Cost control

Cutting costs is the simplest way to improve your bottom line. Introducing a cost control system can bring immediate savings and ensure that you remain competitive in the longer term.

But cost control needs to be carefully managed. While eliminating wasteful activities is clearly beneficial, indiscriminate cost cutting can lead to falling quality and poor morale.

This briefing covers:

- Identifying where to focus your efforts.
- Managing cost control.
- Specific cost control opportunities.
- The pitfalls.

1 Your costs

Cost control works best as part of your routine financial management. The first step is to look at your existing costs.

1.1 Identify your major **cost centres**. Typically these might be purchasing, production, sales and marketing, financing, administration, premises, facilities management, and research and development (R&D).

- In a small business, a cost centre is usually the area one manager is responsible for (see **3.1**).

1.2 Identify the major **types of cost** within each cost centre.

These might include staff costs, raw materials and supplies, utility bills for energy and water, capital expenditure, other purchases (eg consultancy services and advertising space), premises, communication, travel, transport and financing costs.

1.3 Choose the costs to **focus** on first.

- Costs that may offer easy savings (see **5**).
- Large costs that you may be able to change in the short term.
  Fixed costs (eg long-term fixed rate loans or fixed price contracts for raw materials) are hard to control in the short term.

  Some cost centres, such as R&D, make important but indirect contributions to your bottom line.

  You need to account for these contributions before deciding on cutting their budgets.

2 Systematic cost control

2.1 Start from your **business objectives**.

For example, you might aim to manufacture 1,000 units per month, or to win ten new customers.

- What are your quality standards?
  For example, your customer service standards might require you to respond to all enquiries within a specified time.

2.2 Establish your '**standard costs**' for achieving your objectives.

Standard costs are the costs you would have in an ideal world (but see **2.4**).

You need to consider:

- What resources you need.
- How much of the resources you need.
  Standard costs assume optimum performance (eg no unnecessary wastage of raw materials or staff time).
- What the resources cost.

2.3 Establish realistic '**budgeted costs**' based on your actual experience.

- Budgeted costs will usually be higher than standard costs.
  For example, you might expect two per cent of all production to be wastage, raising unit costs.
- Budgeted costs may sometimes be lower than standard costs.
  For example, if you have staff vacancies to fill.

Power supplies

A **Prices** of gas and electricity have increased significantly in recent months.

Businesses are no longer restricted to buying from their local supplier so it is worth shopping around for the best deals.

- Suppliers can offer tailored pricing packages, based on your requirements.
  Remember to compare like with like when looking at competing quotes.
- Suppliers may offer additional discounts for buying both electricity and gas from them, or paying by direct debit.

B Choose a supplier that offers the right quality of **service**. Look for:

- A flexible contract which suits you (eg guaranteed prices).
- Added value services such as technical support and energy efficiency advice.
- A supplier with a good track record.

2.4 Record your **actual costs** and compare them with the standard and budgeted costs.

It may be appropriate to compare unit costs (cost per unit produced) or total costs (including overheads such as premises).

- Costs that are higher than your budgeted costs may indicate opportunities to reduce costs in the short term.
  In general, the larger the cost overrun, the more scope there should be for savings.
- Costs that are higher than your standard costs usually indicate opportunities to reduce costs in the longer term.
- Lower costs may indicate good management, but might also reflect quality failings or impending problems.

Using a spreadsheet or cost control package, it is easy to record and compare costs on a regular basis (eg monthly).

2.5 Periodically **review** what you are doing and how you are doing it.

- Benchmarking yourself against other organisations may show that your performance is sub-standard.
  For example, if your wastage levels are higher than the industry average.
- An internal review, or input from an external consultancy, may suggest alternatives.
  For example, standardising components to reduce design and manufacturing costs.

3 Who is involved?

3.1 Each cost centre is usually the responsibility of one **manager**.

- Some costs can be easier to control if one manager is responsible for that cost throughout the organisation.

3.2 Involve **employees** in cost control.

- Employees can suggest cost-saving ideas, especially if there is an incentive to do so.
  Ask what causes them problems or wastes their time.
- Employees are more likely to co-operate with cost control initiatives if changes are explained to them.

3.3 Include your **customers** and **suppliers**.

- Ask your customers if you are providing them with anything they do not need.
- Your suppliers will know what other purchasing options are available that might suit your business.

3.4 External consultants can be a useful resource (see **7**).

4 Easy savings

Some costs can be reduced with little risk of an adverse impact on quality and performance.

4.1 Checking supplier invoices may reveal **overcharging**.

- Common examples are double billing, incorrect charges and missing discounts.

4.2 Eliminate **unnecessary** costs.

- Get rid of obvious overcapacity (eg unused telephone lines).
- Cut out blatant waste (eg heating premises at night, or with windows open).
- Scrap useless processes (eg paperwork that is completed, filed and forgotten).

