HOLD FIRE

Panic-induced cost cutting in response to financial turbulence can be counterproductive and damaging, warns Tony Grundy. Take a more strategic approach instead

The business and financial environment has been anything but healthy of late. In particular, the collapse of Northern Rock in the UK, and of the profits of numerous major financial institutions around the world, as well as the credit squeeze generally, have all made companies very nervous. The instinct all round is to cut costs.

But reactive and poorly thought-through cost reductions can be counterproductive and damaging to medium and longer-term health. All accountants need to think hard before initiating or advising on ill-focused and poorly thought-through cost control measures brought on by these not unnatural fears. Instead, a more strategic approach to costs is required – ideally to get more value out of better-focused allocation of resources.

Conventional versus strategic cost management

Conventional cost management takes as its premise that if the environment deteriorates, the approach should be to reduce costs, either fairly or where the damage and pain would not be too obvious or quick, in order to achieve profit targets.

Unfortunately this can lead to:

- loss of customers and market share;
- loss of demotivated, high-value-added staff;
- inefficiencies or higher costs later on.

Strategic cost management takes a different tack, and entails three major premises:

- costs should never be reduced if this undermines the business strategy;
- the cost base should achieve strategic objectives with least unit cost;
- costs must always be managed for economic value.

The third premise implies that costs must never be managed in isolation, but always vis-à-vis the value added from that resource.

This brings us now to a five-stage model of strategic cost management (see figure 1). The initial diagnosis phase of understanding what is driving the existing cost base requires an understanding of the business 'value' and 'cost' drivers. Here a value driver can be defined as 'anything either within or outside the business, now or in the future, that directly or indirectly leads to cash inflow generation'. A cost driver can be defined as 'anything either within or outside the business, now or in the future, that directly or indirectly leads to cash outflows'.

Value and cost drivers are best depicted in a visual way, representing the value added and costs of, say, running a fleet of supermarket trolleys. Figures 2 and 3 represent the value and cost drivers for a superior supermarket trolley designed to go in an exact straight line. The value driver picture segments value in terms of a) value to the customer, or delivered value from this (eg, more sales or avoided sales loss), and b) indirect value to the company (such as value to corporate image).

The cost driver picture looks at a life-cycle model of

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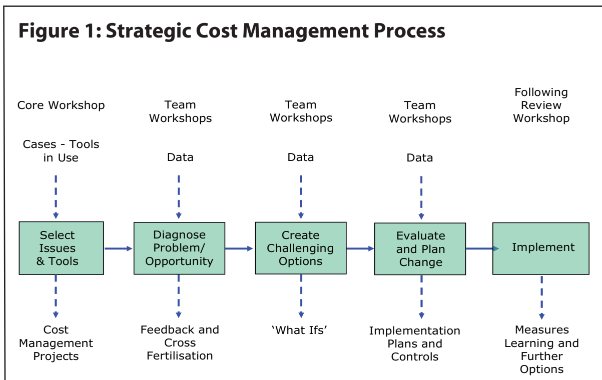

