



Unlocking hidden efficiency reserves – boosting performance through focused and sustainable cost saving programs

by Stefan Heppelmann, Konstantin Wrona and Dimitri Belobokov

Management Summary

Almost every company has been sent on the journey of cost saving programs at least once in its lifetime. The purpose of these initiatives may differ from short-term cash generation to increasing operational efficiency as a base for future profitable growth.

The outcome of these programs is more often than not disappointing: Expected cost savings are not realized and – even worse – sustainability of implemented initiatives and actions is often low. In reality most programs look like defensive acts of desperation rather than targeted efficiency improvements. In the past an undifferentiated motto “10% improvements are always possible” led to undifferentiated, across the board cost cutting. However, for an active management team cost saving initiatives offer the chance to unlock enormous efficiency reserves slumbering in every organization. Focusing on the powerful driver of operational performance improvements is a real chance for substantial value creation if some simple principles are followed. Sustainable results and long-term success is based on three main principles:

1. Start from processes instead of cost centers and headcount
2. Attack structural root causes of inefficiencies
3. Control effects of single initiatives and actions intensively and keep up pressure until effects have materialized in the P&L and Cash Flow statement

Introduction

Cost reduction and earning improvement initiatives stress every company – but they are necessary tools for managing businesses over economic cycles. These programs have been implemented more or less successfully in the past and will inevitably also be applied in the future. They all follow in principle a very simple idea: streamline processes and organizational set-ups to reduce costs and improve cash flow.

How effective are such initiatives? On the one hand, they have undoubtedly contributed to good results in the past few years in Europe and partially in the US, and they also supported the quick recovery of some companies recently. On the other hand, a deeper analysis shows that most of these programs did not realize everything that was possible. Many efficiency potentials were either not touched upon or only touched upon half-heartedly. Only a part of the claimed savings in the project reporting also actually ended up improving earnings. In other cases, the measures were only of short duration – a year later the inefficiencies appeared again – only hidden somewhere else. And there is no indication why future programs should not end in the same trap.

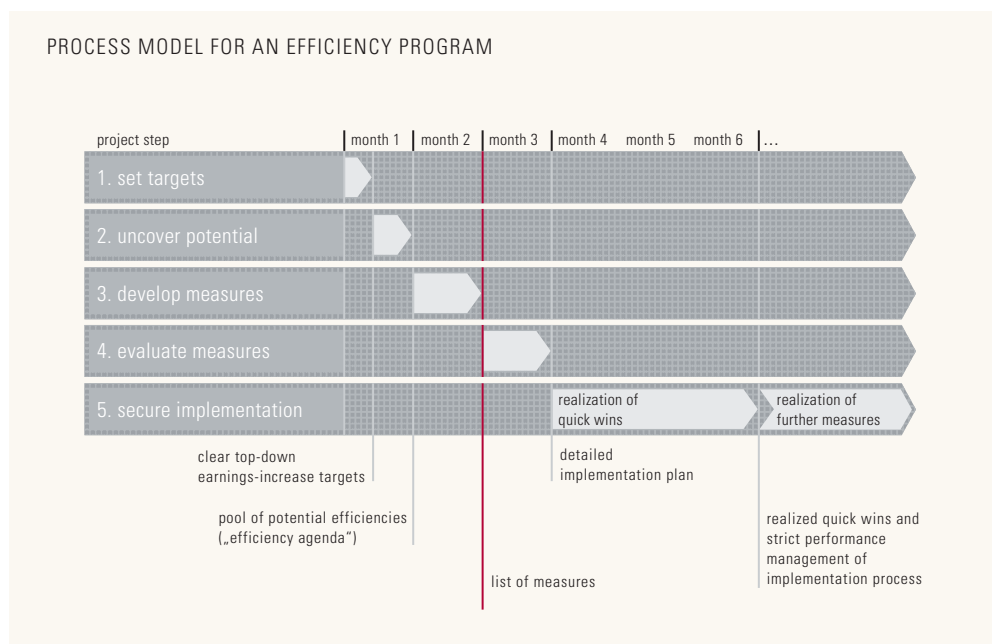
A reason for that is that savings targets are quite often being distributed along the functional organization following the lawn mower principle. Thus, every division tries to realize efficiency reserves out of its own processes. Unfortunately, strong inefficiencies are often located at the interfaces of processes. These are not eliminated but only moved further on along the value chain.

