

# Overheads and Cost Reduction – Squeezing the Lemon

**Maria Land ACMA**

# Biography

- **Degree in Food Science & Chemistry**
- **Worked in New Product Development for McVities, KP and other subsidiaries for 7 years**
- **Technical Buyer for 4 years looking at product and process rationalisation and improvement. Responsible for implementation and purchasing across 3 areas**
- **Founder member of IdeaGen team within UB developing new radical ways of working and designing new products**
- **Re trained as a CIMA accountant and Qualified in August 2003**
- **Currently work with clients to build small business and ensure their businesses are effective and efficient.**

# What are we going to discuss?

- **What are Overheads?**
- **Methods of reviewing what a business needs**
- **The structure of an Overhead Review**
- **Methods of overhead and cost reduction**
- **Alternatives, substitution and outsourcing**
- **Regular reviews of procedures**

# What are Overheads ?



# What is an Overhead?

- **Oxford English Dictionary**

- Adverb above one's head; in the sky.
- Adjective 1 situated overhead.
- Adjective 2 (of a driving mechanism) above the object driven.
- Adjective 3 (of an expense) incurred in the upkeep or running of premises or a business.

# Overheads and Costs

- **How do they link to activity?**
  - Fixed
  - Variable
  - Semi Variable
- **Can they be controlled?**
- **Who should be controlling them?**
- **What are the true costs and how do you measure and apportion them?**
- **What feeds into and influences overheads and cost structures?**
- **Overheads are within the control of managers but can often be generated by the way a business carries out its business.**

# CRISP

- **C**ost **R**eduction with
- **I**mproved **S**ervice
- and **P**erformance
- Can be a very useful tool.
- **CIMA** do a master course on the subject and other related topics and they cover off what a business should be targeting.

# Cost Reduction

- **Not always the cheapest**
  - Reduce the cost of an overhead – i.e. move to a cheaper area for rental and wages
  - Reduce the cost of a component in a product or service
  - Rationalise systems – HMRC computers
  - Reduce double handling
  - Outsource – i.e. Company Cars

# Pencil Power

- **Cost of a pencil** 45p
  - **Cost of Rubber** 75p
  - **Cost of Sharpener** 99p
  - **Total Cost** £2.19
- 
- **Cost of Nonstop Pencil with Rubber** 52p

# Improved Service

- **Much harder to measure – beware that it costs to measure!**
  - Must Benchmark
  - Find out what is expected from the end user
  - Ask staff and employees

# Improved Performance

- **Can a reduction in a cost make a product or process better?**
  - Quality is in the eye of the beholder
  - Joined up services - CIS
  - Automation of the day to day processes
  - Single Forms
  - Call Centres
  - Centralisation of key services

# The M&S Syndrome

- **IF it costs more it must be better?**

- Butter                    £1500 mt
- Margarine                £ 500 mt
- Recipe 18% fats
- Cost of butter        £270     M&S quality
- Cost of Marg        £90     Reduced flavour – lighter texture
- Cost 60:40            £198     NO flavour impact – increased shelf-life
- Impact of 100% margarine – saving
- £180 x 3 x 12hrs x 4 days x 48 weeks = £1,244,160
- OR 40% Margarine
- £72 saving = £497,664
- Extended shelf life – 12 to 20 weeks supply chain savings

# Where should you start when reviewing a Cost Structure?

- **Must be linked to the three key levels of strategy**
  - Corporate Strategy
    - The overall purpose and scope of the review
  - Business strategy
    - The market and its requirements
  - Functional Strategy
    - How things are done
- **Must have one!**

# What Type of Business is it?

- **The key differences with overheads**
  - Service industry often very employee intensive
  - Manufacturing premises costs
- **Service overheads can be often be easy to identify but there is often an overhead or cost “creep” where they escalate if not monitored**
  - Contractors
  - Department power bases
- **Manufacturing have identifiable product costs but often major overheads are neglected or remain unchallenged**

# Where do you start setting up the Team?

- **Project team**
  - The Cost Accountant
  - Multi-discipline team
- **Clear outline of what is expected**
  - Where the boundaries lie – are the directors also included?
- **Clear vision of what is required**
  - What does the end result look like, both in terms of total numbers and the company structure?
- **Understanding of the implications**
  - Has anyone thought about the HR issues?
  - What image/message maybe sent to customers?
  - What are the linkages?

