- White Paper -

Know Your Costs

By Christophe Barriere-Varju
BvW Global

It was cold and windy morning as workers and managers made their way into the plant. The day took a special meaning since the CEO was expected to make an announcement during the lunch hour. Word was out that the news was not good.

At noon, the mood was as grim as the weather. The CEO spoke. There was nothing exciting in his speech – just cold, hard facts. Competition had eroded market share, the economy was still in a downward spiral, and the company again lost money in that quarter. Needless to say, the upcoming Christmas bonus was not looking so good.

In his concluding remarks, the CEO said, "We have no alternative, ladies and gentlemen. The only way we can stay in business, be competitive and profitable, is by following a five-step process:

1. **Reduce costs**
2. **Reduce costs**
3. **Reduce costs**
4. **Reduce costs**
5. **Reduce costs**

"I want each and everyone of you to do your share and help us reduce costs, improve profits, and stay competitive."

Introduction

Is your company facing increasing pressure from top management and the market to reduce costs? The answer is loud and clear!

Be it at Qantas, AMP, American Express, Mirvac, the response is identical – cost reduction is imperative to long-term survival. Engineers, buyers, production or sales people, and even top managers; it doesn't really matter who you ask. Everyone is out trying to "reduce costs."

Go ahead and ask these companies the next question. "How many of you truly understand your costs?" "How many do you think can honestly say that they understand and know the costs associated with what they do in the organisation?"

It is obvious, therefore, that managers in most Australian companies may be sending their troops out to conquer the unknown enemy. And with toy guns, too. Is it possible to reduce and manage something that most employees don't even understand?

Okay. So the CEO made it clear that the company will aggressively pursue a goal of cost reduction in order to be competitive. Then the scramble begins. Managers hurriedly schedule meetings and bark out orders. Subordinates look at one another in amazement. How can someone in a responsible position give such an order? Then, they go off and do nothing, or find ways to modify the orders.

The problem isn't that costs can't be managed. It is just that it is so difficult to accurately define costs. Often, it is a question of conflicting definitions to the term 'costs' that cause confusion and illogical actions.

Slashing personnel, travel, training or R&D budgets is certainly not the way to be more competitive in the long run. It may work for state and federal governments, but not for competitive firms. What we need is a well thought out, understandable and implementable strategy to reduce costs.

Defining Costs

Top Management – If the actions of giant corporations like Ansett are any indication, a sure way to reduce costs is to lay off or 'retire' the firm's most valuable assets: its people. Whether through the dreaded pink slip or a more sophisticated, yet equally frightening, 'voluntary redundancy' severance package. Anyone who has participated in a massive layoff program will admit that they have lost more good workers in the process of weeding out the 'not so good.' The good workers, seeing their mates clear their desks or work areas, are smart enough to get their own resumes out in a hurry. Like any top athlete – it is better to get out when everyone will ask "why are you leaving?" not "why don't you leave?" Those left at the end of an employee shake out are made to take on more important tasks than ever before. But has it really worked?

Middle Management – Other than to follow top management directive to reduce head count, middle managers give their own definition to costs. They then proceed to implement cost-reduction programs, whether or not the firm benefits from those actions.

A *Production* manager's goal is fairly straightforward – reduce the production cost per unit. A high school student would tell you that cost per unit on a production line is calculated by taking a total of fixed and variable manufacturing costs and dividing the sum by the number of units produced.

In most firms today, apart from the direct raw materials and temporary labour, most of the other manufacturing costs are fixed. Depreciation, space, most utilities, insurance, indirect labour or supervision, most annual maintenance, taxes and benefits to name a few, remain relatively fixed. A smart manager would therefore, observe that unit production costs could be reduced by churning out as many units as possible. Throughput, they call it. "Okay, so there isn't a market out there for everything we produce. Let the marketing folks figure out that problem. I can't afford to keep my expensive machines and robots idle, can I? Anyway, it's bad for employee morale to remain idle. So there – I must produce, produce, produce!"

The *Materials/Procurement* manager has her own objective – reduce the price paid for incoming materials. Actually, some managers do try to use the words "reduce material costs": to anyone in the procurement department the message is clear – "Lower the prices we pay our suppliers." After all, how many buyers are evaluated on price performance? Almost all of them. It doesn't matter if the lowest bidder compromises on quality later in the project to make up for the losses incurred on its side. But that's a problem for the Quality Assurance and Production departments. And what if a cheap valve, for example, fails to hold back poisonous gas in a storage tank? "Well," says the buyer of a chemical company, "let those guys in the Legal department figure out a compensation scheme for the dead and injured. I still get my promotion or raise. After all, my materials prices are down 12%. Who could ask for anything more?"

The *Financial* controller, pressured to reduce costs, passes along his orders to Accounts Payable. "We need to increase the float. Centralise our Account Payable in order to delay paying our suppliers at the various divisions. This way we can increase our payment period by a week or more while invoices go halfway around the world, picking up approvals and initials." Now, what if suppliers get so disgusted that they, in turn, begin to delay shipments of critical

orders. "Oh, that's not my problem. Let those blokes in Purchasing and Production figure it out. My cost of financing has gone down, hasn't it?

Conclusion

As you can see, defining costs in an organization is difficult. At BvW Global, we are here to provide you and your company with a winning methodology to managing and reducing costs through the collaborative value-chain (consulting and/or internal training). It won't be easy. There will have to be major sacrifices and compromises, shifts in paradigms and changes in policy. The good news is that a few proactive companies have already embarked on the journey of Cost Management. At least, for these companies, taking the first step was half the battle. No one likes change except a wet baby. But change you must if you want to stay competitive.

In a few years the only differentiation will be *cost.* The company that best manages its costs through the entire supply chain to bring you the latest technology, best quality and delivery at a price lower than the others will take home the prize – your check. There is no prize for coming in second.

About BvW Global Pty Ltd
BvW reduces costs and increases profit across the entire business chain through its proprietary Revenue Management, Cost Management and Trading Partner Management systems.

BvW delivers strategic, operational and tactical outcomes through tailored technology enablers. Our practitioners provide ongoing business mentorship through 'best of breed' expertise in local and international markets.

For more information contact Christophe Barriere-Varju on 0403.444.101 or email info@bvwglobal.com