Chapter 1

Corporate Cost-Control Strategies

CONTROLLERS' CORPORATE COST-CUTTING PLANS

Despite the strongest economic environment and profit rebound in the past 20 years for most businesses, companies are still targeting areas in which to further streamline costs. Because of the strength of the expansion, though, controllers at smaller companies have dramatically altered their focus—away from capital spending, where increases are now the norm, and toward areas such as health care costs and purchasing/materials costs, where prices still can be hammered away at (see Exhibit 1.1). An IOMA survey revealed that although hundreds of controllers at larger companies are still focusing mainly on capital spending, other areas are increasingly coming under the spotlight.

Exhibit 1.1 Most Critical Cost-Control Areas, by Number of Employees

	Overall		< 250		> 250	
	2004	2003	2004	2003	2004	2003
Health care benefits	55.7%	49.6%	70.2%	50.0%	42.6%	45.7%
Purchasing/materials costs	51.5	53.8	53.2	53	48.9	54.3
Capital expenditures	42.3	56.3	34	56	51.1	55.3
Manufacturing/production costs	39.2	41.3	36.2	35.1	40.4	51.1
Professional services costs (i.e., legal, accounting/auditing, banking)	35.1	40	29.8	41	38.3	35.1
Compensation	33	36.3	36.2	40.3	31.9	29.8
Inventories	30.9	45.4	23.4	42.5	36.2	46.8
Advertising expenditures/budgets	27.8	20	29.8	22.4	27.7	13.8
T&E	25.8	27.1	25.5	25.4	25.5	26.6
Use of outsourcing	25.8	—	23.4	—	27.7	—
Sales & marketing costs	22.7	26.3	25.5	25.4	19.1	28.7
Property/casualty insurance	20.6	23.8	27.7	23.1	14.9	23.4
Worker's compensation	20.6	22.5	23.4	19.4	19.1	25.5
DP/MIS expenditures/budgets	18.6	20.8	14.9	20.1	23.4	22.3
Downsizing	13.4	15.4	8.5	12.7	17	21.3
R&D	7.2	5.4	2.1	7.5	10.6	3.2
Pension plans	6.2	2.9	8.5	2.2	4.3	2.1
Retiree benefits	1	2.1	0	1.5	2.1	3.2
Other	11.3	11.7	10.6	11.2	10.6	10.6

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Small Firms Identify Health Care Benefits Costs as Main Focus

A whopping 70% of controllers at small firms (less than 250 employees) now target health care costs as their key focus for the next 12 months. To do this, they are increasing cost sharing with employees; increasing co-pays, deductibles, and lifetime limits; changing to prescription programs with two or more tiers; and adding or enhancing voluntary benefits programs.

For the past few years, employers have emphasized cost sharing as the most effective means of controlling benefits costs, along with increased co-pays, deductibles, and lifetime limits. The shift shows that more companies are asking their employees to pay for more of the coverage. Employers large and small are using this approach. In many companies, all employees are now expected to contribute to the costs of their insurance, even for single coverage. Many also now offer a three-tiered system of contribution to insurance coverage across the board: the more money you make, the more you contribute toward the insurance. Most companies also offer a buyout of the insurance plan if an employee can show that he or she is covered elsewhere.

Changing to a tiered prescription drug program is the next most effective cost-control technique. Under these programs, cost sharing by employees increases if they choose brand-name drugs and decreases if they choose formulary or generic drugs. (See Chapter 3 for a fuller discussion of each of these approaches.)

Supply Management Best Practices: “Get Tough” Attitude

Controllers at both large and small companies place supply management nearly at the top of the list of areas on which they need to focus. This reflects their response to the economy and the upturn in business conditions. Specifically, it means taking a tougher stand on price increases and renegotiating existing supplier contracts when possible. It also means continuing to consolidate the supplier base, issuing blanket purchase orders for some goods, and shifting inventory to suppliers. At the same time, most controllers increasingly recognize their dependence on their suppliers’ control of their own costs; hence, they are looking across the entire supply chain and their logistics operations for savings.

Another best practice that purchasing managers now increasingly favor is global sourcing. Foreign-based suppliers are able to cut most companies’ materials costs by 30% or more, although the supply chain is longer and better planning is necessary. E-sourcing and e-purchasing processes are also gaining favor with purchasing managers, with about one in five now doing either or both. (These approaches are all described in more detail in Chapter 10.)

Controlling Compensation Costs: Reducing the Size of Merit Pay Increases

Controlling compensation costs ranks fifth on controllers’ list of where they are focusing their efforts. In this area, it is often best to take a cue from compensation managers who face this issue every day. Nearly half of these experienced professionals indicated that reducing merit pay increases was their top method for con-

trolling compensation costs. In many cases, however, companies are combining reduction in merit increases with a new emphasis on performance and rewards to top employees, partially as a way to offset any resulting ill will, as well as to emphasize the "merit" portion of the merit increase concept.

Following well behind reduced merit increases are hiring freezes and headcount reductions. More than one-third of compensation professionals indicated that these were their most effective means of controlling costs. Far more creative and less draconian is to create a pay structure that distinguishes much more sharply between high and low performers. This approach ranks third in effectiveness, but has a much better impact on morale and productivity. (See Chapter 4 for more detailed descriptions of these approaches.)

Growth Stage of Business Cycle Alters Strategies

Given the current growth stage of the business cycle, controllers are, for the most part, no longer focused on reducing research and development (R&D) expenditures or downsizing. Inventory strategy, however, requires constant attention. The best way to control inventory, regardless of the stage of the business cycle, remains the periodic review. Identified by more than 60% of inventory managers for the past five years running is the periodic—daily, weekly, monthly, quarterly, or other time frame—seeking-out of slow-moving, excess, and obsolete stocks. This involves virtually everyone in the company who has any impact on inventory. (For more on this and other approaches, see Chapter 11.)

BAIN STUDY OUTLINES STRATEGIC IMPORTANCE OF CONTINUOUS COST-REDUCTION PROGRAMS

More controllers are working with senior managers to develop a new framework for examining and continuously reducing costs. Under this approach, top managers have decided that cost discipline will be a program, not just an implicit element of operations. Further, they expect this program to become a core competency.

In many cases, controllers who participate in these continuous cost-reduction programs are helping to remake corporate culture. *Reason*: At most businesses, cost discipline is an incidental reaction to events—usually a sales slump—and a byproduct of budgeting. Though this cultural change is hard work, controllers usually say the eventual success justifies the effort. Indeed, the consulting firm Bain & Company claims that businesses with successful programs of continuous cost reduction typically achieve half their increase in annual profits directly from cost reduction.

Controllers who work on these programs often emphasize two additional benefits. First, they say a business with a free-standing program of cost discipline stabilizes more rapidly in a downturn. This means that such companies are ready to grow once the business cycle turns.

Second, these firms adjust more rapidly to so-called trigger events. Bain identifies these as a collapsing market, a new technology, or a sudden increase in competition. *Key point*: All of these have a profound effect on sales and profits. In this

situation, companies with weak cost discipline go into a survival mode and respond with across-the-board cost cuts. In contrast, companies with continuous cost-cutting programs tend to be low-cost producers. As a result, trigger events weaken their margins but leave room for flexible responses and decision making.

Starting Continuous Cost Reduction

There are four basic and widely recognized categories of cost reduction:

1. Eliminate waste and duplication
2. Implement best practices
3. Introduce technology where it is effective
4. Create virtual operations through Web enablement

Often, companies that develop continuous cost-reduction programs focus first on eliminating waste and implementing best practices. These are frequently two sides of a single coin and are often achievable through low-tech change.

The monthly close—where costs rise with the duration of the close—is a case in point. Best practices for accelerating the monthly close usually include eliminating multiple approvals, eliminating the filing of multiple copies of a single document, and automating recurring journal entries.

Tying Cost Discipline to Strategy

Certainly, all controllers support the elimination of waste and the implementation of best practices. *Key point*: When these measures are in place, employees are better able to use their natural problem-solving abilities to cut costs and work more effectively.

Even so, top management has to clarify how these cost-reduction efforts fit with the company's strategy. Cost cutting that occurs without reference to an overall strategy feels like torture to employees. Yes, they are happy to have jobs as their companies, say, downsize. If they do not know where the cost cutting is headed, though, they may consider cost reduction a mere tactic to pile more work on their desks, with top management lacking a real vision for converting spending and costs into business growth.

Writing for the *Harvard Management Update*, Bain consultant Vernon Altman described the importance of strategic cost cutting as follows:

> Managers have to address two critical questions. What is the urgent situation that requires reducing costs? How will the company use cost discipline to build momentum for growth? A company's leaders must make their reasons clear, communicating them over and over, so as to create a collective will for tackling the issues.

It has been emphasized that the payback for helping employees work more efficiently is enormous. Altman observed: "The basic insight is that a company that manages to lift the efficiency of its employees from 65% to 70% gets a 5% improvement in productivity. In terms of cost-discipline, that is huge."

Identifying and Empowering Advocates

When implementing a continuous cost-reduction program, top management identifies and empowers champions. These share one quality: they are employees who enjoy focusing on the cost side of the business. Here, top managers work from a premise that is obvious to controllers through their budget monitoring responsibilities: namely, that most managers like the revenue-generation game and are not wired for cost reduction.

Interestingly, Bain recommends giving these champions small centralized teams to plan cost-reduction initiatives. In the Bain scheme, members of these teams come from line organizations (i.e., not sales) and are familiar with potential cost-reduction opportunities. The teams then do rigorous benchmarking, data collection, and diagnostic work, developing a solid analytical basis for any cost-reduction targets they set. *Key point*: By forming these teams from line employees, champions endow their cost-reduction diagnostics with the credibility of insiders who know how the company operates.

These continuous cost-reduction programs use the 80/20 rule, but they apply it with great care. The 80/20 rule states that 80% of a company's cost savings can be extracted from 20% of its activities. Warns Bain: "If the cost champions apply this rule at the company level, they'll overlook a big chunk of potential savings—perhaps as much as 40%."[1] Controllers will make these programs successful by applying the 80/20 rule within divisions or, even better, within departments. "This," says Bain, "will spawn hundreds of worthwhile initiatives across the entire company, with no single team responsible for implementing more than a handful of the most important programs."

Funding Continuous Cost Reduction

Controllers often say the biggest problem that continuous cost-reduction programs face is funding. This is because many of the most promising initiatives that emerge from team diagnostics require up-front investment, especially in process reengineering. *Key point*: Set some money aside, even before teams develop cost reduction ideas.

Certainly, it is important not to overinvest, as big bets on information technology (IT) are risky. Nonetheless, cost-reduction teams often strike gold when examining IT. Says Bain: "Time after time, the largest cost improvement and synergies come from optimizing information technology systems and tightening supply chains to take out procurement costs."

Follow-Up

Top management communicates the strategy. Teams working for cost-reduction champions then identify targets that are consistent with the strategy. What remains? At this point, execution becomes the priority.

Successful programs of continuous cost reduction usually feature weekly reviews by senior management, certainly in the early stages. For these reviews, controllers make sure top managers have simple but precise measures for discussing

progress. These are their tools, when top managers meet in regular face-to-face appraisals with the line leaders who are implementing cost-reduction programs.

Unresolved issue: Managers definitely deserve to be compensated for executing a company program successfully. "Be wary of special compensation plans geared to cost reductions: it is difficult to get compensation plans of any kind right, especially those focused on special cost-reduction efforts."

SHOULD YOUR COMPANY DO AWAY WITH THE BUDGET PROCESS?

Should budgeting, as most companies practice it, be abolished? In effect, should the old-fashioned, slow-to-respond, fixed-performance contract be replaced by a more flexible form of budgeting (along with other types of goals and measures) that tracks the performance of the company relative to its peers and world-class benchmarks? It certainly seems to make sense—but only to a point.

This is the focus of Jeremy Hope and Robin Fraser's book, *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap*.[2] Hope and Fraser point out that the same companies that vow to respond quickly to market shifts cling to a budgeting process that slows response to market developments until it is too late.

Though we agree with the book's premise, a company's financial toolkit will always have room for the traditional budget. True, the use of a new, more dynamic form of budgeting—such as the rolling forecast—is now needed to support more responsive overall corporate strategy development. However, the traditional budget will continue to play a role. For example, the conventional budget is the most effective tool for controlling costs.

The use of more flexible budgets and alternative performance measures is becoming more prevalent, as part of the new concept of corporate performance management (CPM). For instance, a survey from CFO Research Services found that three-quarters of companies polled want the capability to develop rolling forecasts. A Hackett Group study revealed that most companies have already adopted a balanced scorecard, which combines financial and nonfinancial metrics to track corporate performance.

As Hope and Fraser correctly point out, companies have a lot of work to do to revamp their budgeting processes—and their book provides some valuable insights into this process.

Perils of Extremism

Hope and Fraser correctly illustrate how, in extreme cases, use of the budget to force performance improvements can lead to a breakdown in corporate ethics. People who worked at WorldCom, now bankrupt and under criminal investigation, said CEO Bernard Ebbers's rigid demands were an overwhelming fact of life there. "You would have a budget, and he would mandate that you had to be 2% under budget," said a person who worked at WorldCom, according to an article in *Financial Times* last year. "Nothing else was acceptable." WorldCom, Enron,

Barings Bank, and other failed companies had tight budgetary control processes that funneled information only to those with a "need to know."

Companies that have recognized the damage done by improper budgeting are moving away from reliance on obsolete data and the long, drawn-out, self-interested wrangling over what the data indicates about the future. They have also rejected the foregone conclusions embedded in traditional budgets—conclusions that overshadow the interpretation and circulation of current market information, the stock-in-trade of the knowledge-based, networked company.

Alternative Measures

Hope and Fraser correctly point out that, in the absence of budgets, alternative goals and measures—some financial (such as cost-to-income ratios) and some nonfinancial (such as time to market)—move to the foreground. Under this setup, business units and personnel, now responsible for producing results, are no longer expected to meet predetermined, internally selected financial targets. Rather, every part of the company is judged on how well its performance compares with that of its peers and against world-class benchmarks.

At these companies, an annual fixed-performance contract no longer defines what subordinates must deliver to superiors in the year ahead. Budgets no longer determine how resources are allocated, what business units make and sell, or how the performance of those units and their people will be evaluated and rewarded. Some companies estimate that they save 95% of the time that used to be spent on traditional budgeting and forecasting.

Instead of adopting fixed annual targets, business units set longer-term goals based on benchmarks known as *key performance indicators* (KPIs), such as profits, cash flows, cost ratios, customer satisfaction, and quality. The criteria of measurement are the performance of internal or external peer groups and the results in prior periods.