# Assess Overheads and Costs Correctly

- **Look at the impact of that overhead**
  - What if you removed it completely ?
    - Get rid of the staff Christmas party!
      - Loss of moral
      - Loss of staff – especially the good ones that can leave
  - What if the overhead budget was actually increased ?
    - Increase the party budget
      - Improve moral and productivity
      - Show that staff they are valued
- **Understand what causes a cost**
- **Don't be too simplistic – things are never as they seem**

# Reviewing the Overheads and Costs

- **Make sure that the business recognises its overheads and is aware of the costs structures it has.**
- **Try and understand what is the Key Performance Indicator that affects each overhead and cost.**
  - Does it have to be fresh coffee and sandwiches for the meeting or can it be tea and biscuits
    - What impression does that make?
    - Does it matter?
  - You have to have somewhere to work!
    - Do you need a desk?
    - Can an employee work from home (are they trusted)?
  - You must be able to communicate with customers
    - Is a desk top essential, or can they e mail from a blackberry?

# Starting a Review of Overheads and Costs

- **Choose the right approach to the review**
  - Top down edicts (generally large organisations – very formal)
    - “The US board say we have to cut overheads by 10%”
  - Bottom up staff involvement
    - “Finally they are involving us and asking what we think”
    - “I wish they’d leave us alone to get on with our jobs”
  - Radical, quick and sweeping
    - “that was done with no thought for the people involved”
  - Gradual and subtle
    - Can the company afford to wait?
  - Continuous improvements – Based in the principle of Japanese industry
    - Depends on the company culture.....

# The Edict

**Dear Senior Manager,**

**The business is currently experiencing a squeeze on resources and after much discussion at the board level we had decided to ask all departmental Manager to cut their Overheads by 10% by the end of next Quarter**

**Yours**

**The Board**

# The Structure of an Overhead and Cost Review

- **Establish the objectives - are they clear and precise or do they require further clarification**
- **Establish the scope – is it company wide, is it divisional or departmental? Is it product based?**
- **Established the published and actual time frames**
- **Identify the method which is going to be used – top down cloak and dagger or voluntary redundancies**
- **Identify the roles of the people directly and indirectly involved – the importance of a good HR function cannot be underestimated**

# The Structure of an Overhead and Cost Review

- **Appoint a Team Leader and establish their authority and boundaries – who do they report to, are their decision final or can they be challenged?**
- **Set up the lines of reporting and the methods of communication through the business – Who needs to know?**
- **Set a time scale – short and sweet (redundancies), or long and protracted (product phase out or portfolio rationalisation)?**
- **Make sure the timescale is adhered to and especially where**
  - jobs may be lost that employees are kept informed.
  - Products/Services are being phased out that the end user knows.

# The Overhead Review Team Leader

- **Needs to be someone who knows the business well and understand the challenges of the business from the bottom up.**
- **Must be able to know where to get the information required to make the decisions.**
- **Must be involved with the future aims of a business**
- **Must be a good communicator – a listener**
- **Must be able to focus**
- **Should be able to delegate, but also able to make tough decisions**
- **Must not be seen as a confrontational**
- **Must be seen to have been fair**

# Review Teams

- **Works best when they are multidiscipline**
- **Ensure that all levels of the business are asked and consulted**
- **IF there are many levels of management it may work better to have an initial suggestions session, which can be filtered by a team.**
- **Can be used for product/service specific reviews, but must have targets clearly defined**
- **Also good when a business operates a continuous improvement process as they is a recognised point of contact for employees**
- **Must be rewarded for their efforts as it can be a thankless task**

# Identify the Key Business Critical Success Factors

- **Has an overhead or cost structure been set that can be agreed and worked towards?**
  - Where did that come from?
  - Is it achievable?
  - Is it within the correct time frame?
  - How does the business measure the success?
- **Does the review fit in with other strategic reviews and budgets?**
  - Make sure there are no clashes – sales are planning large push into a new sector whilst distribution are closing channels. Beware of local optimisation.
- **Look at the impact on customers, how is the business going to manage it?**
  - External
  - Internal

# The Benefits of a Strategy

- **Avoids short term affect**
- **Proactive – helps identify strategic issues**
- **Allows for Goal Congruence**
- **Improves the stakeholder perception of a business**
  - The external impression is of the graceful swan, without a glimpse of the paddling legs.
- **Ensures that the projects are controlled**
  - Someone is responsible
  - Gives targets for success
- **Improving future management potential**

# Practical Ways to Reduce Overheads and Costs

- **Improve processes**

- Study them first

- Time management – takes time and money to do
    - What makes a process speed up or slow down?

