

< **Cost Optimization** >



Cost Optimization, Not Cost Cutting

Businesses across the globe have been identifying and implementing various methods to reduce costs in order to maintain acceptable profitability. Cost cutting is a drastic operation which is designed to protect the business from failure. It involves redundancies, reduced services and closure of premises often with detrimental side effects. Managements have cut costs by skimming human resource, tightening budgets and cautious investments. While most organizations believe cost cutting is the solution, the objective of maximizing profits in current market conditions has still not been achieved.

Contrary to popular beliefs, cost optimization is a different philosophy from cost cutting. Cost optimization is the process of finding the most cost effective solution under the given constraints. Cost optimization is about cutting overheads without affecting the performance or structure of the business. This technique aims to answer a very important question:

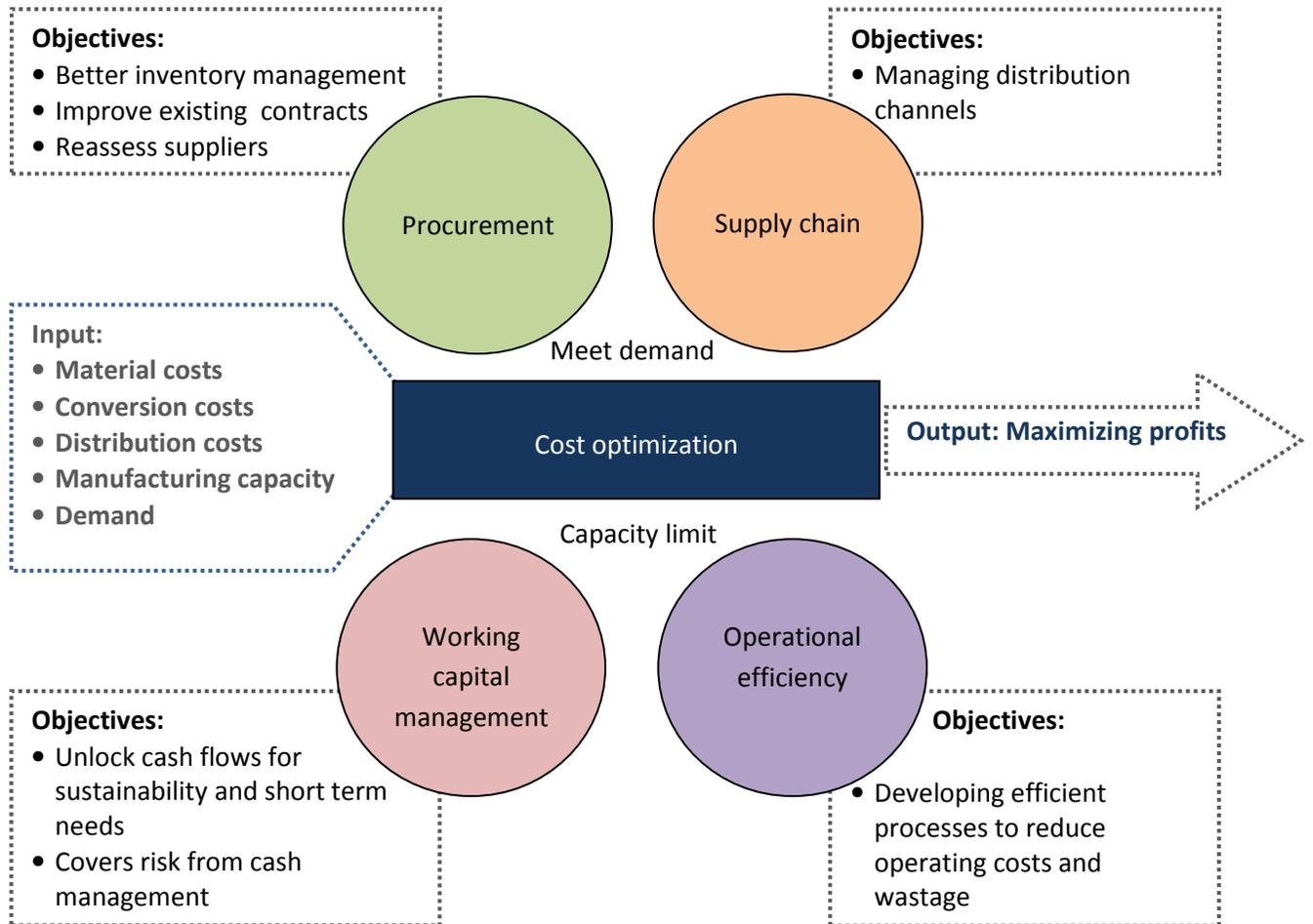
“How do we manage necessary costs to maximize profitability?”

Cost optimization looks into each function of the organization at a micro level to understand the impact of every cost based on the company’s operations. These costs are then filtered through the constraints, such as market demand and capacity limitations, to understand the impact on profitability.

