In this article we discuss the reasons why many companies view cost reduction as a strategic imperative, the frameworks companies use to guide their cost reduction efforts, the goals they adopt, and the range of results that companies can expect to achieve through the use of the techniques we describe. The article concludes with recommendations for a business leader wanting to pursue strategic cost reduction.

When Is Cost Reduction Strategic?

Many well-run companies view cost reduction as an integral part of their business strategy and not as something they do only when times are tough. Many companies adopt cost reduction as an ongoing, never-ending part of their strategy for several reasons:

They may not be up to the profitability level expected by their stockholders, owners, or lenders. In the case of a publicly owned company, stockholders usually expect improved profitability each and every year. For both public and privately held companies lenders look for acceptable profitability levels in order to deem the company a good lending risk.

They may rely on reducing costs in order to fund growth or infrastructure initiatives such as developing new products or replacing older, inefficient business information systems. Most companies have no shortage of good ideas to grow or otherwise improve the business. These good ideas almost invariably cost money, and that money has to come from somewhere. Most businesses, including those that are publicly or privately held, don’t have the luxury to simply fund these ideas by reducing profits; by reducing costs in other areas of the business, a company may be able to fund growth or infrastructure initiatives without reducing their overall level of profitability.

Many companies use cost reduction each year to fund annual employee merit (pay) increases. In times of positive inflation, employees expect to receive pay increases each and every year. Ten years ago it was common for annual pay increases in the range of 2% to 4%; more recently, annual pay increases have been lower, often in the range of 1% to 2%. For many companies, salaries are one of the largest elements of their cost structure.

If your company is lucky enough to be able to increase prices to customers each year, you may be able to recover the cost of higher wages from your customers and not suffer reduced profitability. In many industries, though, companies have limited ability to pass along cost increases to customers. In those instances, many companies reduce costs in other areas of the business in order to avoid having annual pay increases result in smaller profit margins.

In some industries customers expect price reductions each year. This is most common in newer industries that are highly competitive and where aggregate sales volumes are increasing rapidly. It can also occur when there are new entrants to an industry, and those new entrants position themselves as low price providers. In those instances companies may need to reduce costs each year in order to offset price reductions and avoid lowering profit margins.
Finally, those companies that have made an ongoing cost savings program a part of their business strategy generally find it easier to take extraordinary cost cutting measures during economic downturns or other periods of time when their business is significantly depressed.

Companies with more sophisticated cost reduction programs often adopt one goal and set of activities aimed at reducing internal costs and a second goal and set of activities aimed at reducing the cost of purchased materials and services.

**Reducing Internal Costs**

For many companies, the largest element of the cost structure is usually employee salaries and benefits. Manufacturing companies often have other large, controllable internal costs such as material scrap and warranty expense.

Because companies have a greater control over internal costs than they do over the prices they pay for purchased items, they often set a higher goal for reducing internal costs each year. A typical goal for internal cost reduction I’ve seen in use at many companies is 4%, meaning a 4% reduction in the cost of an internal activity as compared to the cost for the same activity in the prior year.

Companies that are serious about reducing costs on an ongoing basis very quickly move beyond the “employee suggestion box” approach to uncovering cost reduction opportunities. Most companies that have adopted cost reduction as an element of business strategy adopt one or more structured continuous improvement approaches such as Lean or Six Sigma in order to drive waste out of processes and achieve cost savings and other very tangible business benefits.

**Lean is both a philosophy and a set of tools for finding and eliminating waste in processes.** An offshoot of the Toyota Production System, Lean considers waste to be anything that doesn’t create value from the perspective of the end customer of the company. There are seven types of wastes, known in Lean terminology by the Japanese term “muda,” that Lean programs aim to systematically identify and eliminate:

1. Transport (moving products more than actually required)
2. Inventory (all physical components and product not being worked on)
3. Motion (people or equipment moving more than required)
4. Waiting (for the next production step)
5. Overproduction (production in advance of demand)
6. Over processing (resulting from poor tool or process design)
7. Defects (effort required to inspect for and correct defects)

