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Cost reduction: Bridging the gap

Making cost savings real and making them stick

Introduction

It is a time of low growth. The Canadian dollar has fallen against the US dollar to a value not seen in more than a decade, putting entire sectors of the economy at risk. Oil prices have plummeted below US$30 per barrel, and tens of thousands of jobs related to the oil sector in Alberta and across Canada were lost in 2015. We are, once again, hearing the dreaded "R" word.

While the challenges of a low-growth environment such as this might call for a whole range of responses, cost reduction remains among the most common and effective—provided it's done right.

Unfortunately, almost 50 percent of companies that pursue cost reduction measures fail to meet their targets. In many cases, targeted savings fail to be realized, ultimately leaving profitability improvement on the table. Realized cost savings are increasingly difficult to sustain year after year, the impact of which is exacerbated by the low-growth and highly competitive environment.

Experience shows that cost savings are lost across multiple points in a cost reduction program. Whether during planning, validation, execution or implementation, program weaknesses occur that lead to failure. However, proven tactics can bring appropriate process and discipline to the program, which mitigate risk and accelerate the realization of savings.

Cost reduction is driven by competition and growth[1]:

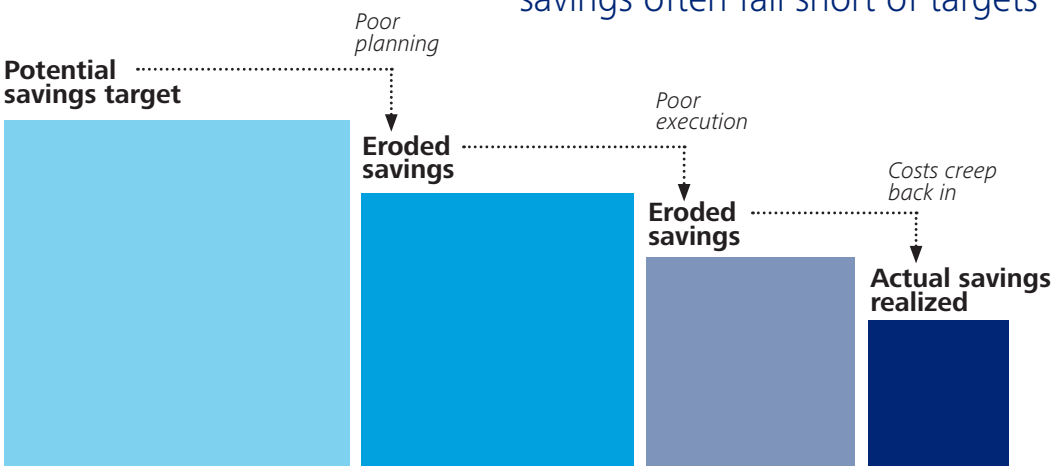
- Most use cost reduction to rapidly improve financial results
- 65 percent of companies are reducing costs to gain competitive advantage
- Over 50 percent are using it to support investment in growth areas

[1]Deloitte. *Save to grow—Deloitte's third biennial cost survey: cost-improvement practices and trends in the Fortune 1000.*

This paper explores a range of challenges that can derail cost reduction efforts and considers ways to overcome them at different points in a typical cost reduction program. Phase 1, "Setting the stage," is concerned with strategy and planning: deciding and articulating what the targeted savings are, where they will come from, who is accountable for them, and how they will be achieved. Phase 2, "Driving execution," is about putting the plan into action and committing the resources to achieve the targeted savings. Finally, Phase 3, "Keeping costs out," considers the actions and decisions that need to be taken after the targeted savings have been realized to ensure they stick and that costs don't creep back in.

The secret is in not just identifying the savings, but making them real and making them stick.

The cost reduction gap: realized savings often fall short of targets



Almost **50%** of companies undertaking cost reduction initiatives **fail to meet their cost reduction targets**. In many cases, potential savings are susceptible to erosion throughout the program.

Tactics to accelerate the realization of savings

01 **Setting the stage**
Set the tone, targets, team, and leadership

02 **Driving execution**
Implement, execute

03 **Keeping costs out**
Monitor, measure, and embed a cost culture

Setting the stage

A cost reduction program should have a clear beginning that visualizes its own end. Best practice cost reduction programs are led by senior leadership with strong decision making that quickly set the tone, outline the program rationale, and establish organizational priorities. Successful cost reduction programs:

1. Set specific and tangible targets
2. Are aligned with strategic priorities
3. Establish program leadership and accountability

Target for success

Picking a number is easy; setting an effective target is something else.

