

Bringing the Discipline of Direct Cost Management to G&A Costs

A report on midsize companies prepared by CFO Research Services in collaboration with Expense Reduction Analysts

Bringing the Discipline of Direct Cost Management to G&A Costs

A report on midsize companies prepared by CFO Research Services in collaboration with Expense Reduction Analysts

Contents

Finance teams at midsize companies return to fundamentals	2
Cost reduction will play an important role in maintaining profitability	3
Companies aspire to use cost savings to strengthen the balance sheet and maintain headcount	4
Companies direct more resources to managing direct costs than they apply to managing G&A costs	5
Finance executives anticipate organizational and operational benefits to emerge from cost reductions	7
Finance executives seek to guide employees to greater thrift	8
Sponsor's perspective	9

Finance teams at midsize companies return to fundamentals

When times are good, they can be *very* good for midsize companies. Nimble, responsive, and entrepreneurial, midsize firms often are able to take advantage of business opportunities that large companies are too cumbersome to seize and that smaller companies lack the resources to pursue. In a strong economy, midsize companies often enjoy strong growth trajectories: investors, managers, and employees alike can become accustomed to seeing these companies meet high expectations for performance.

But when the economic cycle shifts, midsize companies often face hard choices as growth prospects diminish. The global financial crisis that precipitated the current downturn has forced many finance organizations to turn their attention to the fundamental task of funding their companies in an environment of scarce cash and even scarcer credit. At the same time, falling demand is limiting opportunities for top-line growth—at least for now. With production capacity to spare, slowing orders, and uncertain business prospects, many midsize companies are confronting a dilemma: how can they maintain profitability when revenue growth stalls without compromising their ability to take full advantage of the next economic growth period?

To explore this question, CFO Research Services surveyed senior finance executives at U.S. companies on their plans, priorities, and challenges for general and administrative (G&A) cost management over the next year. Why explore G&A costs in particular, when they make up a relatively small portion of a company's cost structure—especially when compared with direct costs? Companies' efforts to reduce direct costs through benchmarking, supplier consolidation, and vendor negotiation are undoubtedly valuable, but many direct costs tend to go down when the flow of incoming orders slows and revenue growth starts to level off (excluding certain economies of scale). In contrast, the need for many G&A items and other indirect expenditures tends to remain stable, even when companies are taking fewer orders and revenue is declining steeply. Companies still need to clean and maintain facilities, process payroll, provide office equipment and work supplies, support communication and IT infrastructure, and have employees travel to acquire accounts.

The results of this study show that companies tend to be much better-equipped to manage direct costs than they are to manage G&A costs; in general, the expertise, information, and resources that many companies have applied to direct-cost management have not been applied to the same extent to G&A costs. But in a challenging environment like this one, the more effectively midsize companies can manage G&A spending (in addition to pursuing savings on direct items), the less likely they are to be forced to make painful cuts in labor and production capacity—cuts that would ultimately weaken their ability to take advantage of the next economic growth period. The finance executives who participated in this study recognize the connection between better G&A cost management and better-funded, more secure businesses, and they look forward to moving into the next period of growth with organizations that are leaner and less wasteful—and more competitive than ever.

ABOUT THIS REPORT

In March 2009, CFO Research Services (a unit of CFO Publishing Corp.) conducted a survey among senior finance executives at midsize companies in North America to examine their views on G&A cost management.

We gathered a total of 218 complete survey responses from CFOs and other senior finance executives across the United States. Respondents work for midsize companies in the following company segments:

ANNUAL REVENUE

\$50M to \$100M	45%
\$100M to \$250M	55%

TITLES

Chief financial officer	62%
Controller	18%
VP of finance	11%
Director of finance	5%
EVP or SVP of finance	1%
Treasurer	1%
CEO, president, or managing director	1%
Other	1%

Respondents work for companies in nearly every industry. The manufacturing and wholesale/retail trade sectors are particularly well represented.

Cost reduction will play an important role in maintaining profitability

Survey results indicate that midsize companies have shifted their focus from revenue growth to profitability as the economic downturn has taken hold. An overwhelming majority of respondents (83%) say their companies have become more likely to focus on profitability (as opposed to top-line growth) over the past year. (See Figure 1.) (Indeed, more than half of all respondents [55%] say their companies have become “*much* more likely to focus on profitability” in the past year.)

