



What are Some Successful and Sustainable Cost Reduction Methods?

Sustainable and Successful Cost Reduction

In this series, we will cover many ways, methods, processes, formulas, and ways to improve an organization bottom line.

Hard Cost Savings versus Soft Cost Savings (Successful and Sustainable Cost Reduction Methods #1)

Two Main Cost Reduction Areas

There are many ways to reduce costs in organizations, which encompasses efficiency improvement, increased profits, best practices, change optimization, driven valued team processes, and many other areas in the cost reduction umbrella.

There are two main ways to reduce costs in organizations:

- Hard cost savings.
- Soft cost savings

Defining Hard and Soft Costs

Hard cost savings relate to reducing the cost of a good and service from the current amount being paid to a new contract amount, or a change in process/technology/policy that directly reduces expenses, and process improvements.

Soft cost savings relate to those areas that reduce costs through less labor, more efficiency, productivity increase, usable information, better compliance, better work environment, and other related areas.

What many organizations do not realize and accomplish is how to continue sustainable improved cost savings through both hard and soft cost savings. Many try in vain to do this by downsizing people, but only find that morale and loyalty hurts their bottom line long-term.

There is an old saying: “Steady plodding brings prosperity”. If profits are all about the quarterly results above all other things, not incorporating the long-term sustainable mission, vision, and growth of the organization (cost savings incorporated in this plan), then this organization will encounter a history of highs and lows, may be acquired/parceled out, or even go out of business.

Cost Reduction is NOT Just Labor



This business generation has been taught that cost reduction takes place through labor. This is only a small part of how to reduce costs (both hard and soft) in an organization. There must be an entire plan that encompasses many areas. Cost savings is not just about the procurement department and a few other departments; it is about the entire organization. We have included some areas about the overall organization, as well as some procurement areas for your review and hope that they help you formulate your own successful cost savings roadmap.

This is the first post of a series that will outline many strategies, actions, methods, processes, and leadership initiatives for your greater organizational, team, and individual outcomes.

What are Some Proven Methods of Bottom-Line Improvement? (Successful and Sustainable Cost Reduction Methods #2)

Sustainable and Successful Methods

Some areas that can help you improve your bottom line and bring more growth for you, your team, and your organization are outlined in this second part of this series.

These proven methods, along with other tools and processes, have been applied globally for thousands of individuals and organizations with sustainable success.

- Procurement cost reduction through the Request for Proposal (RFP) process for the goods and services you are already buying.
- Effective communications that motivate staff to share their ideas.
- Executive and upper management support and empowerment to all staff so that they can perform.
- Create an organizational Standard Operating Procedure that outlines expectations and methods about how to improve bottom line costs with growth – such as, when to have meetings, what is covered in meetings, cost cutting ideas, ways to improve on time management, time management education, how to monitor areas for improvement or changing out to another method / solution, doing away with political and bureaucratic organizational areas that inhibit staff from getting done what they need to get done, how to reward everyone for their efforts and results (not just management), and many other areas that the team assembles (this team should include as many people as possible – the core team should include people at all levels in the organization, and the measure of success will be seen in the cost savings, the growth, and most importantly in the staff's attitudes and involvement over time because the environment has become a safe place to excel in).
- Reward staff for cost saving and growth ideas.



- Meetings that deliver results (hold each person responsible for their tasks, with deadlines, and consequences for lack of meeting these deadlines).
- Utilize results-oriented software for each organizational department (many organizations utilize procurement software that is very cumbersome, does not have effective RFP / Bid processes, is not user friendly, was implemented with finance and other areas in mind, is very expensive, and has not delivered the expected results).
- Manage vendors effectively (create your expectations, terms and conditions, and vendor performance guidelines and ensure that each vendor understands these with written acceptance) – treat your vendors with respect because they are a vital part of whether you can deliver your goods and services to your customers.
- Create a benchmark for the procurement department, finance department, and warehouse/logistics department whereby each department head works with each other to continually work out challenges, improve systems, become more compliant, and help each other to not only purchase goods and services, receive them, but also pay effectively.
- Attract and hire only those people who fit what the organization is looking for (within the environment – will this person positively influence those in the organization and grow because they fit, or will they take away from it and not enjoy their work?).
- Where applicable by position, allow people to be project driven with deadlines instead of micromanaging people by the hour (it is proven that people will work harder and longer when they are given the opportunity to work in this atmosphere).
- Include IT in all areas for efficient, cost effective, user friendly, and usable systems.
- Where possible, allow staff to telecommute (it is a proven fact that those who can telecommute in their position, not only work longer hours and get more done, but they stay at their company longer even without a raise – in other words, when given a choice of a higher paying job/or a raise or being able to telecommute, most choose telecommuting).
- Allow those who work in your team to excel and go beyond you!

What are Some Areas to Consider in the Request for Proposal Tender Process?! (Successful and Sustainable Cost Reduction Methods #3)

Procurement Bid and Tender Outcomes and Areas?!

Below are some areas that might direct and outline your Request for Proposal (RFP) and Scope of Work (SOW) business specifications, and outline some of your requirements within your RFP processes, bids, proposals, and negotiations for your organization.