Another reason for untapped potentials is short-term focus. Earnings increase programs need to deliver quickly by nature. That is the reason for starting many small measures in order to treat the symptoms and produce immediate results. But often, no one dares to touch upon the real potentials and their causes – as the necessary changes loom too threatening. Moreover, many measures fail in implementation. When the first hurdles appear, implementation drags itself out too long or comes to a halt.

In the following we will present a process model of how to create more efficient and effective efficiency programs.

Effectively implement efficiency programs

An efficiency program typically follows a 5-phase approach. The duration of each step can vary according to company size; the process model though tends to be very similar:



Get up to speed quickly at the beginning:

Status quo analysis, allocation of costs and capacities as well as negotiations about target distribution within the company should be done quickly. On average after two months, measures have been attached to the targets; after six months there are clear results.

Act more consequentially at the end:

Controlling of measure implementation is being pursued until the monetary result is visible in the P&L and sustainability is secured.

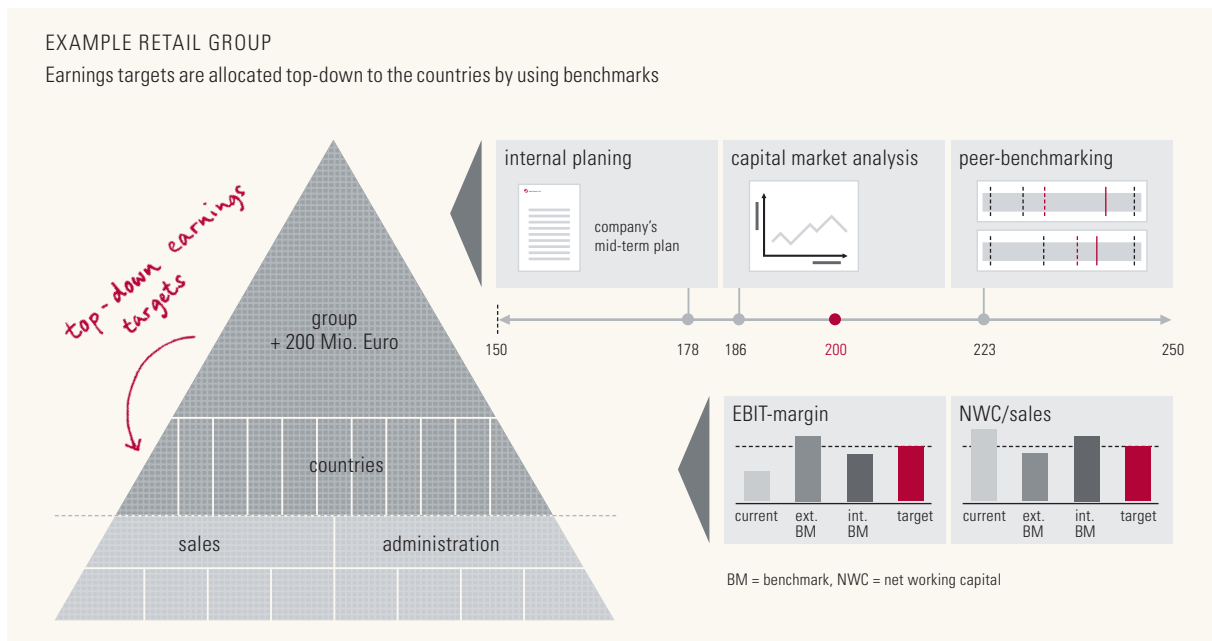
In the following the 5 steps will be described in detail.

