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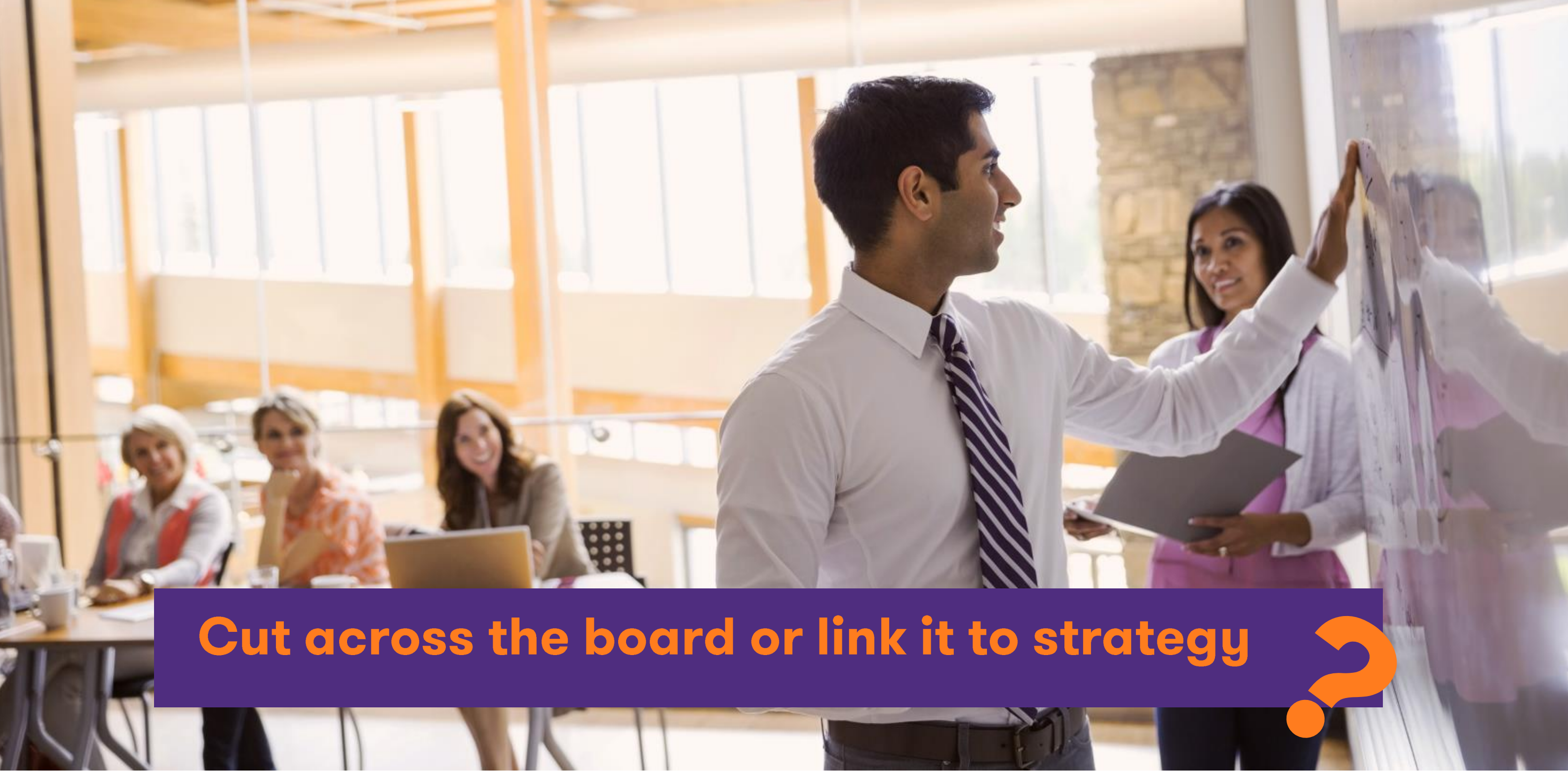
Cost Cutting: What Companies Should Consider

What comes first to your mind in crisis time, when your revenues are decreasing or run the risk of being limited?

Surely – cost cutting and optimization. When you have a stable or growing income, it's rare to think about cost cutting or optimization, but once your revenue decreases, or uncertainty about the future grows, you start to contemplate cutting your expenses to overcome the difficult period of time.

The same is relevant for businesses as well, but is cost cutting an easy task to complete? How to tackle cost optimization, in order do not harm the capacity of revenue generation in the future?

Grant Thornton experts suggest ideas on what to consider regarding cost cutting in a difficult time for the business and what is important for implementing effective cost optimization.