Like other continuous improvement approaches, Lean uses several tools which aid in the identification and elimination of waste from processes. Typical tools used when implementing a Lean philosophy in an organization include:

- **Value Stream Mapping:** An approach to visualize supply chain or transactional processes and sources of waste
- **5S:** An approach for cleaning and organizing an area in order to improve productivity; 5S is a shorthand abbreviation for sort, straighten, shine, standardize, and sustain
• Standard Work: A written, standardized, best practice, step-by-step procedure to do something which is followed consistently by all employees

• Visual Controls: A set of visual tools that indicate the current status of jobs and call attention to issues with simple, visual indicators

• Lean Leadership: A set of recommended leadership activities which help to promote lean thinking in the organization

What is today referred to as the “Lean” methodology was originally known as “Lean Manufacturing.” Over time, manufacturing companies recognized that the Lean Manufacturing philosophy and toolset was as applicable and effective at reducing waste in back-office transactional processes as it was in physical manufacturing and supply chain processes. As the Lean Manufacturing approach and philosophy became more accepted in transactional parts of the organization as well as by service providers, the term “Lean Manufacturing” began to be replaced by the more general term “Lean.”

Today the Lean methodology continues to gain acceptance and be used by more and more companies of all types. In addition to its increased use in non-manufacturing transactional processes and by service providers, we now are seeing an explosion of adoption for other, more specialized uses. In the popular literature it is becoming more common to see references to these special variants of the Lean approach:

• Lean Accounting
• Lean Product or Software Development
• Lean Services
• Lean Start-up

Value Stream Map for a Healthcare Process
When Lean techniques are applied to a manufacturing or distribution process or a transactional business process, the magnitude of the improvements will often be surprising to leaders who are experiencing the approach for the first time. The typical range of improvement you can expect to see when applying Lean techniques to processes designed without a lean philosophy are shown below:

<table>
<thead>
<tr>
<th>Metric</th>
<th>Improvement Potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Productivity</td>
<td>25 – 75%</td>
</tr>
<tr>
<td>Inventory</td>
<td>40 – 70%</td>
</tr>
<tr>
<td>Delivery Lead-times</td>
<td>30 – 50%</td>
</tr>
<tr>
<td>Set-up Time</td>
<td>50 – 75%</td>
</tr>
<tr>
<td>Quality</td>
<td>30 – 50%</td>
</tr>
<tr>
<td>Space Reduction</td>
<td>30 – 60%</td>
</tr>
<tr>
<td>Travel Time</td>
<td>25 – 75%</td>
</tr>
</tbody>
</table>

Typical Benefits from Applying Lean Principles

The reason new Lean practitioners are often so surprised by the magnitude of improvement possible through application of Lean tools is that the original processes were usually set up by highly educated and motivated employees. Lean concepts are not necessarily obvious, but they are straightforward and can have a huge, positive impact on business results when correctly applied.

**Six Sigma is a structured improvement process that reduces or eliminates variation in processes.** Developed by Motorola in 1986, the central philosophy of Six Sigma is that all processes and physical products have variation, meaning a deviation from the ideal state. The more a product or process deviates from the ideal, the less value that product or process will have to the customer. A sensible goal, then, is to identify and reduce or eliminate sources of variation. By doing this, a higher percentage of the product or process output
will be of acceptable quality, thereby lowering costs to the manufacturer or service provider and improving customer satisfaction.

In addition to a standardized, 5 step approach to understanding and improving processes (Define, Measure, Analyze, Improve, Control - referred to as “DMAIC” by Six Sigma practitioners) Six Sigma includes several problem solving tools and a strong reliance on statistics to understand and improve both physical manufacturing processes as well as business processes.

Six Sigma 5-Step Problem Solving Approach (DMAIC)

Representative tools used by a Six Sigma practitioner include:

- **Fishbone Diagrams:** A visual tool used to identify potential sources of variation caused by manpower, methods, machines, or materials.
- **Control Charts:** A graphical, statistically-based way of identifying when processes are showing unusual variation
- **5 Why's:** A method of repeatedly asking the question “Why?” to identify root causes of problems
- **Process Capability Index:** A numerical way of expressing how capable a process is of producing product which meets specification
- **Failure Modes and Effects Analysis (FMEA):** An approach to ensuring that products and processes are designed in such a way as to prevent defects
- **Pareto Analysis:** A graphical way of identifying the causes of problems in descending order of likelihood
While this list of Six Sigma tools is not exhaustive, it should give you a sense of how Six Sigma combines general qualitative problem solving tools with very statistically-based quantitative tools and methods.

