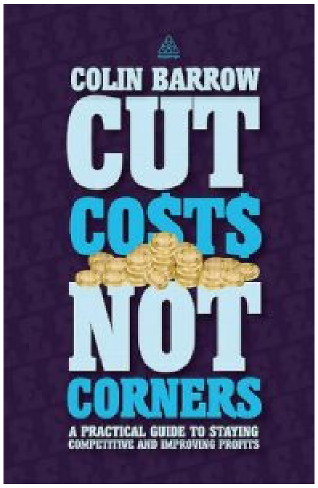

Book Cut Costs Not Corners

A Practical Guide to Staying Competitive and Improving Profits

Colin Barrow
Kogan Page, 2010
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Recommendation

In today's distressed economy, every firm is, perforce, a cost cutter. Your company can achieve lean operations by not overpaying for supplies, lessening employee overtime and getting full value from all expenditures. But beware: Severe downsizing can be hugely counterproductive and might cause serious harm to your business while trashing its competitive position. Business professor Colin Barrow reveals the most effective ways to cut costs and outlines proven practices, tips and techniques to reduce expenditures in every area of your organization. His numerous real-life case studies underscore the imperative of making cost cutting a consistent concern. *BooksInShort* recommends Barrow's helpful, albeit basic, primer to first-time entrepreneurs and small-business owners who need a lucid, straightforward guide to tackling costs.

Take-Aways

- Many organizations mistakenly cut costs only during recessions.
- To operate efficiently and competitively, make cost cutting an everyday activity, regardless of the business climate.
- Downsizing can be counterproductive; it leads to "increased staff turnover, lower morale and reduced effort."
- Monitor your return on investment, as well as your balance sheet and income statements, to find the best places to cut costs.
- You can save substantially when you locate your company in less-expensive districts.
- Encourage creditors to pay you faster to increase your working capital.
- Reduce unnecessary overtime through better planning and controls.
- Most of the ways you can increase employee productivity do not cost money.
- Retaining your existing customers is cheaper than acquiring new ones. To hang onto your clients, provide excellent customer service.
- A crisis might call for drastic measures, such as laying off staff, selling land and other assets, or shutting down. But your firm may emerge stronger than ever.

Summary

Cutting Costs – How Google Did It

In 2009, while other technology firms struggled financially, Google's earnings increased by 19%. What accounted for this sharp rise? While sales revenue grew by 3%, Google derived the majority of its improved results from stringent cost-cutting measures. For example, Google's food service unit reduced its hours, and the company dissuaded employees from taking home the free meals they received at work. Google also disposed of bottled water, afternoon tea and various other employee perks. In total, the firm effectively cut capital expenditures by 80%. Google effectively disproved two myths surrounding cost cutting:

- **“Cost cutting is for times of crisis only”** – False. Cost cutting should be “a permanent management process.” Often, once an emergency has passed, companies revert back to their free-spending ways. For example, companies typically pay too much for acquisitions in rising markets. In “the biggest, and certainly the worst, banking takeover in history,” Royal Bank of Scotland (RBS) led a consortium in July 2007 to acquire ABN AMRO, a Dutch bank, for approximately €70 billion [$97 billion] – a massive €9 billion [$12.4 billion] more than Barclays, an RBS competitor, believed ABN AMRO to be worth. Smart firms delay acquisitions until recessionary periods hit.
- **“Cost cutting is just another word for downsizing”** – Reducing the size of your staff is not the most efficient way to cut costs. Hidden downsizing costs include “increased staff turnover, lower morale and reduced effort.” Thus, downsizing can prove counterproductive.

Trim Expenses

To maintain competitiveness, pare expenses at all times. Focus on your income statement and balance sheet, since your “costs, sales volume, selling prices and profits” are intertwined. Identify your cost categories. First, consider your fixed costs, such as “plant, equipment, computers, desks and telephones,” as well as rent and insurance. Think of labor as a fixed cost for the short term (but not necessarily over the long term). The fewer fixed costs you have, the fewer units you must sell to make a profit. Variable costs fluctuate in relation to output. Semivariable costs include telephone services and electricity. Now, consider your break-even point (BEP) – the number of units you must sell before you turn a profit. BEP equals fixed costs divided by “unit selling price,” less unit variable costs. If you keep your unit variable costs low, you will hit the BEP sooner and reach profitability more quickly.