- Look for double handling

- HMRC 64-8 (VAT,SA,PAYE)
    - Call centre forms for Banking etc – double entry of data

- Ask the people that do the process

- They often can readily identify where process is going wrong they just have never been asked
      - Redundant components – excess packaging
      - Filling silos
      - Answering phones – good voicemail and out of office

# Practical Ways to Reduce Overheads and Costs

- **Reduce internal negative activity**

- Stop in fighting

- Intra departmental
- Inter departmental
- Business Units

- Often the biggest cause of waste

- Staff wasting time or resources
- Staff obstructing other processes which could improve efficiencies

- Hard to identify initially as many are reluctant to discuss

- One of the key tasks of the overhead review team, especially when a team is sent into a section/unit in free fall

- Stop the NIMBY

# Practical Ways to Reduce Overheads and Costs

- **Reduce the externally negative activity**
  - Customer requirements that are above and beyond the norm
  - Customer Account Profitability (CAP)
    - McVities and M&S Cakes
    - Identify projects that are likely to fail from the start not near completion (French Chocolate %)
  - Supplier Requirements
    - Minimum order quantities
  - Local Government
  - Trade Unions
  - Health and safety
  - Other Government agencies

# Counting the Pennies

- **Salt £100 per metric tonne**
  - Recipe level 0.55%
  - Total cost of each metric tonne of product £2500
  - Increase Salt to 0.65%
  - Price of salt in recipe goes up from 5.5p to 6.5p
  - Total cost effect on recipe  $£2.50 - £0.01 = £2.49$
  - Effect on one product
  - $£2.49 \times 3 \times 20 \text{ hrs per day} \times 6 \text{ days per week} \times 48 \text{ wks} = £43027$
  - 10 lines per factory             $£430,272$  per year saving on ingredient costs

# Practical Ways to Reduce Overheads and Costs

- **Change the structure**

- Sounds very easy
- Often the hardest task
- Must have the buy in of the business from the boardroom down
- Sometimes the hardest people to convince are the bottom of the heap and they can make or break a structure change
- Pyramid
- Matrix
- Business units
  - Sectors
  - Products
  - Geographic

# Practical Ways to Reduce Overheads

- **External Service Levels**

- Understand the customer requirements
  - Split the customers into types
    - High/Medium/Low Maintenance
  - Identify their key requirements with regards to the business
- Talk to the customer
  - Identify their key requirements withy regards to their business
- Understand the current service levels
  - Does the company need a reception?
- Look at where resources are concentrated
- Follow processes through
- Ask the service providers
- Benchmarking against the competition

# Summary

- **Costs are in the eye of the beholder**
- **The Team and Team Leader is key**
- **Clear Objectives**
- **A way of measuring success**

# Zero Based Budgets and Costs

- **Assume nothing is sacred**
- **Challenge everything – do you need that chair?**
- **Start with the assumption that nothing is required**
- **Question every cost and ask departmental managers to justify each one**
- **Excellent for service based businesses**
- **Can be very time consuming for a larger business**
- **Liable to a lot of argument and discussion**
- **Very Effective where costs and overheads have been historically rising without any reviews**

# Product Costing

- **Look at the largest costs first**
  - Check the product cost is correct – often products have not been costed to reflect the true cost
- **McDonalds versus Antiques**
- **Challenge all the costs – Jaffa Cake Base Colour**
- **Will the end user notice? – Kit Kat Chocolate/Wagon Wheels**
- **Quality**
  - Alpha Romeo
  - Ford
  - Lexus
- **Quantities**

# Product Costing

- **Look at the impact of cost on each component, can it be replaced with**
  - The same from another supplier (i.e. generic Vegetable Oil)
  - A new product that does the job of multiple components (New Packing boxes)
  - A similar product that won't be noticed by 99% of end consumers (Beware New Recipe Coke)
- **Don't over engineer a product in the first place. Historically products seemed to have been designed for cost reduction.**
- **All new products should be cost challenged before launching, its often easier at this stage to correct mistakes before the end consumer is allowed to compare.**
- **With Service products expect others to critique the product as internal review is far less costly than loss of external customers**

