Sustainable cost reduction*
How to drive financial performance in tough times and beyond

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When times are tough, many companies turn to immediate, short-term cost-cutting measures. Yet the typical approaches to cost reduction often leave the most significant opportunities untapped—and may actually be counterproductive.

A more effective approach—sustainable cost reduction—enables companies to identify immediate cost reduction opportunities while changing behavior so that the resulting savings can and do continue over the long term.

In today’s climate of economic turmoil, many companies are struggling with low demand, shrinking margins, rapidly changing business models, and nonproductive acquisition strategies. Companies are justifiably anxious to reduce costs. But the problem with many cost-cutting measures is that they are put into practice without consideration of their long-term sustainability; often, cost savings achieved in the short term eventually leak away. The failed initiatives may wind up damaging corporate infrastructure and culture, and leave companies struggling well after the recession ends.

What goes wrong in cost reduction attempts?

Companies tend to swing between the two extremes of cutting short-term costs and placing big bets on transformational plans. Short-term measures, driven by a “We need to reduce costs now, and I don’t care how,” mindset are reactive and unsustainable. According to Eric Parnes, a partner in PricewaterhouseCoopers’ Private Company Services practice, “Not only does arbitrary cost cutting miss many real opportunities, but also it can backfire, hurting the business and morale in both the short and long term. Large-scale, ambitious plans, executed during times of extreme stress, are equally risky because they tend to implement initiatives the company may not need, may not be suited for, or cannot handle.”
Companies commonly take one, or a combination, of three largely unsuccessful paths when attempting to reduce costs. These are:

**Top-down.** Senior management focuses solely on transformational opportunities to reduce costs. This approach often fails because:
- The organization bets on a single solution, such as an organizational redesign, IT system changes, or off-shoring.
- Little consideration is given to the behaviors and decision-making processes that drive costs in the first place.
- The complexities of reducing costs are left unaddressed and existing behaviors are not changed.

**Slash-and-burn.** The CEO or CFO mandates a five- or 10-percent cost reduction, without reducing any other activities or demands. In other words, do the same work, but with fewer resources. This approach often fails because:
- It is reactive, often based on arbitrary targets, and lacks sufficient analysis.
- It focuses on one-off savings often through the deferral of select activities, such as reconciliations, account analysis, plant maintenance, and customer visits, until those areas reach a crisis or the need for restraint has passed.
- The savings are difficult to manage and track.
- There is a negative impact on morale and culture.

**Boil the ocean.** All departments conduct extensive interviewing, process analysis, and benchmarking to improve efficiencies, leverage technology, and identify cost savings. This approach often fails because:
- A greater investment is required.
- This is an unwieldy process that typically results in a loss of momentum and focus.
- The process often produces only lists of opportunities rather than actual activity.
- Departments become personally invested in their own budgets and rarely find waste.

Ultimately, these typical approaches to cost reduction are much like an unsuccessful diet: short-term improvements may be achieved, but the costs return as soon as the crisis has passed because the underlying processes and behaviors have not been changed.

What is sustainable cost reduction?

Sustainable cost reduction goes beyond the failings of the three approaches discussed earlier through an approach based on two elements (figure 1).

The first element in reducing costs consists of an understanding of where and why money is being spent, as well as of how much things should cost. The second element consists of mandating change around the way money is spent—that is, implementing a more effective monitoring and control process to know whether the cost reduction plans are achieving the expected results.

Ideally, a company will put in place a parallel process that includes both elements: an immediate cost reduction component alongside a cost management and control component. The cost reduction component involves a systematic analysis that identifies opportunities
for immediately reducing operating and third-party spend to quickly deliver tangible savings. The cost management and control component focuses on changing how money is spent and on creating a culture of cost consciousness that will drive continuous improvement and sustainability.

**A strong foundation is critical**

Sustainable cost reduction goes beyond one-off programs and interventions. It is a series of steps that a company can take to more effectively identify cost reduction opportunities and sustain those cost reductions over the long term (figure 2). Key areas of focus include:

**Reducing discretionary spending.** Discretionary spend is typically the first area to get scrutinized—and rightly so, since it is not essential to business operations. Companies need to determine which of these costs are essential and nonessential, stop spending on the nonessential, and develop an understanding of how much the essential spend should cost. Assessing and challenging this type of spend centrally will help reduce any resentment about cutting these expenses.

**Clarifying business cost drivers and improving accountability.** Managing a cost center as one big pot makes it very difficult to understand what actually drives cost, and analyzing spend data to identify potential savings will work only if the operating teams are properly using the financial accounts. 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. It also enables management to understand operating cost drivers at the budgeted unit level so that, as budgets are put together, financial plans reflect the operating plans and the business strategy.

“Look at the budget process and budget owners. Does the company take last year’s actual spend plus or minus a percentage? Is the budget owner accountable for 100 percent of the spend? Does the budget include amounts for ‘contingencies?’” says Dave Pittman, partner and PwC national sustainable cost reduction leader. “At one company, it was normal to spend the entire budgeted amount to safeguard funding the following year. Simply removing these contingent amounts from the budget eliminated this nonessential spend—and resulted in savings of millions of dollars.”