KPIs, which tend to be financial at the top of an organization and more operational the nearer a unit is to the front line, can fulfill the self-regulatory functions of budgets. KPIs need not be precise to be effective. For example, Sight Savers International, a U.K. charity, has begun to develop target ranges for its KPIs. While managers are free to devise ways of achieving results within these ranges, senior executives look at the risks and test the assumptions of strategic initiatives that require very substantial resources.

At an increasing number of companies, rolling forecasts that look five to eight quarters into the future play an important role in the strategic process. The forecasts, typically generated each quarter, help managers to continually reassess current action plans as market and economic conditions change. Sidebar 1.1 gives an example of one company's approach to eliminating its traditional budgeting process in favor of one that includes rolling forecasts.

Without budget expectations to worry about, staff members can do something with all of the customer and market information they collect. The reporting of unusual patterns and trends as they unfold helps the business make rapid changes in a strategic direction. Instead of being imposed from above, strategy seeps up from below.

Sidebar 1.1. How Ahlsell Discarded Its Budgeting Process

Since Ahlsell, a Swedish wholesaler, abandoned budgeting in 1995, its main lines of business—electrical products and heating and plumbing—have overtaken their Swedish counterparts in profitability. After suffering through a severe business slowdown in the early 1990s, the company realized that it could achieve substantial savings and operational improvements by centralizing warehousing, administration, and logistical support, while devolving responsibility to large numbers of profit centers.

At one time, there were only 14 such centers; now, after a series of acquisitions, there are more than 200. Business-area teams (such as heating and plumbing) within each local unit are now separate profit centers, and they are fiercely competitive with one another.

Detailed sales plans are no longer made centrally. Headquarters communicates only general aims, such as becoming number one in electrical products within two years. The local units have been freed to develop their own approaches in response to local conditions and customer demands. The new organization recognizes that customer relationships are forged by front-line units, which can now set salary levels and customer discounts and even decide to obtain supplies from outside vendors if doing so will save money.

Because unit managers also have the authority to adjust resource levels in response to changing demand, they now recruit staff or order layoffs as required, rather than according to the timing and constraints of the annual budget cycle. (*Note*: Staff turnover is less than 5% per year—the lowest in the industry.) The function of the regional leadership, meanwhile, has changed from providing detailed planning and control to coaching and supporting the front-line units. To help the local units manage themselves more effectively, the finance staff teaches everyone how to interpret a profit and loss statement.

Key performance indicators are now used to set goals and impose controls. In the central warehouse, for example, the KPIs are cost per line item, costs as a percentage of stock turnover, stock availability, level of service, and turnover rate. The key indicators for the sales units are profit growth, return on sales, efficiency (determined by dividing gross profit by total salary cost), and market share.

In the days when Ahlsell kept budgets, it did not monitor how profitable individual customer accounts were or how much it cost to replace them. Selling was treated as an end in itself, and the company simply paid its salespeople for selling products. Since the abolition of budgets, the accounting system has been producing information on customer profitability. According to finance director Gunnar Haglund, the architect of Ahlsell's management model: "Salespeople now have a different approach. They know how every customer wants to deal with us—whether [they are seeking the] lowest-cost transactions, value-added services, or a closer, more strategic relationship—and which customers offer the best profit-making opportunities. This is gradually improving our customer portfolio."

Rolling forecasts are now prepared quarterly by staff members at the head office, who make phone calls to a few key people over the course of a few days each quarter. Results from the previous quarter are available with little delay, and employees at every level in the company see them simultaneously. At the end of each year, unit managers—there are now many of them—receive bonuses based on how the year's return on sales compares with that of the previous year.

Source: Jeremy Hope and Robin Fraser, *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap* (Harvard Business School Press, 2003).

Final Point

Budgeting should not be completely abolished in companies; it merely has to be brought in line with today's need for fast and meaningful information. It also must be recognized that traditional budgeting should remain—but simply as one part of a company's financial forecasting toolkit. The use of other tools and measures, such as balanced scorecards, economic value added (EVA) analysis, and the like, must be incorporated as well. Of course, any revamping of the budget process will be predicated on corporate culture; therefore, changing the process may not be as easy as it seems.

SERVICES SPEND

Company spending on services now reaches as much as 25% of revenue and 85% of total purchasing spend. As a result, more controllers are now looking closely at their services spend, as even a modest improvement in this facet of purchasing management has the potential to reduce costs and drop significant savings to the bottom line.

Exhibits 1.2 and 1.3 provide a starting point for examining the management of the services spend at your organization. Developed by the Center for Advanced

Exhibit 1.2 Services Spend as a Percent of Total Purchase Spend: 24 Functions

	Mean	Minimum	Maximum	Median
Accounting	0.40%	0.02%	2.13%	0.12%
Administrative	1.15	0.04	2.34	1.08
Advertising	3	0	11.62	1.61
Call center	0.76	0	3	0.26
Construction/engineering	6.04	0.78	10.16	6.19
Facilities management	1.86	0.02	7.11	0.68
Finance	0.29	0.06	1	0.13
Human resources	2.04	0	5.38	1.31
Information technology	5.24	0.01	15.63	3.36
Inventory	7.93	NA	NA	NA
Legal	1.45	0.06	4.04	0.7
Logistics	4.94	1.07	12.89	4.25
Manufacturing	20.24	1.02	69.22	6.68
Marketing	5.13	0.33	25.28	1.21
Printing/copying	1.51	0.11	8.03	0.35
Professional services	7.61	0.61	21.68	4.1
Project-based services	2.81	0.28	6.77	2.01
Research & development	0.78	0.18	1.58	0.68
Real estate	4.25	0.27	16.03	2
Telecommunications	2	0.1	7.2	0.98
Temporary staffing	0.97	0.04	4.65	0.72
Travel	1.79	0.01	4.82	1.74
Warehouse management	0.14	0.01	0.28	0.15
Other	8.49	0.75	22.19	6.25

Source: CAPS

Exhibit 1.3 13 Benchmarks for the Corporate Purchase Spend: By Average, Quartiles

	Mean	Minimum	Maximum	Median
Purchase spend as % of total revenue	38.37%	8.35%	88.88%	38.33%
Direct goods spend as a % of:				
Total revenue	21.14	1.69	46.67	19.56
Total purchase spend	82.93	0	100	54.79
Indirect goods spend as a % of:				
Total revenue	13.78	1.91	83.72	16.48
Total purchase spend	NA	NA	NA	NA
Services spend as a % of:				
Total revenue	11.38	1.99	25.52	8.42
Total purchase spend	NA	NA	NA	NA
Spend for direct goods bundled w/services as a % of:				
Revenue	3.19	0	13.56	1.12
Purchase spend	12.55	0	63.38	3.43
Direct goods spend	25.24	0	100	5
Spend for indirect goods bundled w/services as a % of:				
Revenue	1.49	0	16.17	0.14
Purchase spend	3.89	0	37.44	1
Indirect goods spend	16.28	0	100	5
Spend for services bundled w/goods as a % of:				
Revenue	1.88	0	11.66	0.68
Purchase spend	5.84	0	27.96	1.46
Services spend	25.25	0	90	10

Purchasing Studies (CAPS) and published in its new report, "Managing Your Services Spend in Today's Services Economy," these exhibits quantify two critical purchasing issues. Stated as questions, these issues are:

1. *Is our services spend high in particular functions?* In Exhibit 1.2, we show the percent of the total purchase spend that companies attribute to 24 functional services. For example, this shows that median and average services spend in human resources (HR) as a percent of the total purchase spend is 1.31% and 2.04%. But suppose your company attributes 5% of its total purchase spend to services used in HR? In this case, your company is approaching the highest services spend of the 35 companies participating in this CAPS survey. This suggests that your company is outsourcing significant HR services and paying top dollar to these HR vendors.
2. *Is our spending on services underreported and under analyzed?* Importantly, the CAPS survey found that a high percentage of the services spend was bundled with other purchases: 25% of the direct spend (i.e., variable spending) was bundled with services and 20% of the indirect spend (i.e., overhead-type cost) was bundled with services. Finally, 25% of the services spend is bundled with goods. At the same time, CAPS found that "many companies could not

differentiate this service spend from either direct or indirect." Many organizations may thus now underestimate their services spend. Exhibit 1.3 provides a range of benchmarks for bundled services spend.

More Authority for Purchasing

CAPS has a clear agenda. Namely, it believes that companies will lower their spending on services if they involve their procurement specialists in services-spend decisions. Dianna Wentz, a CPM writing for the Institute for Supply Management, states this position as follows:

> Purchasing departments have little or no control over services spend. In the 39 service categories studied, only 3 of the services were "managed, controlled, or otherwise influenced" by procurement staff. Purchasing had no control over the procurement spend of the remaining 36 service categories, which included areas such as information technology, facilities management, and telecommunications. This fact is perplexing, since approximately 54% of an organization's spend is focused on services, yet only 27% of those service purchases flow through supply management.

There are advantages to centralizing services procurement within an organization. Centralization, for example, does alleviate maverick spending. Further, companies that centralize service procurement are better able to leverage their volume. Nonetheless, controllers, as a practical matter, are not in a position to advocate the shifting of services-spend management to procurement.

Leadership in the Services Spend

In general, existing practices suggest that there is an effective and less disruptive approach to reducing the services spend. Basically, these controllers:

- *Develop a complete picture of the total services spend.* Observes CAPS: "There are several disparate systems in which this data is located: purchasing and e-procurement systems; P-card databases; general ledger and accounts payable; enterprise resource planning systems; and inventory/materials management." *Key point*: In many companies, controllers are perfectly positioned to initiate and lead a special project that calculates the total services spend.
- *Analyze the spend.* Observes CAPS: "Determine which business units within the organization are buying these services and how much are they spending. Then, determine if there are opportunities to leverage purchases or to shift purchases to less expensive vendors."

This obvious and basic approach bears fruit. For example, half of the CFOs participating in a survey by Forrester Research did not know their organization's ratio of goods and services spend. In contrast, CFOs and supply management executives at participants that the survey called world-class knew their services spend in great detail. *Key point*: These corporations are better positioned for what

CAPS calls "sourcing initiatives," which in turn drop substantial savings to the bottom line.

USE OF COST-MANAGEMENT TOOLS

An Ernst & Young (E&Y) and Institute of Management Accountants (IMA) study offers a frame of reference for those who wonder if their reporting systems are up to speed.[3] The E&Y/IMA Survey examines priorities in management accounting, the causes of cost distortions, and factors triggering the implementation of new accounting systems. E&Y claims that this information will also help "management accountants [to be seen] more as business partners, focusing more on key strategic issues, well beyond the boundary of traditional finance."[4]

Systems with 60% Usage

To begin, the E&Y/IMA Survey examines the frequency with which controllers and their colleagues use three types of planning and budgeting tools, five decision support tools, six product costing tools, and three performance evaluation tools. (See Exhibit 1.4.) Thus, controllers can use this survey to determine if they have

Exhibit 1.4 17 Cost Management Tools: Usage Rates at 2,000 Companies

Management Accounting Tool	Use	Under consideration	Rejected
Planning: Budgeting Tools			
Operational budgeting	76%	16%	8%
ABM/standard budgeting	65	23	12
Capital budgeting	62	24	14
Decision Support Tools			
Quantitative techniques	76	17	7
Breakeven analysis	62	23	13
Internal transfer pricing	57	23	20
Supply chain costing	31	43	26
Value chain analysis	27	47	26
Product Costing Analysis Tools			
Traditional costing	76	15	9
Overhead allocations	70	20	10
Multidimensional costing	35	39	26
Target costing	27	40	33
Life-cycle costing	32	37	41
Theory of constraint	32	41	37
Performance Evaluation Tools			
Benchmarking	53	36	11
Balanced scorecard	43	40	17
Value-based management	27	41	32

Source: E&Y/IMA Survey

as comprehensive a system for monitoring and analyzing information as their peers at other businesses.

In reviewing this information, readers are urged to start at the standard of 60% usage. At this level, a system is used at a clear majority of companies. By this rough measure, controllers who do not use 60% systems are a step or more behind most of their colleagues in supplying sophisticated information to top management. So, which are the 60% systems?

- *Planning and budgeting tools.* The survey shows that a clear majority of companies now use operational, standard, and capital budgeting.
- *Decision support tools.* Two of five decision support tools cross the 60% usage watershed. These are quantitative techniques, such as spreadsheets (76%), and break-even analysis (62%). At the same time, two techniques that consultants now tout—supply chain costing and value chain analysis—are used infrequently. Further, more than 25% of companies have actively rejected the implementation of these tools.
- *Product costing analysis tools.* Interestingly, controllers seem content to use traditional costing (i.e., full absorption costing) and overhead allocations to analyze and set costs.
- *Performance evaluation tools.* Surprisingly, none of these tools surpasses 60% usage. The relatively low usage of benchmarking here (53%) probably reflects today's emphasis on the implementation of best practices, which, proponents say, skips past the benchmarking step to improve internal processes. Meanwhile, the relatively low use of balanced scorecards (43%) is disturbing, because it suggests that top management continues to undervalue such measures as customer satisfaction and quality when evaluating the health of their businesses.

Strategic Effects of Costs

Importantly, the E&Y/IMA Survey also revealed significant appreciation for the cost information that controllers monitor and deliver through their reporting systems. The survey examined the significance of this cost information from three perspectives. Basically, these are the contributions this cost information makes to:

Strategy. To the survey question, "How important is the role of cost management in establishing your organization's overall strategic goals?," respondents answered: "very important," 53%; and "somewhat important," 27%.

Decision making. To the question, "Has the current economic downturn generated a greater demand for more precise costing or for more cost visibility?," participants answered: "much greater," 17%; "significantly greater," 28%; and "somewhat greater," 30%.

Profitability. "Is cost reduction considered the prime way to impact the bottom line in the current recession?" To this question, the answers were: "very important," 33%; and "important," 37%.

Ernst & Young offers this overview on the contributions of cost information: "80% of respondents said cost management was important to their organization's

overall *strategic* goals. 75% believe the economy has generated greater demand for cost management and cost transparency. 70% say cost reduction is a prime way to impact the bottom line."[5]

Diverging Opinions on Priorities

Though not a major finding, the E&Y/IMA Survey identified a slight difference in priorities of top managers and controllers. The survey asked participants to rate seven priorities, using a scale of one (not a priority) to five (top priority). Overall, the findings across the survey's 2,000 participants were:

- Generating so-called actionable cost information, 4.2
- Cost reduction, 4.1
- Improving processes, 3.7
- Contributing to core strategy, 3.6
- Setting standards, 3.5
- Reducing risks, 3.3
- Automating processes, 3.1

Interestingly, this survey identified only one priority—contributing to core strategy—for which top managers and controllers have even slightly different expectations. Here, what the survey calls "decision makers" rated this priority as third most important, with a 3.8 rating. In contrast, so-called decision enablers rated this priority in fifth place, with a 3.5 score. In doing so, they also rated "contributing to core strategy" below the priorities of "improving processes" (3.7) and "setting standards" (3.6).

