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Towards more strategic cost management

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The prolonged global economic downturn has enforced continuous waves of restructuring across industries. As the recovery is predicted to take years, companies have decided to reduce headcount in less performing units. Unfortunately, many have selected an easy approach and initiated “across the board” cuts without clear choices on what to cut and where to invest.

Those adopting a more strategic approach have emphasized understanding of the company’s value levers, with constant cost structure management both directed from the top but also managed within businesses. In this article, we explain why the more strategic approach should be considered, and how companies can build a more systematic approach to cost management.

Restructuring has become the new norm in many industries

In many industries, the impact of economic downturn has been exacerbated by macroeconomic trends like digitization, consumerization, globalization and sustainability, changing the dynamics of not only these industries but whole value chains. For example, content development is now an entirely different industry due to information technology, which also affects the media and paper industries. Similarly, sustainability and renewable energy sources are impacting the energy industry value chain, and cloud services and consumerization are transforming the IT industry, only to name a few examples.

Due to globalization, the changes affect not only multinational corporations but also SMEs that face global competition all the earlier. The trends also drive demand from developed to developing markets, contributing to overcapacity in the former, and due to the unbalanced structure of some industries have led to price erosions of up to 5-10% per annum, squeezing margins from both sides. All of this has resulted in a situation, where companies need to constantly restructure their businesses to stay competitive. Ever changing industry dynamics, with new entrants and substitutes introducing disruptive business models, call for more strategic cost management than what many companies have traditionally been used to.

Often, the incumbent companies with traditionally profitable business models are reluctant to change because of good historical performance that has enabled a heavy overhead structure fiercely defended by the managers. Employees accustomed to managing their own cost centers do not see the need to change behaviors, which ultimately leads to a culture of tolerated underachievement, until the situation is bad enough to justify a major restructuring.

Also, in the face of changing industry dynamics, the business and operating models of incumbent companies tend to be under-optimized, with blurred value creation logic, overlapping functions between businesses and even subsidization of underperforming businesses. Therefore, as the industries evolve, revising company value creation logic is needed to adapt to the changing landscape.

Companies have responded through cost-cutting programs, but risk to sacrifice their differentiation

To defend their positions, incumbent companies have initiated restructuring programs with ambitious targets. This has borne fruit, as for example in the Helsinki stock exchange the average EBIT of companies on OMXH list excluding Nokia has increased from 5% to 6% in 2008-2011, with the average headcount in the same sample decreasing by 3% (Orbis).

However, at the same time the average revenue of these companies has dropped by 7% (Orbis), whereas the compound average global GDP has increased by 4.5% during the same period (World Bank). Despite the improved short-term profitability, in longer term companies executing continuous restructuring without much growth may risk losing their differentiation. Acknowledging that this period has been one of the fiercest in the modern corporate history, and that restructuring has clearly been needed, too many companies have approached it through “across the board” cost cutting. Companies with global operations, for example, may continue streamlining their site operations to a point where there is no critical mass, even though it might be more sensible to reinvent the business model and focus operations on few key sites while utilizing subcontractors for the rest.

For a more strategic impact, understanding of company’s value levers is the key

A more strategic approach to cost management starts from understanding the company’s value levers. A clear understanding of the value creation logic helps to avoid cutting the foundation for competitiveness and future growth. A pre-requisite for this is adequate industry foresight to build understanding on how the value levers are affected by the changing industry dynamics. For example, understanding and utilizing IT better in company's core would likely enable huge productivity improvements for most companies. Similarly, a better understanding of the impact of globalization may lead to changes in the definition of a company's core business and operating model.

With good industry and market foresight, companies can build a more solid view on future sources of value creation, helping them prioritize both costs and investments. Also, with a well-defined core, a company's business portfolio may look entirely different, allowing more structural cost savings like outsourcing or divestments of non-core operations. The proceedings can then be used to further strengthen core business productivity and competitiveness. Managing an unrelated business portfolio without critical mass easily disperses company's assets too widely, leading to an inefficient cost structure.

To ensure a long-lasting impact, cost management must be ingrained in the organizational culture, where systematic performance management plays a key role. This is emphasized for example by Bloom et al. (Harvard Business Review, November 2012) who found that the only common nominators for high performing companies are how they set targets, follow up and manage target realization, and reward for performance. Performance management begins from aligning key performance indicators (KPIs) with the value levers. KPIs should include both leading and lagging and input and output based indicators to allow proper management. The true impact is achieved when KPIs are cascaded throughout the organization with clarity on targets, accountabilities and consequences. One company, for example, has decided to review and act on costs monthly instead of annual cost saving programs to instill cost consciousness to the businesses, and signal that underperformance is not tolerated.

Combining top-down and bottom-up approaches to build momentum

Sometimes, due to changes in the industry dynamics or to turn around the company performance, a more thorough restructuring program may be needed in addition to the general cost consciousness. Then, the best practice is to combine top-down and bottom-up approaches to validate actions and reach broader buy-in. Traditionally companies have tended to direct restructuring from the top, planned by a small group of people, which may lead to inaccurate cost saving impact and lack of buy-in among the managers responsible for execution. Therefore, an initial analysis at the top should be elaborated through bottom-up estimations by these managers.

Companies may also use restructuring to shake up the power balance within the organization. After structural changes and revised performance management, barriers to cultural change are lower and can better be implemented. For example, a company building new service business may face strong opposition from product businesses even though their performance has decreased and there is an understanding that a combined approach increases the whole company performance. By redefining company value levers and shaking up the structure and accountabilities the company can find a new business model with a lower cost structure.

Possible restructuring approaches include wider cost saving workstream-based approaches, and more specific cost saving directives. Benefits of the workstream-based approach include a more consistent view on the whole cost structure. It is better used to drive bigger changes to the business or operating models and accountabilities, while more specific programs focusing on for example administration or sales costs serve better when the big picture is clear and reaching the desired impact requires digging deeper into the topic.

Driving results through a proactive program management office

Regardless of the approach, an important part of any cost saving program is a well-functioning program management office (PMO). Instead of a "coordinate and report" type of PMO, the best practice is to make the PMO accountable for the program deliverables, driving real business impact. This makes the PMO not only follow up that activities are completed, but ensure that they are enough to reach the targets. This requires a more comprehensive approach to understand the dependencies and sensitivities of the actions.

Another important PMO task is to build metrics to monitor progress. These metrics should be aligned with the overall performance management, while being specific enough to the program. One common pitfall is to create program metrics without connection to P&L. For example, following up how many persons have been cut is different than following up total headcount, or even better employee costs in the P&L.

Third important task for the PMO is to communicate about the progress in a transparent and fair way. Like in any transformation effort, communicating why the program is needed and what is the long-term target, how it proceeds, and what has been the progress reduces uncertainty among employees, allowing them to focus more on executing day-to-day activities driving business impact. Likewise, presenting quick wins is important to demonstrate progress and to build momentum in the organization.

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Overall, companies with clear understanding of their value levers and value creation logic are better positioned to manage costs strategically. This understanding helps companies to make continuous choices on where to save and where to invest. However, sometimes a restructuring program is needed, and should be driven by the top management and managers responsible for execution together, to build broader buy-in and validate the savings estimates. Also, an active PMO is needed to drive results, follow up progress and communicate to the organization. Lacking in one of these areas may undermine the outcome of the program.