These are areas you would add to your bidding processes so that the participating suppliers, partners, and vendors in your RFP process know what you expect in their proposal for your needs.

Procurement RFP Bid and Tender Outcomes:

- Online ordering that can be tracked, with reports that each location and the corporate office can review trends, cost savings, items ordered only from the item list (uploaded into vendor website portal), etc.
- The item prices agreed upon and other related items for the designated contract term.
- Current and future inventory needs assessment (includes any future locations beyond the current location list of this RFP / Bid).
- As necessary, several rounds of negotiations will be conducted resulting in three finalists.
- The total solution provided in your proposal is most important (this includes service, history, pricing, commitment, representative dedication, cost, social responsibility, solutions, etc.).
- Provide the status of your company, type, and size.
- Outline your company recycling program.
- Outline what your service contract includes, service hours, days of the week, turn-around time, and your service ability (specify delivery time from date of order).
- Include all other solutions, cost reduction strategies, and ideas.
- Outline your Return Manufacturer Authorization (RMA) procedures.
- Vendors are expected to closely read the terms and conditions and provide binding signatures as applicable in each document we send to you.
- The successful vendor shall procure and maintain the proper insurance from a carrier licensed to do business in the states specified in this RFP and can obtain insurance in any state that we conduct future business in – A certificate of insurance evidencing said coverage shall be supplied by the successful vendor upon request, naming our company and each location as an additional insured under the liability policy. The liability policy shall contain a provision that such policy shall not be cancelled until thirty (30) days prior written notice of cancellation has been received by us.
- Vendors shall provide a profile of the company (ownership, office locations, number of employees, company background and history, company qualifications as a superior service provider for this RFP; and resumes for key staff to be responsible for contract performance).
- Pricing shall remain firm for the term of the contract, unless specified otherwise.



- In case of default by the winning vendor, we may procure the good(s) or service(s) from other sources and hold the vendor responsible for any excess cost occasioned thereby.
- Any submission not containing total costs will not be considered (no cost increases for the duration of the contract will be acceptable).
- The awarded Vendor must perform full-service support during normal business hours of 8 AM to 5 PM Monday through Friday within the pricing proposed and deliveries must take place between these same hours.
- All goods must be shipped with the applicable Material Safety Data Sheets (MSDS).
- The vendor must provide full-time ongoing customer service support for any questions, challenges, and needs (this must be available at no additional cost).
- Payment will be made on goods and/or services purchased with net 30-day terms from invoice receipt.
- Billing will occur separately for each location, as well as the Corporate Office, unless otherwise stated.
- No fees, freight, re-stocking, maintenance, or charges of any kind will be paid, unless agreed upon for special items.
- The vendor, if a contract is executed, affirms that they are familiar with the conditions under which the RFP outlines and any work / service that is to be provided.
- Include a copy of your contract you would provide to us if you were to win this RFP.
- If you win this award, you will sign our contract as well.
- Shipping costs will be included in all the items listed in the MS Excel spreadsheet and this RFP.
- Approximate annual total for goods and/or services identified are between \$ _____ and \$ _____ (at our current pricing).
- Our corporate office and locations are as follows _____ (as of this RFP letter).
- Detail the process for ordering goods (supplies) including any electronic methods.
- List the main contact person for customer service issues, orders, and questions.
- List the main contact person for any additional needs and on-going pricing.
- Detail your capabilities for reporting (including sample reports).
- Describe your process for issuing credits for billing disputes.
- Detail any additional services, as it relates to the RFP, which would result in any additional charges if there are any.
- Include your RFP timeline in the RFP Scope of Work Letter you will send out to each vendor participating in this bid (first, second, and possibly third negotiations, when the proposals are due, how you desire to receive each proposal, etc.).



What are Some Benefits?! (Successful and Sustainable Cost Reduction Methods #4) Benefits from Procurement Cost Reduction, Request for Proposals (RFP's), and Proper Negotiations

Below are some areas and outcomes that come from the procurement cost reduction, procurement outsourcing, and bidding processes we have conducted over the many years. There are many benefits that can occur from our RFP and Procurement Cost Reduction methodologies.

Some of them are:

- Reduced costs and increased quality.
- Centralized procurement.
- Sustainable strategy and best value.
- Provide needed goods and/or services.
- New market development.
- Just-In-Time Inventory (JIT).
- Increased supply chain efficiency.
- Best value and remain competitive.
- Government compliance.
- Supplier performance improvement.
- Support day-to-day buying activity.
- Policy/Procedure creation, implementation, validation.
- Transaction automation and processing.
- Focus to core competencies.
- Strong end-user to provider relationship developed.
- Lower procurement related labor costs.
- Overall procurement performance improved.
- Greater control, reporting, and vendor compliance.
- Organization and internal cost performance.
- Data for benchmark analysis, goals, and results.
- Procurement personnel training.
- Hedges future increase of raw materials.
- Procurement department creation and implementation.