How will companies maintain profitability in the coming months? A solid majority of respondents (79%) agree that their companies will increasingly rely on cost reduction to meet profitability targets in the next year (45% of respondents “strongly agree” their companies will increasingly rely on cost reduction to meet profitability targets, and another 34% “somewhat agree” with that statement). (See Figure 2.) Close attention to cost reduction is certainly consistent with current economic conditions: amid broad economic decline, few companies have the luxury of relying on revenue growth to maintain profitability targets.

But survey results also show that finance executives are approaching cost management efforts with an unusually high sense of urgency. For example, we asked respondents to tell us how their priorities have shifted among a range of finance activities, including working capital management; cost management; planning, budgeting, and forecasting; regulatory compliance; financial reporting; and decision support. Respondents are most likely to cite cost management as a “much higher priority now than one year ago” for the finance function (49%), followed by working capital management (40% of respondents say working capital management is a much higher priority now than it was one year ago).

Finance executives aren’t alone in feeling the pressure to reduce costs. The finance executives we surveyed often see themselves as leaders of these critical cost-savings efforts; 67% of all respondents say that the CFO and the finance function at their companies play a leading role in identifying and assessing cost-savings opportunities at their companies. But many survey respondents also cite the CEO and corporate operations as leaders of cost-savings efforts (46% of respondents say that the CEO and corporate operations play a leading role in these efforts). These results suggest that finance and operations are working in partnership at many companies to manage costs—and they also show that cost-savings initiatives are originating from the highest levels of management at midsize companies.

FIGURE 1. COMPANIES HAVE SHIFTED THEIR FOCUS FROM REVENUE GROWTH TO PROFITABILITY OVER THE PAST YEAR.

In your opinion, to what extent has your company’s focus on profitability (as opposed to top-line growth) changed over the past year?

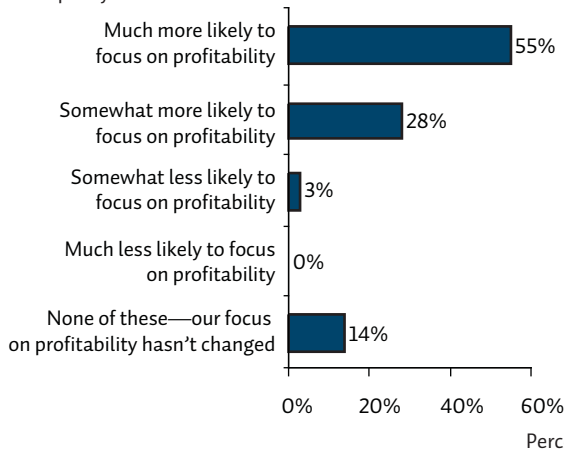
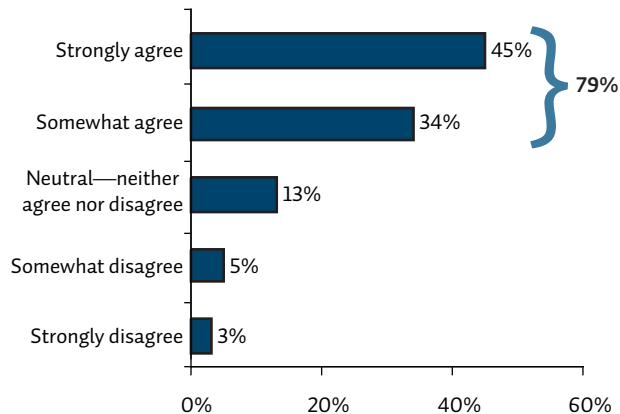


FIGURE 2. COMPANIES WILL INCREASINGLY RELY ON COST REDUCTION TO MEET PROFITABILITY TARGETS OVER THE NEXT YEAR.

“My company will increasingly rely on cost reduction to meet its profitability targets over the next year.”