Fishbone Diagram for Error Causes in Insurance Claims

Control Chart to Reduce Errors in Mortgage Applications
After Six Sigma had been in use for several years, some shortcomings of the framework became apparent. Some companies reported that a strong focus on the use of the Six Sigma methodology in some instances stifled creativity in R&D groups. Other companies experienced a resistance to the use of the framework due to the strong focus on statistical techniques which were hard to understand for many employees and not always required to understand or solve simpler problems, especially those outside of the manufacturing environment.

As a result, in the past several years alternative continuous improvement frameworks have emerged which include standardized, multi-step problem solving approaches analogous to Six Sigma’s DMAIC, simple problem solving tools such as the fishbone diagram example above, but which eliminate or greatly reduce the focus on statistics.

**Practical Process Improvement (PPI), a framework developed by Ed Zunich, consists of an 8 step problem solving approach, many of the simpler Six Sigma tools, and has a more limited focus on statistics.** Because this framework was easier to understand than the statistics-laden Six Sigma, I observed a much greater acceptance of PPI by employees at my last company than employees at my prior two companies accepted the Six Sigma programs in use at the time. While PPI is an excellent framework for generating cost savings in the organization, its more general purpose is to drive profitable growth of the company; it is equally useful for tackling customer satisfaction opportunities as well as improving processes associated with top-line growth of the company.
Hard Versus Soft Cost Savings

One issue you will invariably stumble upon if you get serious about your cost saving efforts is that not all of the cost savings your organization reports result in increased profitability for your company, at least initially. The issue has to do with the nature of the cost savings and whether or not the costs physically leave the business. To understand this concept it is helpful to think of all cost savings as being in one of two categories, hard cost savings or soft cost savings.

**Hard Cost Savings: The activity stops and the costs leave the business.** An example of a hard cost saving is a reduction in overtime expense incurred by a particular group within your company. In a typical cost savings project, a business process is analyzed, waste identified and eliminated, and the resulting process takes less labor hours to perform. If this is done in a work group that incurs overtime expense (i.e. time-and-a-half or double-time pay), the result is often less overtime hours worked each week, and a corresponding reduction in wages paid to the group of employees. In this example, the amount of activity associated with the process is reduced, and the amount of cash the business pays out each month in wages is reduced as well. Because costs of the business are reduced, a project with hard cost savings will result in higher profitability for the business.

You also generate hard cost savings when you don’t replace an employee that leaves your company. This is often possible when wasteful practices are reduced in the workgroup that the individual who left worked in. Similarly, it can be considered a hard savings if you avoid hiring a new employee that you otherwise would have had to hire had you not undertaken the cost reduction project. Finally, if you reduce the amount of materials you use or scrap you generate in a manufacturing process you are generating hard cost savings as well.

**Soft Cost Savings: The activity stops but the costs remain in the business.** In many cases a cost reduction project results in one or more employees spending a few less hours per week on a particular activity. In many instances those employees simply use their time freed up from the other activity to do something different. If there was no overtime expense in that group which was reduced, and no employees leave the business as a result of the cost savings project, the business sees no reduction in the amount of wages they pay out every month. In other words, the activity associated with the cost savings project stopped, but the full costs of the employees doing the activity remain in the business. Because costs of the business remain the same, a project with only soft cost savings will not improve profitability, at least initially.

Projects with only soft cost savings may be very worthwhile for reasons unrelated to short-term profit improvement, though. These projects often result in faster turnaround time for transactional processes, reduced error rates, and greater satisfaction for employees involved in the process and internal or external customers of the process. In addition, the new activities that employees can now spend their time on may eventually yield additional top line or bottom line business benefits.