Cost of Requisition-to-Order Cycle

A study by *Aberdeen* measured the costs of the requisition-to-order cycle in many companies. What they found through procurement outsourcing was lower costs through lower transaction



costs, as well as from lower absolute costs on the items purchased. Before outsourcing the cost was \$33.00 – after outsourcing, the cost was \$14.15 – a savings of more than 57% in staff resource costs.

Aberdeen's research found that for each dollar of spend brought under outside procurement management, companies were able to realize cost savings of between 5% and 20%. Keep in mind that this is an average, with larger companies. With smaller and medium-sized companies, there is a greater opportunity to increase the percentage savings.

The percentage provided by Aberdeen as the average is very conservative. We have averaged more than 28% bottom line improvement (cost reduction) for our procurement cost reduction and procurement projects for all clients over the last 30+ years.

Cost Reduction and Avoidance ...? (Successful and Sustainable Cost Reduction Methods #5) What is Cost Reduction and Avoidance?

Below is some great information summarizing cost reduction and avoidance in a highly organized, insightful, and understandable way.

What is the meaning?

We utilized eSourcingWiki, because of the great explanation and outline about cost reduction and avoidance. The data, "Defining Cost Reduction and Avoidance" was released in 2006, which includes seven major points. They are:

- Critical to the sourcing professional's mission of reducing costs and delivering savings is the proper categorization of the various types of cost reduction and their application to the company's operating budgets and profit and loss (P&L) measures.
- Cost reductions come in two different categories: "hard" cost savings and "soft" cost avoidance.
- A great deal of supply management's efforts results in cost avoidance, yet this category is more intangible than cost savings.
- Even though many people might find it easy to discount cost avoidance as "phantom" or lesser savings to the company, these are "real" savings nonetheless and, despite the challenge, these savings must be properly quantified.
- Flexible and comprehensive IT systems are critical, as they are the medium that will provide the visibility needed to accurately assess costs and expenditures.
- Cost savings and cost avoidance metrics should be standardized throughout the company, should be clearly defined, and should be available to all personnel so that each area can be tracked.



- The key to success is to create a proper incentive structure for procurement, purchasing, and supply management personnel.

Seven Major Facets

This section discusses the seven major facets of cost reduction and avoidance identified in the introduction in detail.

Proper Categorization is Critical

In any organization if there is no measurement there will be no successful management (with no measurement there is no management). Every member of the procurement / sourcing team needs to measure, using standardized metrics, cost reduction efforts, but before metrics can be applied, the data needs to be normalized. This involves properly categorizing each type of cost reduction. Thus, the first step is to define each type of cost reduction and how it relates, directly or indirectly, to the company's budgets and / or profit and loss measures. Some categories will be obvious, such as material cost reduction or freight reduction; some will be less obvious, such as decreases in process cycle times.

Cost Reductions may be “Hard” or “Soft”

Hard cost savings are easily defined as and characterized by:

- Year-on-year saving over the constant volume of purchased product/service, actions that can be traced directly to the P&L.
- Direct reduction of expense or a change in process / technology / policy that directly reduces expenses.
- Process improvements that result in real and measurable cost or asset reductions.
- Examination of existing products or services, contractual agreements, or processes to determine potential changes that reduce cost.
- Net reductions in prices paid for items procured when compared to prices in place for the prior 12 months or a change to lower cost alternatives.

Soft cost avoidance is much more difficult to define. Some suggested areas and definitions include:

- Avoidance is a cost reduction that does not lower the cost of products / services when compared against historical results, but rather minimizes or avoids entirely the negative impact to the bottom line that a price increase would have caused.
- When there is an increase in output / capacity without increasing resource expenditure, in general, the cost avoidance savings are the amount that would have been spent to handle the increased volume / output.



- Avoidances include process improvements that do not immediately reduce cost or assets but provide benefits through improved process efficiency, employee productivity, improved customer satisfaction, improved competitiveness, etc.; over time, cost avoidance often becomes cost savings.

Cost Avoidance is More Intangible

Some examples include:

- Resisting or delaying a supplier's price increase.
- Purchase price is lower than the original quoted price.
- Value of additional services at no cost (e.g., free training).
- Long-term contracts with price-protection provisions.
- Introduction of a new product or part number requiring a new material purchase; spend is lower, but savings are classified as avoidance due to a lack of historical comparison.

Quantifying Cost Avoidance / Challenging

Some of the challenges faced by a company as they seek to accurately assess cost reduction include:

- Cancellation of net savings due to an increase in the business unit's cost structure.
- Supply management's role in the cost savings allocation decision.
- Chronology of supply management's involvement and the need for budget cuts.
- Visibility, in terms of systems, people, and metrics.
- Total Cost of Ownership (TCO) concept for purchases of items / services.
- Multi-year issues in cost savings.
- Creating a proper incentive structure for supply management personnel.

Required Flexible IT Systems

Systems, understood as both IT infrastructure and company policies, need to be in place to allow managers to get a realistic handle on what costs are, what areas might benefit from cost reduction efforts, and how company policies are designed to track and execute these savings. Also, processes for executing and tracking cost reduction projects should be in place and available to all personnel.

Company Standardized Metrics

The establishment of clear metrics and definitions helps avoid "fuzzy math" or the arguments over what amount has been saved in each cost savings / avoidance initiative.