Cost Optimization: Aimed at Maximizing Profits

Cost optimization entails a systematic and sustainable method to manage priority costs to ensure that delivering capabilities of the company is not affected or better yet, improved. Implementation of such techniques charge companies to achieve their long and short term objectives boosting their ability to grow. A company’s growth is reflected by its capability to efficiently manage costs while ensuring optimum productivity. The constraints faced by each organization are unique based on its capacity, target market demands and its objectives. Cost optimization technique by its very nature, identifies these constraints on which the costs are incurred. It identifies four main pillars on which the organization is raised; ***procurement, supply chain, working capital and its operational efficiency.***

By understanding the operating framework, it identifies the key costs that have significant impact on each of these pillars and their relation to necessary costs. It assesses the elements of each cost such as distribution channels, inventory management, vendor contracts, cashflow management and streamlining process. It further, provides a clear correlation between the pillars, necessary costs incurred and the constraints highlighted by an organization to provide the management with the optimal blend which will enable the organization to maximize profits.



Differentiating Costs that Matter - Techniques

While there are many techniques to implement cost optimization within an organization, a few have stood out to be the most successful and effective over a period of time. However, an organization is free to use more than one technique to better understand and implement an effective cost optimization model.

This makes understanding the techniques, their uses and requirements imperative before the start of implementing the model. Some of the popular techniques are the Fishbone technique, 5S analysis, benchmarking, breakeven analysis, fixed cost analysis, Pareto chart, value stream mapping and zero based budgeting.

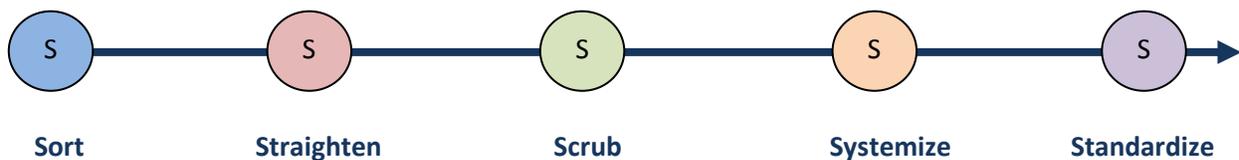
Fishbone (Ishikawa) technique

The Fishbone or the Ishikawa diagram brings together six main elements of an organization’s function towards a common purpose of designing products, preventing defects in process and ensuring productivity.

The Fishbone tailors its elements based on the industry under which the organization operates. It helps the management identify the main elements within each of the core areas that will have impact the organization.

5S Analysis

The 5S is focus one particular aspect of cost optimization: **How to reduce waste?** Waste refers to the non value added services performed within an organization which can be avoided. By dealing with identified waste, an organization can promote workplace efficiency.



This technique is most effective when used on each identified section within an organization rather than attempting to implement on the organization as a whole.

Benchmarking

Benchmarking is a powerful tool to assess the level of cost associated to a particular activity. This provides the management with an understanding of when and which cost reduction technique to apply. The technique provides cost levels of other businesses in the similar industry to assess the variance in an organization’s own cost model.

Benchmarking technique by its very nature is a simple tool and can be used within any parameter; internal and external. Internally, this technique provides management with the information related to the cost bifurcation between other divisions or department. This helps the management reassess the cost allocation within the organization.

Differences in costs that are highlighted by a benchmarking review can result from a broad range of factors, such as plant layout, automation, employee training, management practices, and cultural issues. Ideally, the primary step to conduct a benchmark is to assess the internal allocation of costs within an organization. This can be followed by an external benchmark with other similar organizations to identify the areas where cost can be reduced.

Breakeven analysis

Breakeven analysis mainly aids management in understanding the minimum requirement of products or customers required to cover the incurred costs. A breakeven analysis helps understand the thresholds the organization needs to maintain in order to be viable. This understanding can then lay the field open for looking at excess costs and how to address them for optimal use. It is a good tool for resource optimization as well.

Fixed cost analysis

Identifying the fixed costs that will be incurred by an organization can be tricky. The factors that need to be considered when assessing a fixed cost are quite vast, each as important as the other. In the past, a lot of organizations have spent significant amount of the capital in the fixed costs hoping that they would be able to generate higher margins through greater productivity.

However, the implication of higher fixed costs only means that the break even sales requirement for an organization also increases. In a volatile market such as today, where everyone is on the look out to reduce spending, the idea of investing heavily in fixed assets can be more of a liability than benefit.

A fixed cost analysis provides management with information regarding the fixed costs already incurred such as the return on those costs, are the costs really necessary, if yes, can they be reduced by alternative sources and what are the implications of making such a change.

An assessment of fixed cost can provide management with solutions and ways to reduce costs all the while enabling them to increase the productivity related to those costs.

Pareto Chart

Pareto chart is a graphical overview of the process problems, from the most frequent to the least thereby illustrating the frequency of fault types. This chart helps users identify the most serious and most frequent problems.

80% of the problems incurred are caused by 20% of the problem cause types

While it is mainly used as an assistive tool to identify issues within an organization, in certain cases this tool helps identify issues. A simple example for this would be a small or medium organization where the complexities of the processes are minimal.

How can a Pareto chart help ?