Set targets

The first step serves to establish and/or to increase pressure for realizing efficiency gains in the operating units. For the definition of targets a “starting level” is needed – this is defined on the basis of existing data. The allocation of actual costs and current personnel capacities to the processes is only pursued at the top process level, in special cases possibly one level below. The documentation of activities at level 5 to 6 with an exactness of less than one full-time-equivalent is never a precondition for the identification of potentials. If that is necessary for the evaluation and implementation of measures it is better applied on a case-by-case basis in later project phases.

It is the responsibility of the company’s management to provide a quantified earnings or cash flow increase target for every operating unit. While doing this, it is very important to avoid (a) time consuming discussions about target distribution and (b) losing oneself in details. Two recommendations help to achieve this:

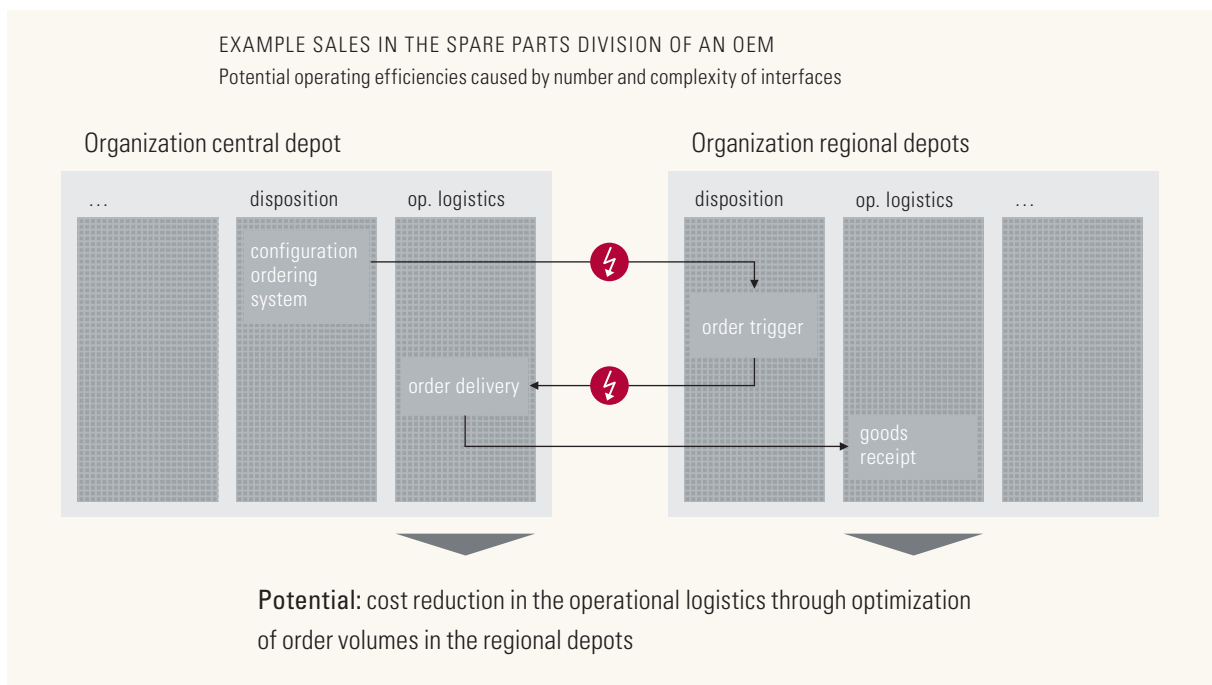
1. Limit specifications of targets for earnings and cash flow increase to levels within the organization where an integrated optimization of the process value chain is possible
2. Set targets top-down, but use internal and external benchmarks to validate them



At the end of this step, every operating management team knows the target of its earnings or cash flow improvement.