Proper Incentive Structure Success

Like all employees, a supply manager will engage in behaviors rewarded by the company. This will create a problem if cost avoidance or cost reduction efforts beyond hard savings do not count toward a procurement / supply manager's compensation and performance.

A successful company must count cost reduction as savings, clearly laying out how different cost reduction efforts count towards goals, and what their relative weighting or importance is. The share of credit that goes to supply management in cross-functional initiatives needs to be clearly defined and procurement / supply managers need to be recognized for their contribution to improvement projects with "soft" short-term benefits but "hard" long-term savings.

This can be particularly challenging in evaluating actual savings in costs other than the price of a purchased item or service. Usually, items such as freight and duties are accounted for in a universally applied "overhead" account.

A procurement / supply manager who agrees to pay 5 percent more for an item to achieve a 5% duty savings and a 5% freight savings might be penalized by the performance metric system.

One idea is to provide procurement / supply managers with variable compensation as part of their incentive for meeting various savings goals. Such bonus plans are common for senior management, marketing / sales, and production. Such (uncapped) bonus plans could have an overall positive effect on the company's overall cost reduction goals.

And all things considered, who is likely to work harder: a procurement / supply manager who makes \$100K a year regardless of his performance, or a procurement / supply manager with the potential to double their salary if they hit a savings target of 5M?

Some Cost Reduction Types? (Successful and Sustainable Cost Reduction Methods #6)

What are Some Types of Cost Reduction and Avoidance?

There are many types of cost reduction and avoidance in addition that need to be recognized as valid cost savings. This section presents some examples of cost reduction that can contribute significantly to the organization's bottom line.

Negotiated Discounts against Material Cost Increases

If the products being sourced are primarily made from a commodity whose average market price or index has increased significantly since the last procurement / sourcing cycle, and a



buyer manages to negotiate a price that increases less than the increase in underlying material costs since the last sourcing event, this is a valid cost avoidance.

For example, if a buyer was sourcing gold-plated circuitry, with gold roughly \$649/oz., and the last time the buyer sourced the circuitry gold was roughly \$590/oz., and gold makes up 25% of the cost of production of the gold-plated circuitry, then the buyer should expect the cost of the product to increase by at least 2.5% (on a unit basis). If the cost increase is less than 1%, then the buyer has obtained a cost reduction by way of a successful sourcing event. The formula to measure this type of cost avoidance is:

$$((\text{new raw material cost} - \text{old raw material cost}) / (\text{old raw material cost}) * (\text{material percentage of cost}) - (\text{actual percentage increase})) * (\text{total cost of buy})$$

For example if the buyer was buying 10M worth of gold-plated circuitry:
$$((649-590) / 590 * 0.25 - 0.01) * 10M = 150,000$$

Substitution

If a buyer manages to find another product that performs the same function or can collaborate with a supplier to produce a functionally equivalent specification that is more economical to produce, then the buyer has obtained a cost reduction on behalf of the organization. Substitution cost avoidances are extremely easy to calculate.

$$(\text{Original product cost} - \text{new product cost}) * \text{Quantity}$$

For example, if engineering thought the organization needed a Widget Grinder 10000 that cost \$1M, but the buyer was able to determine that the Widget Grinder 8000 that could be obtained for a mere 750K would be more than suffice, then the buyer saved the organization:

$$(100000 - 750000) * 1 = 250,000$$

Waived Fees

This form of cost avoidance is quite self-explanatory. For example, if a supplier normally charges an installation fee for a new piece of equipment, but the buyer can negotiate free installation, then this would be an example of cost avoidance of the waived fee variety. Another example would be free training or services. However, this is one example where the cost avoidance is not equal to what the vendor quotes, but what the market average for the service is. Thus, if two days of installation time was included in a purchase, and the average rate for



that service from a third-party vendor is 2000 / day, then the buyer saved the organization 4000.

Inventory Reduction

This occurs when the buyer comes up with a strategy to reduce the inventory that the organization needs to hold at any given time. Inventory is associated with a carrying cost and inventory reduction often represents significant cost savings to an organization over time. Inventory can be reduced when a buyer finds a supplier who can handle a shorter lead time or when inventory is turned over to a vendor who specializes in inventory management (Vendor Managed Inventory). In this situation, the cost avoidance is calculated as:

(Number of units of inventory removed * carrying cost per period)

Process Improvement

Processes consume overhead, and overhead costs money. Thus, any significant process improvement could represent significant cost avoidance to an organization. However, unlike the other types of cost avoidance, process improvement cost reductions can be a bit tricky to evaluate.

The key is to look at the average number of units of product or work produced per day, week, or month prior to the improvement. Then, look at the number of units of product or work produced per day, week, or month after the improvement and calculate improved percentage.

If 40 units were produced per day before the improvement and 50 units were produced a day after, then the process improvement was 25%. Then, the cost reduction can be calculated as this percentage of the overall overhead cost attributed to the process since the process is now more effective. Thus, if the cost per day before was 10,000, then the cost avoidance is 2500 since it would take 12,500 to produce as many units as possible under the old system of production.