- Process improvement efforts
- Technical skills required for the job
- Customer needs
- Supplier management

Why use a Pareto chart?

- Breaks down bigger problems to smaller sizes
- Identifies most significant factors
- Show which areas need more focus and effort
- Allows better use of limited resource

Value stream mapping

Value stream mapping (VSM) is a technique which can be called as a byproduct of Lean Process Thinking. This technique identifies the activities that can be avoided in a process thereby reducing time, increasing productivity and helps overall management of the process.

A VSM chart identifies all of the actions required to complete a process while also identifying key information about each action item. It identifies bottlenecks arising in a process and reasons for the process. This technique gives management a clear picture of where the lags are being created and enables them to identify ways to reduce the lag and ensure a smooth process.

While VSM is a very good and highly recommended technique, its main objective and function limits VSM to the most effective in highly focused, high - volume processes where reducing a few second of repetitive process counts.

Global response towards cost optimization

The main goal of any organization is to maximize profits and sustain growth with time. Profit is based on two simple variables: *revenue and cost* (each with their own limitations, both internal and external). In the past, companies have seen a healthy growth and high revenue figures in a much favorable market. With time, the increase in competition, pace of technology advancements and shortened lifecycle of products forced organizations to divert attention to the other variable: **COST**.

Traditional Approach to Cost Optimization

Cost optimization has always been an important aspect and a key strategic decision for any organization. While many techniques exist to implement an effective cost optimization model, previously, outsourcing had risen as the winner and preferred choice of most if not all organizations across the globe. This technique provided organizations a way to lower costs, up sell/cross sell opportunities and retaining customers through effective services.

While outsourcing has changed today's business landscape, changing developments across the globe such as developments in Asian countries (which were primary hubs for outsourcing) and increased cost of labor have forced organizations to consider cost optimization through internally managed processes.

Organizations presently have shifted focus from cost optimization through outsourcing and are looking at enhancing internal manufacturing productivity as a viable option.

Modern Approach to Cost Optimization

In the recent past, the focus for optimizing costs has moved to a more intrinsic resolution. Organizations routinely expect procurement and other departments to contribute to annual revenue targets even when business is slow or slumping. By improving *operational efficiency*, *procurement organization* can achieve significant savings and meet revenue targets.

- **Working around the expenses**

In medium and large organizations, EBITDA (Earnings before interest, tax, depreciation and amortization) spending accounts for two thirds of the revenue. This means that controlling the expenses under this category can prove to be beneficial to an organization in terms of profitability followed with sustained growth. Investing in better cost management has shown significant uplift in an organization's profitability.

- **Closely monitoring the labour cost**

Diminishing labour cost gap has made the option of outsourcing to be less beneficial than expected. This in turn has created new opportunities for cost optimization such as internal process optimization, reduction in material costs and managing operational expenses.

What are organizations in GCC upto?

Since the global economic downturn, market demand within the GCC has become weak. This has weakened demand has infiltrated financial performance of companies putting significant pressure on the financial teams within organizations to perform.

As a result, financial decision makers have implemented cost cutting techniques in various areas such as human resource, marketing, sales and logistics among others. Currently the GCC has witnessed organizations' concentrated efforts on restructuring; focusing on a certain aspect (HR, marketing or logistics).

However, cost cutting implementations by most organizations were not as successful in terms of profitability within the GCC. In order to benefit the implementation of these techniques, it is imperative to conduct an in-depth analysis of the existing operations and business model which is **Cost Optimization**.

An unsuccessful implementation could result in blind siding decision makers and weaken the organizations ability to rebound when necessary. This factor makes it essential for organizations to ensure that the right technique and tools are utilized during the execution and implementation of a cost optimization program.

How can Falak help: *A catalyst to successfully implementing cost optimization*

Successful implementation of cost optimization requires an expert team who shares the objectives of the management and understands the shifts in market demand. Communication becomes one of the most important factors which steers the objective to a successful implementation.

We believe in the success of delivering projects together with our clients at every step. We tailor our internationally proven methodology to specific requirements of the region and organization. We provide the following cost optimization services:

- Review of existing structures and identification of wastages and gaps in processes.
- Implementation of various techniques to manage and monitor costs.
- Creating excellence centers and shared service centers.
- End to end identification of optimization techniques and implementation of the roadmap.

Our solutions are tailored to meet the company's objectives while foreseeing the change resistance that follow.

The information contained herewith is deemed confidential and remains commercially sensitive.

Contact us

Maniza Dewan
Cofounder & Principal Director
T: +973 13355441
D: +973 13355443
M: +973 36736863
F: +973 13355442
E: maniza.dewan@falakconsulting.com

K. Kritivasan
Subject Matter Expert
T: +973 13355441
M: +973 39616508
F: +973 13355442

Mohammad Usman Baig
Core team leader
T: +973 13355441
M: +973 36737629
F: +973 13355442
E: mohammad.usman@falakconsulting.com

Omkar Halady
Consultant
T: +973 13355441
M: +973 36552050
F: +973 13355442
E: omkar.halady@falakconsulting.com