Other information in the E&Y/IMA survey suggests why controllers rate "contributing to core strategy" as a lower priority than do CEOs. In particular, this survey asked respondents to identify factors that distort true cost calculation in their organizations. *Background*: 98% of respondents acknowledged some cost distortion in their reports, with 38% deeming these distortions significant. The survey identified the sources of these cost distortion problems as:

- Distortions from overhead allocations: causes mild distortion, 50%; causes significant distortion, 35%
- Shared services: mild distortion, 59%; significant, 23%
- Greater product diversity: mild, 45%; significant, 25%
- Increasing IT expenditure: mild, 55%; significant, 15%
- Greater customer diversity: mild, 43%; significant, 18%

The top two priorities in businesses are generating actionable cost information and reducing costs. Certainly, these priorities focus controllers on process improvement, which supports both the development of actionable data and lower costs. This pushes the priority of contributing to the core strategy down a notch. To most controllers, moreover, this probably seems like a *critical* operating contribution to the core strategy.

Having an Impact

Certainly, many readers want to improve the cost information they generate. This ambition, of course, begs the following question: What factors will trigger the adoption of new management accounting tools in my organization?

On this final point, the E&Y/IMA survey showed how differently large ($1 billion in revenue and up) and small companies operate. At large companies, the critical factor is management buy-in, which got a 4.2 rating on a one (unimportant) to five (important) scale. Thereafter, significant factors are adequate technology (3.3) and organization expertise (3.2).

In contrast, the two critical factors at "small" businesses are organizational expertise (4.5) and adequate technology (4.4). What's happening? At large companies, adoption is a top-down process. At smaller firms, infrastructure precedes and enables the adoption of new accounting tools.

TEN MOST EFFECTIVE TECHNIQUES FOR ENHANCING CORPORATE VALUE

With today's increased scrutiny on corporate financial reporting, it is no wonder that more than 70% of financial managers cite improvements to reporting as the top way to enhance corporate value. This is the main finding in an IOMA survey in which almost 200 participants reported on the financial techniques they used over the past year that had the most impact on corporate value. In addition to improved reporting, participants cited new approaches to budgeting, benchmarking, and changes to corporate and departmental planning as other top ideas.

Improvements to Reporting

Improving the reporting process is the top approach for companies large and small and in both manufacturing and nonmanufacturing sectors (see Exhibit 1.5).

Exhibit 1.5 Most Effective Financial Techniques or Operations Used to Enhance Corporate Value, by Number of Employees and Industry

	Up to 250	More than 250	Overall
By Number of Employees			
Expanded/enhanced reporting to management	73.1%	66.0%	71.5%
Enhanced/changed approach to budgeting, cost, & performance analysis	64.2	60.4	63.8
Instituted benchmarking/added new performance metrics	50.7	54.7	56.9
Changed/enhanced corporate financial/strategic planning approach	43.3	58.5	47.7
Changed/enhanced division/departmental financial planning approach	31.3	47.2	42.3

(continued)

Exhibit 1.5 *(Continued)*

	Up to 250	More than 250	Overall
By Number of Employees (*cont.*)			
Revised how we analyze new projects (i.e., payback, ROI, NPV, etc.)	35.8	35.8	37.7
Analyzed new e-commerce opportunities (i.e., e-purchasing, e-sales, e-logistics, etc.)	20.9	28.3	26.2
Analyzed new or ongoing special projects (i.e., reengineering, joint ventures, alliances)	28.4	17	23.1
Adopted or migrated financial applications on to intranet/Internet (i.e., e-G/L, e-reporting, e-AP)	20.9	20.8	22.3
Expanded/enhanced reporting to suppliers, shareholders, financial institutions	25.4	13.2	22.3
Adopted new FASB, IRS, or SEC reporting requirements	11.9	34	20.8
Used new valuation or analysis approach (i.e., EVA, CFROI, balanced scorecard, etc.)	17.9	11.3	16.9
Changed accounting practices (i.e., for revenue recognition, poling of interests, tax shelters, etc.)	13.4	7.5	12.3
Revised how we analyze M&A candidates	1.5	7.5	3.8
Other	9	7.5	9.2

	Mfg.	Nonmfg.	Overall
By Industry			
Expanded/enhanced reporting to management	68.8	67.0	71.5
Enhanced/changed approach to budgeting, cost, & performance analysis	58.3	63.4	63.8
Instituted benchmarking/added new performance metrics	56.3	52.4	56.9
Changed/enhanced corporate financial/strategic planning approach	41.7	50	47.7
Changed/enhanced division/departmental financial planning approach	37.5	40.2	42.3
Revised how we analyze new projects (i.e., payback, ROI, NPV, etc.)	35.4	36.6	37.7
Analyzed new e-commerce opportunities (i.e., e-purchasing, e-sales, e-logistics, etc.)	27.1	25.6	26.2
Analyzed new or ongoing special projects (i.e., reengineering, joint ventures, alliances)	14.6	25.6	23.1
Adopted or migrated financial applications on to intranet/Internet (i.e., e-G/L, e-reporting, e-AP)	18.8	23.2	22.3
Expanded/enhanced reporting to suppliers, shareholders, financial institutions	25	15.9	22.3
Adopted new FASB, IRS, or SEC reporting requirements	20.8	20.7	20.8
Used new valuation or analysis approach (i.e., EVA, CFROI, balanced scorecard, etc.)	16.7	17.1	16.9
Changed accounting practices (i.e., for revenue recognition, pooling of interests, tax shelters, etc.)	6.3	14.6	12.3
Revised how we analyze M&A candidates	6.3	2.4	3.8
Other	10.4	7.3	9.2

What are the best ways to improve internal financial reporting? Increase the speed of reporting, develop more meaningful reports, and deploy more state-of-the-art reporting technology.

Speeding It Up. One of the key goals of internal financial reporting is to alert management to problems that need attention. Of course, the sooner management is made aware of these problems, the sooner it can act to solve them. Therefore, increasing the timeliness of financial reporting can yield significant benefits.

"More timely financial information enabled management to make decisions based on actual numbers and get a sense of where the firm is going financially or where adjustments need to be made before it is too late," reports the controller of a 43-employee accounting firm. "Last year alone it saved the company money and time as well."

When increasing the timeliness of reports, do not think just about top management—think about the operating departments. They will be able to act quicker if something has to be done. "We implemented more in-depth reporting and reviews with division management weekly and monthly. This enables us to correct problems sooner," says a controller at a 400-employee telecommunications company.

Making Reports More Meaningful. Take a fresh look at the reports being sent out. Are some being generated just because that is the way it has always been done? Are they really necessary?

Of course, the trick is deciding what reports to keep and what reports to scrap. Often, you can do this by deciding yourself what reports to send to management, instead of having management decide. They often do not know what they want, so they just ask for everything.

"We scrapped some old reports we were doing just because they had always been done," says an accounting manager at a manufacturing company (75 employees). "Finance decided which direction to point them in. We began to develop easier-to-use reports, and we also began focusing on support functions, such as logistics and customer service, as a way of improving the bottom line."

As discussed above, the emphasis should be on reporting matters that are most controllable. Also, the way revenues and expenses are reported and analyzed can make a big difference. "We divided our product lines into subcategories and tracked gross profit. That has really magnified products that may need to be discontinued or should be promoted to a greater extent," says a controller of a training materials supplier (28 employees).

Deploying Technology. Automated financial reporting and analysis tools have come a long way, and can yield significant benefits. "We use enhanced data mining tools, which enable us to obtain data which was previously unavailable," reports a vice president of administration for a 270-employee manufacturer. "The tools give us better data for analysis and decision making. The only trouble is verifying the validity of the data."

The use of Web-based tools has also transformed the reporting function. "We provide better information to management through a new Web-based financial

reporting system that clearly identifies the drivers of the business and our performance against those drivers. The result has been better management decisions," says a CFO of a 7,500-employee auto supplier. "The only disadvantage has been the time and expense to launch and implement the new system."

New automated tools can be expensive. However, you do not always need to buy new software to leverage technology—you can use tools that you already have, such as e-mail or your corporate intranet. "We utilized an internal company Web-based network to store and make available several key types of financial and operational data, such as sales, orders, inventory, and production," says a controller at a 1,800-employee manufacturer.

Enhancing the Budget Process

The second most cited technique for enhancing corporate value was changing the approach to budgeting and analysis; 63.8% said this was the most effective tactic. A number of the ideas companies are using are particularly worth noting: namely, getting business units more involved, switching to rolling forecasts, and leveraging technology to help the process.

Getting Business Units Involved. Getting business units into the process involves pushing more responsibility for the budget down the ranks. "We enhanced our budget process by empowering business units to take ownership of their data," says a director of financial reporting at a 175-employee leasing firm. However, you cannot just drop this in their laps without giving them some direction. "We took steps to educate our front-line managers in the basics of budgeting—not only for labor but for all expenses," says a controller at a 55-employee agricultural company. "We show them how their area affects the bottom line of the business."

There are definite benefits in giving front-line people a key role in developing their own budgets *and* the responsibility for performance to budget. A cooperative approach can cut the amount of time needed to develop the budget in half. Driving the budget process down the line also increases accountability; all of the time and effort spent on creating the budget will be wasted if individuals are not held accountable for staying on budget.

When managers are involved and held accountable, they will be more apt to search out hidden opportunities for cost savings and to catch mistakes. "All directors are given worksheets to chart their expenses, which they could then use to verify expense amounts on their monthly financial statements," reports the financial director of a 118-employee service firm. "This makes the directors very aware of their expenses versus budget and also catches any errors on the financials in a more timely manner."

As an example, use a team approach when pushing the budget process down the line. "We looked at each department's budget as a team this year. We thought that the two-heads-are-better-than-one idea would be more effective," says an accounting director at a health care organization (900 employees). "Each person saw different things in the budget and helped us to cut some costs. It took a little longer to do but was very beneficial in the end."

Using Rolling Forecasts. Some companies report moving from the traditional annual budget to a more dynamic process, typically in the form of a rolling forecast. “We began a weekly forecast meeting where all managers forecast net sales and profits for the month,” says a controller at a 430-employee engineering firm. “Now the managers can be proactive rather than reactive to changing times. We are also getting many more people involved, which improves morale as well as knowledge.”

“The rolling budgets enabled us to track our success against our updated forecast, which replaced stale/outdated annual forecasts,” says a controller at a public utility (82 employees). “Using rolling forecasts can require additional staffing to effectively run them and to continuously update the company’s forecasts.”

Leveraging Technology. There are several ways to capitalize on automated budgeting technology. “We started using Cognos’ Analyst tool for budgeting analysis. It allows much more flexibility than spreadsheets,” says a manager of finance/accounting at a water utility (188 employees).

Technology can also help push the budgeting process into the business units. “We implemented new financial reporting/budgeting software. The most favorable result is enhanced reporting to the firm and a hands-on tool for department managers to prepare budget activity,” says a controller of a 500-employee legal services firm.

Benchmarking and Performance Metrics

Ranking third overall, more than half (57%) of companies cited success with implementing benchmarking and adding new performance metrics. *Benchmarking* involves identifying best practices, both within your company and at similar companies, and then comparing your company’s performance with those best practices. A director of finance at a 75-employee human resources firm put the benefits of benchmarking in a nutshell: “Benchmarking our results versus the leaders in our industry flags potential revenue sources, as well as excessive cost structures.”

In particular, improvements in productivity matter. “Production benchmarking is the most successful technique used. It gives real-time costs of production and alerts us to weaknesses in the process,” says a CFO at a manufacturing company. “However, information submitted from production is sometimes erroneous and needs to be double-checked and verified.”

In addition to potential problems with bad information, you may encounter some resistance when trying to implement benchmarking. “There was initial resistance to change, as some employees perceived this as a negative attitude about their performance,” says a controller at a 40-employee service firm. “However, we used benchmarking to develop performance feedback for sales and operations. It helped increase productivity.”

Benchmarking metrics should be as specific as possible. It may take some time to develop them, but it can be well worth the effort. “The initial research to develop and look up peer results and organize them into a reportable format cost some time,” reports a controller at a financial services firm (30 employees). “But

the initial cost should be absorbed over time. It has given our board of directors a better feel for the numbers and what we are trying to explain."

Enhanced Corporate Planning

The fourth most cited technique for enhancing corporate value was changing the approach to corporate financial/strategic planning; 48% said this was the most effective tactic.

One of the main ways to make overall planning more effective is to improve top-down guidance and to get everyone involved. This helps ensure buy-in. "We involved all the executive staff as well as key sales personnel, business unit corporate directors, and finance," says the controller of a 700-employee health care information firm. "The CEO established overall objectives. The general managers brought to the meeting their first draft as to how those objectives would be achieved financially. The team spent two days discussing and prioritizing key objectives. We used an interactive financial model to test different scenarios suggested by the group to arrive at the target. The final step of the process was to ensure everyone who participated agreed and bought in to the plan."

As with the budget process, empowering business units can go a long way in improving the corporate planning process. "We turned our divisions into semi-independent businesses, giving them more control over marketing, sales, and collections decisions. So far it is working rather well," says an accounting manager at a financial services firm (2,500 employees).

Planning at Divisional Level

Having the planning process reach down to the department or division level produces top results; 42% of companies said this is effective in enhancing corporate value. "Prior to last year, my company never forecasted down to the department or cost-center level. Due to this, there was no accountability for the numbers, which left little room for valuable analysis versus goals," says a manager of financial planning and analysis at a 1,400-employee distributor. "Since doing this, we have reached our expense target each month!" This also improves accountability, especially if compensation is linked to performance against plans.

COMPUTING THE VALUE AND COST OF A FLEXIBLE CAPITAL STRUCTURE

Even if your company is operating at its "optimal" capital structure, it may be losing value. How much value? A newly developed model can help you calculate it.

The Premise

Under the prevailing theory, a company's value will be maximized when it operates at its "optimal" capital structure. We were all taught that the optimal capital structure is the mix of debt and equity that minimizes the company's cost of capital.

The trouble with this notion is that at optimal levels of debt and equity, a company may not have the financial flexibility it needs. That is, it may not have quick access to financial reserves (such as cash or debt capacity) to respond to market or economic forces. For instance, if a new market opportunity arises, a company needs cash reserves to be able to move into the market before its competitors. Similarly, a company may not be able to fund efforts to prevent it from being a takeover target. True, the company could issue new equity to raise the funds, but this is risky. It dilutes ownership, and unfavorable stock market conditions could force the company to issue equity at a low price relative to value. *Key point*: To maintain financial flexibility, a company must have either excess cash balances or excess debt capacity. The trouble here is that too much cash is not good, because it earns below-market returns; excess debt capacity means that the company is not operating at its optimal capital structure.