> “Whilst Google has 78,200,000 entries for chief executive, there are no listings at all for chief cost cutting officer, which is a pity as it is arguably one of the most important jobs going.”

Your return on investment (ROI) is the best measurement for assessing the effectiveness of your performance and your cost-cutting efforts. By analyzing your income, expenditure, profit and loss, you can work out various ratios “to compare cost performance in one period...with another.” You also can use ratios to measure performance against your budget.

> “Cost cutting is seen as a one-off task, usually in response to some external crisis.”

Some effective ways to cut costs include:

- **“Operating efficiencies”** – Find ways to maintain your business at a lower expense.
- **“Product redesign”** – Develop your products less expensively.
- **“Product standardization”** – The wider the spectrum of goods you offer, the higher your costs will be. Cut back on this differentiation.
- **“Economies of scale”** – Spread out your cost base; for example, a “warehousing network” will run more cheaply if it supports 3,000 stores than if it serves 1,000 stores.

Decrease Your Capital Expenditures

Capital expenditures appear on the books “at their cost at date of purchase.” Their values decrease as they age. Depreciation is an accounting technique that enables firms to allocate a portion of the cost of their capital expenditures over a set period of time, determined by “the working life of the asset.” In the UK, tax laws forbid you from showing depreciation as a business expense, although you can get “tax relief on the capital expenditure known as ‘writing down’.”

> “Nothing is considered sacred in a downturn, and almost anything can be sacrificed to ensure corporate survival.”

To save money on capital expenditures, examine your premises costs, including “heat, light and power, insurance, and repairs and maintenance.” Location also figures into the cost equation. Often, a company receives only minimal benefits from locating in a prestigious area. By originally headquartering in Newbury, around 60 miles from London, Vodafone was able to maintain rent and salary costs that were a third less than they would have been in the city. In 2009, after office rates had dropped by 30%, Vodafone finally moved to London’s Paddington area. Also, if you have space you no longer need, rent it out, as did Atrium, a London wholesale furniture and lighting company. Atrium also provided accounting services to a supplier that moved into its reorganized space and rented warehouse space “to a former competitor.” Additionally, Atrium provided that company with a “delivery and fitting service.”

> “Low cost should not be confused with low price.”

Save by buying secondhand equipment and office furniture online. Most businesses spend an average of 20% more than they need to on technology. Unless you are in publishing or design, buy PCs, not Apple computers, which are more expensive by a third. Save big by outsourcing tasks that are not essential to your core business and using free software.

Monitor Your Working Capital

Working capital is the “shorter-term cash revolving around the business.” Collecting money faster is a great way to control costs. In effect, you are bankrolling customers who do not pay you promptly. Send “reminder letters” to clients who are late with their payments. Eliminate costs “associated with bad debts or late collection” by accepting credit card payments, which also frees you from doing customer credit checks. Use these tools to keep account of your working capital:

- **“Current ratio”** – This indicates your firm’s short-term liquidity. To calculate the current ratio, divide “the current assets by the current liabilities.”
- **“Quick ratio”** – To guarantee that your firm has sufficient cash on hand to pay your creditors, deduct inventory from current assets and divide that by current liabilities.
- **“Average collection period”** – Divide “sales made on credit by the money owed (debtors)” and then multiply this figure “by the time period in days.”
- **“Average payment period”** – Use the same calculation, but substitute “creditors for debtors and purchase[s] for sales.”
- **“Days’ stock held”** – Save on interest and space by holding sufficient stock for a shorter period, say 13 weeks, rather than an entire year.

- **"Circulation of working capital"** – This computation helps you find out how efficiently you use your working capital. To calculate it, divide sales by working capital.

Slash the Cost of Sales

Any cost incurred in the manufacture of your product is a cost of sales. The cheaper your material, the more you will save and the greater your profits will be. Therefore, buy your raw materials as inexpensively as possible, and shop around for the lowest priced suppliers. Labor is a huge expense, and paying employees for overtime can drive up costs. Studies show that overtime comes about from "poor management, poor planning and poor controls," and it usually does not result in the completion of extra work. Indeed, "overtime creep" often occurs because employees manufacture conditions so they can receive extra pay for more time spent on the job. Instead, with planning and effort, you can increase worker productivity and make your operations more efficient. Frederick Hertzberg, a psychology professor, says that five factors motivate employees: "achievement, recognition, responsibility, advancement and the attractiveness of the work," all of which cost nothing to stimulate.