Companies aspire to use cost savings to strengthen the balance sheet and maintain headcount

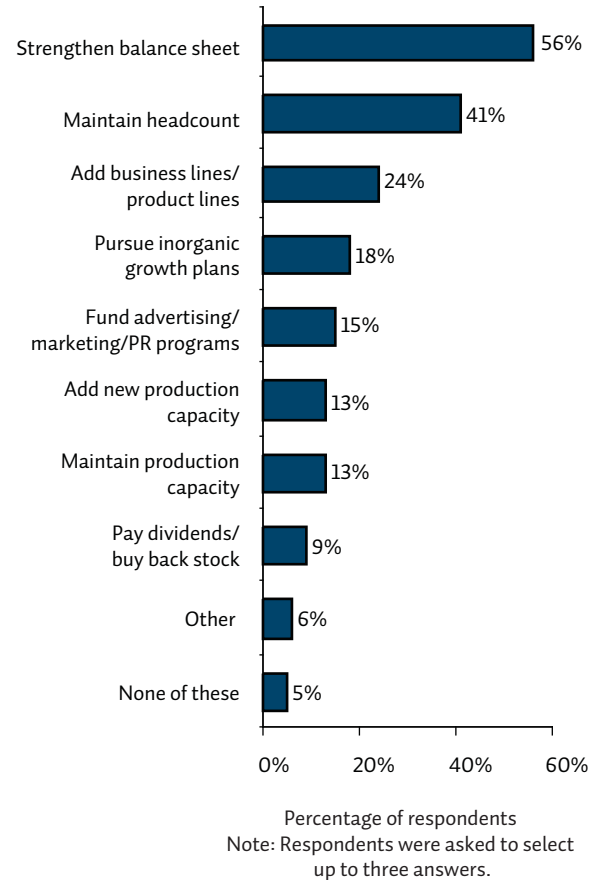
We asked finance executives to tell us how they planned to use any savings they might realize through cost reduction efforts. In general, survey respondents strike a defensive posture: they are much more likely to say their companies would direct savings toward strengthening the balance sheet and maintaining headcount than to pursuing growth-oriented initiatives such as adding product lines or making acquisitions. Indeed, a majority of respondents (56%) say their companies are most likely to use any savings they realize through cost reduction efforts to help strengthen their balance sheets in the coming year. (See Figure 3.) Forty-one percent of respondents say their companies plan to use savings to help maintain headcount.

With cash and credit scarce, survey respondents acknowledge that cost reductions can help keep their organizations fully funded.

These results are consistent with current business conditions—few respondents, for example, are in a position to return money to shareholders (only 9% say their companies are likely to use savings to help pay dividends or buy back stock). Similarly, most companies are likely to have an excess of production capacity until the next period of economic expansion—so few respondents (13%) say their companies are likely to use savings to help expand production capacity. But these results also provide insight into midsize companies' critical objectives as they seek cost reductions: with cash and credit scarce, survey respondents acknowledge that cost reductions can help keep organizations fully funded. Furthermore, survey results show that finance executives see cost reduction efforts as a way to keep critical employees on the payroll. Despite heavy job cuts in recent months, companies recognize the value of retaining highly productive employees who could be difficult to rehire when conditions improve.

FIGURE 3. SURVEY RESPONDENTS PLAN TO USE SAVINGS REALIZED THROUGH COST REDUCTION EFFORTS TO HELP STRENGTHEN THE BALANCE SHEET AND MAINTAIN HEADCOUNT.

Over the next year, my company is most likely to use savings realized through cost reduction efforts to help...



Many companies are pursuing cost reduction efforts in order to keep critical employees on the payroll.

Companies direct more resources to managing direct costs than they apply to managing G&A costs

We asked respondents to tell us the extent to which they use a range of resources—including time, attention, expertise, and information (both internal and external)—to manage direct and G&A costs, respectively. (See Figure 4.) Unsurprisingly, most survey respondents say their companies make at least some use of these resources to manage both broad cost categories.