A Steering Committee is a Vital Element of the Program

Many companies find that after the first projects are completed, usually with a significant degree of success, there is tremendous enthusiasm to expand the program, address more opportunities, and “fix” all of the issues that employees have lived with for a long time. One of the quickest ways to stall a continuous improvement program and frustrate employees is to allow for unmanaged growth of the program. Project work is done during discretionary time that employees have, meaning that this is something they do in addition to their “day job.” When a continuous
improvement program is allowed to expand too quickly it can disrupt the ability of the organization
to serve customers and attend to other, day-to-day needs of the business.

Having a Steering Committee with company leaders engaged in the specific focus and growth of the
program is the best way to prevent these issues from occurring and maximize the business benefits
from the investment in employee time. A Steering Committee has several important roles to play:

- Set annual goals for the program
- Manage expansion of the program over time
- Select the right high-impact projects
- Define project objectives and scope
- Help project teams to avoid “scope creep”
- Resolve resource conflicts impacting project success
- Recognize teams and individuals for their contributions
- Reinforce program participation through performance review, pay increase, and promotion
  processes

**Reducing the Cost of Purchased Materials and Services**

Some companies adopt a goal for year-over-year price reductions for purchased materials and
services of 3%, meaning that they aim to pay 3% less this year than they paid a year ago for the
same material or service. Yes, you read that right. Some companies actually achieve a reduction in
the prices they pay as compared to the prior year for a surprising high percentage of their total
spend. This is achievable in many instances for products or services for which there are multiple
suppliers, an intense rivalry among the competitors, and where there is not an established
industry-wide price.

Meeting a 3% cost reduction goal does not mean that you should expect to reduce costs on all of the
materials and services you buy. It is quite normal for some prices to increase a little over the prior
year, some to remain flat, and others to decline from what you paid the year earlier. The goal
should be to see the average across your entire spend on products and services decline year-over-
year.

To achieve this level of cost savings companies use a combination of an open, competitive bidding
process coupled with a long-term commitment to the chosen supplier. The trick is to let all of the
suppliers know that there are multiple suppliers vying for the business, that price will be one of
several decision criteria for awarding the business, and that you are willing to make a long-term
commitment to the winner in exchange for favorable payment terms and pricing.

**Typical Elements of a Competitive Bid Process:**

- Clear expectations are set for product or service quality
- Initial pricing is expected to be lower than what you currently pay (3% target)
- Favorable payment terms (Net 60 days is common in some industries)
- Further price reductions expected in future years
• 3–5 suppliers bidding on your business is ideal; all suppliers are told that the bidding is competitive
• All suppliers access the same information at the same time (level playing field)
• A long-term contractual commitment of your business (typically 3 years with an option to extend) provided that the supplier performs to expectations

To achieve this level of savings does not mean that you have to abandon all of your local suppliers and start buying all or most of your materials from a low cost supplier in China, Mexico, or Eastern Europe. Moving some of your spend to those regions may make sense as an element of your overall cost savings program, but it is not absolutely necessary in all but the most cost competitive industries.

Larger manufacturing companies that are most successful at reducing the cost of purchased materials and services will often split the purchasing group into 2 types of roles: Commodity Managers specialize in specific commodities or services and have the responsibility to identify potential suppliers, manage competitive bid events, draft and negotiate contracts including pricing, provide periodic performance feedback to suppliers, and drive for ongoing price reductions beyond year one of a new supplier relationship. Buyer-Planners are responsible to forecast the quantity of material required and place purchase orders with suppliers. Buyer-Planners are responsible to ensure that the manufacturing organization has the quantity of materials they need to meet their production schedule while also meeting inventory turn expectations.

The reason larger companies often split their purchasing department into the two roles I mentioned is that the two roles require very different skills, interests, and personality types; Commodity Managers tend to be more relationship oriented, are tough negotiators, and have significant contracting experience. Buyer-Planners on the other hand need to be experts in Material Requirements Planning (MRP) business systems which translate production requirements and inventory policies into required quantities and delivery schedules for materials. It is extremely rare in my experience that Buyers will be good at and enjoy doing both sets of activities I described.