Therefore, you might think that having financial flexibility reduces corporate value. But this cannot be true, because there must be some value to being able to move fast in response to market conditions—so-called strategic financial capability. But how can you quantify this value?

New Model in Action

Using the concept of real options, a new model seeks to quantify the value of strategic financial capability. The developers, Nancy Beneda, assistant professor of finance at the University of North Dakota, and Theron R. Nelson, a finance professor at the same institution, explained their model in great depth in a recent *Corporate Finance Review*. The valuation is done using the Black-Scholes option pricing model.

The amount that is calculated represents the additional firm value created as a result of the strategic option to invest funds that are available because of increased financial flexibility. Put another way, with financial flexibility, a company has the option to invest in future opportunities. This option has value.

To demonstrate, Beneda and Nelson selected a company, Toll Brothers Inc., a major home construction company. Companies in this industry are faced with highly volatile investment needs. That is why they require the flexibility to be able to fund these needs. Using the Black-Scholes model, Beneda and Nelson categorized Toll's strategic financial flexibility as an embedded call option and used these five inputs:

1. Expected investment needs in excess of internal funds for the upcoming year (the strike price)
2. Present value of expected future cash flows on expected investment needs, in excess of internal funds generated by the firm for the upcoming year (the value of the underlying asset)
3. Volatility of reinvestment needs
4. Risk-free rate of 5%
5. Time frame of one year (to keep the analysis simple)

Using data from company financial statements, Toll's current debt ratio is 43.25% (debt level of $1,121.86 million), and its weighted average cost of capital (WACC) is 7.169%. Doing the analysis of optimal capital structure reveals that the optimal debt ratio is 50% ($1,296.95 million), which yields a WACC of 7.04%. Therefore, the company has excess debt capacity of $175.09 million (optimal minus actual). Add to this amount $21.44 million in marketable securities, and you get a total excess financing capacity of $196.53 million.

The following sections explain the various inputs to use for the Black-Scholes option pricing model.

Strike Price. Exhibit 1.6 illustrates the computation of the investment needs in excess of internal funds over the past four years. Internal funds include net income, dividends, depreciation, change in target debt level, and change in regular equity financing. A target debt level of 43.25% is used because it is the current level. It is assumed that this is what the company wants to achieve over the long term. The target debt level for each year is determined by multiplying 43.25% by the value of the firm (book value of debt + stock price × number of shares outstanding). As mentioned before, the optimal debt level is 50%, so the target debt level incorporates excess available debt financing for the company.

The actual investment requirement for each of the four years is calculated as the changes in property, plant, and equipment (PP&E), changes in operating working capital, and changes in other operating assets. Excess investment requirements are computed as actual investment requirements minus available internal funds. If the available internal funds are greater than the investment requirements, the excess investment requirement is zero for that year. The average of the excess funding requirements over the past four years is $90.5 million (varies between zero and $207 million). The $90.5 million is used as the strike price in the option pricing model.

Exhibit 1.6 Average Excess Funding Required to Meet Annual Operating Requirements ($ Millions)

Computation of Internal Funds	2002	2001	2000	1999
Net income	$ 220	$ 214	$ 146	$ 102
Dividends	0	0	0	0
Depreciation	10	9	9	7
Target debt level	1,121	938	860	579
Change in target debt level	184	78	281	6
Regular equity financing	(10)	(16)	(18)	(20)
Available internal funds	404	285	418	95
Investment requirements	276	440	249	302
Investment requirements in excess of internal funds	0	155	0	207
Average excess funding for investments required	$ 90.5			

Source: Beneda & Nelson, 2004

Exhibit 1.7 Volatility of Investment Needs

Year Ending	Investment Needs ($ million)	Natural Logs (Investment Needs)
October 2002	$276	5.62
October 2001	440	6.087
October 2000	249	5.517
October 1999	302	5.71
Standard deviation of natural logs (investment needs)		21.5%

Source: Corporate Finance Review

Value of Underlying Asset. The value of the underlying asset is the present value of the expected future cash flows as a result of the expected excess investment requirements for the current year, which equals:

$$(\text{Excess investment needs} \times \text{ROC})/\text{Current WACC}$$

ROC equals the five-year historical average return on capital (11.14%) and the current WACC is 7.169%.

Plugging in these figures, the value of the underlying asset is:

$$(\$90.5 \text{ million} \times .1114)/.07169 = \$140.63 \text{ million}$$

Volatility of Investment Needs. Exhibit 1.7 shows the computation of the volatility of investment needs. The volatility as the standard deviation of the natural logs of the annual investment needs is calculated. The volatility for Toll Brothers Inc. is 21.5%. Consistent with option pricing principles, the higher the volatility of investment needs, the higher the value of excess financial capability.

Option Valuation

Exhibit 1.8 presents the calculation of the option valuation using the inputs developed above. The value of the financial capability as a real option for the upcoming year is computed to be $54.63 million. This amount represents the additional firm value from excess financial capability.

The cost of maintaining this excess financial capability also must be computed. When computing the cost of maintaining excess financial reserves, the focus should be on the opportunity cost or the value of additional operating income (cash flows) forgone as a direct result of holding the funds. The focus here is only on the cost for one year, as the option is valued for only one year.

Beneda and Nelson point out that estimating the cost of holding excess investments is difficult because the purpose of these types of accounts is to hold funds temporarily while the company waits for valuable investment opportunities. For

Exhibit 1.8 Real Option Analysis and Valuation

Value of Financial Capability as a Real Option*

		Number of time steps	5
Expiration in years	1	Time step size (dt)	0.2
Volatility	21.50%	Up jump size (u)	1.1009
PV asset value	$140.63	Down jump size (d)	0.9083
Risk-free rate	5.00%	Risk-neutral probability (p)	52.82%
Dividend rate	0.00%		
Strike cost	$90.50	Binomial approach	$54.62
		Black-Scholes model	$54.63
		Super lattice	$54.62

Cost of Excess Financing Capability

Cost of maintaining investments:

Investments return	4.00%
Current WACC	7.17%
Return on capital	11.14%
Investments	$21.44 million
Cost of maintaining investments for one year	$2.378 million

Cost of excess debt capacity:

Optimal WACC	7.04%
WACC	7.17%
Opportunity cost	11.14%
Operating invested capital	$2.263 million
Loss in firm value from maintaining excess debt capacity for one year	$4.656 million
Total cost of excess financing	$7.034 million
Excess of value of financial capability as a real option over total cost of excess financing	$47.596 million

*Real Options Analysis Toolkit (Mun, 2002) was used to perform the real option computation.

Source: Corporate Finance Review

simplicity, assume that the funds have an opportunity cost. The cost of maintaining excess investments is computed using this formula:

[Value of investments × (ROC – Return on investments)] × ROC/Current WACC

The amount calculated represents the value, created in one year, from the additional cash flow, which would have been achieved had the excess investment funds been invested in company operations rather than in a money market account. The opportunity cost is equal to the value created in one year by the difference between the return on capital, 11.14%, and the return most likely achieved by these funds (assume 4%). It is assumed that the additional cash flow created is reinvested in the company at the end of year one. It is also assumed that the reinvested

cash flow earns the return on capital, 11.14%. These hypothetical earnings are discounted at the current WACC, 7.169%. The cost of maintaining investments for one year is computed at $2.378 million.

The cost of excess debt capacity is computed using this formula:

[Operating invested capital × (Current WACC – Optimal WACC)] ×
ROC/Optimal WACC

The cash that is lost from using a less-than-optimal WACC for one year is determined by multiplying the difference between the current and optimal WACC by the firm's operating invested capital of $2.263 million. Thus, if the firm utilized its optimal WACC, additional cash in the amount of $2.942 million would result. It is assumed that this amount is reinvested and earns the firm's average return on capital, 11.14%. These expected future cash flows are discounted at the optimal WACC, 7.039%, which is the discount rate for the firm had the optimal capital structure been in place. Therefore, the lost value from operating at a less-than-optimal capital structure is $4.656 million.

The total loss in value incurred by the company as a result of maintaining excess financial resources is $7.034 million, which is the total of the cost of excess investments ($2.378 million) and the cost of excess debt capacity ($4.656 million).

Bottom Line

In this case, the value of financial capability as a real option exceeds the cost of maintaining excess financial reserves by $54.63 million less $7.034 million, which equals $47.596 million. This figure, then, represents the value of strategic financial capability. Put another way, if this company had operated at its "optimal" capital structure—with no flexibility—it would have lost this value.

We hope this framework will help financial managers implement a strategy of financial flexibility. If one is not able to put a value on this strategy, selling the idea to the top brass will be tough.

PLANNING CAPITAL EXPENDITURES

Companies generally have a dim view of their capital expenditure planning and analysis process, reveals a new study. Fortunately, the study also examines companies that are very happy with their process. What these companies have done can help you improve your company's setup.

There have been many studies on the subject of capital planning, but they mostly focus on the application of formal financial methods instead of the actual process. However, it is the planning process itself that can cause problems with the overall operation. This is the focus of the new study, *A New View of Capital Planning*, which reveals the factors that most differentiate the best from the mediocre.

Sources of Trouble

On an overall basis, companies rate their capital investment planning process at 5.8 on a scale of 1 (poor) to 10 (best). Companies that are unhappy with their process cite the following problems:

- "Gaming" of the process
- Special treatment of certain capital investments (such as information technology projects)
- The effect of executive incentive bonuses on investment decisions
- The treatment of implementation and uncertainty risks by the project appraisal process

Also, only about half of the companies examined conduct postinvestment reviews. However, when such reviews do get done, the primary intentions are perceived to be to learn lessons from investment decisions and to improve forecasting. Fewer companies use the reviews to help improve their capital planning process.

Ways to Improve

Companies with the highest level of satisfaction with their capital planning processes use the following techniques:

- *Treat all proposals consistently.* Best-practice companies evaluate all capital spending proposals consistently. That is, they do not approach different kinds of capital investment in different ways. There is no special treatment for strategic investment decisions (i.e., top-down initiatives, as opposed to bottom-up proposals).
- *Assess risks.* Sound risk-management principles are an essential component of the capital planning process. Uncertainty risk (e.g., business cycle, commodity prices, foreign exchange, and interest rates) should be assessed using sensitivity/scenario (what-if) analysis. As for implementation risk, companies need to examine whether they are well equipped to deliver the projects.
- *Consider all stakeholders.* The capital planning process should address the wants and needs of multiple stakeholders, not just those of shareholders.
- *Use nonfinancial measures.* Factors such as customer satisfaction, employee attrition, and market share should be used along with traditional financial factors to support proposals.
- *Expand breadth.* The breadth of what is included in the capital planning process should be expanded, to include such elements as brand investment and other intangibles.
- *Do a postaudit.* Significantly more of the best-practice companies tend to conduct postinvestment reviews: 78% of these companies always or usually do them, as opposed to just 50% of the rest.

A postaudit can also help ease the gaming-the-system problem. For instance, these reviews can reveal who is being overly optimistic in cash-flow projections. This technique is better than, for example, setting artificially high hurdle rates to prevent gaming, because this may cause the company to miss genuinely favorable capital investment opportunities that add shareholder value.

ROOTING OUT CORPORATE FAT DURING THE CAPITAL BUDGETING PROCESS

Most controllers now have optimistic feelings about the economy. Nonetheless, many report contentious capital budgeting processes at their employers, with new funds often available only after money shifts from other projects in a zero-sum game. As a result, finding the fat in capital budget requests remains a critical responsibility for most controllers. *Key point*: In many companies, top managers focus on big-ticket investments—usually no more than 20% of the capital budget—that have strategic importance to their companies. As a result, they depend

Sidebar 1.2. Driving Waste from Capital Budgeting: Eight Fat-Busting Questions

Stage 1: Getting Airtight Budget Proposals

1. ***Is this your investment to make?*** Sometimes unit managers overstep their territories and request an investment that is the responsibility of someone else in the company—or even of some other organization. For example, an inventory manager that is shifting to vendor-managed inventory (VMI) may request funds to create a vendor-managed site in the company warehouse. Here, the controller can ask why the company, rather than the supplier, should make this investment. Observes Copeland: "By forcing unit managers to explain why they, rather than others, need to make particular investments, managers can head off unnecessary spending."
2. ***Does the equipment have to be new?*** When their production facilities are aging, managers use the budgeting process to advocate for the lease or purchase of new equipment. In fact, the alternative that is often less expensive (but that managers tend to omit from their budget requests) is to service existing equipment. Contends Copeland: "In most cases, the overall cost of equipment (including breakdowns) is 30% lower if a company continues servicing an existing machine for five more years instead of buying a new one." *Recommendation*: Make sure managers analyze the lease, buy, and maintain options when pushing for the replacement of existing equipment.
3. ***Is there a lower-cost way to meet our compliance obligations?*** In their budgets, many managers take a conservative approach to compliance with environmental, health, and safety regulations. They think it is smarter to be safe and overspend on inescapable compliance costs than underspend and be left holding the bag if something goes wrong. Says Copeland: "This sometimes-irrational fear prevents managers from thinking as clearly or imaginatively as they should about how to save money on compliance, so they gold plate their investment requests." *Recommendation*: To avoid unnecessarily conservative and costly compliance spending, ask managers to analyze and report on compliance practices at other companies.

(continued)

Stage 2: Rooting Out Redundancy

4. ***Will the budget request duplicate already existing capacity?*** Even smaller companies with minor operations away from headquarters can accumulate excess capacity. Today, this risk is especially acute with capital spending requests for new technology. Observes Copeland: "A company may discover that it has inadvertently created excess capacity in its server networks. How? Its field engineers, unaware that those designing the network had already built in a 30% extra server capacity, may install additional servers to ensure sufficient capacity." *Recommendation*: Here, the solution lies beyond the capital budgeting process, with controllers fostering communication among decisionmakers and making sure they share information. There will then be fewer requests for capital expenditures that accumulate needless and overlapping capacity.
5. ***Are managers shifting short-term costs to the capital budget?*** In some departments, executives "manage" their costs by shifting spending to capital accounts. Their knowledge of basic accounting tells them that short-term costs that run through the income statement diminish department profitability more than costs that are capitalized in the departmental budget and then depreciated. *Recommendation*: If possible, controllers should ask department managers to include analyses of after-tax capitalized costs in their budget requests.
6. ***Are there signs of budget massage?*** Budget massage is common when senior managers, instead of policing capital spending, merely compare a unit's spending to its forecast. In this environment, shrewd managers manipulate their budgets, shuffling expenditures between their capital and annual operating budgets, to achieve steady year-to-year capital budgets. This way, they avoid the risk of denied capital spending requests following years when their capital budget goes down. Further, they avoid visits from internal audit. Why? Often, top managers, who do not scrutinize spending detail, send auditors to investigate big or fluctuating requests for capital spending increases. Though the practice is well known, Copeland reminds controllers that one capital-budget game managers play is end-loading. For example, at year-end, a dented fender becomes a new delivery truck. When managers realize they are going to underspend an allocation, they start putting in unnecessary expenses to make up the shortfall. Suggests Copeland: "By going to the trouble during the year to query unit managers about small decisions of this sort, senior managers can discourage units from massaging their budgets."