Although most respondents make at least some use of these resources to manage costs, far fewer make extensive use of these resources. Survey results also

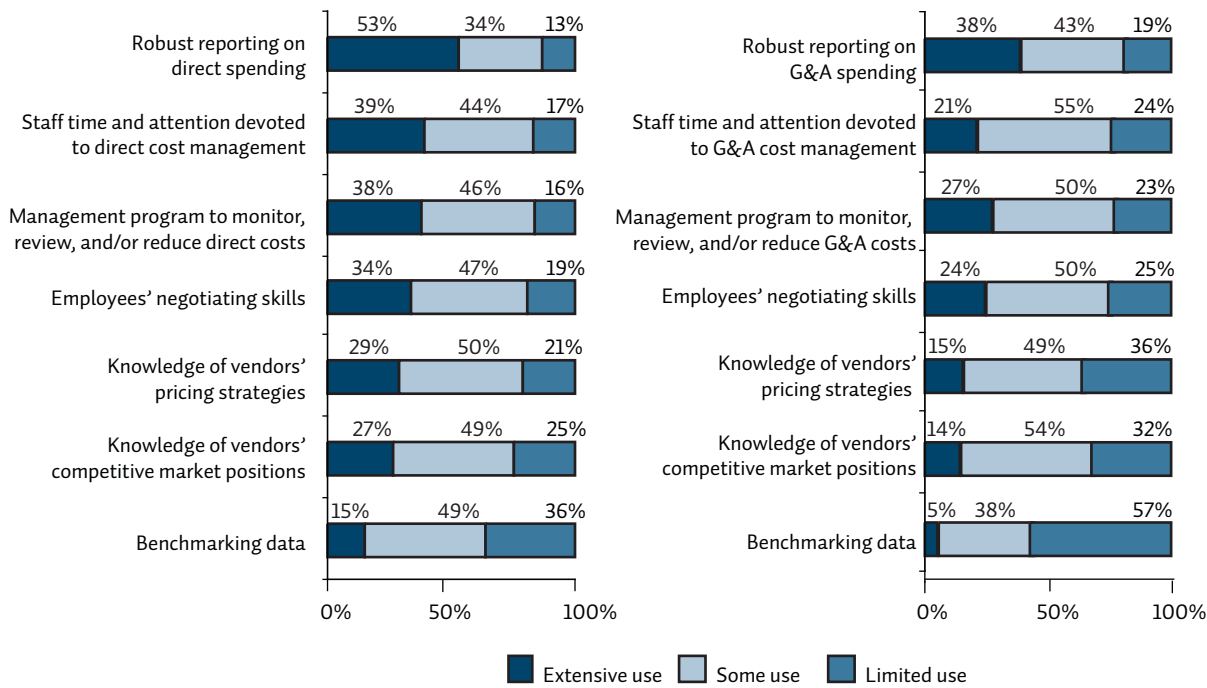
demonstrate a clear difference in how often midsize companies make use of these resources to manage direct costs compared with G&A costs: across the board, we found that respondents are much more likely to say they make “extensive use” of this array of resources to manage direct costs compared with G&A costs. (See Figure 5.) Survey results show that midsize companies apply more resources—time, attention, skill, knowledge, and information—to the management of direct costs than they apply to the management of G&A costs.

Survey results demonstrate that many companies are less equipped to pursue savings on G&A costs than they are to extract savings on direct costs.

FIGURE 4. MOST RESPONDENTS SAY THEIR COMPANIES MAKE AT LEAST SOME USE OF AN ARRAY OF RESOURCES TO MANAGE BOTH DIRECT AND G&A COSTS.

In your opinion, to what extent does your company make use of the following items in order to manage its **direct costs** (including COGS)?

