

Cost Savings That Stick

Most CFOs Focus on Cost-Cutting Efforts on Large SG&A Line Items; Elite Cost Cutters Achieve Sustainable Savings by Focusing on Sources of Variance in Cost of Goods Sold

EXECUTIVE SUMMARY

- ▶ Nearly 90% of companies fail to sustain cost reductions for more than three years.
- ▶ While most Chief Financial Officers are quick to cut overhead (SG&A) to achieve cost-reduction goals, companies that **maintain** cost reductions over the long term actually spend more on SG&A to help the business drive operational efficiency and reduce cost of goods sold (CoGS).
- ▶ Elite cost-cutting companies sustain gross margin expansion by 2.5% annually across five years, generating more than \$50 million in savings on average.

Circulate To:

- ▶ Cost-Reduction Project Team
- ▶ Senior Finance Management
- ▶ Business Leaders

Contact the Board

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Results from Cost-Cutting Campaigns Prove Alarming Temporary

Nearly 90% of companies fail to sustain cost reductions more than three years.

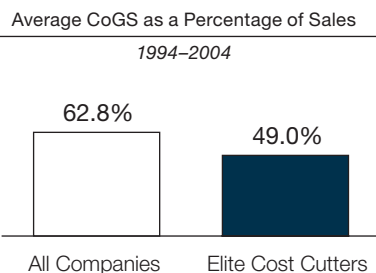
Companies that want to cut costs due to market pressures or other external forces tend to focus on the large variable costs that can have an immediate, significant impact (e.g., IT spend, travel and entertainment, administrative staff). Unfortunately, as soon as the external pressure is gone, these costs creep back into the cost base.

We examined 230 major corporate cost-cutting initiatives at S&P 500 companies from 1999–2004. In the first year, only 100 companies, or 43%, achieved cost reductions. After three years, that number has fallen to 24 companies, or only 11%. We have tagged the companies that generated lasting cost-efficiencies as elite cost cutters.

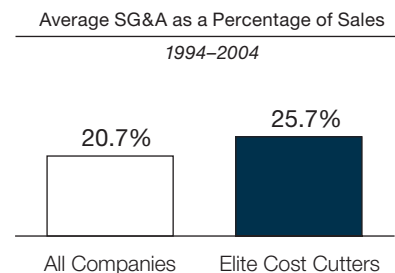
Sustainable Cost Reduction Comes from CoGS, Not SG&A

While most Chief Financial Officers are quick to cut overhead (SG&A) to achieve cost-reduction goals, the companies that are able to maintain cost reductions over the long term spend more on SG&A as a leveraged way to help the business drive operational efficiency and reduce cost of goods sold.

Elite cost cutters have focused on controlling CoGS expenses...



...while tolerating higher SG&A expenses



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2. For more cost-management findings, visit our Web site at www.cfo.executiveboard.com

Indeed, while elite cost cutters have much lower costs of goods sold, they maintain slightly higher SG&A costs than their peers. These elite firms make leveraged investments in the corporate center on staff who help identify systemic costs associated with corporate complexity and supply chain improvement opportunities. These resources help efficient cost cutters avoid two common traps:

- ▶ **Trap #1: Delegate Cost Cutting to the Line**
 - Delegating cost cutting to the line often results in cuts to long term projects, not to the lowest-return projects. Central staff focused on operational improvements can provide a cross-company view to objectively identify areas with the greatest impact on the firm's cost base, not just set overall cost-reduction targets for the firm.
- ▶ **Trap #2: Underestimate the Cost of Complexity**
 - Increasing the number of products or services can result in a disproportionate increase in systemic costs distributed across the company. Failing to estimate and account for these complexity costs can lead companies to make bad decisions about launching new products or entering new markets.

Sustainable Advantage

Elite cost-cutting companies sustain gross margin expansion by 2.5% annually across five years, generating more than \$50 million in savings on average.

By focusing cost cutting on operational efficiency rather than overhead, elite cost cutters are able to boost return on equity relative to peers without sacrificing growth. Indeed, elite cost cutters are rewarded by investors with price/earning multiples 15% higher than their peers on average.

▶ *How much do your processes cost from a cross-functional perspective?*



Clorox evaluated ideal costs for their critical processes by mapping them and tracking resource consumption.

▶ *How much is product or market complexity costing your business?*



By deriving complexity-cost estimates for its product portfolio, HP identified and pruned unprofitable SKUs, generating \$4 million of savings in its desktop PC business alone.

▶ *Do your line managers know how their actions really impact the bottom line?*



Johnson & Johnson developed a clear framework for managers to know how operational metrics link to financial metrics.

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