## Limited Resources

- **Change part of the product (Smarties tube)**
- **Change methods (Smarties tube)**
- **Change process (Smarties tube)**
- **Change service levels by devising new work methods and/or services available (Not Smarties!)**

# Waste

- **Look at the entire process, as is it never only at the end that waste is generated**
- **Is your waste another product ? (Whey)**
- **Aim for waste free processes – Zester Crackers**
- **Time wasted – me!**
- **One person's waste is another person's resource (Al cans)**
- **The less a business throws away the cheaper its bills will be**
- **Don't let the pursuit of waste cost the business though (thinning syrups)**

# Small Businesses

- **Often a formal approach can be unsuitable but control is still required**
  - Differences in Goals
    - Not always the same reasons for running a business (they don't need the money)
  - Limited Scope
    - The activities of the business are very narrow
  - Limited Resources
    - There are no excess to trim
  - Small Organisational Structure

# Product Rationalisation and Optimisation

- **The pencil example**
- **Diaries**
- **Have one service product with wider scope**
- **Generic products – own label (all biscuits are made equal)**
- **One form**
- **The cardboard box**
- **Beware the multipurpose remote control**

# Other Theoretical Methods

- **Rational Approach**
- **Value Chain**
- **Business Process Re-Engineering**
- **Continuous Review Process**
- **Outsourcing**

# The Rational Process

- **Set the objectives**
  - Specifies and quantifies
- **Corporate Appraisal**
  - Can the business do this without substantial effect on core activity
- **Generate strategic options**
  - Look at the alternatives, never assume that there is one solution
- **Evaluate and choose**
  - Short list
- **Implement**
  - The “how too” and the action
- **Review and Control**

# The Rational Process

- **The drawback of the rational approach**
  - Conflict of objectives
  - There is often a gap between the people dictating and those that implement
  - There is often a political element that cannot be planned for
  - Actual events unfold and emerge (emergent strategies and adaptive strategies – Mintzberg 1987)
  - Management should focus on the positives as the process is never rational (Brunsson 1985)

# The Value Chain

- **Porter (1985)**
- **Ignores departments and looks at activities and processes instead**
- **Developed to demonstrate how management can analyse their business in terms of how it generates value for its customers and overheads**
  - “ a sequence of business activities, by which, in the perspective of the end user, value is added to the product/services by the organisation”
  - The firm becomes a sequence of value creating activities
  - A good basis for developing performance measures
    - “Porter’s Value chain is only a way of “seeing” things

# The Value Chain

- **The Value system**
- **Describes the position of a firm relative to the companies up and down stream**
- **The entire system generates costs**
- **Each part of the chain generates value and your business wants to have the biggest slice**
  - Inhabit the highest value segment
  - Strike good deals (supplier low/Customer high)
  - Collaborate with other in the system
    - Work together with customers and suppliers to reduce the cost of the system
      - Supply chain partners

# Business Process Re-engineering

- **Radical redesign with a view to creating and delivering better customer value**
- **A Root and branch redesign of the way a business operates**
  - Organise around the outcomes and not the tasks
  - Have those that use the output perform the process and drive the system down to the end user – i.e. Sales do the Credit checks
  - Subsume information processing into the real work that produces an outcome (i.e. online analytical processes from sales data)
  - Treat disperse functions as centralised i.e. use a central database
  - Link parallel activities (Insurance clerks and managers)
  - Make decisions at the point where the work is performed and build control into the system
  - Capture information once and at source

# Continuous Review Process

- **Never relax**
- **Ask staff – often the best use of a review team**
- **Reward for innovation**
- **Always respond, any idea is better than none**

# Outsourcing

- **Very popular method of reducing overhead costs starting in 1990s with the rapid outsourcing of IT functions, HR, Van Sales etc**
- **Should not be driven by cost alone**
- **Many advantages**
  - Often an instant result for the bottom line
  - Allows a company to focus on core activities
  - Some larger accountants outsource the preparation of accounts
- **Some key disadvantages**
  - Potentially less control over IT functions, at the mercy of others
  - Continuity guarantees
  - Control procedures
  - Compatibility of culture and personal

