

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?**
- **What is happening out there.....**
- **Various methods of reviewing what a business needs**
- **The types of review structure**
- **Potential methods of overhead and cost reduction**

What are Overheads ?



What is an Overhead?

- **overhead - The expense of a business not directly assigned to goods or services provided.**
- **Any cost or expenditure (monetary, time, effort or otherwise) incurred in a project or activity, which does not directly produce a product or service.**
- **The costs associated with providing and maintaining a manufacturing or working environment.**

What is happening at the moment? Diageo plc

- **Mr Walsh said he was "very comfortable" with the cost-cutting measures, which he claimed would save the company £120m next year and allow greater spending on marketing its brands. Protests 'could hit Diageo sales'**
- **Diageo announced plans to cut about 900 Scottish jobs in July**
- **"Short-sighted" protests over planned job cuts by drinks giant Diageo could affect future sales, its boss has said.**
- **Paul Walsh's comments came as the firm announced pre-tax profits of £2.01bn, a fall of 3.7% on the previous year.**

BT plc

- **BT axes graduate recruitment scheme**
- **The news comes as graduates face an increasingly tough job market**
- **Telecoms giant BT has closed its graduate recruitment programme as it continues to cut costs in the downturn.**
- **The firm said it had no plans to reopen the scheme, but added that it remained "committed to the 2009 intake", who are due to start in September.**
- **The news will add to rising concern about youth unemployment. According to BBC calculations, the unemployment rate among 16 to 24 year olds stands at 19%.**
- **In May, BT said it planned to cut about 15,000 jobs in 2009, mostly in the UK.**

WPP Group plc

- **WPP's Martin Sorrell says he acted too slowly to cut costs**
- **Sir Martin Sorrell, chief executive of WPP, admitted he should have made cost savings sooner and was not cautious enough, as the advertising giant unveiled a 47pc tumble in first-half profits on like-for-like revenues 8.3pc lower.**
- **The company has responded to the economic downturn by cutting 6pc of staff over the past 12 months, a move it expects will contribute to an 'improvement in profitability' in the second half of the year.'**

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.**

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!**

The Benefits of a Strategy

- **Strategy first – cost cutting after**
- **Proactive – helps identify strategic issues**
- **Allows for Goal Congruence**
 - People don't see the path to that winning outcome, they are all too busy worrying
- **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**

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.

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 Project Team

- **Project team**
 - The Cost Accountant – only?
 - 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, company structure and timings?
- **Understanding of the implications**
 - Has anyone thought about the HR issues?
 - What image/message maybe sent to customers?
 - What are the linkages?

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**

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**

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?

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**
- **Push capital spending to the end of the year**
- **Speed can be good**

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
 - Beware of the hidden dependencies (Home Depot)
 - What are the specific “things” that a business needs to accomplish as a opposed to the “process”. Look at what is high value (Ric Merrifield of Microsoft *Re Think*)
 - “Trapped inside your company’s processes are activities that can now be swapped, bought, and sold. If you liberate them, you can create a radically more efficient plug-and-play business.”

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

Example

- http://www.businessweek.com/managing/content/aug2009/ca2009084_763270.htm
- **Business Week Article 4th August 2009**
- **Home Depot CFO gave store managers better purchasing and budgeting technology, tied employee bonuses to profits instead of sales**
- **One of the most critical strategies for staying flexible in a downturn, was heavily weighting Home Depot's capital spending to the back half of the year, giving the retailer the chance to correct course and do less if things got worse in the second half. "Typically we would pull a lot of that spending forward—people want to get their projects done. But we pushed it to the back half. It's given us more nimbleness."**
- **Change from an annual budget-planning process in 2008 to a semiannual one, allowing changes if things don't go as planned. "That should help us on the up, as we can redo the budget every six months."**

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
 - Cut out the unnecessary complexity of how business is handled.
 - Payments and invoicing
 - Silos

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
 - Stop the NIMBY

Practical Ways to Reduce Overheads and Costs

- **Reduce the externally negative activity**
 - Customer requirements that are above and beyond the norm
 - Not all customers are good customers (Ing Direct and “needy” customers and Best Buy returns)
 - Larry Selden – “Angel Customers and Demon Customers”
 - Customer Account Profitability (CAP)
 - McVities and M&S Cakes
 - Identify projects that are likely to fail from the start (French Chocolate %)
 - Supplier Requirements
 - Minimum order quantities
 - Local Government, Trade Unions, Health and Safety

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

Practical Ways to Reduce Overheads and Costs

- **Change the structure**

- Sounds very easy
- Very slow – Nokia took 7 months to restructure in 2008/09
- 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
- What structure do you go for?
- reengineering has involved recasting processes and the information systems that support them in a proprietary, rather than a standardized, form—that is, customized for individual organizations. Such designs make it difficult and expensive for businesses to share, consolidate, and change processes

Service-Oriented Architecture (SOA)

- **A new way of designing the technology that supports your business processes.**
- **SOA allows processes to be accessed on the Internet, makes it easy to share processes with other units, delegate processes to suppliers or customers, and update IT systems.**
- **The company must transform itself from a collection of proprietary operations into a collection of “plug-and-play” activities.**

Service-Oriented Architecture (SOA)

- **Break down each business process into its component activities.**
- **Activities that should be eliminated (they're redundant),**
- **Activities that should remain in-house (they give you a strategic edge),**
- **Activities that could be outsourced (someone else can perform them better).**
- **Use SOA to automate strategically crucial activities through Web-based services anyone (business units, customers, suppliers) can access. Eg Airlines do this by enabling passengers to check in for flights on their home computers, at airport kiosks, or through customer-service representatives.**

