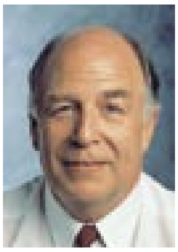
Reducing costs in business



Mark Toner, a former CEO of Kvaerner E&C Australia, recounts some lessons he learned in controlling business costs

RIGOROUS cost control is recognised by engineers in both single- or multi-disciplinary projects as an important component of a successful project, however it is important to remember that control of costs is also essential within the business organisation that runs these projects.

Every business needs cost control if its managers wish to meet or exceed profit targets; even non-profit organisations need to control costs to meet their budgets. And the organisational structure where engineers would typically see non-project cost control being exercised is the department or unit to which they belong. Moving up the staff hierarchy, it is the responsibility of senior management to control costs for the whole business.

When workload or throughput in a company turns down, a number of business functions are typically given more attention by management. Activities in marketing (which including sales) are increased and cost reduction programmes re-introduced to protect operating margins and increase profits or decrease losses. As the CEO of Kvaener engineering and construction Australia, I learned some valuable lessons in cost reduction when our markets turned down severely.

For convenience in analysis, business costs can be split into two types: the direct and indirect costs of employing people (here called “labour costs”), and all other costs and expenses (“non-labour costs”). Each type could be further split into overhead and non-overhead areas. In an engineering consulting or contracting company, labour costs might be of the order of 80% of total costs, whereas in manufacturing and production businesses where capital equipment is bought and used, the proportion can be much lower. Nevertheless, labour costs are usually a significant part of the total costs of running a business, and therefore need to be monitored closely.

non-labour costs

I learned two lessons in controlling this type of cost in a service company. The first is that no matter how well you might think you have cut non-labour costs, you can always make more savings – year after year. By analysing your business in an objective way, you might realise you can make new cost-effective changes to the way the organisation runs, and this can be repeated many times.

A complicated example of this approach would be to map all internal business processes, particularly all departmental or unit interfaces, and eliminate inefficient processes and/or impose stricter requirements on the delivery of information or materials across all interfaces, both internal and external. On the other hand, a simple example would be to examine cost savings available by switching to new suppliers for consumables and utilities. Phone (both fixed line and cell/mobile) contracts can often be switched to new plans with very significant savings, and low-cost voice-over-internet systems can now be used for many internal international calls. An even simpler example is to print and photocopy all documents double-sided, giving both storage and paper savings. And it always amazes me how many businesses leave all or much of their office lighting on every night. As a last example, using a corporate charge or credit card to pay for consumables and utilities can earn frequent-flyer points that can be used to buy air tickets or other items.

The second and rather obvious lesson I learned is that although you can keep finding ways to continually reduce non-labour costs if you are committed to it, there will be a diminishing return on the effort involved, particularly because these costs are often overshadowed in magnitude by labour costs. But I am not advocating abandoning efforts to reduce non-labour costs over time; on the contrary, a watchful eye always needs to be kept on them because there are always new ways to save money. I am saying that reductions in both types of costs should be pursued in parallel.

labour costs

The obvious saving to be made from labour is to work out how to increase business productivity further and to tighten the performance requirements for all staff and contract personnel. Dispensing with poorly-performing staff is one of the most difficult tasks which managers face, but to accept poor performance from a few does a disservice to remaining staff, and determines the performance culture of the organisation. Poor performers should first be made aware of the problem through regular performance appraisals and they should be given training and even counselling to assist them in raising their competency and performance levels. But ultimately, if this doesn’t work, their employment should be terminated using proper legal processes, because there is a miss-match between their performance and the organisation’s expectations and requirements; these staff members should be treated with dignity throughout the dismissal process. Unfortunately, some engineers who become managers resist carrying out regular performance appraisals of their staff because they believe the technical work they are doing is always more important – in their view this is the 'hard' work of their own roles. These managers often see the above process of dealing with poor performance as unnecessary, presumably because they have not had the right training or do not possess the skills to deal with issues they see as 'soft' and of low priority.

Apart from reductions in direct and indirect labour costs, staff training often appears to be an easy target for cost reduction. Technical training of staff is usually seen as essential because it directly affects the quality and timeliness of future product or service delivery. But the training of staff in non-technical areas, such as leadership, management, commercial law, accountancy and HR, never appears to be as urgent, or important, as technical training and, because it is discretionary, frequently suffers as a result. Indeed, in some engineering organisations this type of training might not be planned at all.

As a ceo in the late 1990s facing a severe downturn in my company’s workload because of falling commodity prices and lower industry investment in new plant, I cut severely the non-technical training budget of my business for a few years in a row to improve the company’s profit position. In later years I regretted doing that. I should have worked harder to persuade my manager in London that more

Pictured: Look after the pennies...

financial pain at that time meant a stronger future in terms of the capability of my organisation and he might have agreed – my mistake was that I didn't argue that such training should be retained. I now believe that my actions slowed the acquisition by the company's managers of important non-technical competencies, eg an understanding of emotional intelligence and its significance, which no doubt hindered in some way the future development of staff and therefore the company.

Another approach in dealing with labour costs in difficult market conditions is to increase the proportion of remuneration "at risk" for particular staff members – that is, to introduce a direct pay-for-performance focus. This may require a slight culture change and is applicable in all types of markets, poor or healthy. For some staff, eg those in sales and project management, it may be appropriate to reduce their base salaries a little and set aside additional amounts as short-term cash incentives for superior performance. This will require the use of key performance indicators (KPIs), which should be in place anyway as part of good staff management, to form the basis of incentive targets. This restructuring will result in changed labour costs, which won't necessarily decrease in poorer markets. Given that few engineers are motivated solely by financial rewards, this approach has limited application, but can be part of a visible drive by senior management to recognise and reward superior staff performance in a variety of ways. This could have beneficial effects on the organisation in the medium and longer term.

managerial accountability

The managers of departments or other organisational units should be accountable not just for their own work and that of their staff. They should have been given delegated accountability and authority to run their units to pre-agreed budgets, just as project managers should be accountable for all costs on their projects. These unit managers may have two budgets, one for overhead costs and one for delivering the required outputs from their own units. Marketing and business development managers may have their own individual budgets for overhead costs, tendering activities and so on, but they sometimes fail to realise that a dollar saved in cost is worth as much as an extra dollar earned in gross margin from sales, as both have the same direct effect on profit.

So managers who value 'hard' technical work above all else may see cost control as a low priority, particularly if it requires additional expenditure on HR systems for formally monitoring staff performance. As a result, their own cost control performance may be poor. They forget that the primary raison d'etre of a business is to make an adequate return on the owners' investment. This is another reason for not neglecting management training in commercial and business subjects, and for promoting commercially-oriented staff.

In summary, one of the key accountabilities of senior managers should be to improve the competencies and capabilities of their organisation. And cost reduction measures, if taken too far, will conflict with that objective.

The best way to learn how to reduce costs in an organisation is to be personally accountable for the outcomes. And cutting either labour or non-labour costs too far can be detrimental to the ability of the organisation to do quality work for its customers in the future. The difficulty for any manager is to decide how the right balance can be found between improving the organisation's current profit position by appropriate cost reduction measures and not harming the organisation's future ability to achieve improving performance and profitability. ■

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