Stage 3: Improving the Process

7. ***Are we using fixed assets fully?*** Slow-moving bureaucratic procedures or mediocre tracking of fixed assets will inflate the capital budget. How? Say a company is slow to compile information about computers that it is disconnecting and relocating. Because these appear slowly on the excess capacity list, managers will buy new computers to meet their needs, even though the company's current computer assets make the purchases unnecessary. *Recommendation*: In this situation, controllers may have to visit their company's paper trails—not just its extra capacity lists—to see if fixed assets are tracked and recycled, avoiding needless capital spending.
8. ***Are our capacity measures valid?*** Sometimes, overspending is a direct result of poor measurement. *Example*: Copeland did consulting work for a cable company whose measurements indicated that a cable was fully utilized if one in a bundle of optical fibers was carrying information. The problem was that the measure pushed the company to spend on new cable capacity, even though each bundle contained 11 fibers.

Source: Thomas Copeland, Monitor Group

on their controllers to ensure that the remaining 80% of capital spending contains no profit-consuming corporate fat.

Though there are many approaches to this responsibility, eight simple practices can help root the waste out of the capital budget. These practices address the tendencies of engineers to insist on better-than-necessary parts and equipment, of managers to ask for more money than they need, and of low-level executives to be risk averse (for example, ordering extra parts to ensure no delays in the pet project of a senior executive). *Key point*: These fat-fighting practices look at expenditures that tend to be rubber-stamped in the budgeting process. As a result, they challenge spending that has built gradually into budget fat.

Sidebar 1.2 reviews these eight practices. Developed originally by Thomas E. Copeland, who is associated with the Monitor Group (www. monitor.com), these fat-busting practices share one valuable feature: they are easy to communicate in meetings. These fat-busters can be used in capital budget meetings to state clearly that "this year, we're emphasizing two tactics to keep capital budget requests lean, three to eliminate padding from existing programs, and two to ensure that fat-eliminating processes are effective."

Note that Copeland has framed these practices as easy-to-use questions. Further, he urges controllers to ask these questions in three distinct phases. In the story "Copeland on Capital Efficiency," he says:

- "Put the first three questions to your operating managers as they assemble their capital project requests. The questions will help them submit airtight proposals."
- "Put the next three question to yourself and your colleagues as you examine small-ticket proposals. These questions will help you root out much of the gold-plating and redundancy built into budget requests."
- "Post the last two questions at the end of the process. They will help you improve next time."

The following discussion provides more than 240 recommendations that controllers have said can help to reduce costs.

BENEFITS

Cut Back Health Benefit Offerings to Reduce Costs.

Challenge: Reduce health care costs while maintaining employee goodwill.

Action: We reduced the benefit offerings from our largest single medical plan—that is, the plan with most enrolled employees. At the same time, our benefit reductions were relatively small and we made a big effort to communicate to employees that this plan was still above "median value," as defined by Hewitt's Benefits Index product. Altogether, we changed 12 specific benefits and reduced our health plan costs by over $2 million. —*Controller, pharmaceuticals, 80,000 employees, New Jersey.*

Adjust Benefits Offerings and Funding to Seize Savings Opportunities.

Challenge: Improve benefits offering to sales force while lowering costs.

Action: We consolidated our HMO offerings in Illinois from three to two, while offering a nationwide PPO for our sales force. This helped us control rate increases in Illinois, since it gave us economy of scale. The PPO for sales was helpful as well, since it replaced a bonus we paid to these employees, who for geographic reasons previously had no way of participating in our HMO. We also self-funded our dental plan, saving us about $15,000 a year. The savings exist because many of our staffers are younger and mostly require only cleanings. —*Controller, manufacturing, 2,900 employees, Illinois.*

Adjust Service Provider Fees Downward for Our 401(k) Plan.

Challenge: Lower fees as our plan assets rise.

Action: We have renegotiated fees as our plan has grown. Here, the history is that competition first increased noticeably among service providers when our plan exceeded $20 million. Then, we were able to bargain for a lower fee schedule. When the plan hit $40 million, the provider agreed to drop some fees altogether. At the same time, our current provider is improving access to plan information, with Web access for employees so that they can shift assets, as well as Web access for HR to input employee changes. —*Controller, manufacturing, 2,000 employees, Michigan.*

Adopt a Mail-Order Drug Program to Contain Soaring Prescription Spending.

Challenge: Shift our employees to a mail-order drug program.

Action: We changed the prescription co-pay for employees. It was a flat 20%. We changed it to a minimum of $10 and a maximum of $40, or 20% if the cost falls between. We also adjusted our plans so that the cost to the employees is the same for a three-month mail order as for a one-month pharmacy order. This has been a major incentive for employees to use mail order and we have saved about $40,000. —*Controller, transportation, 1,200 employees, Washington.*

Combat Surge in Health Care Spending with Increased Cost Sharing.

Challenge: Keep managed care costs from going through the roof.

Action: Our medical enrollment is evenly split between PPO and HMO plans. To minimize cost increases, we reduced the out-of-network benefits on our PPO plan to a 70% reimbursement from an 80% level. We also increased the prescription drug co-pay from $5/$10 to $10/$15. Then, we used a heavy communication effort to en-

courage use of our mail-order drug plan. With a heavy concentration in managed care, the only cost-saving option left to us is increased cost sharing. *—Controller, wholesale/retail, 1,300 employees, Louisiana.*

Contain Health Benefit Costs with Simple Modifications.

Challenge: Modify health plan to combat cost increases.

Action: We looked for simple changes in our benefits plan that would keep costs from jumping 18%. Our principal move was to couple an increase in deductibles with a contribution increase. This saved the company roughly $150,000. Formerly, we also included dental coverage with the cost of medical. Now, we charge additional amounts for it. Finally, we increased co-payments for our drug program. To lessen the sting of these increases to employees, we supplemented our life offering, which was viewed positively. *—Controller, transportation, 400 employees, Connecticut.*

Decrease Company Health Benefit Expenditures by Raising Cost Sharing.

Challenge: Increase cost sharing for health benefits.

Action: We have been moving over the last several years to higher cost sharing with employees. Our goal is to reach 20% on medical and 40% on dental and retiree medical. We also increased cost sharing by employees who use tobacco products. Here, we used an honor system and offered a discount for nontobacco users. Over 47% of employees indicated that a covered person used a tobacco product. *—Assistant controller, services, 1,000 employees, North Carolina.*

Implement a Discount Program That Reduces Prescription Drug Costs.

Challenge: Contain costs without diminishing drug benefits for employees.

Action: Previously, employees paid full retail for their prescription drugs and then submitted their claims for 80% reimbursement. So, we set up a three-tier prescription drug program with an associated mail-order discount element. Now, the mail-order program fills all prescriptions that last over 30 days at a discount to both the company and employees. Although our total prescription drugs costs went up, they would have been higher had we not implemented this program. *—Controller, manufacturing, 550 employees, Wisconsin.*

Implement a Wellness Program as Part of Our Attack on Rising Health Benefits.

Challenge: Build lower costs into our benefits program.

Action: We started a wellness program, which includes events such as health fairs and breast cancer awareness week. By implementing

this program, we were able to reduce our overall costs by 4%. This past year we also increased our employee's overall share of health benefit costs to 21% from 18%, largely by raising our deductible $100 per person and lifting premiums by about 10%. *—Controller, services, 400 employees, Illinois.*

Join a Business Coalition to Broaden Health Benefit Offerings.

Challenge: Stabilize health benefit costs without compromising employee coverage.

Action: We were self-funded for medical, dental, and vision. We decided to join our region's major health care alliance. Seven of the largest employers in our city joined to increase bargaining power with Blue Cross Blue Shield. This helped us stabilize costs and increase the plans we offer. For example, we have broadened from an HMO and have added a PPO. Cost savings are impossible in today's environment. *—Controller, services, 800 employees, Iowa.*

Lower Corporate Benefits Spending by Modifying Our Co-Payments.

Challenge: Keep the increase in our health benefit premiums near 10%.

Action: We adjusted our co-payment structure, raising the cost for doctor visits from $10 to $15, doubling co-payments for prescriptions, and raising the charge for hospitalization from zero to $100 per day for the first five days. This helped reduce the cost of renewing our insurance from a 20% jump in premiums to 12%. We did not really have a strategy for introducing these changes. We simply announced them as we announced open enrollment. *—Controller, services, 500 employees, South Carolina.*

Lower Medical Benefit Costs through Self-Funding.

Challenge: Boost cash flow while self-funding health benefits.

Action: We have switched to self-funding with stop-loss coverage from a traditional premium program. This is a tremendous boost to our cash flow, since there is usually a three-month lag between the service from the medical provider and payment by the carrier. Also, we are not "funding" reserve projections on a monthly basis, as with traditional premium programs. Altogether, we have reduced our monthly payments $15,000 on average. *—Controller, manufacturing, 500 employees, Pennsylvania.*

Lower Total 401(k) Plan Costs by Adapting a New Program from Our Vendor.

Challenge: Make the smart choice on pension program alternatives.

Action: Last year, our 401(k) providers pitched their new full-service program to us. Called 401(k) Complete, this program seemed superior

to the plan we were using. We did detailed comparisons, liked what we saw, and switched. Altogether, the new plan will deliver more services, reduce time spent internally administering the plan, and cut total fees by approximately $57 per participant. —*Controller, distribution, 150 plan participants and $3.2 million in plan assets,*

Reduce Benefits Costs with a Cafeteria-Style Flexible Benefits Plan.

Challenge: Design plan structure to lower health benefit spending.

Action: We have begun to offer multiple health plan options—a PPO with various deductibles and company contributions—within a cafeteria plan structure. These options range from a very-low-deductible plan to a catastrophic plan. Within this context, we have increased employee cost sharing for the best plan option and have designed premiums for lesser plans to encourage movement into higher-deductible options. We expect employees to become better consumers as they share more costs. —*Controller, finance, 250 employees, Wisconsin.*

Reduce Health Benefit Spending through Employee Cost Sharing.

Challenge: Get greater employee contributions for health benefits.

Action: We had not increased contributions for dependent health coverage for the last five years, even though our premiums had increased substantially in the last three years. We evaluated our program and saw that norms for employee contributions were upward of 25% of costs. In contrast, contributions at our company were 25% of costs five years ago. We explained this situation and told employees they should expect an increase next year. Then, we announced the addition of a wellness benefit. —*Assistant controller, services, 2,100 employees, California.*

Reduce the Rate of Benefit Increases by Raising Employee Cost Sharing.

Challenge: Increase cost sharing without alienating employees.

Action: We began charging employees for single-coverage health benefits and increased the amounts paid by those with family coverage. This tweaking the plan will soon reach its end, however, since employees will stop perceiving the plan as a benefit if we tweak cost sharing any more. In the meantime, we shifted our dental plan to self-funding and started a wellness program, which we offer in addition to our PPO. —*Assistant controller, services, 5,000 employees, Texas.*

Renegotiate Fees with Our 401(k) Service Provider to Cut Pension Plan Costs.

Challenge: Get our 401(k) provider to renegotiate terms of a dated deal.

Action: We went to our provider and requested that it reduce certain fees, noting our ten-year history with the provider and the growing assets in our plan. It wasn't exactly easy but the provider reduced our costs by dropping the administration fee (it was $10 per account) and reducing the charges on different asset classes. Helpful to us in negotiations was this fact: We made it clear that if the provider would not budge, there were plenty of other companies that would like our business. —*Controller, manufacturing, 550 employees, New Jersey.*

Shift Costs from Overhead by Automating Benefits Functions.

Challenge: Move benefit systems and interaction online.

Action: We centralized some benefit administration functions and then outsourced. We now use our outsourced vendor to scan all benefit documentation instead of keeping hard-copy files. This centralization has also reduced the need for various regional HR benefit functions. Further, we began to offer online enrollment for benefits, which serves as an information source for benefit options. Now employees can access their accounts from work or home, make changes, and eliminate paper enrollment. —*Assistant controller, health care, 9,000 employees, California.*

Switch to Self-Insurance to Contain Rising Health Care Benefits.

Challenge: Find lower-cost alternatives to coverage from insurers.

Action: We are a fast-growing company and our HMO costs were increasing rapidly as we grew. So we switched to self-insured medical coverage. We calculate that savings will be around $80,000 to $100,000 yearly. We also added wellness benefits and incentives to keep employees and their spouses healthy. Other changes in our health care benefits since self-insuring include coverage for mammograms, prostate exams, and well-baby check-ups. —*Controller, manufacturing, 1,600 employees, Indiana.*

Capitalize on Young Workforce by Self-Insuring More Health Benefits.

Challenge: Switch successfully to self-insurance.

Action: Last year, a larger company purchased us. This company self-insured health benefits to a very high level. So, we went self-insured this year, switching from a fully insured approach. The move has reduced our overall insurance expenses by about 15%, largely because we are a young population and are having a good year. So far, there have been no claims over $100,000. —*Assistant controller, manufacturing, 2,500 employees, California.*

Stabilize Benefit Costs through Increased Cost Sharing with Employees.

Challenge: Undertake a comprehensive restructuring of our health benefits.

Action: We increased employee contributions for health care and dental benefits. We increased our co-pays for both medical appointments and medicine. We made sure employees knew about our opt-out policy, where we pay a small amount in each paycheck to those who get their medical coverage elsewhere. Finally, we decided to self-fund our dental plan. Altogether, we budgeted for approximately $300,000 in savings because of these changes last year. *—Controller, manufacturing, 600 employees, Illinois.*

Cut Health Benefits Costs through Self-Insurance.

Challenge: Finance benefits at lower cost without perceptible change to employees.

Action: We self-insured our health benefits, using a third-party administrator. We found that our actual costs are much lower than the premium we had paid in the past. I was the one behind this change, and pushed hard after the insurance premiums at one of our sites increased. At first, parts of the company wanted to self-insure with networks. But our stop/loss provider pushed us under the umbrella of one third-party administrator (TPA). Now, we are now considering self-insuring dental. *—Controller, wholesale/retail, 200 employees, Ohio.*

Use Self-Insurance to Cut Health Benefit Costs.

Challenge: Devise lower-cost self-funded programs that meet employee needs.

Action: We now partially self-fund our health benefits. What we do is rent a network of doctors. And, we have designed our own self-insured health plan to duplicate the insured products that we had previously. We have a PPO and now an HMO look-alike. We also have a strong professionally managed wellness program. While this approach moves costs around a great deal, it probably lowers total benefit spending somewhat while costs for most companies are rising. *—Assistant controller, manufacturing, 600 employees, Florida.*

Improve the Cost-Effectiveness of Our Mail-Order Prescription Drug Program.