In other words, “A company needs to develop a culture of cost consciousness, not just budget spend,” says Parnes. “Cost consciousness involves clearly understanding why and how money is spent as well as accurately measuring and tracking that spend. This is especially important in a private company with a lean management infrastructure, because

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**Figure 2: The cost reduction journey**

Sustainable cost reduction is actually a journey or a progression of activities rather than “one-off” programs and interventions.
all of the efforts made to identify cost drivers and opportunities for savings can be lost if the company does not effectively capture the actual spend and provide timely information on who spent it and why it was spent.”

**Taking control of third-party spend.** Many companies experience cost leakage as a result of inadequate processes around contract management of third-party spend. Major contracts, especially long-term contracts, are particularly ripe areas for reducing costs. Often, those managing the execution of the contract were not involved in its negotiation and, consequently, do not understand the terms and the cost drivers—at least not as well as the vendor does.

“This is particularly true when a company has many external sourcing providers, often a result of the decentralized decision making,” says Parnes. “Costs go down when the right processes are in place. For example, the company should be asking why there are one-off contracts throughout the organization, rather than a centralized procurement process through which the company can negotiate with vendors based on company-wide spend.”

A forensic review of suppliers has historically found savings of five to ten percent in the following areas:

- **Recoverable claims.** Non-compliance against an established contract, or contractual arrangements where compensation is variable based on information received from the counterparty on a “self-reported” basis (including royalty payments, supplier tolling agreements, joint-venture cost-sharing and allocation arrangements, time and rate reporting issues, and discount application).

- **Cost avoidance areas.** Changes in procurement and operations contracting strategies, use, and language (including crew composition definition, order consolidation discounts, consistency of lease terms, and price controls).

- **Off-contract and off-price book opportunities.** Changes to strategies and procedures to minimize or eliminate non-price book and “convenience buy” spend.

**Creating operational efficiencies that last**

“Once a company has a baseline for managing costs, it can further simplify processes and eliminate non-value-added activities in order to reduce waste and operate more leanly,” says Anthony S. Passaretti, a partner in PricewaterhouseCoopers’ Private Company Services practice.

Consider how this process worked in part within one company: Interviews with the leadership team and functional managers were conducted to assess the current state of the overall business. The financial performance and operational performance of each business in the group were compared with the others as well as with leading industry practices. Several different scenarios for consolidating processes were assessed; a business case was developed along with one-time costs and run-rate savings, and risks and issues were identified for each scenario. Best practices for various functions at each of the three business units were identified and used as a road map for what should be done across the consolidated company. The result? “Ongoing G&A [general and administrative] costs were reduced by 26 percent to 36 percent [approximately $5.5 million to $7 million] through consolidation of the back-office functions for two of the businesses with similar product lines and processes,” says Passaretti. “In addition, these actions positioned the company to sell one of its warehouse buildings, which it no longer needed. When completed, the sale will provide a substantial amount of additional cash for the business.”
Making it sustainable

Cost reduction gains can only be sustained within a culture that encourages individual responsibility for managing and controlling spend. Cost management and control focuses on changing behavior and building that culture of cost consciousness throughout the organization. To do this, behavioral change is necessary in four areas:

- **Financial management and control.** This involves how the company forecasts spend, develops the operating plan, and manages cost drivers. Common weaknesses include a lack of alignment between cost accountability and the authority to manage the cost drivers, as well as outdated delegation-of-authority policies for the types and sizes of expenditures being made.

- **Business process activities.** Gaining an understanding of why and how dollars are spent is critical to cost management and control. An analysis of business processes and activity drivers will shed light on the interventions necessary to control and reduce spend. These are often unique for each company.

- **Contracts and third-party spend.** An analysis of the controls, spend authorization, processes, and support of the company’s strategic vision within procurement identifies gaps and areas for improvement.

- **Performance management.** The availability of accurate, timely financial and key operating metrics enables management to assess business performance and take action when necessary to achieve savings and promote continuous improvement.

Plan for today—and tomorrow

To achieve sustainable cost reduction, companies must first stabilize their cost environments and then move into transformational alternatives. The goal is to create a culture in which cost is seen as an investment and is optimized across the entire business model through quality management information; this culture enables cost reduction gains to be sustainable.

“Tone from the top is a critical success factor,” says Parnes. “Without strong support from the board, the CEO, and other senior management, cost reduction initiatives cannot succeed. Leadership must develop a cost culture and avoid the ‘Do as I say, not as I do’ mind-set.”

Cost management is a key issue today and will continue to be one for the foreseeable future. How companies manage this issue may well mean the difference between simply surviving the downturn and successfully positioning the company for future growth.

Results of sustainable cost reduction

- Immediate cost control stabilization
- Clarity of cost drivers
- Operating and discretionary cost savings
- Financial discipline and cultural awareness
- Linkage of financial and operating plans
- Operational insight
- Transparent management information
- Improved budget accountability
- Waste elimination
Want to know more about sustainable cost reduction?
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