How to cut costs effectively

It is inevitable that the ongoing economic problems will lead to major cost reductions for many businesses. Management's challenge is to deliver cost savings that help both short-term profit performance and longer-term value growth.

In my experience companies can fall into one of three traps:

1. Focusing cost reduction on areas with highly variable costs. Advertising, training and recruitment are often hit simply because they are easy to switch on and off.

2. Seeking to give all areas of the business an equal share of the pain. For example, all departments may be required to find 20% cost savings regardless of their relative importance.

3. Enabling a political power struggle. I have witnessed organisations where departmental leaders use their influence with the CEO to campaign to protect their area, whatever the cost elsewhere.

So how do you cut costs effectively? Here are three approaches to help you deliver short *and* long-term gains.

1. **Identify and protect your key value drivers.** A value driver is a business activity that has a disproportionately large impact on the profit and value of the organisation. These drivers should be managed so that they optimise long-term value, not so that their costs are minimised. The latest edition of Business Week, for example, reports that companies such as American Express, Accenture and Kellogs are protecting or increasing their marketing budgets because effective marketing is a key value driver of those organisations.

2. **Understand where you are competitively disadvantaged on cost.** Don't just review your own costs to drive profits, you should also critically review and understand your competitors' costs. By identifying the activities that your competitors are delivering more efficiently you will be able to focus your efforts where you can improve profits and your competitive position.

3. **Determine where you make and lose money.** A good starting point for increasing profit is to stop losing money. In most businesses there are areas of high profitability and areas of low returns or losses. Poor-performing businesses cannot be switched off overnight, but focusing your resources and effort where you deliver the greatest returns is likely to raise profits. Tesco, for example, continues to devote more resources and space in its stores to

non-food categories primarily because it makes more profit from them than it does from its food categories.

These three principles of cost reduction are sound business practice in good economic times, but can be the difference between corporate life and death during periods of market decline. Where are you cutting costs to ensure that your business not only survives but also thrives?