Cut across the board or link it to strategy

When it comes to cost cutting, many companies set a target and try to achieve it by decreasing all type of expenses and from every department or unit. Sometimes it seems more straightforward for management to cut about equally everywhere and it even seems like a fair solution to them. Another solution is when the amount of cost optimization is decided at the top and distributed to departments, so cutting costs remains under the responsibility of each department or function heads. It is assumed that each manager will be better aware of any areas of possible cost optimization. But is it always true? It may happen so, that the “agency theory” may come into force, and managers will act within their own interests. As a result, some costs, essential for revenue generation in the future, may be cut.

Then, a question arises whether cutting from everywhere is the best solution. Apparently not, and particularly not for a long run, if it is not linked to the strategy of the company. Indeed, strategy must lead cost-cutting decisions, and management should ensure that cost cutting efforts reflect the company strategy, so that they do not lead to a limitation of the future growth of the company. Moreover, it should be communicated and well understood by the managers in each function, otherwise initiatives in one area of a business may have unintended negative consequences for the company as a whole.

To do it intuitively or based on analytical data ?

Another challenge is to understand which costs should be cut or optimized. Moreover, it is not an easy task to understand which cost center is responsible for a given expense. Of course, managers are those who often take decisions on cost cutting and they must ensure that cost management is not doing damage to the business. Decision makers sometimes act intuitively, based on experience or have lack of analytical data to refer to in the cost optimization process.

Why is it important to make decisions based on analysis and how may the managers not have all necessary information to make those decisions?

There can be a number of reasons for that, particularly:

1. Not all companies have a sophisticated management accounting approach, a granularity of expenses, a necessary breakdown of costs, identified cost centers. There can simply be a lack of knowledge and experience, or not having recognized the importance of management accounting.

2. Not all companies have implemented systems which allow the treatment of accounting transactions with the principle of effective management accounting. Sometimes CEOs of small and medium enterprises particularly do not place importance on such systems or do not want to spend money on empowering the finance function, hence the absence of a database which could be used for effective cost management and optimization.

3. Sometimes, on the contrary, large enterprises may have many systems which are not integrated, or may have different systems in geographically different business units, and aggregation and consolidated view can be difficult to obtain or may be hard to interpret.

4. It can happen that companies do not have proper planning and budgeting processes, and they do not dig into the cost drivers to find optimization opportunities.

Cost cutting decisions will always be more efficient if they are based on well-defined cost drivers and sufficient and detailed analysis. However, if the company does not have sophisticated systems and broad analytical data, the decisions should be made based on available information and reliance on top management or managers' understanding of the situation, knowledge and experience. In addition, it should be a sign for the company to implement necessary systems and elaborate enough analytical data for decision making.

What tools are needed?

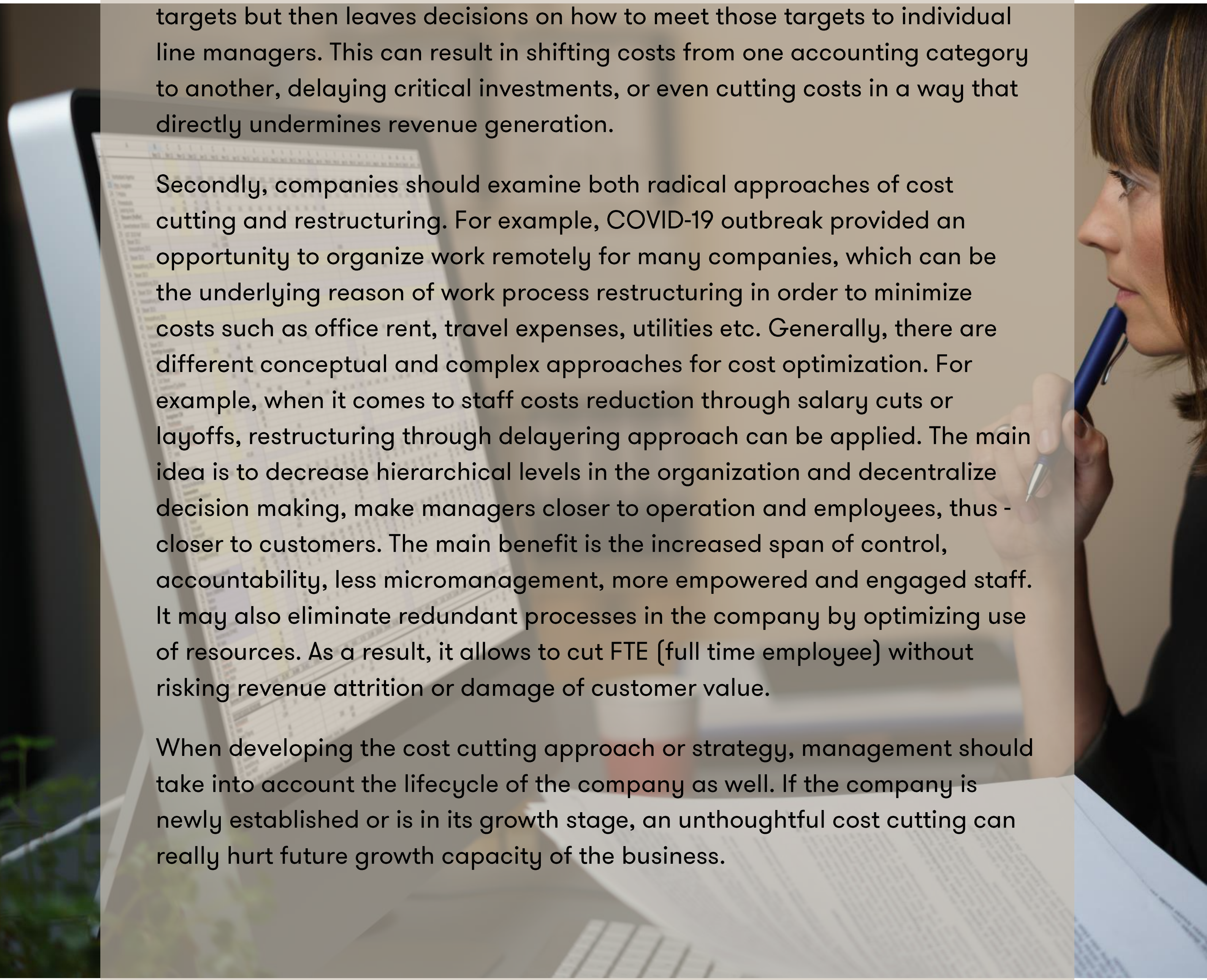
Just scissors or thoughtful approach?