Too often in cost reduction programs, conservative targets are set because they are viewed as minimally invasive and readily achievable. While these savings may be realized, the organization is leaving profit improvement on the table for the sake of minimizing disruption and gaining consensus. At the other extreme, some companies set overly aggressive targets that are simply unachievable. These situations undermine the program team's ability to identify and execute on the savings. The most successful cost reduction programs set ambitious yet achievable targets that create healthy organizational tension. They require strong leadership and persistence to fully realize the savings.

One approach to target setting is the application of annual zero-based budgeting. On the rise, zero-based budgeting requires managers to plan each year's budget anew. This level of cost discipline requires them to analyze structure, processes, and expenditures annually and shift spending in accordance with cost targets and changing business priorities.

Benchmarks are also a frequent consideration of organizations setting cost reduction targets. While they present useful data points on which to reflect, they do not tell the whole story. In some instances, organizations use benchmarks as the key determining factor in setting targets, without the appropriate understanding of the organization's context. Directionally, a benchmark can be a useful reference, but the unique circumstances of an individual business and its nuances limit a benchmark's direct applicability. Further, benchmarks developed entirely inside the organization may not adequately reflect industry standards or best practices. To be safe, benchmarks should be used more to *inform* than to *drive* the process.

There is no single answer for what the right cost reduction target should be. Experience does show that a savings target in the range of 10 to 30 percent is commonly achievable when backed up by a properly structured program. Higher savings can be achieved in situations where more extensive change and transformation is at play and steadfast commitment from leadership is present. Best practice suggests to err on the side of ambition when striking a balance between too easy and too much—it's usually much less palatable to revise expectations upward after the program launch.

Cost reduction programs set ambitious yet achievable targets that create healthy organizational tension.

While setting a target is critical, the most crucial activity in planning a cost reduction program is the *validation* of the savings target's achievability. In the majority of cost reduction efforts that fall short of targets, a key underlying reason for failure is a lack of savings opportunity validation from the outset. The most successful cost reduction programs spend time validating the proposed savings at a more granular level, often using a bottoms-up and/or zero-based approach. This includes translating overall corporate goals into each division and function of the organization, identifying the specific initiatives and changes that need to be undertaken, and gaining confidence that they can be realized. Successful initiatives always challenge core assumptions and legacy decisions, leaving as few stones unturned as possible.

Key actions, dependencies, timing and ownership for each cost reduction initiative (whether they be related to headcount, operating or capital expense, discretionary or non-discretionary spend) should be outlined at this stage and form the execution plan. Each valid savings initiative should be rolled up and compared to the overall target so that any shortfalls can be addressed before moving into execution.

Feedback from successful organizations suggests that this kind of bottom-up stress testing and analysis of the savings target ensures appropriate input is obtained from the organization and helps build trust and enterprise-wide acceptance of the program.

Three out of four companies say their biggest barriers to effectively meeting cost reduction targets are:

- Employees not understanding the need or benefits
- Failure to fully validate cost initiatives, which erodes savings

No strategic alignment, no dice

Simply put, cost reduction efforts misaligned with corporate objectives can lead to wasted efforts and may do more harm than good.

The problem could be as simple as failing to communicate the complexity and urgency of the program and how cost reduction objectives align with the company's strategic priorities. In other cases, it might not be clear to those charged with identifying the savings that achieving the target is a necessity. It must be clear to the organization that competing priorities do not supersede the importance of the cost reduction program.

Frequently, cost reduction programs start well with top-level, executive support. But leadership and ownership accountability can degrade when the detailed planning and execution grind begins. Competing interests that pull the program in different ways can be a real problem. A successful program cannot be delivered alone by a few key leaders; cost reduction is a team sport. Engaging a team of leaders at various levels of the organization is a key success factor—everybody needs to be on the same page and playing their part. Functional and area leaders must be willing to take ownership, work collaboratively, get into the details, and commit to making the effort a success from start to finish.

Strategic alignment requires both a short-term and long-term outlook.