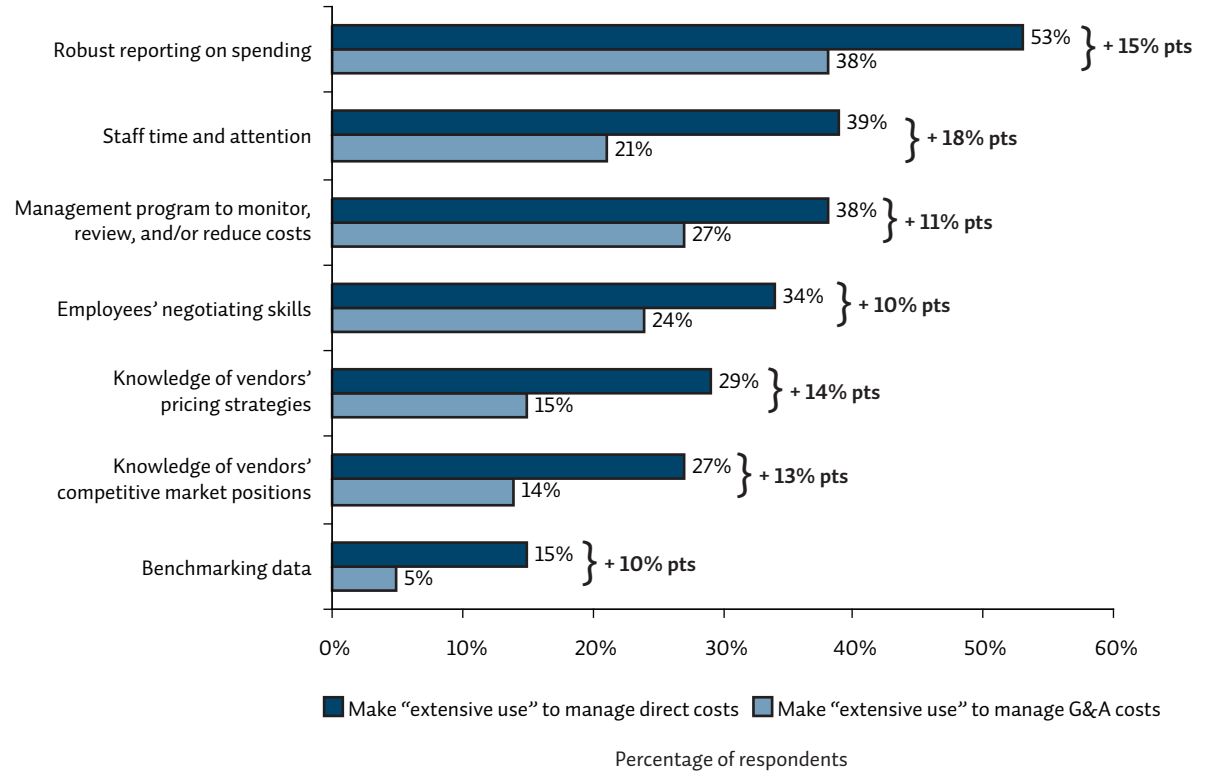
In your opinion, to what extent does your company make use of the following items in order to manage its **general and administrative (G&A) costs**?



Percentage of respondents
 Note: Percentages may not total 100%, due to rounding.

FIGURE 5. ACROSS THE BOARD, COMPANIES ARE MORE LIKELY TO MAKE “EXTENSIVE USE” OF RESOURCES TO MANAGE DIRECT COSTS THAN TO MANAGE G&A COSTS.

In your opinion, to what extent does your company make use of the following items in order to manage its costs?



Because G&A cost reductions are relatively nondisruptive (particularly compared with reductions in headcount and other labor costs), and because direct costs tend to fall roughly in proportion with falling revenue, many well-managed companies seek to realize savings on G&A cost items before resorting to more painful and lasting cost reduction measures. The results of this study demonstrate, however, that many companies are less equipped to pursue savings on G&A costs than they are to extract savings on direct costs. At a time when many companies are asking the finance function to scrutinize all costs—line by line—to uncover savings, these results suggest that many companies could realize further savings, with comparatively little pain, by approaching G&A cost management with the same discipline and rigor that they apply to direct cost management.

Many companies could realize further cost savings, with comparatively little pain, by approaching G&A cost management with the same discipline that they apply to direct cost management.