It is possible in many instances to reduce the cost of purchased materials and services as compared to what your company pays today. A good place to start is to hire an experienced Buyer with good negotiation and contracting skills who can set-up and administer a formal program to reduce material and service costs.

**Customers Benefit From Your Cost Reduction Efforts**

The activities that reduce costs in a business often improve customer satisfaction as well. Examples include:

• A project which reduces warranty expense for a company results in fewer quality issues experienced by customers
• A project which takes waste out of a business process to accept returned merchandise from customers results in customers getting their refunds faster
• A project which takes waste out of the process which generates sales quotes for sales teams results in customers getting their quotes faster
• A project which removes unnecessary steps in a manufacturing process results in shorter order lead-times, and as a result customers get their product shipments faster
• A project which makes a service process more efficient results in lower cost and time to deliver the service to the customer; the company may share some of the savings with the customer in the form of lower prices

**The Role of the Finance Team**

The CFO, Controller, and Finance Team play important roles in a cost reduction strategy. A good CFO or Controller ensures that their business partners including the CEO, President, or other business leaders have the financial reports they need to understand and manage costs within the business.

The ability to reduce costs starts with a solid foundation of budget preparation, ongoing management of expenses to budget, clear ownership for each cost center making up the overall expense budget for the firm, timely and accurate expense variance analysis and reporting, and identification of issues and opportunities to the responsible business leader.

In addition, the Finance Team needs to validate the magnitude of projected cost savings generated by projects throughout the organization, help the organization understand and differentiate between hard and soft savings, restate budgets based on realized cost savings, and help to ensure that projected cost savings are actually realized.

If these basic disciplines are in place and functioning properly, then the application of a strategic cost reduction program to the overall business strategy can provide greater profits over time, a source of funds to cover annual merit increases and strategic investments in the business, or both.

**Recommendations for the Business Leader**

There are dozens of continuous improvement / cost reduction frameworks available to businesses and hundreds of consulting companies who teach these frameworks to businesses. How is a business leader to choose the right framework for their company?

My general advice is that in all but a few specific circumstances, the right starting point if a business wants to adopt a structured approach to continuous improvement and cost reduction is to explore the use of Lean concepts and tools. Lean tools and principles work very well in service industries, back-office functions within any type of company, and they certainly work well in most manufacturing settings since manufacturing companies were the first adopters of Lean principles.

Lean will give your work teams the tools to analyze processes, identify sources of waste, redesign the process with less waste, pilot the improved process design, and then scale-up the improvements once they are proven to be more effective than the initial approach.

The Lean tool set is readily understood by both technical as well as non-technical employees, and its applicability in non-manufacturing as well as manufacturing settings is relatively obvious.

If you are looking to drive improvement and reduce costs in complex manufacturing processes such as semiconductor manufacturing, high-precision machining, or sensitive measurement equipment or medical equipment, then it makes sense to consider adopting Six Sigma or one of the related but simplified frameworks. The employees involved in the design and manufacture of these types of products are generally much more technically adept and will be more likely to see the value of and successfully employ Six Sigma methodologies to the design and manufacture of these complex products.
In any case, my recommendation is to engage a local consultant to teach your organization to employ the framework, provide the necessary training materials and tool templates, and to facilitate several initial projects. After completing a few projects you should have a good idea of the impact on your business and the acceptance by your employees of the general approach.

When selecting a consultant for Lean or Six Sigma, three important factors to consider are implementation experience, facilitation skills, and experience working in an industry similar to yours. Some consultants gained the bulk of their experience working within a company that utilized Lean or Six Sigma methodologies. While they may understand and be able to explain the concepts, they may not have had the experience of implementing a program from scratch which can present challenges of employee buy-in, inadequate management support, and other change management issues.

One of the best ways to ensure that your employees have a favorable first experience with one of these methods is for the facilitator to use language and examples that your employees can relate to. For example, if yours is a service or transactional business and the facilitator uses terminology applicable to a manufacturing or supply chain operation, your employees will have a difficult time understanding how the tools can be applied to their situation. Make sure that the consultant you select has implementation experience in an industry similar to yours and that they are willing and able to use terminology and examples which your employees can relate to.