Service-Oriented Architecture (SOA)

- **Describe operations in terms of desired outcomes.**
 - “Collect customer payment.”
- **Identify the activities supporting the desired outcomes.**
 - “Generate demand,” = three activities: “Manage partner relationships,” “Market services,” and “Sell services.”
- **Identify the capabilities supporting each of the activities.**
 - “Sell services” = “Manage orders,” “Manage sales,” “Manage immediately filled sales,” “Configure service pricing,” “Manage contracts,” “Qualify prospects,” and “Conduct business intelligence.”
- **Identify activities most critical to your company’s success.**
 - The *most* critical activities are those that differentiate the business from competitors, strongly influence whether customers buy and remain loyal, or drive a key performance measure (such as manufacturing cost, product quality, or time to market). Grade current performance on each critical activity’s supporting capabilities.

Service-Oriented Architecture (SOA)

- **Design a more efficient operating model.**
 - Identify activities that lend themselves to a plug-and-play approach. For example, analyze whether seemingly similar activities in different areas really are the same (in which case they could be automated for use by multiple areas. Place each activity in one or more of the following categories:
 - Primary: Keep in-house and designate as a top priority for improvement.
 - Shared: Share with other divisions.
 - Shifted: Transfer to customers, suppliers, or operational specialists.
 - Automated: Use SOA to automate any of the above through Web-based services.
- **Federal Express were unable to smoothly intergrate the many small businesses it had acquired because of its own “bespoke” systems.**
- <http://hbr.harvardbusiness.org/2008/06/the-next-revolution-in-productivity/ar/1>

Counting the Pennies

- **Salt £100 per metric tonne**
 - Recipe level 0.55%
 - Total cost of each metric tonne of product £1000
 - Increase Salt to 0.65%
 - Price of salt in 1mt goes up from 55p to 65p
 - Total cost effect on recipe reduces the cost/mt by 35p
 - Effect on one product
 - $35p \times 3 \times 20 \text{ hrs per day} \times 6 \text{ days per week} \times 48 \text{ wks} = £6048$
 - 10 lines per factory £60480 per year saving on ingredient costs

Summary

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

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

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

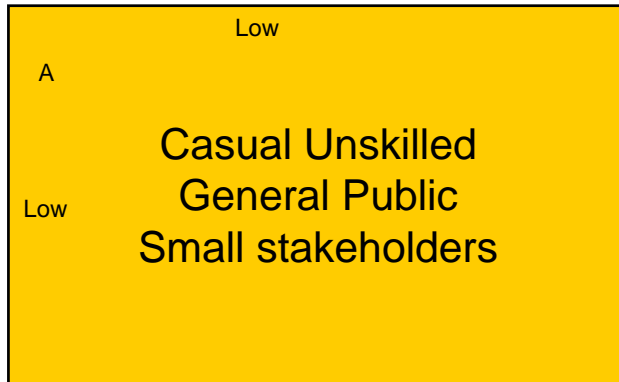
- **“stick to the knitting”**
- **But don't weaken a company by risking customer service levels or the perception of quality – Customer Call Centres**
- **Key relationships with out source companies**
- **Many businesses are bringing IT back into the business as Enterprise Resource Planning (ERP) becomes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

People

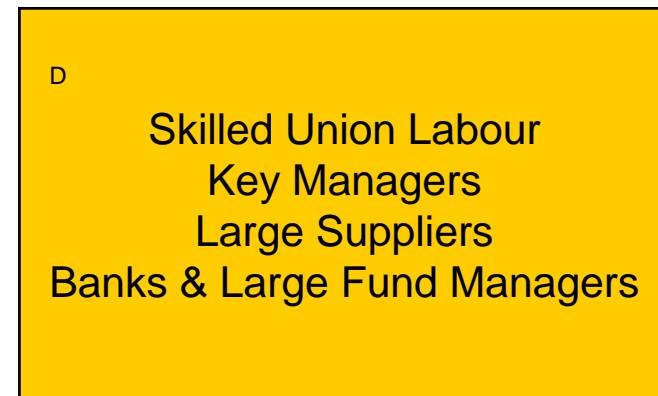
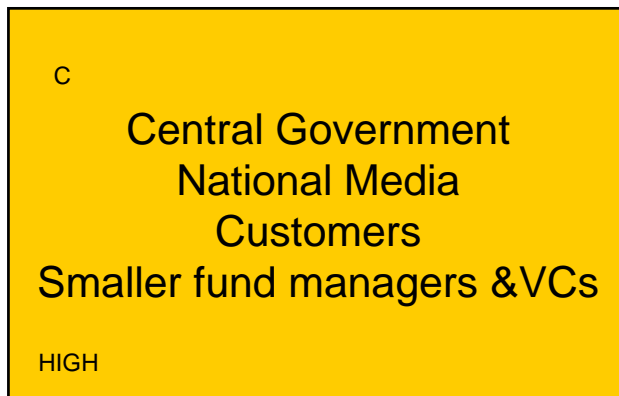
- **Outsourcing again!**
- **The most emotive area**
 - Recognise the extra loss
- **Management structures – less of a pyramid**
 - Matrix
- **Central processes**
 - HR
- **Complete organisational restructuring**
- **Project management**
- **Process management**
- **Functional management**

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.**