Uncover potential

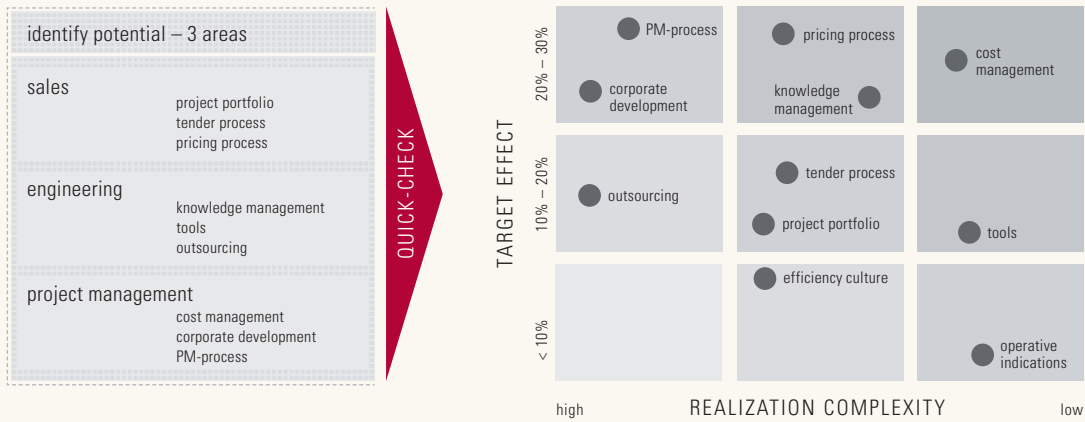
The goal of this step is the quick determination of substantial potential cost savings on the basis of an efficient status quo analysis. Again, it is not about detailed modelling of current processes but about understanding the logical coherency in the company's value chain. The goal is to lay bare the interfaces and therefore to map the known business model process structures into the organizational structure. From this result, hypotheses regarding efficiency potentials can be directly derived. As we have seen for example in the spare parts business of an OEM, the strongest cost driver in the centralized logistic center was the ordering process of decentrally located internal customers. Because of the way the system operates, the ordering process was also strongly influenced by the materials planning department – and that's precisely also where the biggest cost reduction lever has been identified.



Identified potential efficiencies are then submitted to a "quick check". Based on a qualitative criteria catalogue potentials are classified with regard to estimated target contribution and to realization complexity. On the one hand, this results in a clear prioritization of potential efficiencies. On the other hand, it is already the first test whether the target efficiencies can be made: In this phase, we recommend that the sum of the potential efficiencies identified to be followed upon should be at least 150% of the total savings target.

EXAMPLE INDUSTRIAL SERVICE COMPANY

potential prioritized according to realization complexity and target effect



Only a few weeks of analytical work by the project team are needed to identify and prioritize potential efficiencies, plus 2–3 workshops with business unit and line management. This project step results in the creation of an “efficiency agenda”. It also leads to a realistic number of priority cost savings for the business to which clear actions or measures can be attached to in the next step.

EXAMPLE WASTE MANAGEMENT COMPANY

An efficiency agenda lists the starting points for measure definitions

core process	potential	priority	responsibility
sales/ sales management	<ul style="list-style-type: none"> simplification of supplementary contracts standardization of test process increase attestation limit 	<ul style="list-style-type: none"> A B C 	<ul style="list-style-type: none">
finance	<ul style="list-style-type: none"> automation accounts clearing optical archival storage invoicing / dunning 	<ul style="list-style-type: none"> A C B 	<ul style="list-style-type: none">
IT	<ul style="list-style-type: none"> introduction of clearance system inclusion of data and system history 	<ul style="list-style-type: none"> B C 	<ul style="list-style-type: none">
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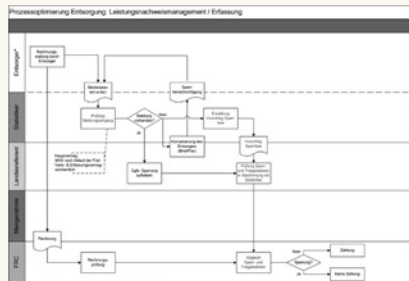
Develop measures – attack the root-causes

This step it is about identifying the causes of inefficiencies and defining clear measures to eliminate them. Firstly, every efficiency target is analyzed through roll back analysis in order to determine the link between the cause and the symptoms. On demand, focused process and system analysis as well as the interpretation of the operational data are applied. Following this approach inefficiencies are precisely located and their monetary effect can be approximated.