CFO/COOs routinely sponsor cost reduction programs. Successful sponsorship includes early and active participation throughout the process. However, cost reduction is not solely the responsibility of Finance or Operations. To truly get costs out, leadership and engagement across all functions is required.

Moreover, strategic alignment requires both a short-term and long-term outlook. Hitting a series of short-term objectives—often through across-the-board cuts that are simpler to implement—may appease shareholders, but sometimes results in targeting only the *symptoms* of costs rather than their *causes*.

Figureheads need feet

A cost reduction program needs executive commitment, expertise, ownership and relentless energy and capacity—not just a sponsor. Often, the individual charged with leading the effort also has other critical organizational responsibilities. This brings a "capability vs. capacity paradox" into play, which organizations can struggle to solve as they undertake their cost reduction program.

Driving execution

Effective execution is crucial if planned cost savings are to materialize. In the execution stage, cost savings are lost for various reasons:

1. Setting an inadequate governance and accountability structure
2. Building a 'set-and-forget' plan vs. rigorous tracking of results
3. Allocating insufficient resources to get the job done

Identified savings are not booked savings. The real work begins as the organization works to realize actual savings. To that end, the organization must ensure the right people—working with the right priorities, parameters and capacity—are in place to get the job done.

Robust governance is key to sucessful execution

With a variety of ways to manage a cost reduction program, divergent approaches can evolve across an organization's functions and divisions. Without centralized direction or oversight, what is executed and how it is executed may not be aligned with the plan.

Successful cost reduction requires a consistent and measurable program that includes governance and dedicated project management. Best practices include establishing detailed work plans by function and/or division, deploying consistent tools and templates, outlining clear role accountabilities across the organization, and defining a forum and cadence to track execution progress.

This level of oversight is often marginalized after the target-setting stage or viewed as unnecessary structure. However, driving the coordination of efforts across complex cross-functional dimensions is not a part-time job. Successfully implementing the identified changes creates disruption and requires a focused resource effort that many organizations are not equipped to deal with as a matter of course while also juggling the responsibilities of ongoing business operations.

In this regard, a dedicated project management office (PMO) is critical for creating the necessary governance and accountability. It enables the business to focus on the key tasks of execution and provides structure to improve the visibility, leadership, and results of the program. The PMO can also manage behind-the-scenes noise (e.g., competing initiatives, hand-offs, plan updates, communications, etc.) that can derail effort or distract.

> An effective cost reduction PMO can be structured and scaled to suit any situation and is a proven means to enable the execution of targeted savings.

The need for formal coordination, templates, and dedicated management will vary with the size, opportunity, and complexity of the program. In setting a cost reduction PMO, some factors to consider include:

Coverage: Is this meant to be an enterprise-wide initiative or focused on a particular division? Is the footprint national, regional, or local? Increased geographic separation and need for enterprise-wide cooperation will heighten complexity.

Visibility: What are the reporting requirements to varying stakeholder groups (e.g., board, leadership committees)? The need to keep various stakeholder groups apprised of activity and results requires a centralized and sufficiently detailed view of progress, with a common way to report results for discussion.

Culture: Capabilities to drive a cost reduction program will vary and will be significantly influenced by the existing cost culture. The lower the sophistication, the greater the need for formal coordination by the organization to channel efforts in the right direction.

Change: The level of change being contemplated with initial targets can largely influence the need for a dedicated PMO. In many cases, as the organization removes costs, they overlook what is left over. Similarly, unplanned outcomes can result. A PMO will address and mitigate unintended consequences.

Timing: The urgency to drive results (next month, next quarter or next year) will influence the PMO's nature and role. A PMO can help bring and sustain a heightened sense of urgency to achieve results.

The old adage that what gets measured gets done holds true for organizations seeking to reduce costs and sustain them on an ongoing basis.

Effective tracking drives accountability and therefore results

Successful cost reduction programs have a rigorously documented cost reduction plan that enables real-time tracking and incorporates the financial impacts (savings) of each executed activity. This plan is critical to the PMO and leadership to control and monitor the program.

Insufficient tracking has resulted in many organizations failing to identify risks and issues to achieving the cost reduction plan, resulting in an unexpected shortfall. The degree of tracking can scale with the program, but the need for an integrated and real-time view of progress will not.