(Current number of units – old number of units) * operating cost

“Cancellation” of Net Savings

“Cancellation” of net savings can occur as the result of an overall increase in the business unit’s cost structure. Sourcing should not be held accountable for cost increases outside their control, such as increased demand (which generates higher spend) or increased operating costs in overhead or salaries solely under the control of the appropriate unit manager. Furthermore,



savings should be calculated on a per-unit basis relative to historical costs, market baselines, or otherwise expected spend levels, depending on the context of the project. Examples:

- A buyer is sourcing an existing product, and the buyer expects a cost reduction. Last year widgets cost \$2 each and production required 10 units. This year, the buyer negotiated the cost down to \$1.50, but production ended up ordering 12. If one looks at raw numbers, last year production spent \$20 and this year production spends \$18, a difference of \$2. But this does not represent the true savings of \$6, since production saved \$0.50 per unit on each of the 12 units they bought.
- If the buyer is sourcing a new product, chances are the buyer could still be saving the company money no matter how much the product costs per unit. Measure cost avoidance using the average unit price in the marketplace, as obtained from a respected market analysis firm or other third-party source. (Do not use initial supplier bids since the argument could be made that the suppliers bid high in the expectation of a reverse auction or other sourcing event designed to ultimately lower their quoted costs).
- If the products being sourced are primarily made from a commodity whose average market price or index has increased significantly since the last sourcing cycle, measure the cost avoidance relative to the percentage increase. If a buyer was sourcing gold-plated circuitry, with gold roughly \$649/oz., and the last time the buyer sourced the circuitry gold was roughly \$590/oz., then the buyer should expect the cost of the product to increase by at least 10% of the raw material cost (unit basis). If the cost increase is less than 10% of the raw material cost, then the buyer has obtained a cost reduction by way of a successful sourcing event.

What are Some More Cost Reduction Types? (Successful and Sustainable Cost Reduction Methods #7)

What is Supply Management's Role in the Allocation Decision?

If the team is cross-functional, then a decision needs to be made up front, by an appropriate manager, with respect to how much of the cost savings will be attributed to supply management and how much to the other business unit(s). This could be an even split, or a weighted split dependent on who is taking the lead and how the work is expected to be split among the team members. There's no hard and fast rule here, but all parties involved should agree that the split is "fair" before the project gets underway.

Visibility

Visibility here refers to the systems, people, and metrics. The agreed-upon metrics and the data that the cost avoidance metrics are calculated on need to be accessible to the entire organization so that there are no challenges as to their accuracy and validity.



TCO concept for purchases items / services

TCO is a hard calculation. It includes all the direct cost components that go into the landed cost calculation (unit cost, freight, interim storage, tariffs, etc.), storage costs, and processing costs. Probably the easiest way to approach this calculation in cost reduction metrics is to base the cost on landed costs and then factor in adjustments for any additional costs that are above or below average.

For example, if a buyer was sourcing a food product and only one option is frozen, then the storage costs for all items but the frozen item will essentially be the same, with the frozen item costing more due to increased energy costs of using a freezer over a fridge, and only the landed cost for the frozen item needs to be adjusted. If the buyer worked for a chemical manufacturer, and all but one option can be used as-is without refinement, then the processing costs for all but the option that requires refinement will be essentially the same, and only the landed cost for the product that requires a refinement phase will need to be adjusted. Similarly, when computing savings, a buyer needs to adjust for differences in incurred costs between respective time periods.

It could be argued that this is not a proper TCO, but when it comes to calculating savings, mathematically speaking, it is only the differences in cost between last year's buy and this year's buy that matters, and this simple approach is sufficiently accurate for TCO calculation purposes.

Multi-Year Issues

Sometimes the savings from switching to a new product or new supplier will not be realized until the second or third year of a contract, due to up-front costs associated with new equipment or investments. However, it is important that supply and spend managers be rewarded each year for their contribution to this savings initiative.

Although one may think that one may not be able to accurately calculate savings from such an endeavor until the contract ends, since investment costs have to be amortized, if investment costs are equally amortized over a fixed period, then an organization could adopt a calculation that realized savings each and every year (if losses occurred in the first year, they could be carried over and then the sourcing team could be rewarded as soon as hard savings were realized).



For example, let's consider the scenario where a 3-year contract was signed for gadgets with a new supplier who promised, based on demand estimates of 1000, 1500, and 2000, all the gadgets the organization needed at \$7 each, compared to the \$10 the organization is spending now with the current gadget supplier. However, switching requires an upgrade of the production process, and this is going to cost \$5,100 up front.

At a contract level, the buyer expects to save \$8,400 since instead of spending \$45,000 for 4500 units; the buyer is in fact spending only \$31,500 plus \$5,100, or \$36,600. If, in fact, the actual demands were 900, 1600, and 2200, then the actual savings could be calculated on a unit basis using an amortized fixed cost of \$1,700 a year as follows:

$$\text{Year 1: } (10 * 900) - (7 * 900 + 1700) = 9000 - (6300 + 1700) = 1000$$

$$\text{Year 2: } (10 * 1600) - (7 * 1600 + 1700) = 16000 - (11200 + 1700) = 3100$$

$$\text{Year 3: } (10 * 2200) - (7 * 2200 + 1700) = 22000 - (15400 + 1700) = 4900$$

Or:

$$(\text{Old contract cost}) - (\text{new contract cost} + \text{amortized cost})$$

Alternatively, the organization could estimate total savings up front, amortize savings for the year, and then correct them in future years using actual demands versus projected demands. If the calculation is sound and agreed upon up front, it doesn't really matter if the sourcing professional is fairly acknowledged for the contributions made.

