



business optimization

WHITE PAPER

FIVE ESSENTIAL STRATEGIES FOR MANAGING COST

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Executive Summary

Next to ensuring growth of the enterprise, the top-most priority for most executives is to effectively manage costs. Profitability is under continual pressure from rising costs and declining margins on products and services. Furthermore, costs resulting from outside forces such as employee benefits, Sarbanes-Oxley compliance, and other drivers escalate every year. An organization's continued viability requires management to control costs effectively.

The remainder of this article will discuss five simple strategies for managing cost that can be easily incorporated into a firm's culture. They are:

1. Focus on operating costs and cost of poor quality
2. Limit rework through enhanced quality
3. Continual improvement of systems, processes, and methods
4. Attention to customer retention
5. Reduce employee turnover

Focus on Operating Costs and the Cost of Poor Quality

While management teams pay close attention to the aggregation of cost on their financial statements, far less attention is paid to reduction of operating costs or how poor quality affects the bottom line. Operating costs need to be monitored and reduced throughout a product's lifecycle as margins fall due to commoditization. Additionally, management must understand the impact of poor quality on bottom line results.

There are many ways to reduce cost by being more efficient, but let's consider just one, reducing cycle time. This powerful tool is often overlooked because it is associated with manufacturing operations. However, it has proved to be very effective in other enterprises and the benefits are real. For example, as a software design firm, what if you could improve your speed to market, produce more products with the same staff, and reduce defects, all at the same time? How would your development costs be affected? We are familiar with a case where the interval to release new software loads was reduced from 23 to 9 weeks without additional overtime or staffing, by reducing the cycle time. The process of reducing cycle time starts with assembling a team, examining a particular work process, and eliminating wasted work. It is relatively simple and pays huge dividends. Integrating it into the corporate philosophy, however, can be more difficult.

Limit Rework through Enhanced Quality

In his book *The American Samurai, A warrior For the Dark Ages of American Business*, William Larue says that quality cannot be manufactured into a product; rather it must be designed into it. Designing for manufacturability is critical. However, poor quality, whether in design, development, manufacturing, or services, drastically reduces an organizations ability to earn a profit. The numbers are staggering. According to NIST, the National Institute of Standards and Technology, software bugs cost the U.S. economy \$59 billion dollars in the year 2000. A similar study from the Standish Group in 2003 found that canceled software development projects cost organizations \$55 billion annually. Other major studies indicate that poor quality accounts for as much as 25-35% of a firm's total operating costs. If your total cost of operation were 25 million dollars a year that would mean your cost of poor quality at 25% would be 6.3 million dollars. Reducing it by half would yield 3.2 million dollars directly to the bottom line!

What about the impact of rework on production and the cost of staffing? *Computer Finance Magazine* reports that nearly 60% of all software developers are involved in fixing errors! Said another way, 60% of your staff is not producing revenue because they are busy doing REWORK. In this scenario, which projects will you need

to delay or eliminate because your staff is preoccupied with rework? Suppose you could implement methods to reduce rework and free staff to work on revenue producing projects? Such methods can be implemented with a consistent commitment on the part of senior management to ensure their effectiveness.

Continual Improvement of Systems, Processes, and Methods

Reducing costs by reacting to specific problems or negative data trends is certainly effective. However, continual improvement is a proactive way to control costs and reduce defects before they leave your organization. Studies show that it costs ten times as much to fix defective products once they leave the manufacturer's facility. Instead of waiting until something breaks or is manufactured incorrectly, continual improvement encourages management to eliminate product problems *before* they occur. In other words, how can the firm's valued employees constantly seek better ways to do things in order to *prevent* problems from happening? For example, what would it be worth to prevent a single network outage? Top management's commitment to quality, along with an organized quality management system will promote a culture of continual improvement and preventive action. Among other things, a quality management system will:

- Drive regular management review and analysis of quality and customer satisfaction
- Provide a formal means to initiate, test, and deploy potential improvements
- Measure the results of improvements on profitability and customer retention
- Ensure that employees have the tools and training needed to produce positive results

Attention to Customer Retention

Consider the Lifetime Value of your customers. How much are they worth in terms of goods and services delivered by your firm over the lifetime of a customer relationship? The value can easily be in the multiple millions of dollars depending on what you sell. It is a proven fact that it is expensive to sell to new customers. Studies by Gartner Group and others estimate that it costs nearly five times as many dollars to acquire a new customer as to retain a current one. Studies by the AIAG (Automotive Industry Action Group) demonstrate that companies who managed customer relationships using a quality management system increased market share by as much as 23%. Eventually, ensuring customer satisfaction and loyalty can dramatically lower sales costs and improve profitability.

Reduce Employee Turnover

The cost of employee turnover to an employer is easily overlooked and can reach as much as 150 to 200% of the salary paid to an employee. To put this into perspective, let's assume the average salary of an employee in a given company is \$50,000 per year. Taking the cost of turnover at 150% of salary, the cost of turnover is then \$75,000 per employee who leaves the company. For the mid-sized company of 1,000 employees who has a 10% annual rate of turnover, the annual cost of turnover is \$7.5 million! That's a lot of money in anyone's book. Furthermore, a recent study reported in Quality Progress Magazine demonstrates a direct correlation between high turnover, low quality, and financial results. Companies with a high people equity ingrained in their organizational DNA have a much better chance of sustaining ongoing financial and quality improvement initiatives and outperforming their peers in the marketplace.

With the movement toward outsourcing and down turns in industry sectors including telecommunications, employee turnover as a key performance indicator has lost some of its luster. However, it may be time to pursue this area with renewed energy.

Conclusion

Is there an overarching strategy that can help executives address these critical challenges in a systematic way? Yes, there is. Studies have shown that firms with mature quality management systems such as ISO 9001 and TL 9000 or business excellence systems, such as the Malcolm Baldrige Quality Award program produce consistently superior financial results over firms without them. These systems, when properly implemented, provide the following cost reduction enablers:

1. Leadership that supports and drives lower cost through continual improvement
2. A culture that values and pursues customer satisfaction and loyalty
3. An organization that is intolerant of product defects
4. An environment that encourages employee contributions to cost and quality improvement

For more information about specific topics mentioned in this paper, contact Bob Clancy at bclancy@bizphyx.com, or at (972)-429-5560.

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