As already presented, it is better to match cost cutting decisions to the strategy of the company and base them on detailed analysis. But this is not enough to succeed in this initiative, as the company should elaborate an effective approach and apply thoughtful methods for cost optimization.

First of all, it is important that top management defines a clear reason of cost optimization and cost cutting target. However, it is not enough just to set a target: top-management should provide constant and consistent support and surveillance. Cost reduction programs often lose effectiveness over time because top management kicks off the effort with extensive cost reduction targets but then leaves decisions on how to meet those targets to individual line managers. This can result in shifting costs from one accounting category to another, delaying critical investments, or even cutting costs in a way that directly undermines revenue generation.

Secondly, companies should examine both radical approaches of cost cutting and restructuring. For example, COVID-19 outbreak provided an opportunity to organize work remotely for many companies, which can be the underlying reason of work process restructuring in order to minimize costs such as office rent, travel expenses, utilities etc. Generally, there are different conceptual and complex approaches for cost optimization. For example, when it comes to staff costs reduction through salary cuts or layoffs, restructuring through delayering approach can be applied. The main idea is to decrease hierarchical levels in the organization and decentralize decision making, make managers closer to operation and employees, thus - closer to customers. The main benefit is the increased span of control, accountability, less micromanagement, more empowered and engaged staff. It may also eliminate redundant processes in the company by optimizing use of resources. As a result, it allows to cut FTE (full time employee) without risking revenue attrition or damage of customer value.

When developing the cost cutting approach or strategy, management should take into account the lifecycle of the company as well. If the company is newly established or is in its growth stage, an unthoughtful cost cutting can really hurt future growth capacity of the business.



One-time effort or cost optimization culture

Many companies treat cost cutting or optimization as a one-off exercise, main reason being short-term decrease of expenses to achieve target profit. This may result in success in the short term, thanks to the pressure from the CEO or top management, but once the crisis is overcome or the pressure from top-management is relieved, the cost cutting measures go into reserve.