What is Cost Avoidance? (Successful and Sustainable Cost Reduction Methods #8)

What are Some Strategies for Identifying Cost Reduction Opportunities?

Defining Cost Avoidance

Cost avoidance is a cost reduction that results from spend that is lower than spend that would have otherwise been required if the cost avoidance exercise had not been undertaken. This accounts for the situations where spend is higher due to higher demand but overall cost per unit is lower, where up-front investments reduce overall spend in one or more categories over a multi-year initiative, and where a process improvement or product replacement resulted in a lower operating cost or cost per unit compared to what the company would have spent had the company not improved the process or replaced the product.

How is it measured and calculated?



The cost reduction enabled by a process is easily calculable by comparing the average operating cost for a fixed period before the process changes with the average operating cost for a fixed period after the process change, and everything that has been mentioned is measurable and calculable.

Thus, if the organization adopts this open definition of cost avoidance and maintains a document of common examples and their associated metrics, which is updated each time a new type of project is encountered that could result in a cost avoidance, the organization can fully quantify the “hard” and “soft” savings delivered by the sourcing team to the management team.

By doing this, the organization will have clearly defined cost reduction efforts, tied them to savings, defined their relative importance, and defined the share of the credit that will go to supply management in a cross-functional initiative. The organization will also have avoided the problem where the team over concentrates on finding “hard” dollar savings, which is a serious problem if raw material and energy costs keep rising significantly and the largest savings potential is in the “soft” savings realized by long-term process and product improvements.

Strategies for Identifying Cost Reduction Opportunities

There are many types of cost reduction and avoidance opportunities that could be significant to an organization and for which a buyer could get benefit for. In a large organization, there are usually a larger number of opportunities for cost reduction and avoidance because there is a lot more spend, along with other areas.

If you need some help identifying potential areas, ATS offers a no cost and no risk analysis assessment. This will provide you with some potential procurement areas to reduce costs in at no cost to you until we perform for you.

Analyze the Supply Chain for Cost Reduction

The reality is that unless an organization is best in class, and the harsh reality is that only a few companies are best in class, the organizational supply chain is losing cash in many areas.

Take a simplified PC supply chain for example. Raw materials are mined and shipped to a processing plant where they are refined and shipped to base part manufacturers. These base parts (such as chips, wires, etc.) are then shipped to component manufacturers who produce circuit boards, hard drives, cables, etc. These base components are then shipped to an assembly plant where the PC is assembled. From the assembly plant it is shipped to a central



distribution center where it is then shipped to a regional distribution center, store, or consumer's home, depending on the sophistication of the distribution center. Furthermore, the specifics of the supply chain depend on the suppliers the organization chooses to buy from, the carriers the organization chooses to handle its transportation requirements, and the consumer markets the organization chooses to sell to.

From this example, the following fundamental sources of cost can be derived:

- Labor (incorporate raw material collection, processing, and subsequent part and component handling).
- Parts (incorporate design, component raw materials, and built-in production operations).
- Operations (incorporate part production, handling, and overhead).
- Transportation (incorporate raw materials, parts, components, and finished product).
- Buying (who the organization buys from, where, and when).
- Selling (who the organization sells to, where, and when).

However, from a savings viewpoint, not all of these are equally important, since only some of these will be hemorrhaging cash in the supply chain, despite the absolute value on the cash flow statements. Furthermore, not all these sources of cost are under your control. Labor and selling, if being done right, will not be hemorrhaging cash, and even if they are, procurement only has limited control.

- Labor is defined by market rates. Moreover, companies that pay more for more productive people often have a higher ROI per person than those that pay less.
- Selling is marketing, materials, and labor. The first is generally not under your purview, and again the issue is not cost, but results; the second is covered by buying; and the third was just discussed.

From a supply chain perspective, the fundamental sources of cost in an organization that are likely ripe with cost reduction opportunities are:

- Parts.
- Operations.
- Transportation.
- Buying (goods and services).



How Do You Identify Associated Cost Reduction Opportunities? (Successful and Sustainable Cost Reduction Methods #9)

How does our Global Experts Identify Associated Cost Reduction Opportunities?

Our experts apply tried and true sourcing and procurement methodologies and technologies to each of these areas, analyzes the results, and extracts the most likely opportunities.

ATS conducts an analysis / assessment for its clients that encompass RFP review, contract review, staff questions, organizational structure (centralized?), culture, industry segment, communication effectiveness, upper management support for procurement, and many other areas. For the general purpose of this paper, the buyer can apply the following methodologies and technologies.