It's necessary to consider what appropriate tracking and reporting looks like in each situation to achieve savings and drive accountability. Experience shows reporting and monitoring frequently follow extremes, with a tendency to be too simplified or too complex. Over-tracking—using overly complex metrics, for example, or tracking unnecessary granularity—can lead to excessive administration. Under-tracking—using high-level or non-specific metrics to track and attribute progress toward targets—results in an inability to understand what is not working. Once the right level of reporting is identified, there should also be objective resources (sourced from Finance or elsewhere) whose sole focus is validating, tracking, and measuring results in order to hold both the organization and individuals accountable.

Moreover, there must always be a singular version of the truth. A common baseline against which to measure savings is frequently absent in cost reduction programs that fail. Additionally, a basic definition of what actually constitutes a "saving" in the context of the program should also be considered. This will mitigate the risk of claiming savings from other initiatives or earlier programs that may already be underway or realized. In the event of disagreement, the final decision should rest with one individual—the cost program champion or leader—to ensure consistency and fairness.

Finally, establishing a consistent cadence to tracking is key. This includes the frequency of follow-up with business owners accountable for achieving cost savings, as well as clear and consistent timetables for reviewing results. The right cadence directs focus and maintains execution momentum. In most successful programs, activity includes weekly check-points for business owners and the PMO to ensure savings are on track, with periodic updates to senior leaders. Reports and KPIs are not, however, a substitute for real dialogue between program owners and leaders.

Programs too often lack horsepower

Cost reduction is typically higher on executive priority lists than those of the front-line leaders charged with delivering the results. It comes down to the sheer number of competing responsibilities. Project success requires commitment—not just *to* the ideas but *of* the necessary resources to get it done.

It is true that as organizations have become leaner, time and resources are increasingly scarce. Stakeholders to a cost reduction program sometimes put their day jobs ahead of the program objectives. While part-time engagement in cost reduction has the potential to grab some low-hanging fruit, a successful program requires more than a few hours a week to achieve results. Experience shows that the expected annualized benefits of a cost reduction program are several multiples of the upfront cost. This is key when cost reduction is competing with other organizational priorities or there is a need to ensure investment in dedicated resources is justified.

The hesitancy to commit resources is ironically a cost-based decision. How can we add more cost while trying to cut costs out? When done right, achieving the annualized benefits of a program will far outweigh the upfront costs. A challenging reality of cost reduction is that, as savings opportunities increase, they are also harder to realize. Why? Because complexity increases as well. Unprepared organizations end up abandoning real opportunities because they lack the necessary people time, know-how or financial resources to act.

With limited talent or resources, organizations need to prioritize, simplify, and consolidate the number of priority projects on the go. This often requires:

- **Refocusing existing effort that aligns to the right objectives.** Not all organizational pursuits are core to the business strategy. Often, companies will have built up lists of initiatives that they consider high priority. However, these initiatives and resource commitments need to be re-evaluated against current organizational priorities. Reducing the sheer volume of initiatives and rededicating effort will drive better enterprise-wide results.
- **Seeking dedicated support for a select period of time.** Not all organizations will be able to dedicate their own resources without compromising or creating risk to running the day-to-day business. Adding new full-time resources can add unnecessary ongoing costs. Looking at more flexible alternatives (e.g., contractors or consultants) can provide the necessary short-term support needed to drive cost reduction success. The cost of flexible resources that bring the necessary discipline, experience and tools can come at a fraction of the benefits achieved.
- **Managing efforts within a clearly defined time frame, rather than designating them as "ongoing."** Many organizations become victims of cost reduction fatigue, when programs fail to have a clear start and end. While good cost management behaviours should continue, the program itself should not. Clearly defining an end and what success looks like is critical to retaining focus and commitment. When there is an end in sight, stakeholders can be more focused on achieving results.