> "For most organizations, the premises from which they operate are the largest single cost area."

To cut costs from profitable products, determine what your customers truly value, and eliminate elements that don't matter to them. This is IKEA's approach. It sells furniture "flat packed for self-assembly," chopping significant manufacturing, warehousing and delivery costs. Avoid discounting your merchandise. Customers assume that goods sold at reduced prices are inferior in quality. Plus, you must sell additional cut-rate products to make the same profits as when you price them normally.

Reduce Overheads

To operate more efficiently, trim your overhead costs in, for example, marketing and sales, insurance, office supplies, and so on. When it comes to advertising, the Internet is a cost-effective medium where you quickly can assess how your marketing works and easily make changes. Worthwhile online promotions include "search engine advertising" (check out GoogleAdWords) and "online display advertising." Feature something online – "jokes, games, pictures, quizzes and surveys" – that people will pass along. Use blogs and podcasts to promote your company. The Internet gives you a global presence at minimal expense, and it enables you to sell your products and services at a low cost but high efficiency. The business information service eMarketer claims that 88% of all shoppers prefer online shopping to conventional shopping.

> "You can avoid using up your cash by bartering your products and services for those of other businesses."

Holding on to your current customers is cheaper than attracting new ones. Firms can increase profits by 75% with a "customer retention" increase of only 5%. To keep customers, and thus save money, provide excellent customer service. Since 96% of complaints never surface (irate customers simply move on to other providers), listening to your clients is important. Respond promptly to the grievances you do receive, since 94% of unsatisfied customers will give firms a second chance if their complaints are dealt with "quickly and fairly." Treat customers as special to enhance their loyalty.

Taxes, Fees and Interest

Besides operating costs, your other main expenses are financing costs (including interest payments), taxes, and audit and accounting fees. These nonoperating outlays can have a huge effect on profits, but business-unit managers can't do much about them.

> "Sales and marketing are the area of cost that are most likely to have an impact on business performance."

You can secure government grants by meeting certain criteria, locating in special areas or developing advanced technologies. Small businesses can win various awards for "exporting, innovation, job creation," and so on. Local exchange trading schemes enable member companies to trade skills and services with no money changing hands.

> "[Budgets] are not set in stone, since circumstance change. In the words of John Maynard Keynes, the famous economist: 'When the facts change, I change my mind'."

Do not be afraid to negotiate with banks for better interest rates. Remember: They must compete for your business. When doing credit analysis, banks pay attention to the "five C's":

- **"Character"** – You need a good credit rating to get a better deal.
- **"Capacity"** – This is a forecast of your ability to pay back your loan. New enterprises need solid business plans. Established firms should show strong financial statements and favorable industry trends.
- **"Collateral"** – Banks want it to back up the loans they make.
- **"Capital"** – By how much do your "assets exceed debts?"
- **"Conditions"** – The economic climate affects your credit. Your business plan must demonstrate how your firm will thrive today and tomorrow.

Budgets

Create realistic budgets, and review them two or four times annually. Think of them as contracts: Employees agree to stay within budget, and the company promises to accept those results and supply all needed resources. Benchmark your budgets to match the standards your successful competitors set. For example, ask why your audit costs $33,000 while your rival gets the same service for $8,500. Get employee buy-in for all budgets and "strategic cost cutting." Understand that the benefits of cost cutting take time to materialize.

> "Most major changes make things worse before they make them better...It is vital to set realistic goals for the change period and to anticipate the time lag

between change and results."

Crises require dramatic measures. Be ready to cut staff, pay and pensions, and put a hold on hiring and all wage increases. Sell assets such as land. Cut dividends. Another survival tactic: exchange debt for equity. If all else fails, fold the business; you can emerge stronger. Sock Shop has shut down and reopened three times since it first opened in 1983.

About the Author

Colin Barrow is a visiting professor at numerous business schools. He is the author of *The Thirty-Day MBA* and *The Business Plan Workbook*.