- Parts: Design for Supply, Enterprise Cost Management.
- Operations: Manufacturing Intelligence, Supplier Management.
- Transportation: Distribution Network Design, Consolidated Shipments.
- Buying: Strategic Sourcing, Spend Analysis, Award Decision Optimization.

Tackle the Four F's of Cost Avoidance

Although analyzing the supply chain as discussed in the previous section is a great start, there are cost reduction opportunities beyond the physical aspects of the supply chain. Just like there are four areas where the right technologies, methodologies, and strategies will save a lot of money (cost reduction), there are four areas where the right technologies, methodologies, and strategies will help an organization avoid spending money in the first place. They are the four business F's of cost avoidance:

- Failure.
- Facility.
- Focus.
- Finance.

Failure

According to **Aberdeen's Global Supply**, Visibility, and Performance Benchmark Report released in the fall of 2006, the average company had an average of two major supply chain disruptions per year and industry average and laggard companies were only able to meet customer-requested ship dates 40% of the time. Every time something goes wrong, it not only costs the organization revenue (lost sales, etc.), but it costs the organization cash as it usually requires expensive action to fix. Thus, an organization that could prevent failure could prevent costly expenditures and revenue loss that, when combined, could easily break six to even eight digits.



How does a buyer prevent failure?

Manage suppliers and manage risks. Do this by investing in visibility, supplier enablement, and risk mitigation strategies. Of course, unlike most of the cost reduction opportunities and measurements that have already been defined, this type of cost avoidance is not easily measurable. However, considering that preventing disruption insures that negotiated savings and reductions are realized, it's worth the effort – no point identifying ten million dollars of cost reductions just to have a supply chain disruption wipe them all out. After all, most organizations compensate a buyer on realized reductions and savings, not negotiated.

Facility

Facility can be defined as readiness or ease due to skill, aptitude, or practice. In other words, facility defines an organization's level of productivity. As hinted at in the section on types of cost reduction and avoidance, improved productivity is a valid form of cost reduction, and one that is easily measured. Maximizing productivity allows each organizational resource to do more, effectively lowering the overall cost of each product or service offered. There are many ways to improve productivity, but three that are generally applicable to most organizations are collaboration, e-Procurement, and Procure-To-Pay systems. Collaboration systems allow remote groups to work together more effectively and e-Procurement and PtP systems greatly simplify the actual ordering and payment processes, allowing more time to be spent on the development of strategies to reduce and avoid costs.

Focus

This refers to the organization's market focus and how the organization addresses the market. More specifically, it refers to organizational market and sales cost. Don't just let marketing outsource a campaign, there's no guarantee the agency selected is going to get anywhere near the best prices for print and media production. If the organization needs to bring in an agency to help with messaging, then it should do so especially since it's often a great idea and if the agency has a keen understanding of the target audience. However, it's critical to make sure service costs are decoupled from the print and media production costs that can be controlled. This allows procurement to determine how much is being paid for the service and to get the best price on production costs, by amalgamating campaigns and strategic sourcing required materials.

Finance

Money is the most expensive asset an organization could have. It needs to be collected, disbursed, protected, taxed, and, often, financed. And financing can really cost the organization a lot of money, even when the organization is not financing it directly.



The fact of the matter is if anyone, anywhere in the supply chain must borrow a lot of money to meet the demands placed upon them, they are probably paying a large financing charge, which is being rolled up into their production costs, and inflating costs throughout the supply chain. Therefore, a buyer should investigate whatever can be done to assist its supplier in mitigating financing costs whenever it has the opportunity, as this could considerably reduce costs in large purchases.

In addition, disbursements can also be costly as well, especially if the organization has mavericks not buying on contract and using the absolute best price that procurement spent a considerable amount of time negotiating and securing. It's worth having a good contract and compliance management system in place to track contracted costs, track purchases against those contracts, prevent maverick spend, and, most importantly, ensure that suppliers are invoicing at negotiated rates and that accounting is not paying them when they are not, as this can quickly eat away at cost reduction efforts.

Solutions?! (Successful and Sustainable Cost Reduction Methods #10)

What are Some Solutions that Can Be Initiated for Successful Outcomes?!

Solutions

Implement Best Practices

Sometimes the easiest way for a buyer to find cost reductions is just to run through a list of best practices and see if any might be appropriate for the organization. Below is a list to help you get started.

Look at opportunities for Lean Initiatives

Process improvements increase productivity which allows a company to generate more revenue with the same resources.

Look for previously untouched indirect materials and services spend categories

Chances are these categories are ripe with opportunities. They may not be the most profitable opportunities, but they are likely quick hit opportunities.

Leverage new technologies to tackle complex direct materials categories

For example, sourcing enabled PLM, collaboration, design to source, process cost models, and should cost models all be leverageable to produce cost savings.



Embed best-in-class processes in technology to reach a larger user base

In most organizations, only a handful of individuals are aware of, and fluent in, best practice processes at any one time. However, once embedded in user-friendly technology, they can be rolled out organization wide with minimal training.

Launch an aggressive internal marketing campaign on the benefits of procurement

Drive visibility and excitement around new procurement initiatives to get everyone on board. This will have a positive effect on maverick spend, allowing more negotiated savings to be captured. Without upper management support, the procurement initiative will not be sustainable.