Challenge: Shift more costs to employees who do not use generic drugs.

Action: We revamped our mail-order program. Specifically, we shifted from a two-tier structure—generic/brand—to a three-tier structure—generic, preferred, nonpreferred. This design will pass more expenses for higher-cost brand-name drugs and nonpreferred drugs to employees who use them. The program is new so we have not yet quantified any savings. But we anticipate at least 30% reduc-

tion in prescription drug costs. —*Controller, manufacturing, 1,100 employees, Tennessee.*

Shift Spousal Health Coverage from Our Medical Plan.

Challenge: Remove participants from our health plan when possible.

Action: We no longer cover a spouse who is eligible for coverage through his or her own employer. In making this change, we had to switch to a four-tier system, distinguishing "employee and children" from "family coverage." We now cover 225 fewer spouses than we did in the previous year. This produced an annual savings of about $450,000 per year. —*Controller, manufacturing, 4,200 employees, Illinois.*

Lower Mutual Funds Fees with Hard-Nosed Negotiation.

Challenge: Get provider to help us to reduce our 401(k) fees.

Action: We switched from a mutual fund that tracks the S&P 500 with an annual fee of 35 basis points to a common trust that the same provider offers that is priced at a fee of 20 basis points per year. We discovered this option only when we asked if any institutional pricing was available for a plan of our size. The provider told us only when we complained that its S&P 500 index fund was twice as expensive as Vanguard's. —*Controller, real estate, 1,600 employees, Maryland.*

Cut Back Health Benefit Spending by Fine-Tuning Managed Care.

Challenge: Make our PPO more cost-effective.

Action: We contracted a new rate directly with our hospitals, which brought us a small savings on this expenditure. We also implemented new health plans, using a national PPO that will give us discounted rates throughout the country. Before, we only had discounted rates with hospitals in Chicago, which is our largest location. —*Assistant controller, manufacturing, 850 employees, Illinois.*

Capital Expenditures

Minimize Capital Expenditures by Outsourcing Noncore Activities.

Challenge: Focus capital spending on mission-critical functions.

Action: We have downsized and outsourced noncore processes. As a result, we are focusing our capital spending on our core areas and are paying for noncore activities only as needed. Further, we do not have to spend time or resources training staff on tasks where our performance is mediocre, at best. Our cost per unit is now lower, and worker's compensation costs have dropped because we divested ourselves of activities that were accident-prone. —*Controller, transportation, 275 employees, Tennessee.*

Tighten Procedures That Contain Capital Expenditure Costs.

Challenge: Insure funds for authorized projects only.

Action: We have taken a basic step—improved control of our capital expenditures by insisting on use of budget authorization (BA) numbers. Now, no purchases can be made without a BA number. With this system, there can be no question as to the validity of the purchase of the general ledger account to which it belongs. We are also looking into software that will improve tracking of capital expenditures and assign responsibility for spending at the executive level. —*Controller, manufacturing, 250 employees, Kentucky.*

Improve Capital Spending Decisions in the Slow Economy.

Challenge: Tighten our approach to capital expenditures.

Action: We are applying new return on investment (ROI) and payback methodologies to our capital expenditure lists. And, we have decided to do more leasing. We now have deals with two financial institutions, where we get very competitive rates. This has reduced large cash outflows and kept the assets off the balance sheet. We have tried to instill a new attitude: unless we are generating hurdle-rate revenue or lowering costs, we will wait on a capital expenditure. —*Controller, manufacturing, 500 employees, Oregon.*

Lower Capital Expenditures by Delaying Special Projects or Sharing Their Costs.

Challenge: Make capital expenditures affordable.

Action: We have placed expensive special projects on hold until the third quarter. We will wait and see how the market develops, reassessing if we should restart, continue to hold, or cancel altogether. We are also looking into a joint venture with another company to see if we can share expenses. On the bright side, we are working closely with major suppliers to trim expensive parts from our designs and to use more standard components. Our goal is a 5% drop in capital spending. —*Vice president of finance, manufacturing, 500 employees, New York.*

Compensation

Stabilize Compensation Budget with New Merit Increase Policy.

Challenge: Keep the lid on the comp budget without demotivating employees.

Action: We widened the range of merit increases to better reflect performance, rather than simply giving everyone approximately the same annual increase. In addition, we reduced the company-wide increase-percentage slightly to better control costs. Finally, we used lump-sum merit payouts for those employees who are at the top of their range. We think, in this way, this tightening in merit increases

will still motivate our people, since it forces more money into a risk-based bonus plan. *—Controller, wholesale, 350 employees, Indiana.*

Contain Compensation Costs by Expanding Use of Salary Benchmarking.

Challenge: Align our compensation with norms for our industry and region.

Action: We have expanded our use of benchmarking. As a result, we now have a better method for comparing our compensation costs to those of our industry and location and for determining merit-increase budgets. In formalizing our system, we also evaluated the performance review process and educated our managers on its link to compensation. Thanks to this program, our compensation costs were flat last year. *—Controller, trades, 600 employees, North Dakota.*

Stabilize Compensation Costs by Adjusting Merit Increases.

Challenge: Salaries of many employees had grown well above market.

Action: We decided to slow raises for employees whose salaries were above market, while helping those earn generous raises who were paid below the market. (We define market as 94 to 106% of salary range midpoint.) To achieve this, we made our increase guidelines richer for below-market employees and a little more conservative for employees at market. We also used lump-sum merits for employees over market. To contain the costs of these awards, we stipulated that only above-market employees who were outstanding performers qualified. Since we have many employees, we expect recurring low six-figure savings. *—Controller, manufacturing, 2,800 employees, Washington.*

Slow Compensation Budget Growth by Adjusting Mix of Salary and Bonus.

Challenge: Keep executives motivated but avoid overpaying.

Action: We revamped the mix of base and bonus and redesigned the long-term plan for executives and senior management. We also increased the cycle between long-term payments. Finally, we introduced lump-sum merit and bonus awards, coupled with the introduction of a market-based pay program. This has reduced the base pay increases for middle managers who are already well paid in relation to the relevant labor market. *—Controller, R&D, 1,000 employees, California.*

Raise Payback of Compensation Dollar by Instituting Skill-Based Pay.

Challenge: Build understanding and support for skill-based compensation.

Action: We implemented a certification process that allows employees to increase their pay when they increase their skills. This program is self-paced. Employees meet skill criteria on their own schedules and then earn more money. The company has gained through workforce reduction, increased employee flexibility, and cost realignment. We estimate a 5 to 10% savings. —*Controller, manufacturing, 150 employees, Minnesota.*

Contain Compensation Increases through Greater Use of Merit Raises.

Challenge: Change compensation options of staff at top of their salary range.

Action: Some employees had long service and were overpaid for their jobclass. In this case, we fixed their current base pay and redlined further increases. Here, we told them that they would have to expand or enrich their jobs in order to receive merit raises. Meanwhile, their raises would take the form of one-time bonuses—that is, pay for performance. We also developed a salary guide chart, which makes our new system fairer and easier to administer. We expect a small annual savings. —*Controller, banking, 400 employees, California.*

Contain the Compensation Budget in a Period without Revenue Growth.

Challenge: Implement a range of change to contain compensation costs.

Action: We have taken several actions. For example, we are not replacing all employees after they leave. Instead, we delay finding a replacement for up to six months. We have also delayed the awarding of merit increases by six months and reduced the merit budget by 1%. Finally, we are shifting to a company-wide review cycle. This will give us better control of the comp budget. —*Controller, manufacturing, 1,400 employees, Illinois.*

Limit Compensation Increases by Adjusting the Mix of Salaries and Bonuses.

Challenge: Reward performance while slowing growth of total salary base.

Action: We decided to shrink the merit increase pool (to 3% from 4%) and to offset this change with increased short-term incentive (STI) opportunities. What we did: We expanded STI opportunity to all salaried associates. Then we based the STI pool on a combination of company and business-unit performance. Individual employees received awards from this pool, based on personal performance. Now we reward top performers and contain costs at the same time. —*Controller, insurance/financial service, 3,600 employees, Massachusetts.*

Reallocate Funds in Compensation Budget to Combat Rising Employee Costs.

Challenge: Shift money in the comp budget to reduce long-term costs.

Action: Last year, we split out 1% of the merit budget (which is 5% of our compensation budget) and paid it as a lump-sum bonus, rather than adding it to base pay. This saved approximately $150,000 in base salary increases that would have continued to have a multiplicative effect as the years went by. We also restricted merit increases to 2 to 6%. Finally, we are working to get better market pricing capability to managers so that they can make better decisions and not overpay at the top of salary ranges. —*Controller, nonprofit, 200 employees, Michigan.*

Reduce the Size of Merit Increases to Combat Soaring Compensation Costs.

Challenge: Shift to a more performance-based compensation program.

Action: We adjusted the merit budget so that it fits within realistic affordability parameters. Now, increases that are outside these guidelines need CFO and business unit head approval, as well as HR approval. In addition, we modified the overall compensation program so that a greater percentage of the budget does not increase base pay. Here, our goal is to provide more bonus opportunity and to manage this budget more competitively. We are more closely monitoring merit increases. —*Controller, manufacturing, 400 employees, Massachusetts.*

Restrain Rising Compensation Trends by Adjusting the Mix of Salary and Bonus.

Challenge: Implement a company-wide bonus tied to performance.

Action: Two years ago, we shifted our compensation structure, reducing merit increases but offsetting this with a bonus plan based on corporate goals. This shift raised the percentage of employee compensation based on salary and slowed increases in our base, thereby decreasing expenses for the 401(k) match and future merit increases. At its implementation, we told employees this bonus was not guaranteed. This year we did not achieve the bonus. This enabled us to control direct costs associated with salary. —*Controller, manufacturing, 200 employees, Georgia.*

Slow Compensation Increase by Simplifying Administration.

Challenge: Get employees to accept cost-saving system changes.

Action: Last year, we switched to a common salary date. All employees are evaluated once a year and salary merit adjustments are effective on the same date. This has saved manager's administrative and processing time, as well as resources. This is more effective for budgeting, as all salaries are looked at at one time, with projections

easier to cast forward accurately. *—Controller, finance, 725 employees, Florida.*

Expand Our Use of Salary Benchmarking to Contain Total Raises.

Challenge: Shift to a market-driven salary structure.

Action: We expanded our use of salary survey data and benchmarked salaries of key company positions. This more accurate information has allowed us to move toward a market-based compensation model, instead of paying employees according to longevity. Eventually, we think a system providing annual merit-based increases and competitive market wages will lower the annual growth in our salary budget by 2%. *—Assistant controller, manufacturing, 1,600 employees, Texas.*

Raise Performance Incentives by Redesigning Our Compensation System.

Challenge: Connect compensation increases to achievement.

Action: For salespeople, we instituted maximum base salaries, while providing more opportunities to earn incentive bonuses. Through the refinement of our sales teams and the individualization of incentives, we are now able to measure results more usefully. Meanwhile, we put more dollars at risk for managers. To do so, we froze base pay but increased bonus potential. The bonus is based on individual business units and company performance. Across the company, we are now doing a better job of paying our top performers. *—Controller, insurance, 1,600 employees, New York.*

Controllership

Squeeze Costs and Float from Finance by Implementing Electronic Data Interchange.

Challenge: Establish an electronic data interchange (EDI) system for billing and cash receipts.

Action: Establishing the system required the cooperation of customers. But now, everything runs smoothly. With the new system, we send freight bills electronically to eliminate mail time. Customers wire funds directly to our bank, which reduces the float, and send remittance information to us by EDI. The information updates in accounts receivable automatically, eliminating input chores. Altogether, we have reduced certain processing times dramatically. *—Director of accounting, transportation, 750 employees, Missouri.*

Establish New Channels of Distribution to Reduce Export Costs.

Challenge: Cut our international distribution costs.

Action: We have established new channels of international distribution. Now, we are supplying finished and component goods to five manufacturing locations around the world and six major distribution centers. In contrast, everything used to move through the United States. But now, only what is sourced here, moves here. Otherwise, only the documents come to the United States. We estimate this change in our distribution knocks 3% off our product costs. *—Controller, manufacturing, 3,000 employees, Ohio.*

Implement P-Card Program to Save Money on Office Supplies.

Challenge: Take full advantage of potential P-card savings.

Action: The company shifted to desktop delivery of office supplies, which we purchase over the Internet using P-cards. Clerks and administrative assistants who have a P-card do most of the ordering. If they place an order before 3:00 p.m., we have delivery on most items the next morning. Annual savings: $700,000 in negotiated pricing; approximately $1,000,000 in inventory reduction; $380,000 in transaction savings. *—Controller, technology, 5,000 employees, Utah.*

Reduce Corporate Costs through Downsizing.

Challenge: The company needed to reduce its costs by 15%.

Action: We did a top-to-bottom reorganization of responsibilities. Afterward, we were able to outsource certain support functions. In addition, we consolidated operations, thereby reducing rent and other facility maintenance costs. Finally, we gave every department head a mandate to cut by 10% in their areas. *—Controller, manufacturing, 3,000 employees, Utah.*

Cut Total Travel and Expense Spending by Modifying Cash Advance Policy.

Challenge: Adjust travel and expense (T&E) system to a lower-cost model.

Action: We rolled out a corporate charge-card program. Then, we reduced the petty cash fund in the office, deciding to give travel advances only to employees who do not have corporate credit cards. This reduced our need for petty cash, cut down on general ledger entries, and cut down on following up with people to hand in reports who owe money. Altogether, this reduced the average monthly cash advance balance from the $50,000 to $85,000 range to the $10,000 to $15,000 range. *—Assistant controller, services, 1,000 employees, Maryland.*

Use Web-Based Technologies to Lower T&E Costs.

Challenge: Implement an Internet-based expense management automation system.

Action: We reviewed the expense management automation (EMA) systems of several vendors, including Concur, Extensity, and Necho. Finally, we decided to go with Concur on an ASP platform, thereby

avoiding implementation costs and an increased burden on our IT department. The system has certainly streamlined our reimbursement. Plus, the system has built-in policy monitoring, red-flagging spending that exceeds our policies. Altogether, this EMA system will save us substantially in travel administration costs. —*Controller, services, 4,000 employees, New York.*

Tap Staff Expertise to Find and Unleash Cost-Lowering Improvements.

Challenge: End knowledge compartmentalization in the company.

Action: The company has established "asset management" teams, with diversified membership representing different departments. These teams focus on specific areas, such as inventory, production, purchasing, health and safety, and communications, where we want to cut costs. We encourage each team to challenge current practices and develop cost-effective ideas, which they formally give as reports to upper management monthly. In the past year, these teams have generated savings exceeding $1 million. —*Corporate controller, durable goods manufacturing, 900 employees, New Jersey.*

Improve Back-Office Efficiency by Implementing Imaging.