Keeping costs out

Organizational focus on ensuring that costs don't creep back is just as important as identifying and executing the savings in the first place. This includes:

1. Fully considering change management and communication needs
2. Embedding and maintaining a sustainable cost management culture

Change is always harder than expected

Change such as reconfiguring P&Ls, business models or organizational structures invariably raise more issues than the average organization is prepared to address as costs are taken out. Considering the upfront impact to people and process is one element, but support after the fact also plays a big role in how organizations manage the changes that inevitably stem from a cost reduction program. As an organization works through more significant or complex change efforts, details can be overlooked. As a result, organizations need to anticipate change requirements and be prepared to respond accordingly. Establishing a clear cost reduction change management plan—one that addresses strategy, stakeholder concerns, communication approach, project management, and risk mitigation—is vital to maintaining morale, driving new behaviour, and supporting achieved cost benefits. It's a complex process, and all leaders and employees tasked to support the program should be engaged from the outset.

For example, communications for the broader organization and external stakeholders need to be contemplated prior to, during, and following execution. Middle managers are not always comfortable addressing fall-out from change and can be ill-equipped to properly articulate the program to staff, customers, vendors, and other important stakeholders. Support structures should be in place to assist and guide those executing those changes. An appropriate balance between transparency and privacy needs to be reached and disseminated by the right leaders with the right knowledge.

Without proper change management and communication discipline, cost savings are diminished.

The whole organization needs to think in terms of cost

In the same way that execution can suffer from a fall-off in leadership, maintaining cost reduction savings over the longer term is equally problematic. When such a fall-off occurs, hard-earned cost savings are given back and the impact of the overall program is diminished. Not to mention a return to financial underperformance for the company. The more a cost reduction program is seen as a once-and-done effort, the more costs tend to creep back in. To be deemed a success, cost reduction programs should instill a cost-conscious culture that helps to maintain the benefits realized into the future.

The best practices developed by the organization through the program should not cease. Things such as improvements to budget planning and cost controls, cross-functional collaboration and an organizational "cost-value" mentality should not stop. Once the program is understood to be complete, the reset-cost baseline should become the new normal and leaders should jealously guard savings achieved and lessons learned. The experience should not be forgotten and the lessons should be both maintained and periodically revisited to ensure behaviours and decisions continue to reinforce the desired level of cost discipline.

Simple and visible actions taken by leaders can maintain the momentum and reinforce the new cost culture that is being nurtured. These could include setting and holding to revised travel and expense policies and spending thresholds, as well as implementing zero-based budgeting, eliminating private offices, and more purposeful reviews of discretionary spend in the organization. These are just a few examples; some are easy to implement, some are more difficult – but they all send a clear signal to the organization around cost.

The fact is, *continuing* good cost behaviour is not an unreasonable expectation. But it doesn't happen overnight and is therefore an important factor in change management plans. Institutionalizing new ways to encourage cost-conscious behaviour can also be embedded into performance management to ensure a healthy focus on a continuous performance improvement culture going forward.

Key questions for companies considering a cost reduction program

- Have we set a target and how do we know it's achievable?
- Do we require more transformational change?
- How quickly do we need to get the cost out? Next month? Next year?
- How can we align cost targets with organizational priorities?
- Do we have the right team and leaders to get the job done?
- Can we dedicate the team to the project envisioned or do we need help?
- What should our PMO look like (size, structure)?
- Have we considered what the necessary reporting and tracking looks like?
- Do we have a change management plan in place?
- Can we create a better cost culture going forward?
- How do we keep costs from creeping back in?

Making it real, making it stick

Cost reduction remains a top-of-the-agenda item for companies looking to address performance challenges, yet sustainable success in this area remains elusive for many companies. Despite best efforts, many companies fail to get what they want—and need—from their cost reduction measures.

This doesn't mean cost reduction success is out of reach, but it does mean organizations need to take specific steps to make it happen—and keep it going. Threats to cost savings are present throughout each key phase of a cost reduction program. Experience suggests that sources of lost cost savings are common across industries and scenarios. By addressing these threats early and consistently and leveraging the best practices outlined in this paper, organizations can significantly enhance their chances of meeting targets and achieving long-term, sustainable cost reduction results.

Organizations can fall victim to invalidated targets, poor execution and costs gradually creeping back in.

About us

Deloitte's Performance Enhancement Advisory team offers a suite of solutions to drive improved performance for businesses facing urgent and critical challenges. Our team of professionals assist companies to quickly identify the critical performance levers and provide hands-on guidance to help them execute on strategies to achieve peak performance.

For more information about cost reduction and how our team can assist your organization validate, realize and sustain your cost savings target, please contact us.

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