure realisation. The budget is an important tool to motivate and monitor cost reduction performance.

2. Benchmarking

Benchmarking can be performed externally against other organisations, or internally across divisions. While many variations exist in the use of internal and external benchmarking, the two approaches focused on here are high level benchmarking and detailed benchmarking.

High level benchmarking usually involves comparing costs or performance data against other organisations selected for peer characteristics, or “best practice metrics”. This can usually be performed quickly. Differences identified are often considered as identified cost savings and built into top down budget cuts. The problems this causes include that:

- It provides no insight to line managers as to how to achieve cost reductions.
- Cost reductions may not be achievable as:
  - Measures may not be comparable (apples/oranges comparisons). For example one organisation may include all costs in process costs while another may exclude IT costs, recording them in a different cost centre.
  - The “best practice” organisation may have invested heavily to achieve process savings or benefit from much greater scale.
  - Cost reductions may not be appropriate due to different strategies.

High level benchmarking can be very useful to target areas for further cost reduction opportunity analysis, but must therefore be interpreted with care.

Detailed benchmarking involves low-level comparison of the metrics and processes of the organisation with those of peers. This can identify substantial opportunities to improve operations and reduce costs. Such analysis requires detailed knowledge of the processes performed by other organisations, involves a longer timeframe than high level benchmarking, and is often performed by operational managers and staff. This involvement can lead to more pervasive “buy-in” for change and implementation at all levels. As the organisation often starts significantly behind the companies it is benchmarking against, reaching an equal point can require considerable investment.

An example of successful detailed benchmarking is a food manufacturing company that internally benchmarked production output across plants. The processes of the most effective plant were then compared to those at the remaining plants. It was identified that by automating one activity, for a relatively low investment, efficiency could be increased substantially across all plants.

3. Activity Analysis

Activity analysis focuses on the relationship between activities performed by the organisation, resources utilised
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...and costs incurred. The analysis also considers the multiple reasons for which activities are performed, including to produce products, to service customers and to administer or sustain the business.

Activity analysis involves mapping key processes, gaining an understanding of the activities performed within each process, the cause of the activities, and the customers and products serviced by the activities. Activity Based Costing is often utilised to determine the resources and costs associated with these activities.

Table 2 provides examples of the types of activity attributes that are sought in activity analysis, and potential improvement opportunities for each.

<table>
<thead>
<tr>
<th>Activity Attributes</th>
<th>Potential Improvement</th>
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</thead>
<tbody>
<tr>
<td>1. High cost activities.</td>
<td>-Focus analysis on activities where potential cost reduction opportunities are high.</td>
</tr>
<tr>
<td>2. Low value activities or non-essential activities.</td>
<td>-Determine the cause of these activities, eliminate if possible.</td>
</tr>
<tr>
<td>3. Duplicate activities (eg. multiple inputs of identical data into financial applications)</td>
<td>-Redesign so that the task is performed once.</td>
</tr>
<tr>
<td>4. Significant rework or wastage.</td>
<td>-Identify causes of rework and rectify.</td>
</tr>
<tr>
<td></td>
<td>-Ensure wastage is identified early in the process and no further work is performed on wasted product.</td>
</tr>
<tr>
<td>5. Fragmentation occurring when similar tasks are performed in many places in the organisation or there are many hand-offs in a process.</td>
<td>-Consider the possibility of consolidating similar activities:</td>
</tr>
<tr>
<td></td>
<td>-Are there opportunities for shared resources or services?</td>
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<td></td>
<td>-Can jobs be expanded to include other activities in the process?</td>
</tr>
<tr>
<td></td>
<td>-Can electronic commerce be utilised within the firm and/or with suppliers and customers?</td>
</tr>
</tbody>
</table>

By focusing on current activities improvement opportunities are often incremental, as brand new processes are not necessarily implemented. The benefit of this incremental approach is that significant cost reductions are often identified that can be achieved relatively quickly for a substantially lower investment outlay than that required for a complete process or system change. Involving staff in the opportunity identification process can greatly enhance the ability to manage and implement the changes identified.

A financially troubled clothing manufacturer performed a detailed activity analysis of its high cost sales and delivery processes. Gaining an understanding of activity costs and the relative profitability of customer segments highlighted the underlying causes of the company’s financial problems. By reducing the delivery frequency to low volume customers and introducing minimum order sizes, management substantially reduced costs.