4.3 Crack down on **excessive** costs.

- Use second class postage, email or fax, unless only first class post will do.
- Find alternatives to high priced suppliers, or negotiate discounts.
- Avoid over-specifying (eg high-quality components for a low-quality product).
- Ban wasteful luxuries (eg full-fare business class flights).
  Cutting back on items employees see as 'benefits' or 'perks of the job' needs careful handling (see **6.1**).

4.4 Root out **inefficiency**.

- Identify manual, paper-based systems that could be computerised.
- Avoid frequent small orders. They waste time and may mean you lose discounts.
- Consider switching to single monthly invoicing to cut processing and costs.

5 Opportunities

Effective use of a systematic approach will highlight opportunities to control costs with little risk. In some cases, there will be easy savings such as cutting the cost of supplies (see **4**).

In others, cost reduction will require changing the way you do things. Some of the most common opportunities are listed below. In every case, be aware of the potential pitfalls (see **6**).

5.1 Reduce your **payroll** costs.

- Outsource non-core activities.
- Use consultants, freelancers or part-time employees, instead of full-time employees.
- Redesign processes to eliminate duplication of effort and to cut out time wasting.
- Make more use of technology and automation.
- Do not overpay when recruiting new employees.

5.2 Improve your **purchasing**.

- Switch to cheaper suppliers, or negotiate price reductions or higher discounts for early payment.
- Consolidate purchasing with fewer suppliers to get better discounts.
- Agree long-term supply contracts or guarantee minimum annual purchase volumes in return for lower prices.
- Build personal relationships with suppliers to encourage preferential treatment.
- Simplify purchasing procedures to reduce your costs, and those of your suppliers.
- Form strategic buying alliances (eg purchasing consortia) with businesses in your area or trade to buy larger volumes.
- Give individual employees purchasing limits to reduce administration and ask your bank about purchasing cards.

5.3 Find ways to make **production** more efficient.

- Trim back your product range and increase production runs.
- Use standard components to lower design, purchasing and manufacturing costs.
- Change processes to minimise wastage of raw materials and energy.
- Improve quality control to cut rejection rates and reworking costs.

5.4 Review your **finances**.

- Finance fixed requirements using loans, instead of overdrafts.
- Reduce unnecessary overdraft and loan facilities.
- Cut back on working capital through just-in-time purchasing, better credit control and agreeing longer payment terms with your suppliers.
- Apply for grants and subsidised loans.

5.5 Get the most out of your **premises**.

- Introduce homeworking or hot desking to cut space requirements (and travel costs).
- Reconfigure existing premises and work flows to minimise wasted time and space.
- Sub-let spare space.
- Control utility costs.

5.6 Cut the cost of **communications**.

- Use email whenever possible.
- Use the corporate intranet to reduce duplication of information and unnecessary meetings.
- Use cheaper telecoms facilities (eg alternative suppliers, leased lines).

6 Pitfalls

Reducing costs can be damaging. Before making changes, check that your standards will not be compromised and that your ability to meet objectives will not be harmed.

6.1 Reducing costs which directly impact on **employees** is fraught with difficulty.

- Employees are not machines.
  The work performance suggested by time and motion studies is unlikely to reflect people's actual behaviour.
- Reducing costs such as training and meeting times is often counterproductive in the longer term.
- Introducing improved procedures can be difficult and expensive.
  Employees may be resistant to change, and may need extra training.
- Poor conditions, pay and benefits will not attract and retain good employees.
- Changing an existing employee's terms and conditions, to the employee's detriment, can be a breach of contract.
- Making employees redundant brings short-term costs and the risk of possible employment tribunal proceedings. It may also damage long-term morale.

6.2 Almost every cost saving has a potential **downside**. For example:

- Over-dependence on one supplier puts you at risk if the supplier fails.
- Production and marketing plans driven by cost-cutting considerations are unlikely to be responsive to customer requirements.
- Tighter control of financing may leave you with no safety margin when cashflow is unexpectedly poor.
- Cutting short-term 'investment' costs (eg training, advertising, equipment or new product development) can lead to long-term weakness.
- Attempting to control unalterable costs is itself a wasteful process.

7 Consultants

7.1 External consultants can offer an **advantage** over purely internal cost control.

- Consultants may have up-to-date, specialist knowledge.
  For example, they may be acquainted with up-to-date benchmarks for your industry and current market conditions for utilities and other suppliers.
- A consultant's thinking may be able to avoid being influenced by vested interests and historical preferences within your company.

7.2 **Select** a consultant carefully.

- Look for membership of an established and appropriate professional body, with a published code of conduct.
  For example, the Chartered Institute of Purchasing & Supply (01780 756 777; www.cips.org).
- Check references and look for evidence of a good track record, working with businesses comparable to yours.
- Find out about the consultant's financial standing and check that there is indemnity insurance cover in place.

7.3 Negotiate a clear, written **contract**.

- Agree what you will pay.
  If fees are to be based on a percentage of savings, agree how these savings will be calculated.
- Arrange when you will pay.
  Avoid having to make upfront payments, before you can see the results of a consultant's work.
- Insist that the consultant signs a formal confidentiality agreement.

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Tel: 020 8672 6844, www.bhpinfosolutions.co.uk