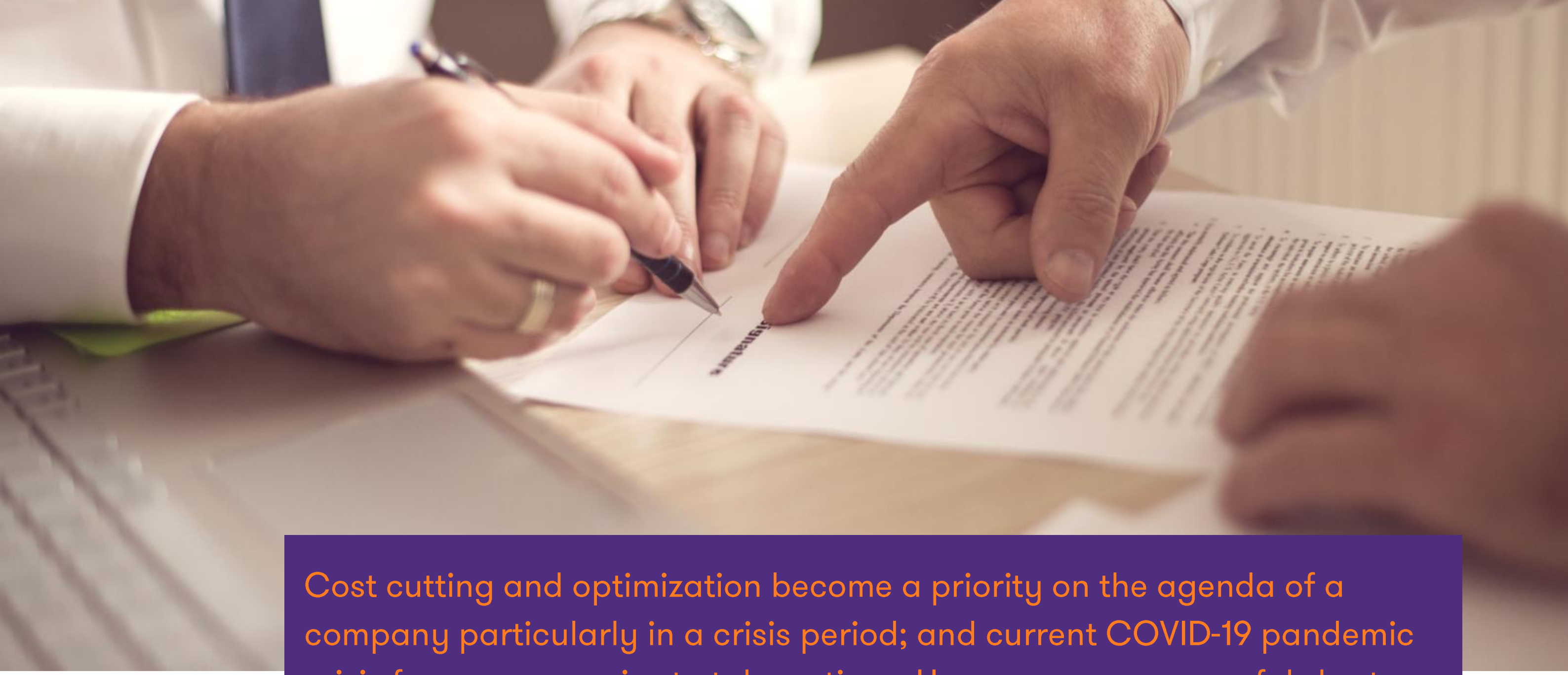
To make cost optimization continuous, a complementary culture and mindset should be established in the company together with the implementation of cost and performance management systems. The identification of costs which are important and the ones that can be decreased or eliminated, becomes easier if:

- performance of the business is based on clearly defined objectives
- profit maximization and customer value creation are the underlying goals for everyone's performance
- people understand what drives the result

This kind of culture creates less resistance once cost optimization becomes an actual topic, as it is better understood and easier accepted by the personnel. On the contrary, cost optimization will create constraints and discontent in a corporate culture with a consumerism attitude towards the business, where the reasons why costs should be kept under control and how result is generated is not clearly perceived by the staff.

To continuously optimize costs, companies must improve their processes and build competency in cost management. Rethinking common practices in cost management should help to realize this goal. In particular, achieving a more fine-grained perspective on where costs occur should be a centerpiece of any successful cost management program. Moreover, sustainable improvement in such areas requires companies to be willing to make significant changes to how products and services are designed and delivered—and to develop a more sophisticated understanding of how customers perceive the value of product and service features.

Hence, one-time effort of reducing cost is a short-term measure, but it is efficient when it is based on an initial cost management effort: a capability of sustainable cost management approach is developed to keep costs under control and increase the profitability of the company.



Cost cutting and optimization become a priority on the agenda of a company particularly in a crisis period; and current COVID-19 pandemic crisis forces companies to take actions. However, any successful short-term results need to also be converted to a long-run effect.

For this, we recommend:

1	To back-up cost cutting decisions by a detailed analysis of expenses and cost drivers so that the future growth of the company is not put at risk;
2	To match cost reduction to the company's strategy and apply thoughtful approaches when optimizing costs, avoid cutting across the board just to achieve the target;
3	To put in place support and surveillance of top management;
4	To create a culture driven by profit optimization and customer value creation, which will support the common understanding and acceptance of cost reduction and continuous cost optimization measures by managers and employees.

Grant Thornton experts will guide every business in this challenging task. Our business consultants will help develop effective cost cutting strategies, suggest cost optimization measures and support implementation of necessary systems and management accounting principles, processes and procedures, regardless of the industry the company operates in.

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