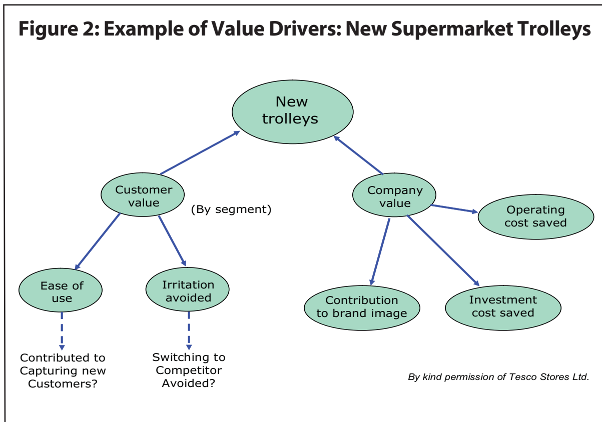

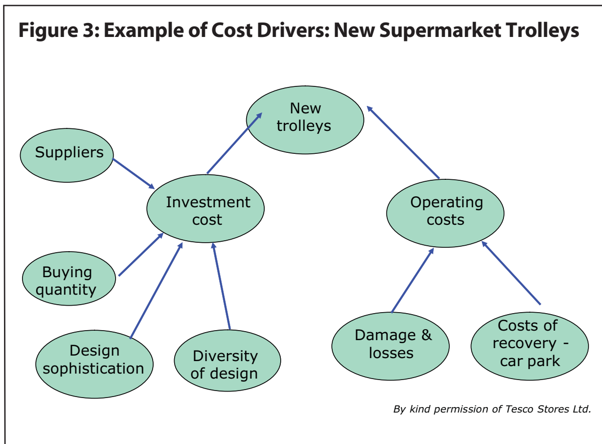

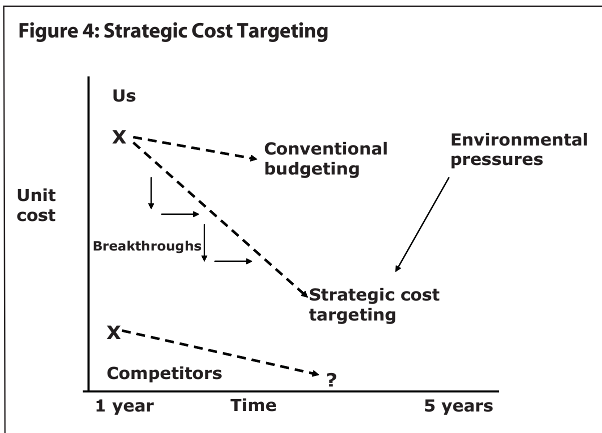

costs, both short-term and longer-term. These two pictures allow one to visualise causes of value and cost, and to trade these off so that cost allocation can be optimised.

Conventional cost management, focusing primarily on costs, would mean saying: 'Why don't we cut down the current range of five models to three, buy cheap trolleys from the Far East, and halve costs?' Unfortunately many customers, disgruntled by the disappearance of their favourite trolley, might then leave the supermarket, making savings counterproductive.

It is, therefore, essential to consider the structure and behaviour of both value and cost drivers, and how they interact with one another. Look at :

- Which 20% of costs offer 80% of the opportunities for potential major reduction?
- Which costs can be more quickly reengineered (the 'behavioural' cost drivers) than others ('structural' cost drivers)?

Thinking differently

In the second 'challenging options' phase (figure 1), further opportunities are identified by thinking very differently about the cost base. For example:

- By imagining you are an alien, landing for the first time in this industry or company: why are things done this way? Do these processes add sufficient value?
- By imagining you are from another industry: how would you do things differently?
- By targeting your unit costs strategically, say over three to five years.

Amplifying the final point above, figure 4 looks at how costs should be competitively benchmarked and targeted, not just one year, but potentially several years ahead. This means that you should seek to anticipate the dynamics of the relative costs in an industry, taking into account future environmental or competitive pressures and learning the effects producing cost deflation. Just see how different figure 4 depicts strategic cost management from conventional cost management. For instance, the time scales for cost are often two to three years, not just 12 months, and cost improvements are step changes, not incremental.

In planning (phase 3 of figure 1) it is time to prioritise options for major cost or value improvements ('breakthroughs') and more incremental or continuous improvements. Options are evaluated in terms of:

- net benefit relative to investment ('attractiveness') – using value or cost drivers again to provide a visualisation of the trade-offs, before doing the financials;
- the total difficulty over time to achieve the results – which is frequently underestimated.

Implementation and control

It is very important to monitor the buy-in of key stakeholders. 'Stakeholder analysis' can help greatly, particularly as costs are such a highly political area. Stakeholders are all those individuals who are decision-makers, advisers, implementers or victims. Each stakeholder is evaluated according to their perceived agenda or influence level. This is used to try to influence a more favourable balance of political forces.

Finally in the 'control' phase (phase 5 of figure 1), we look at:

- The assumed incremental net value realised from the process, compared with what was, and the assumed level of difficulty compared with the actual difficulty;
- What further improvements can or should be made;
- What other lessons have we learnt, particularly to manage the trade-offs, and to get fully aligned behaviours, in the organisation.

You and the management team should:

- Question all obvious self-defeating and potentially damaging attempts to reduce costs that are likely to undermine longer-term business strategy, or to lead to economic value being destroyed;
- Try to put a more structured and creative process in place for managing costs more strategically;
- Initiate this before rather than after environmental turbulence;
- Never just try to hit a particular cost number, as this could be arbitrarily too high or too low. Target costs strategically.

Hopefully my message is a timely one in these interesting, if not financially quite frightening, times.