Challenge: Use the Internet to cut processing costs.

Action: We used imaging to move access to our invoices to a portal on the Internet. This way, any person needing duplicate copies of invoices can get their forms by going to our Web pages. This has saved us the cost of several people at central billing who did nothing but print duplicates and invoices and about five full-time equivalents (FTEs) in offices throughout the United States who did the same. —*Vice president and controller, transportation, 10,000 employees, California.*

Use Bidding Process to Get a Better Deal from Our Bank.

Challenge: Reduce corporate banking costs by 10%.

Action: We moved the company's banking activities, 401(k) plan, loans, credit cards, and daily operations to a new bank. In doing so, we identified our five top objectives, solicited input from four banks, analyzed their proposals, negotiated with the top two bidders, and selected the best offer for our business. We have not dollarized the effects. But the results are better service, lower costs, and less administrative time. —*Controller, transportation, 400 employees, Wisconsin.*

Combat Budget Overruns by Strengthening Leadership of Product Teams.

Challenge: Develop new products on schedule and within budget.

Action: We assigned project managers to key projects and gave them responsibility for all functional resources, as well as making them responsible for coordinating project efforts. Further, we brought in seasoned program managers to mentor our project managers and assisted them with day-to-day management. We went from 30% of projects meeting budget, schedules, and performance criteria to 90% doing so. —*Controller, manufacturing, 400 employees, Wyoming.*

Improve Banking Procedures to Eliminate Needless Float.

Challenge: Squeeze float from check disbursement and reconciliation.

Action: We switched to a controlled disbursement system from a standard checking account. This gave us an additional day of float and increased our interest income by $25,000 yearly. We also arranged to get a daily download from the bank that indicates the checks that have cleared that day. This download reconciles checks in our accounting system daily, so we have current information to work with when we invest funds short term. This download also eliminated two to four hours of manual check reconciliation daily. —*Accounting manager, services, 700 employees, Minnesota.*

Human Resources

Save Back-Office Costs by Implementing Timekeeping Software.

Challenge: Implement timekeeping and automated payroll processes.

Action: Before implementation, employees completed paper time sheets manually and routed them to supervisors, who routed the time sheets to payroll after approval. Payroll then manually keyed the information into an ADP program for weekly processing. Employees now swipe a timecard, which eliminates errors from misreading. Supervisors log into the timekeeping system for a quick weekly sign-off. And, payroll downloads the information from four separate departments with just a few keystrokes. Now, hourly employees, supervisors, and payroll staff spend less time on payroll, while the system is more accurate. —*Controller, manufacturing, 200 employees, Wisconsin.*

Decrease Training Costs by Adopting Intranet Learning Modules.

Challenge: Develop system for training hourly employees at reasonable cost.

Action: We made sure our hourly workers had access to intranet-based learning modules that are self-paced. This reduces our costs for travel, trainer salaries, and contracted trainers. There are also intangible benefits in this approach, such as that the training in our modules is immediately usable on the job. Even so, there seem to be some drawbacks, with some managers not happy with the quality of staff learning. We are sticking with this approach, however,

since the cost savings may reach $25,000. —*Controller, government, 500 employees, Texas.*

Streamline Back-Office Overhead by Automating the Benefits Function.

Challenge: Implement a human resources information system (HRIS) system successfully.

Action: Our new automated HRIS system allows us to process, track, and record information quicker, as well as to provide management reports faster. Since implementation, we have brought the preparation of employee benefits statements in-house. We have also reduced work we formerly outsourced to vendors. We estimate our approximate yearly cost savings at $15,000 to $30,000. —*Assistant controller, manufacturing, 1,300 employees, Wisconsin.*

Introduce e-Learning System to Lower Sales Training Costs.

Challenge: Use existing resources in our sales training programs.

Action: We implemented a program we call knowledge on demand. This is a collection of electronic files that we have created from existing product information and hard-copy training programs that we placed on our intranet for instant, searchable access 24 hours a day. This has substantially decreased the lost time we were experiencing in the field when information was needed but not available. Further, it has helped us bring existing resources into the sales program. Our sales force is able to close sales faster. —*Controller, manufacturing, 2,000 employees, Texas.*

Lessen Administrative Costs by Migrating HRIS Applications to an Intranet.

Challenge: Provide intranet-based self-service for human resource information.

Action: We moved human resource information to our intranet. Now employees can download various human resource forms, view upcoming events, schedule training, and so on. Meanwhile, management can view their schedules, employee vacation and sick-day accruals, enter attendance, and so forth. We have not formalized cost savings yet; however, we have saved approximately four hours plus per week across the various areas (payroll, benefits, etc.). —*Controller, services, 870 employees, Washington.*

Reduce Overhead Costs by Using a Less Paper-Intensive Human Resource System.

Challenge: Implement first phase of SAP human resource system.

Action: We selected and implemented this challenging program. Ultimately, this will lead to an integrated HR/benefits/payroll/training system that eliminates duplicate entry and massive paper movement. Now,

data changes take effect immediately—not in a week, as before. We estimate our back-office saving to be $150,000 the first year. —*Assistant controller, manufacturing, 1,000 employees, Minnesota.*

Shed Overhead by Migrating Certain HRIS Functions to Our Intranet.

Challenge: Deliver human resource information less expensively.

Action: We provided online benefits enrollment via an intranet. This reduced our error rate by 95%, increased employee access to benefits data, and made them more informed consumers. Additionally, the new system executes confirmation statements immediately, not in two weeks as before. Altogether, we have saved between 400 to 600 hours of data entry yearly. —*Controller, services, 1,100 employees, Texas.*

Use Corporate Intranet to Streamline Labor-Intensive Human Resources Functions.

Challenge: Use our Intranet as a time-entry system.

Action: We implemented a Web-based time-entry system for employees. Now, we capture time-worked information throughout our multistate organization via Web-based panels. This information then loads—after review—into our time and labor system, which is by PeopleSoft. We calculate that we can reassign staffers in 12 data-entry jobs thanks to this system, eliminating about $200,000 per year in overhead costs. —*Assistant controller, finance, 10,000 employees, Kansas.*

Lower Information Expenses by Adopting an HRIS.

Challenge: Shift information management away from human resources staff.

Action: We are in the process of implementing a new HRIS system that will provide employee and manager self-service capabilities. We will provide 24-hour access to human resources information with this system and reduce employee reliance on human resources staff. The system will link facility locations in several cities and also provide access via the Internet to employees who work out of their homes. This is a major money-saving investment, but we are anticipating almost immediate ROI. —*Assistant controller, manufacturing, 1,400 employees, Minnesota.*

Reduce Human Resource Budget by Centralizing Training Management.

Challenge: Get more bang for the buck in training.

Action: We investigated our training programs and found that we could outsource some programs while making better use of our trainers.

We also centralized our registration, billing, and purchasing. The final numbers are not in, but we expect to save at least 40% of last year's costs. Note that the training program was in a unique situation, in that this was the first year all company training was unified in one "corporate university." —*Controller, manufacturing, 10,000 employees, Ohio.*

Implement Benchmarking to Assess Training Program Effectiveness.

Challenge: Reduce training costs while raising trainer productivity.

Action: We began to benchmark employee performance "before" and "after" training. We then modified training to increase its effectiveness, all the while monitoring our progress. As a result, we were able to cut unnecessary training hours and materials. We have experienced a 12% reduction in total training cost, with a 7% jump in trainer productivity. —*Controller, government, 750 employees, Iowa.*

Inventory

Reduce Inventory Levels by Shifting Ownership to Suppliers.

Challenge: Create a win/win situation that lowers our inventory costs.

Action: We negotiated long-term agreements and then shifted ownership of our inventory to suppliers. A specific example is the program we developed with our glass supplier. Here, we agree to a longer-term contract and buy a larger quantity of glass (maybe up to a year's worth). Then, the supplier warehouses the stock for us and bills us only after use. As a result, inventory levels are down and our glass prices are less, because of the higher order quantity. Meanwhile, the supplier has higher sales. Estimated annual savings: $100,000. —*Controller, furniture manufacturers, 350 employees, Wisconsin.*

Reduce Inventory Levels by Upgrading Our Control Measures.

Challenge: Shift to a more effective system of inventory control.

Action: We have implemented a monthly review process, where we count inventory levels by cell. The process of cell review identifies usage by item, improving our planning. This monthly mandatory count is a key practice, saving our company thousands on shipping costs and rush charges applied by vendors to our own orders. For the next year, we have these goals: a full cellular manufacturing process in a pull system, with three-day lead times, and a 95% on-time ship rate with finished goods. —*Controller, high technology, 250 employees, Maryland.*

Use Hurdle Rates to Fight Production of Slow-Moving Inventory.

Challenge: Establish an effective system for discontinuing inventory.

Action: We are implementing an item rationalization model. Here, we recommend hurdle rates for an item, which it must surpass to remain on our price list. After two years, every item must now attain a critical mass and profit potential or we discontinue. So far, we have dropped 17 items out of 101 evaluated and have 800 more items to evaluate. Overall, we expect to reduce our inventory value by $4 million by the end of the year. *—Controller, pet food, 1,000 employees, California.*

Standardize Inventory to Lower Purchasing Costs.

Challenge: We reduced purchasing costs through centralization.

Action: Senior management formed cross-functional teams and asked them to reduce the cost of particular commodities by 25% to 40%. The teams generated many ideas, including specification changes, redundant stock elimination, and better planning or requirements. We conducted approximately 20 sessions. Many improvements tie reduced product costs to our adoption of products with specs that are industry standards. This has led to improved availability and lower costs. Our estimated savings for one year is $6 million. *—Controller, manufacturing, 8,500 employees, New York.*

Reduce Inventory Carrying Costs with an Activity-Based Costing System.

Challenge: Streamline our inventory management operation.

Action: We implemented a modified activity-based costing (ABC) approach. We classified 6% of our SKUs as A items, 10% as B items, and the remaining 84% as C items. Then, we established a bi-level policy. With the C-1 items, we only place an order with a supplier when we receive an order from a customer. With C-2 items, we try to have one item on hand or on order at all times. This has reduced order review and processing time by over 70% and cut our slow-moving inventory. Overall, inventory costs are down 5% to 10%. *—Controller, medical instruments, 200 employees, Massachusetts.*

Reduce Inventory Costs with Pervasive Use of Competitive Bidding.

Challenge: Get better and cheaper vendors to bid for supply contracts.

Action: We now actively source new, best-class suppliers that do not yet do business with us. Then, we bring them into our competitive bidding process, where we buy key commodities. One recent initiative was for an electric part that is a commodity. Our system yielded actual savings of $3,000 on an annualized basis. We calculate a $22,000 future value. *—Controller, manufacturing, 2,000 employees, Indiana.*

Lower Inventory Costs by Making Production Schedules Available to Suppliers.

Challenge: Execute a concept we knew would free cash from inventory.

Action: We started a supplier integration program this year. This computer-based system allows critical suppliers into a “reserved office,” where they can access our inventory and production planning screens. This helps us reduce inventory, lead times, and obtain schedule reliability. We are also providing less critical vendors with a 90-day forecast and 30-day production schedule. This helps to push inventory levels to a minimum. —*Controller, food industry, 500 employees, Pennsylvania.*

Reduce Level of Inventory Investment by Shifting Ownership to Suppliers.

Challenge: Get parts suppliers to sign on to our new management system.

Action: In the past, we have stored spare parts for every piece of equipment and never utilized our vendors to keep the cost down. Since we have a time-critical product—newspapers—we viewed our large spare parts inventory, which totaled about $3 million, as a necessity. But in the past two years, we have reviewed each part and then approached the appropriate vendors, asking them to stock certain items with the assurance that they could ship the inventory in 24 hours. The results: a reduction in inventory of over $400,000. We plan to reduce our stock levels another 20% next year. —*Plant controller, newspaper, 2,000 employees, Illinois.*

Cut Inventory and Logistics Cost by Consolidating Our Supplier Base.

Challenge: Get more bang for the buck from a smaller supplier group.

Action: In reducing the supplier base, we acquired more purchasing leverage, since we concentrated our purchase dollars. As a result, we were able to lower prices and to work with suppliers to improve quality and service. In many cases, we also shifted large-dollar purchases from distributors directly to manufacturers. This single move saved us $500,000. Altogether, reducing the supplier base enables us to use more blanket purchase orders, share annual forecasts, and negotiate better terms, while insisting on guaranteed performance and quality. —*Controller, manufacturing, 500 employees, Wisconsin.*

Lower Inventory Costs by Renegotiating Existing Supplier Contracts.

Challenge: Bring contract prices down to market level.

Action: We had multiple suppliers bid or rebid our existing demand. This allowed us to find the true market price for these materials. We

then set up contracts reflecting these true prices to supply our manufacturing sites. Whenever possible, I tried to keep our contracts with our present vendors, since they know our specific needs. Altogether, the process took six months and saved over $200,000. *—Controller, manufacturing, 450 employees, Pennsylvania.*

Lower Supply Costs by Shifting Inventory to Vendors.

Challenge: Reduce inventory levels without hampering our manufacturing system.

Action: We are doing several things. For example, we installed a real-time inventory reporting system, which is readable via our intranet. We also altered payment terms and our system of supplier performance measurement. Most important, we shifted inventory assignments to individual suppliers with minimum levels to be maintained. Our estimated annual savings for these measures is $400,000 to $500,000. *—Controller, manufacturing, 225 employees, Arkansas.*

Scrutinize Inventory Closely to Ferret Out Extra Spending.

Challenge: Develop a comprehensive inventory-monitoring program.

Action: We set up inventory reduction teams by product and vendor and then reviewed each line item, its usage, our future needs, "blue light" sales potential, and scrap value. In addition, we reduced safety stock and lot sizes. So far, the program has been successful and we have seen a $1 million reduction in our inventory position, even as we are increasing output to meet new higher demand. Over the next 12 months, our goal will be to cut $2.5 million from our position. *—Controller, manufacturing, 300 employees, Virginia.*

Slash Throughput Costs by Implementing a Warehouse Management System.

Challenge: Eliminate excess operating costs from our warehouses.

Action: We implemented a warehouse management system. Savings are expected to be $100,000+ annually, due to labor reductions alone. This system will also allow us to better serve our customers by increasing throughput, reducing shipping errors, and meeting all customer labeling requirements. *—Controller, manufacturer, 200 employees, Ohio.*

Use Range of Management Practices to Lower Inventory Costs.

Challenge: Take cash out of inventory without affecting production.

Action: We integrated a just-in-time (JIT) buying process with vendor-managed inventory (VMI) to reduce our carrying costs by 50%. To do so, we took the top 20 items, which equal 80% of inventory dollars, and stocked them on site. Then, we put these stock items on consignment. The 80% of items that equaled 20% of inventory dol-

lars were put on the JIT program and stored at the vendor's facility. —*Controller, manufacturing, 550 employees, North Carolina.*

Periodically Review Inventory with the Intent of Lowering Stock.