# Outsourcing going forwards

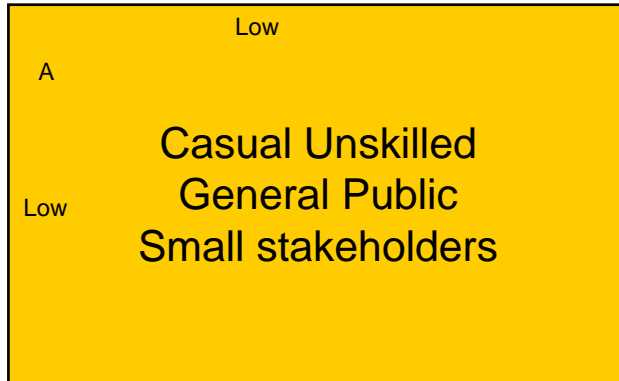
- **“stick to the knitting”**
- **But don't weaken a company by risking customer service levels or the perception of quality – Customer Call Centres**
- **Key relationships with out source companies**
- **Many businesses are bringing IT back into the business as Enterprise Resource Planning (ERP) becomes essential**

# People

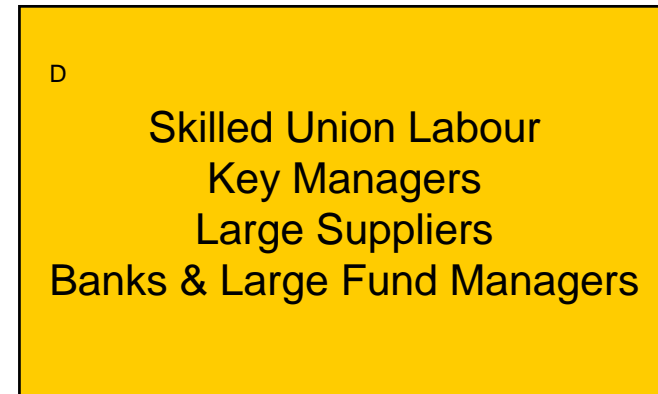
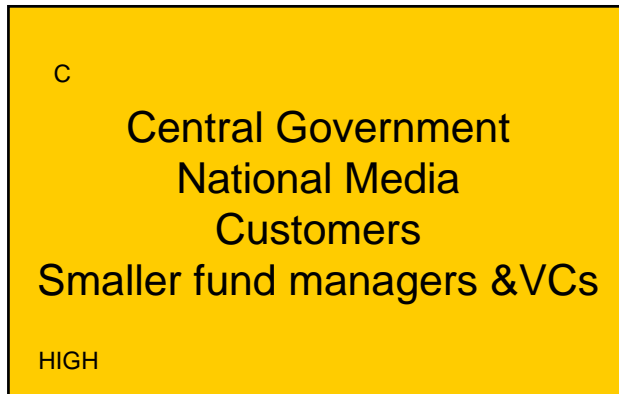
- **Outsourcing again!**
- **The most emotive area**
  - Recognise the extra loss
- **Management structures – less of a pyramid**
  - Matrix
- **Central processes**
  - HR
- **Complete organisational restructuring**
- **Project management**
- **Process management**
- **Functional management**

# The Stakeholders

Importance



Power



Dyson Factory Closure

# The Stakeholders

- **Box A**
  - Direction – they maybe the most malleable
- **Box B**
  - Educate and Communicate to reduce the impact
- **Box C**
  - Intervene and keep satisfied
- **Box D**
  - Make then key drivers for change

# Reviewing the Changes

- **Make sure that reviews are regularly scheduled otherwise those doing the actual overhead reduction never get to know how well (or not) they are doing**
- **The reviews must be recognised at the highest level**
- **No review is worth anything without the original to benchmark**
- **After the results are shared, ask “could we do better?”**
- **Make sure if mistakes have been made that they are not ignored but studied and the key findings shared to ensure that it does not happen again**
- **Don't find scapegoats – reward for success, otherwise no one will ever want to do it again.**

# Reviewing the Changes

- **Ask how the changes fitted in with the company culture?**
- **Can this process become continuous?**
- **Have the senior managers got the commitment to make it part of normal day to day business**
- **Make sure that the costs of reducing the overheads doesn't exceed the savings made!**
- **Ensure that the costs do not creep back in to the business by another route**
  - Rehiring staff as contractors

## At the end of the day .....

- **Overhead and cost reduction is the natural result of good forecasting and budgeting**
- **All companies owe it to their stakeholders to review and challenge the costs**
- **Make sure that all actions taken can be backed up by solid data and are not made at an emotional level.**