4. Reengineering

In the early to mid-1990s reengineering was all the rage. Almost all process improvement and cost reductions were (often erroneously) tagged “reengineering”. The term is now much less popular and often viewed with a negativity born of the failure of many early attempts at such “reengineering”. As a result, many true reengineering projects are today called anything but.

Reengineering begins with the premise that as organisational processes grow over time, they may lose appropriateness due to new technology, shifts in customer needs and other analogous factors. Proponents of “pure” reengineering argue that new processes should be designed from scratch, as existing process analysis is ineffective.

Reengineering often uses firm objectives, benchmarks and best practice information to create a vision of, and then redesign, processes. As the new processes often different greatly from existing processes, significant investments in new technology can be required, and implementation can take many years due, in part, to internal resistance.

Many reengineering projects now include preliminary activity analysis to identify “quick wins” in order to keep support and motivation for the overall project until the full anticipated benefits flow.

An insurer identified that its manual back office processes (such as claim handling) could not cope with increased paper volumes. These process complexities affected the company’s cost competitiveness. It was decided to “reengineer” the process, utilising electronic document and workflow management technology. Substantial investments were made and the new technology and processes were implemented over a two-year period.

The pervasive impact of the reengineering created substantial change management and training requirements to give staff the skills and motivation to use the new system. Cost reductions have been substantial, but have taken in excess of two years to realise.

COMPARISON AND CONCLUSIONS

Table 3 summarises the key attributes of different approaches to cost reduction. The approach utilised by management should apply the method(s) that align with requirements such as the desired size of reductions, investment funds, timeframe available and the appetite of the organisation for risk.

For example, where cost reductions need to be realised quickly and the firm has minimal funds for investment:

- Cutting the budget is appropriate where excess or slack resources, and/or non-customer critical processes exist
- Benchmarking would be useful to identify areas for further analysis, and detailed benchmarking to identify cost reduction opportunities
- Activity analysis would be appropriate to realise incremental cost reductions
- Reengineering would likely not be appropriate due to implementation timelines and costs.
Table 3. A Comparison of Cost Reduction Methods

<table>
<thead>
<tr>
<th></th>
<th>Budget Cuts</th>
<th>Benchmarking High Level</th>
<th>Benchmarking Detailed</th>
<th>Activity Analysis</th>
<th>Reengineering</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identification of <strong>HOW</strong> reductions are to be realised?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Potential to <strong>improve processes</strong></td>
<td>Low</td>
<td>Low</td>
<td>Medium-High</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Potential <strong>size of cost reductions</strong></td>
<td>Low</td>
<td>Low - Medium</td>
<td>Medium-High</td>
<td>Medium</td>
<td>Medium - High</td>
</tr>
<tr>
<td>Likely <strong>investment</strong></td>
<td>Low</td>
<td>Low - Medium</td>
<td>Medium-High</td>
<td>Low-Medium</td>
<td>High</td>
</tr>
<tr>
<td><strong>Risk</strong> to service or non-delivery of benefits</td>
<td>High</td>
<td>High</td>
<td>Medium-High</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td><strong>Timeframe</strong> to realise benefits</td>
<td>Short</td>
<td>Medium</td>
<td>Medium-High</td>
<td>Short</td>
<td>Long</td>
</tr>
<tr>
<td><strong>Level of management</strong></td>
<td>Senior Manageme nt/ Corporate</td>
<td>Senior Management/ Corporate</td>
<td>Divisional Management/ Operational</td>
<td>Divisional Management/ Operational</td>
<td>Divisional Management</td>
</tr>
</tbody>
</table>

In order to obtain sustainable cost reductions it is necessary to ensure work is changed and resources are reduced to reflect changed processes. Management must also ensure that changes do not damage relationships with key customers nor destroy competitive capabilities. Understanding the behaviour of costs will enable managers to determine the real impact of cost reduction initiatives. While some approaches such as activity analysis and detailed benchmarking provide opportunities to involve staff to improve ownership of solutions, staff are unlikely to rush to utilise new processes and technology without significant communication, training and - in many cases - rewards.

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**Updated Author Details (March 2014)**

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