Refresh Spend Visibility at least monthly

Make sure this data is always available to all stakeholders.

Take a total cost perspective on implemented savings

The organization should have incentives based upon the total value of implemented and captured savings.

Outsource non-core categories

Chances are that the underperforming indirect and services spend categories of one organization, are the core competency of a procurement services provider that constantly scores stellar results in these categories.

Partner with strategic suppliers

Don't just beat a supplier up on price – work with the supplier to improve processes and quality and get a bigger bang for the organizational work.

Think and act globally

Best-in-class organizations do not think or act local – they right-source on a global scale.

Proper Incentives

Successful companies must count cost reductions as savings. In addition, a company must clearly define recognized cost reduction efforts, tie them to goals, define their relative importance or weighting, and define the share of the credit that will go to the sourcing team in a cross-functional initiative.



Structured Incentive Plan

As mentioned before there is a strong argument to be made that a sourcing professional's compensation should include a variable compensation component based on meeting or exceeding various savings goals. These types of bonus plans are already common for senior management, marketing/sales, and production and have been shown to yield significant positive benefits when an individual's earning potential is limited only by her own efforts. And all things considered, who is likely to work harder: a supply manager who makes \$100K a year regardless of his performance, or a supply manager with the potential to double, or even triple, her salary if she hits a recognized savings target of 5M or more?

This is also a good argument to be made for properly structured uncapped compensation packages. This might sound crazy to a manager, like a CFO, whose job it is to reign in expenses, but it is not expenditures that ultimately determine a company's success, but profit, and when procurement is involved, this depends soundly on ROI. Arguments might be made to the contrary, but clearly there is sound logic in paying a sourcing professional 500K a year if that sourcing professional can generate 10M in savings that the company would not otherwise have seen. Why? Let's say instead of \$100K / yr. + 4% on all recognized savings the sourcing professional had a fixed compensation structure of \$100K + 20K bonus for hitting a 2.5M savings target or a 40K bonus if he hit a 5M savings target. Given that he can't earn more than 140K, how hard is he likely to work once he hits 5M? Back to our ROI perspective, it makes much more sense to offer a limitless bonus plan.

With the fixed plan, it costs the organization 140K, but the organization saves 5M for an ROI of \$4.86M. But with the variable plan, the organization spends 500K and saves 10M for an ROI of \$9.5M. Maybe the first option sounds more inviting to a penny pincher like Scrooge, but what sane individual in their right mind would seriously turn down the second option with its additional \$4.64M of savings?

Successful companies have known for years that the best performing salespeople are those with the potential to make more than anyone else in the company. Consider that it is a well-known fact that each dollar saved is worth five to ten dollars in sales revenue (with respect to its bottom-line impact), doesn't it just make sense to incentivize sourcing at least as much as sales are incentivized, especially considering what they can do? HP's first quarter results for the year 2006 - earnings went up 51% even though revenue increased by only 5.5%! Why, because "procurement across the board at HP made a substantial contribution to the results"!

http://www.esourcingwiki.com/index.php/Cost_Reduction_and_Avoidance



Hard Savings vs. Soft Savings: Creating a Spectrum

Most of the information below was taken from Six Sigma, because of the great explanation and outline about Six Sigma, its definition, hard savings, soft savings, and intangible costs (URL listed below for reference). Six Sigma is a process based entirely on what can be measured and quantified. Keeping this in mind, it should be no surprise that companies incorporating Six Sigma into their culture prefer to measure success in terms of hard savings. Corporations nearly always see financial savings as the bottom line and don't like bothering with the intangibles associated with soft savings. Before completely dismissing them when evaluating a potential Six Sigma project, keep in mind that soft savings are more beneficial and "hard" than may first be realized.

Hard savings are traditionally much easier for management to understand and that's why they are so desirable. It's easier to give the green light on a project that results in increased revenue/sales, lower overhead costs, and reductions in unit costs.

One way to shift this way of thinking about hard savings versus soft savings is by not thinking of them as hard or soft at all, but rather as a spectrum. This spectrum has four categories; each labeled individually yet represented as a whole (think 1-4).

A sample project, using this way of thinking, would go as follows:

- Category 1 – this represents a hard savings in the current financial period that's documented on the budget (It must be hard if it's worked into the budget (keep this in mind when putting together your spectrum)).
- Category 2 – this may also represent hard savings but it's not something that's documented in the current financial period and is more of a projection (It might be something involving a balance sheet, etc.)
- Category 3 – this begins a gentle shift into soft savings and may point to things like cost avoidances (This is a great way to introduce them, as they will certainly occur softly, but there is no hard and fast documentation for this).
- Category 4 – this is more of a complete intangible and would be measured as soft in a traditional sense (It may deal with safety improvements or something else with no measurable proof and no quantifiers).

The key to really giving these potential improvements a chance is by not always thinking of them as "savings." This word can prove limiting, and your project may best be served by instead looking at these as "benefits."



<http://www.sixsigmaonline.org/six-sigma-training-certification-information/articles/hard-savings-vs-soft-savings-creating-a-spectrum.html>

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