Challenge: Constantly refine and improve our system of inventory management.
Action: A program of periodic review has helped us to discontinue doggy items, introduce new items in hot product lines, and implement the economic order quantity order method. We also keep our sales staff posted. They, in turn, successfully sell down historically slow-moving products. Our buyers also spend less time cutting purchase orders, down to 3,000 per year from 7,000. In the last three years, sales have risen about 10% annually, while inventory levels have been stable. —*Controller, wholesaling, 200 employees, New Mexico.*

Reduce Inventory Costs by Improving Coordination with Suppliers.

Challenge: Communicate our production plans to suppliers.
Action: On a limited basis, we had made production plans/schedules available to suppliers. But we expanded the program. We expect differences in the piece price, since—by seeing future production needs—the supplier is able to combine runs and reduce this price to us. We have also addressed our internal costs by expediting express shipments, changing schedules, and experimenting with multiple line changeovers. —*Assistant controller, manufacturing, 500 employees, Ohio.*

Avoid Expensive Overhead Charges by Maintaining Accurate Inventory Counts.

Challenge: Maintain the effectiveness of our cycle counting system.
Action: We have an effective system of daily work-in-progress (WIP) cycle counts. Here, our WIP cycle-count process measures inventory accuracy of the work order and the piece count of each operation. To enhance this process, we utilize a hand-held barcode reader, which records the work order, operation, quantity, floor location, date, and time. We download these data to a spreadsheet, comparing them to baseline-system data. Our accuracy (95%) has eliminated the need to perform a wall-to-wall physical inventory for the past two years. Its cost: $150,000 plus two days of lost production. —*Controller, manufacturer, 520 employees, Ohio.*

Outsourcing and Professional Services

Employ Competitive Bidding to Force Vendors to Lower Prices.

Challenge: Conduct widespread bidding on outsourced programs to cut costs.
Action: We reevaluated our outsourced programs, such as payroll, benefits administration, and 401(k) recordkeeping. In doing so, we cast a

wide net for vendors. Then, we gave vendors the opportunity to meet bids from competing vendors. Our total annual savings were just over $40,000. This demonstrates to me that all pricing for these outsourced human resource programs is negotiable. *—Controller, finance, 800 employees, Pennsylvania.*

Outsource Training Functions to Lower Human Resources Overhead.

Challenge: Use capabilities of nearby college to prepare staff for promotions.

Action: We outsourced our leadership development training instead of hiring a leadership development specialist. To do so, we partnered with a local college that provided 11 different leadership development courses. We saved 50% of salary in this function while meeting identified needs. We are now considering outsourcing some of our information systems training. *—Controller, health care, 1,500 employees, Illinois.*

Cut Overhead by Outsourcing Specific Human Resources Functions.

Challenge: Identify functions that service providers can do for less.

Action: We outsourced our 401(k) plan to a full-service provider. We save $13,000 a year in trustee fees and have less administrative work. Meanwhile, employees have daily access to fund balances and transfers, more fund choices, and the option of in-house investment training three-times a year. We also outsourced new-hire background checks and felony report searches. As a result, we can now downsize Human Resources, provide better 401(k) service, and cut back hiring mistakes. *—Controller, retailer, 400 employees, Indiana.*

Reduce Annual Accounting Fees by Shifting to a New Accounting Firm.

Challenge: Lower professional service costs while raising service quality.

Action: After seven years with a major national accounting firm, we shopped around among the Big Four and large local firms. We did so because we perceived a decrease in services without a decrease in fees. Eventually, we selected another Big Four firm and received an annual fee cap of 5% increases for the first three years, ensuring that the initial fee was not a teaser fee, just to get in the door. Bottom line, we have reduced accounting/auditing fees significantly—approximately $100,000 per year. *—Controller, manufacturing, 400 employees, Arizona.*

Tap In-House Talent to Tighten Spending on Professional Services.

Challenge: Achieve an across-the-board 10% cut in professional services fees.

Action: Our corporate counsel took the lead in fee/contract negotiations with our auditors, banks, and insurance brokers. This was useful,

since friendships were having a cost-inflating effect on negotiations. In doing so, we traded overly close business relationships for black-and-white dollar discussions. We also reorganized the accounting department for the year-end audit. Because we are more efficient internally, we have reduced our audit fees by 25%. *—Controller, manufacturing, 800 employees, Michigan.*

Use Multiple Strategies to Reduce Annual Audit Fees.

Challenge: Reschedule and refocus auditor activities.

Action: Our fiscal year is the calendar year and auditors were working at our company in February and March. That is premium time for auditors when their fees are highest. As a result, we rescheduled our internal deadlines and moved some audit activities to one week before December and one week in January. We also assumed more paperwork preparation internally, reconciling, analyzing, and balancing accounts before year-end. Altogether, these changes lowered our fees by 15%. *—Financial officer, manufacturing, 280 employees, Iowa.*

Purchasing

Take a Tough Stand on Price Increases to Lower Purchasing Costs.

Challenge: Keep vendors from increasing their margins at our expense.

Action: We have implemented a cost-reduction program in purchasing, where each buyer is committed to saving $*x*. As a part of this program, each buyer nets each price increase against a cost-reduction commitment to our company. This way, we ensure that they meet their targets. Further, we are forcing suppliers to verify in writing the need for actual pass-along price increases. This stops proposed price increases for which there is no justification. *—Assistant controller, technology, 1,000 employees, California.*

Cut Inefficiencies via Electronic Commerce with Suppliers.

Challenge: Use electronic commerce to streamline accounting.

Action: We are a direct mail-order company that does a significant amount of drop shipments. Our new electronic commerce capability, which our CFO researched and recommended, gives us a new quick and efficient capability that updates orders, invoices our customers, and processes the invoices from our suppliers. Cost savings approximate the equivalent of one FTE. *—Controller, marketing services, 350 employees, Arizona.*

Clarify Supply Issues and Lower Costs with an In-Plant Store Program.

Challenge: Shift maintenance and repair operation (MRO) purchases to a supplier-managed program.

Action: We implemented a supplier-managed in-plant store program for designated categories of MRO material. This in-plant store program was very successful and resulted in an annual $100,000 cost reduction. Further, it eliminated the processing of 6,200 annual transactions related to purchase orders, receipts, and invoices. We should have done this a year or two earlier. —*Controller, manufacturing, 1,000 employees, Pennsylvania.*

Lower Purchasing Costs by Shrinking Our Supplier Base.

Challenge: Get our buyers to support this fundamental change in purchasing.

Action: We have started to leverage our spending with fewer vendors. Our goal is to have one major, one minor, and a third in the closet for each category of part or commodity. So far, we have been able to negotiate better discount/contract programs for our division, with costs lower by 10% or more for certain items. We have also received improved service and our suppliers are showing greater concern with quality. —*Division controller, medical devices, 1,100 employees, Arizona.*

Maximize Purchasing Power by Taking a Tougher Stand on Price Increases.

Challenge: Manage vendors so that they are reluctant to raise prices.

Action: We've been tougher on price increases. What we did is to set across-the-board reduction targets. We keep those suppliers who are working toward meeting these targets. Otherwise, we are changing suppliers, with the suppliers we drop basically not cost-effective in their own operations. We are also requiring vendors to document thoroughly the rationale for any increase. Finally, we are working with vendors to decrease their own costs, so that they can achieve their own margins without increasing their prices. Last year, we actually maintained our supply costs while increasing volume. —*Controller, drug manufacturing, 900 employees, Delaware.*

Consolidate Our Supplier Base to Lower Materials Costs.

Challenge: Join supplier reduction with better terms.

Action: Where we were using two or three suppliers for a particular commodity, we now use one. In exchange for the additional business, that supplier gives us concessions on price, terms, and sometimes freight, as well as rebates as incentives for additional business this year and next. By consolidating and leveraging our spending with fewer suppliers, we have produced a 5% price reduction, as well as improved our ability to integrate with e-commerce. —*Controller, manufacturer, 500 employees, Illinois.*

Contain Costs by Working Closely with Suppliers during Equipment Design.

Challenge: Build supplier expertise into the design process.

Action: Now we come up with initial design and performance standards. Then we share this information with our suppliers, asking for their input on improving the design or making it easier to manufacture. This has worked well for us. For example, we eliminated "overkill" on new equipment for certain high-volume work cells. For the two cells, this saved $215,000 on equipment, when the total cost was $1.6 million. —*Controller, manufacturing, 550 employees, Florida.*

Improve Purchasing/Manufacturing Coordination to Reduce Safety Stock Levels.

Challenge: Lower safety stock needs through better purchasing timing.

Action: Most of our accessories/consumables that come off the shelf to accessorize our made-to-order equipment were coming in far too early. This occurred because accessories/consumables typically have a two- to four-week lead time while the core equipment has a five- to six-week lead and we ordered everything at once. What we did is upgrade our logistics system, so that we break down demand by release date. Now, all this accessorizing stock appears when needed. —*Controller, medical equipment, 300 employees, Massachusetts.*

Lower Purchasing Costs through Revising Supplier Agreements.

Challenge: Meet senior management request for 10% lower purchasing costs.

Action: We reduced our materials costs $120,000 (15%) by restructuring agreements with suppliers and getting higher discounts in return for long-term purchasing agreements. We also ended one of our supplier partnerships, and are able to receive lower pricing for one commodity through a new bidding process. —*Controller, manufacturing, 325 employees, South Carolina.*

Lower Shipping Costs by Modifying Arrangements with Freight Forwarders.

Challenge: Make shipping less costly and more efficient.

Action: We have stopped relying on a single freight forwarder. Instead, we use different forwarders in different regions, usually those offering the best regional price. Now, we also pay in conjunction with a monthly retainer fee. The effect of these changes was to save 10% on freight forwarding, as well as to reduce the time spend on bill verification. —*Controller, distribution, 350 employees, North Carolina.*

Renegotiate Shipping Rates to Free Up Money in Our Logistic Spend.

Challenge: Get more bang for the buck in logistics.

Action: We reduced the number of our carriers by 40%. Then, we negotiated new freight agreements with our remaining carriers, saving us about $300,000. We also negotiated new rates with Federal Express. With this vendor, we also took about one-third of our next-day shipments and turned them into second- and third-day shipments. With FedEx, we are looking at a $90,000 to $125,000 reduction. —*Controller, pharmaceuticals, 100 employees, Missouri.*

Renegotiate Supplier Contracts while Raising Their Value-Add.

Challenge: Get more value from established suppliers.

Action: We told suppliers that we have worked with for many years that we were looking for new ideas and technologies and, therefore, new suppliers. This made them reexamine prices and products. Several came up with new products we could use for the same applications at cheaper prices. We also renegotiated some contracts by defining specifications better, insisting on different and less costly packaging, and specifying freight carriers with lower rates. Finally, we combined several programs for better purchasing leverage. —*Controller, nondurable goods manufacturing, 300 employees, Arizona.*

Tighten Travel and Expense Spending by Implementing Better Vendor Programs.

Challenge: Implement a cluster of new programs that lower T&E costs.

Action: We reduced T&E costs by 10% by implementing a new travel policy. This requires our corporate travelers to take the lowest fare possible and our agency to set up programs with major airlines to get free tickets based on mileage flown. We also implemented direct-billed corporate AmEx and set up automated reimbursement with Gelco. We expect further savings to come later as we issue fewer checks and we use travel expense information to negotiate rates. —*Controller, communications, 650 employees, New Jersey.*

Worker's Compensation

Act as an Agent for Subcontractors to Lower Worker's Compensation Costs.

Challenge: Change approach to worker's comp insurers.

Action: We require each of our subcontractors to maintain worker's compensation coverage while on our job sites. By mandating that all subcontractors obtain insurance through our corporate office, we,

in effect, became the bidder for each area. Through economies of scale, we now are able to purchase insurance for less than what each subcontractor could contract for. —*Controller, professional services, 150 employees, Texas.*

Contain Worker's Compensation Costs through Improved Data Flow.

Challenge: Automate our system for monitoring worker's compensation issues.

Action: We purchased an OSHA/worker's comp software program to keep track of all accidents and worker's comp costs and generate OSHA reports. Our former system was manual and the new software has improved our efficiency and productivity, particularly our claims monitoring and the follow-up in our preventive programs. Now we are better able to manage the process. Across the entire company, we think there is a 25% savings in data entry and paperwork. —*Controller, retailer, 1,500 employees, Montana.*

Tighten Worker's Compensation Administration to Reduce Costs.

Challenge: Tighten worker's compensation recordkeeping and follow-through.

Action: We began to focus on the cost drivers in this program and to analyze the information we filed. We saved thousands by reviewing and correcting the classification of our jobs. We also implemented a new policy: Any employee who incurs a job-related injury must subsequently meet with and be interviewed by our general manager. We hope this will also impact our worker's compensation rates and the productivity we lose to injuries. —*Controller, manufacturing, 250 employees, Michigan.*

Use Multiple Strategies to Lower Worker's Compensation Spending.

Challenge: Implement self-insurance more effectively.

Action: The plant nurse worked with our third-party administrator to close many old claims. These were expensive, since our company allocates money to all claims, no matter how old, because we are self-insured. We also implemented a new plant safety committee that has raised the level of awareness for accident prevention. Approximate savings: $200,000 per year. —*Controller, trades, 400 employees, California.*

Employ a Range of Tactics to Cut Worker's Compensation Expenses.

Challenge: Get the entire company focused on worker's comp costs.

Action: We used a variety of programs to lower this cost. These were: give employee in-service training, modify work programs, create interactive safety committees, undertake postaccident drug testing, hold adjusters accountable for closing claims, involve our managed care

network, gain the commitment of employees to lower this cost, improve screening methods, and revise our appraisal system. Overall, these tactics reduced worker's comp expense by 58%. *—Assistant controller, services, 2,000 employees, Iowa.*

Restructure Our Insurance Coverage to Lower Worker's Compensation Costs.

Challenge: Consolidate property and casualty insurance spending at subsidiaries under one policy.

Action: We combined all our subsidiaries in a master, paid-loss, retro property and casualty program. Altogether, this reduced our spending from close to $4 million to about $3 million, mostly through improving the management of our worker's comp programs. We also hired nurse-managers, whose job is to actively intervene early in all injury cases. This way, very few injuries become worker's comp cases. *—Senior vice president, finance, private practice, 4,500 employees, Texas.*

ENDNOTES

1. Harvard Management Update.
2. Harvard Business School Press, 2003.
3. Ernst & Young and the Institute of Management Accountants, *2003 Survey of Management Accounting* (2003) [hereinafter E&Y/IMA Survey].
4. *Id.*
5. *Id.*