



## Strategic Cost Management in a Recession

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In times of uncertainty and harsh economic conditions, the instinctive reaction of most companies is to cut costs. Hold your fire! Panic-induced cost cutting in turbulent financial times can be counterproductive and damaging to a business. For a viable future, companies must think strategy, not just bottom line.

Conventional cost management usually follows the formula that when the economy deteriorates, companies should reduce costs to become profitable again. This cut-and-slash approach to cost management can lead to a loss of customers and market share, unsustainable turnover of experienced staff, and inefficiencies in the long term.

In comparison, strategic cost management holds that cost should not be reduced at the expense of business strategy and that costs must be managed for economic value. Costs should not be managed in isolation to each other, but always with regards to the value generated from the costs spent.

### *Step 1: Determine Value and Cost Drivers*

First, determine the drivers of the existing cost base. Managers must understand value and cost drivers, and how they interact. A value driver is “anything within or outside the business, in the present or future that directly or indirectly leads to cash inflow generation” (“Hold Fire!” Tony Grundy, Charter Magazine, December 2008).

A cost driver has an almost identical definition, except in this case it is anything that generates cash outflow, instead of inflow.

By viewing costs and their associated contribution to value this way, companies can assess which costs lead to the highest value-add, and which ones are superfluous to the business. Value drivers derive from value to the customer for example improved product quality, or delivered value such as an increase in sales or an improvement in corporate image and brand value. Cost drivers must consider the entire life cycle model of costs, both short and long-term.

For example, a supermarket looking to reduce costs might be considering buying a fleet of new trolleys. Under conventional cost management, this may mean reducing the number of trolleys ordered from 5,000 to 2,000 and ordering from a cheaper supplier for a lower price. Strategic cost management takes into account the fact that customers may become disgruntled with the lack of trolleys available and the poor quality of a trolley’s deviating wheel. These customers may then decide to shop elsewhere, making the savings counterproductive.

### *Step 2: Strategic Cost Analysis*

To cut costs strategically, consider the two following questions:

What is the 80/20 split? Determine which 20 per cent of costs offer 80 per cent of the opportunities for major reduction in costs.

Which costs can be re-engineered? Some costs are easier to reduce than others. Behavioural cost drivers, for example, the amount of stationery used by employees, is more easily modified than structural cost drivers such as size of the factory used in production.

### ***Step 3: Strategic costs reduction***

These two steps allow businesses to reduce costs without damaging long-term strategic prospects:

#### **a) Protect key value drivers and optimise long-term value.**

Many businesses fall back on cost cutting in advertising, training and recruitment in the economic downturn, simply because these expenses are not structural cost drivers and are easy to turn on and off. However, taking a longer term view of costs and strategy, a business should also consider how lessened market visibility, unskilled staff and insufficient employees will impact the company in the future.

For example, American Express, Kelloggs and Diageo are companies that are maintaining or increasing their marketing spend in the recession because effective marketing is one of the key value drivers for these organisations (“Best Global Brands,” Burt Helm, Business Week, September 2008).

#### **b) Review and reduce costs.**

Based on the cost analysis performed in Step 2, change, remove or reduce activities that do not contribute to an increase in sales, cash flow or opportunities for the business. Some examples are finding a cheaper supplier without compromising on quality or stopping direct mail marketing if there have been no sales generated from this method. Businesses must think outside the box to find ways of decreasing costs while also improving long term sustainability in line with strategic goals.

Tesco, the global supermarket chain, is reducing store extensions. The company is reported to be spending £1 billion less in the 2009/10 financial year compared to last year. Instead, the supermarket is focusing on stocking more non-food items on its shelves as profit margins are higher on these products compared to from its food categories. (“Three Cost-Cutting Traps and How to Avoid Them,” Stuart Cross, blogs.bnet.co.uk, September 2008). In another bid to

reduce costs, Tesco has also virtualised their real-time sales system, which has saved the company a significant amount of electricity costs and supports Tesco’s long term strategic goal of reducing CO2 emissions (“Tesco Increases Virtualisation to Cut Costs,” Angelica Mari, computing.co.uk, March 2009).

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