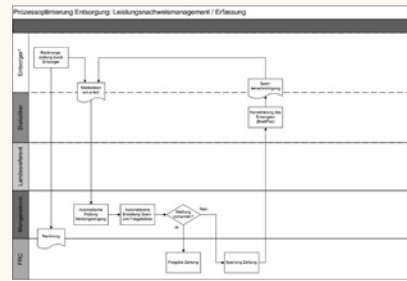
EXAMPLE INSURANCE COMPANY

Process optimization in the damage department:
standardization of identical processes, process variety is reduced

Before optimization



After optimization



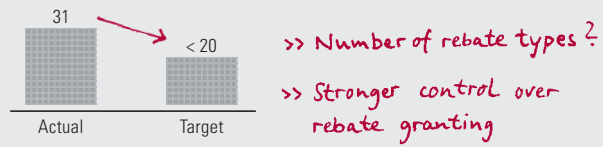
Depending on the causes of inefficiencies, improvement measures are defined for every potential along the following dimensions: processes, systems, operating resources, organizational structure and knowledge as well as target- and incentive system. First, the short-term measures with immediate monetary results ("quick wins") are identified followed by measures dealing with the primary causes of the inefficiency.

EXAMPLE CONSUMER GOODS COMPANY

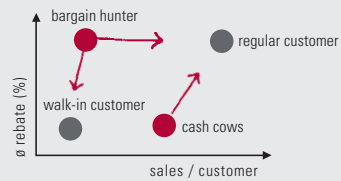
Short-term improvement of margins and sustainable optimization of the pricing process

Quick wins

1. Simplification of rebate system



2. Adjustment of customer contracts



Measures for sustainability

3. Creation of transparency regarding margins

Introduction of margin controls

4. Extension of target system for sales

Focused in profit margin instead of sales

5. Optimization of pricing process

Clear process incorporating good and timely dialogues between R&D/innovation, marketing/pricing, product management and sales regions

The result of all this is a comprehensive list of measures which shows how potential efficiencies can be achieved on a sustainable basis.

Evaluate measures

The goals of this step are to identify the precise origins of the savings opportunities (one by one) and to evaluate the impact on earnings of making these efficiency savings.

First the timeframe within which the benefits can be achieved are assessed. Then, the value of the expected cost savings or earnings improvements taking into account implementation costs and needed investments are assessed. In order to ensure successful implementation all monetary effects are categorized according to type (sales, personnel and material costs, net working capital, etc.), location (profit center, cost position) as well as time of realization (year, quarter).

In addition to this, measures are also examined with respect to their non-monetary (non-P&L) aspects. This includes system benefits (e.g. when they are necessary for ensuring the sustainability of other measures) and potential implementation risks.

A key success factor is to include everything in one measure scorecard. From this point in time onwards the owner of each measure is also identified and included. He or she is individual responsible for implementing each measure. These measure scorecards are also very valuable project management tool in the subsequent implementation phase.

