Enterprise Cost Management

AVOIDING COMMON TRAPS

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Enterprise Cost Management

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Introduction

ANOTHER WAY OF LOOKING AT COST CUTTING

Introduction

- Why manage costs?
  - Reduce cash requirements
  - Stable cash flows
  - Lower risks

Introduction

Cut the fat

Keep some slack

Business

- What is a business?
  - Islands of prosperity
  - In a sea of red ink

Business

- Who lives on those islands?

GOOD (PROFITABLE) CUSTOMERS

Business

- Who are swimming in the sea?

BAD

(UNPROFITABLE) CUSTOMERS

Business

NO
CUSTOMERS
NO
BUSINESS

Common Traps

- Cutting without looking
- The position of customers (*meaning?)*
- Not enough slack for emergencies

Business

- Activity based costing helps find:
  - Good customers
  - Bad customers

Example

	Good		Bad	
	%	$'000	%	$'000
Sales				
Manufactured	75.0	900	60.0	1,080
Resale	10.0	120	30.0	540
Services	15.0	180	10.0	180
	100.0	1,200	100.0	1,800
Gross Profit				
Manufactured	33.0	297	33.0	356
Resale	25.0	30	25.0	135
Services	40.0	72	40.0	72
	32.7	399	32.7	563
Expenses	#		#	
Sales Visits	4	10	12	30
Orders	50	9	112	20
Shipments	50	18	210	76
Invoices	12	7	210	123
Support Calls	2	2	104	104
		46		352
Interest		2		5
Referrals		(2)		-
Other - Allocated by Sales	19.5%	234	19.5%	351
		280		708
Pre-tax Profit (Loss)		119		(145)
Margin		9.9%		-8.0%

Customers

- Cut costs only by improving relationships with customers
- Help them need fewer resources
- Reduce their demands
- Find loss making activities that can be sold

Example

- Raising prices is hard

so

- Lower the level of the sea

Customers

- Customers are king in all businesses
- Customers are important to every activity
- No buyers no firm
- Strong customer relationships are key
- Create them through repeated interactions with buyers

Customers

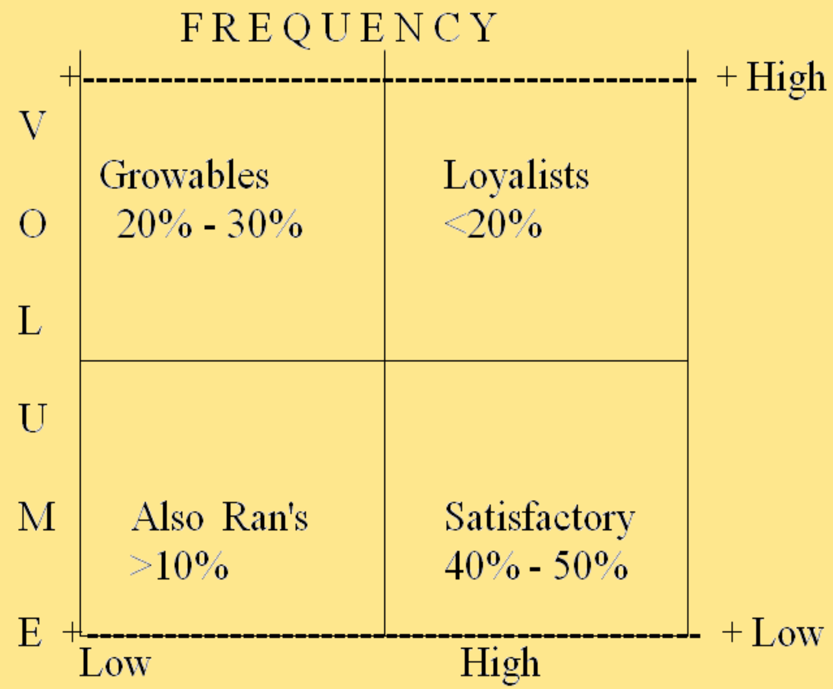
- Expectations of continuing sales to existing users are valuable intangible assets
- Many firms have been acquired just to gain access to them
- Customer relationships are among the most prevalent intangible assets even within large multi-line organizations

Customers

- Continuing long-term relationships with loyal customers is a primary objective
- Each interaction creates on-going financial benefits
- Customer relationships are a predominant driver of many firm's value
- It is the sum of the lifetime values of existing and future purchasers

Customers

- Customers can be grouped in several ways
- The Boston Consulting Group divides them into four categories



Customers

- Not all customers are equal
- The well-established 80:20 rule applies
- Profits come from "Loyalists" – the only customer relationships with value
- "Growables" and "Satisfactory" contribute to overhead and keep the firm alive
- "Also Ran's" reduce earnings

Customers

- When cutting costs

Do Not

Cut

Customers

Common traps

- Top “cost cutting” activities:
  - Lowering advertising expenditures
  - Reducing R&D/new product launches
- Advertising and new products help generate additional customers and improve positions of existing ones

Customers

- Of your business what percentages are "bad" (unprofitable)?
  - Customers
  - Orders
  - Product lines

Customers

- For a US distributor of lab supplies the "bad" figures were:

	<u>**Divisions**</u>	<u>**Overall**</u>
Customers	29% to 42%	33%
Orders	23% to 50%	35%
Product lines	38% to 45%	40%

Activities

- Where can we cut costs?
  - Services for bad customers
  - Delivery for bad orders
  - Support for bad products

Activities

- Redesign services for unprofitable customers
- Limit deliveries for bad orders
- Change support for bad product lines

Activities

- Dell Corp. is a wonderful example

IT SELLS WHAT IT HAS ON HAND

- Limits unprofitable orders

Profit Maps

- How do we know when to cut?

PROFIT MAPS

Profit Maps

- A form of activity based costing that develops, analyses & models a few months transactions
- The next slide illustrates how it might be done
- Choose categories that matter to you

Profit Maps

	Good		Bad	
	%	$'000	%	$'000
Sales				
Manufactured	75.0	900	60.0	1,080
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Profit Maps

- Include all sales
- Pick up every cost even if not apparent "angels" share of inventories
- Allocate everything
  - general overhead
  - interest derivatives
  - taxes, etc.
- Use simple rules
- Accept some inaccuracy – 70% is okay
- Get down to Net Income

Modelling

- Model one large and one small typical customer for each market segment
- Compare fast moving and normal items for each product family
- Use 6 to 12 examples

Modelling

- For each case look at profit drivers
  - Revenue
  - Margins
  - Costs

Modelling

- Try different configurations changing
  - Sales patterns
  - Delivery intervals
  - Service levels
  - Pricing policies
  - Product mix

Modelling

- This should provide knowledge of:
  - Which elements can easily be altered?
  - What will be the effect?
  - Customers' reaction to potential changes?
  - How the staff will respond?

Modelling

- Project the results to the whole business
- Divide it into clusters or areas similar to each of the modelled cases
- Have the islands of prosperity grown?
- How has the sea of red ink changed?

Essential Activities

- Secure the profitable customers
- Improve the profitability of the multitude
- Cut costs where there is little hope
- Maintain slack for emergencies

Avoiding Common Traps

Thank you

Questions?