If you find that the framework is delivering useful cost and non-cost business benefits and your employees are generally accepting of the approach you can then consider whether it makes business sense to hire a full-time employee on your staff to expand the program to other areas of the business and sustain it over time.

**Focused Execution and Strategic Cost Reduction**

Because a cost reduction program takes time and attention from the management team as well as key resources throughout the organization, you should implement it as part of an overall strategic plan for the business. Focused Execution is a highly effective approach to strategic planning for businesses of all types and sizes.

In a Focused Execution engagement our consultants work with your team to develop high level objectives for the business and a differentiated strategy that will allow you to achieve those objectives. Cost reduction is very often one of the elements of the overall business strategy. Next, we help your team to identify the initiatives and action items that form the Strategic Action Plan that will make your strategy a reality. Because our consultants have run businesses that implemented similar strategies and initiatives, we can help you to avoid implementation pitfalls many companies experience when implementing programs such as these.

Finally we work with your team to set up a project review cadence and a culture of discipline and accountability that ensures that the initiatives and action items get completed and that you achieve the expected business benefits. Focused Execution has had such a track record of success for businesses across an incredibly large range of sizes and industries that we offer a satisfaction guarantee for our services.
Additional Resources

If you search on the key words “Lean Manufacturing” or “Six Sigma” on Amazon’s book section you will get several thousand results. Both topics have been popular book subjects for consultants, academics, and practitioners for many years. I can recommend a handful of books which are useful to read if you want to get more information on the subjects. You will notice if you pursue additional information on these topics that more and more practitioners and consultants are combining both Lean and Six Sigma approaches into a single methodology, taking the best of what both have to offer.

Recommended Books


2. Rother, Mike and Shook, John. (1999). *Learning to See: Value Stream Mapping to add Value and Eliminate Muda*. Brookline, MA: The Lean Enterprise Institute, Inc. Focused on Value Stream Mapping, mainly in manufacturing and supply chain operations. Describes how to create a value stream map, identify various wastes, and apply Lean concepts to reduce waste, lower costs, and shorten lead-times. John Shook is the current Chairman and CEO of the Lean Enterprise Institute.


Recommended Websites

1. The Lean Enterprise Institute: [www.lean.org](http://www.lean.org)
2. The Lean Enterprise Academy: [www.leanuk.org](http://www.leanuk.org)
3. iSixSigma: [www.isixsigma.com](http://www.isixsigma.com)
4. Practical Process Improvement: [www.ppiresults.com](http://www.ppiresults.com)
About the Author

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Based in Roseville, California, Allen leads the Strategic and Operational Advisory practice of the professional services firm DCA Partners. With more than 20 years of experience in general management, supply chain management, and operations consulting, Allen has held chief executive positions for businesses ranging in size from $90 million to $750 million in annual revenue. He has broad industry experience having worked in or consulted to companies in the consumer goods, automotive, aerospace, medical equipment, life science, and computer hardware industries. He holds a BSEE from MIT and an MBA from Boston University. At the start of his career he served in the US Navy as a nuclear trained division officer on submarines.

Since 2001, DCA Partners has earned its reputation as one of the nation’s finest strategic advisory firms, delivering exceptional results for middle market clients across a wide variety of industry sectors. Headquartered in Roseville, CA, DCA works primarily with companies in the broader Northern and Central California regions, as well as adjacent underserved markets across the western U.S. We also advise and invest in companies outside our targeted geography where our Partners possess particular industry or situational expertise.

Mergers and Acquisitions: Whether you are looking to acquire another company, sell your company, or position your company for sale in 2-5 years, DCA can help ensure a successful transaction which maximizes your financial returns and mitigates both economic and qualitative risks. We have worked with some of the region’s largest and most respected companies. We can bring this same world-class expertise to your transaction – no matter how large, small or specialized it may be.

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Private Equity: DCA Capital Partners, LP provides expansion capital to growth-oriented, middle-market businesses in underserved and rural communities across California and the Southwest, where such growth capital has historically been unavailable or difficult to access. The Fund provides promising later-stage companies, typically in the range of $10–100 million in revenues, with the additional capital and expertise needed to successfully expand and extend their businesses.