EXAMPLE TELECOMMUNICATIONS COMPANY

Measure scorecards summarize all effects and ensure implementation controlling

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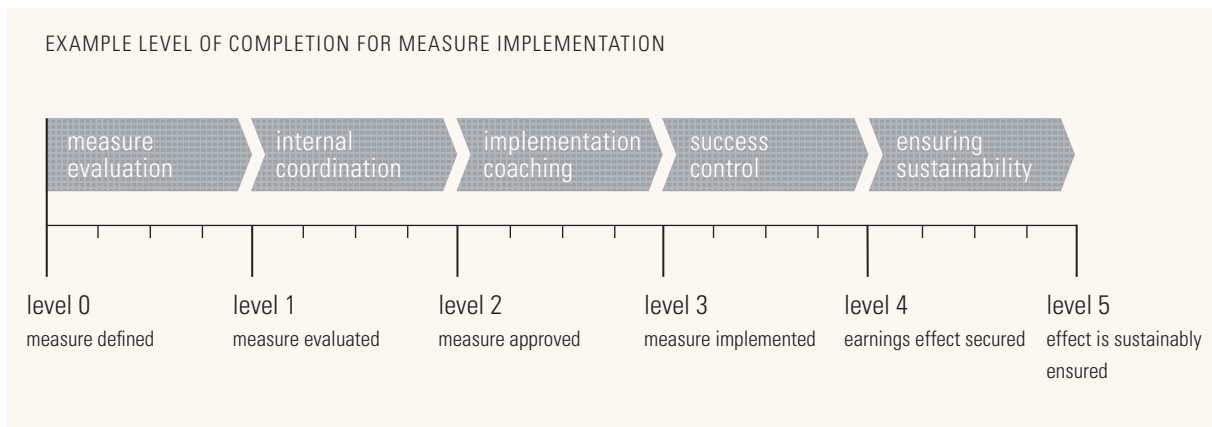
At the end of this project step, all potential cost savings are linked directly to measures that will be taken to deliver them. The project can only be deemed to be “on track” if the cumulated financial effect of all the measure scorecards – reduced by the implementation costs – is at least 120% of the target total desired savings.

Financial effects of all measures are aggregated by responsibility area (e.g. business units, divisions, functions, groups). Thus, not only the measure owners but also the heads of respective business units or functions are responsible for realizing the effects of the measures. Moreover, this secures the inclusion of all effects in budgets and forecasts.

Secure implementation

In a last step, measures have to be implemented and the potential cost savings realized. In this phase it makes sense to structure the program into many sub-projects usually according to the size of the potential cost savings. Responsibility for implementation lies typically decentrally with the respective business unit management. It has been shown over and over again that the size of the cost savings achieved i.e. which ultimately find their way into the P&L-statement depends on having an effective central project office to guide, oversee, coordinate and quality control activities as well as to communicate to the organization.

Central program management is necessary until the effects of measures taken are visible in the P&L. Even after that, this tool is still beneficial for a period to ensure the benefits are sustained. In order to keep the pressure on throughout the implementation “realization levels” can be used – in this way no measure should be described as implemented until its potential is actually realized.



In the implementation phase though, some simple factors determine the success of the whole program. Following these principles requires empowered, highly skilled and effective project management:

- Allocate responsibility for measures and for their expected results to specific individual managers
- Demonstrate continuously and clearly that the program is at the top of the company's management agenda
- Manage the realization of the cost savings very diligently – if necessary even at the level of single cost categories. This is especially true for savings measures in the overhead area – personnel costs there tend to show a very strong inertia despite process optimization
- Ensure coordination between sub-projects and that information and communication flows through a highly effective central program office
- Communicate the purpose progress of the program frequently and clearly, using a variety of vehicles communication methods throughout the organization
- Support program management with simple, intuitive tools and frameworks

EXAMPLE RETAIL GROUP

Simple and effective program management tool

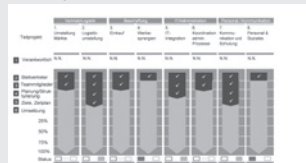
controlling of milestones



list of potential measures

Maßnahme	Maßnahme	Start	Ende	Status
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early warning indicator



overview of potential cost savings

Maßnahme	Maßnahme	Start	Ende	Status
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Summary

In closing, we list the primary success factors of corporate efficiency savings programs:

- Don't get bogged down in exhaustive data and process analysis at the beginning of the process. Focus efforts on identifying the most significant savings opportunities and quick wins.
- Do attack inefficiencies at the process interfaces – this is where they tend to “hide”
- Focus on achieving the highest value savings rather than on many little cost savings measures
- Realize quick wins and eliminate important causes for inefficiencies
- Assign personal responsibility for each cost savings measure and the subsequent results
- Pinpoint the sources of the inefficiencies and manage their cost savings specifically through to the P&L
- Apply pressure until all P&L-effects are achieved sustainably

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