Finance executives anticipate organizational and operational benefits to emerge from cost reductions

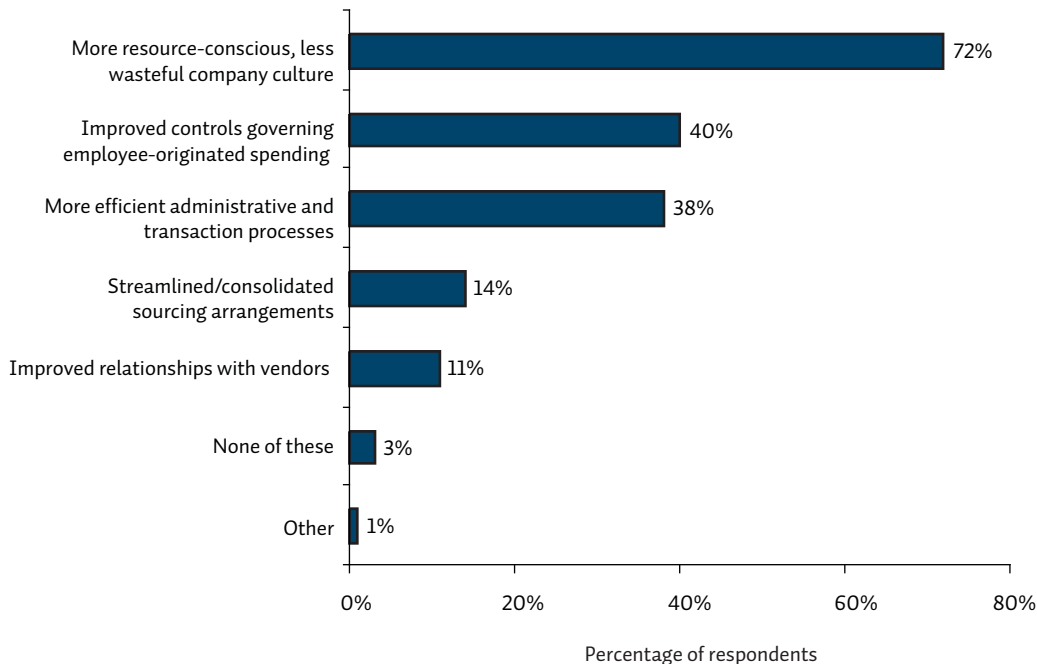
Are cost reductions always painful for employees? Do they place operational activities—production capabilities, customer service, and more—at risk? While there can be little doubt that finance executives approach cost reductions with the utmost seriousness, survey results show that many finance executives anticipate that organizational and operational benefits—not detriments—are likely to flow from cost control efforts. Indeed, a solid majority of respondents (61%) say that their companies' cost reduction efforts will have a positive effect on operating activities over the next year. Very few respondents—only 8%—say they believe cost reductions will have a negative effect on operations.

In a separate question, we asked respondents to tell us the extent to which cost reduction efforts expose their companies to the risk of a variety of problems, including deterioration in customer service levels, erosion of competitive positions, and the inability of employees to get what they need to do their job. Few respondents say their companies' cost reduction efforts have exposed them to acute risk for any of these problems.

Respondents may see little operational downside to cost reductions because they hope to target wasteful spending—which, by definition, yields little value. Survey results confirm that respondents are looking forward to seeing their companies shift toward a culture of thrift in the coming months. Nearly three-quarters of respondents (72%) say they expect a more resource-conscious, less wasteful company culture will emerge from their companies' cost reduction efforts. (See Figure 6.) Respondents are much less likely to say they expect more vigorous spending controls or more efficient administrative and transaction processes to flow from their companies' cost reduction efforts in the coming months—perhaps because heightened spending controls and efficient processes have long been in place.

FIGURE 6. SURVEY RESPONDENTS LOOK FORWARD TO A RENEWED CULTURE OF THRIFT AS A RESULT OF COST REDUCTION EFFORTS.

In your opinion, which of the following business benefits (in addition to monetary savings) is your company most likely to realize as a result of its cost reduction efforts?



Note: Respondents were asked to select up to two answers.

Finance executives seek to guide employees to greater thrift

Although finance executives seem to sense an opportunity for a cultural shift to resource-consciousness and thrift amid the current downturn, survey results show that they anticipate resistance along the way. When asked about a wide range of obstacles to improving G&A cost management at their companies, respondents most often say that organizational resistance is one of the greatest obstacles (42%), followed by a lack of time, attention, and resources (37%). (See Figure 7.)

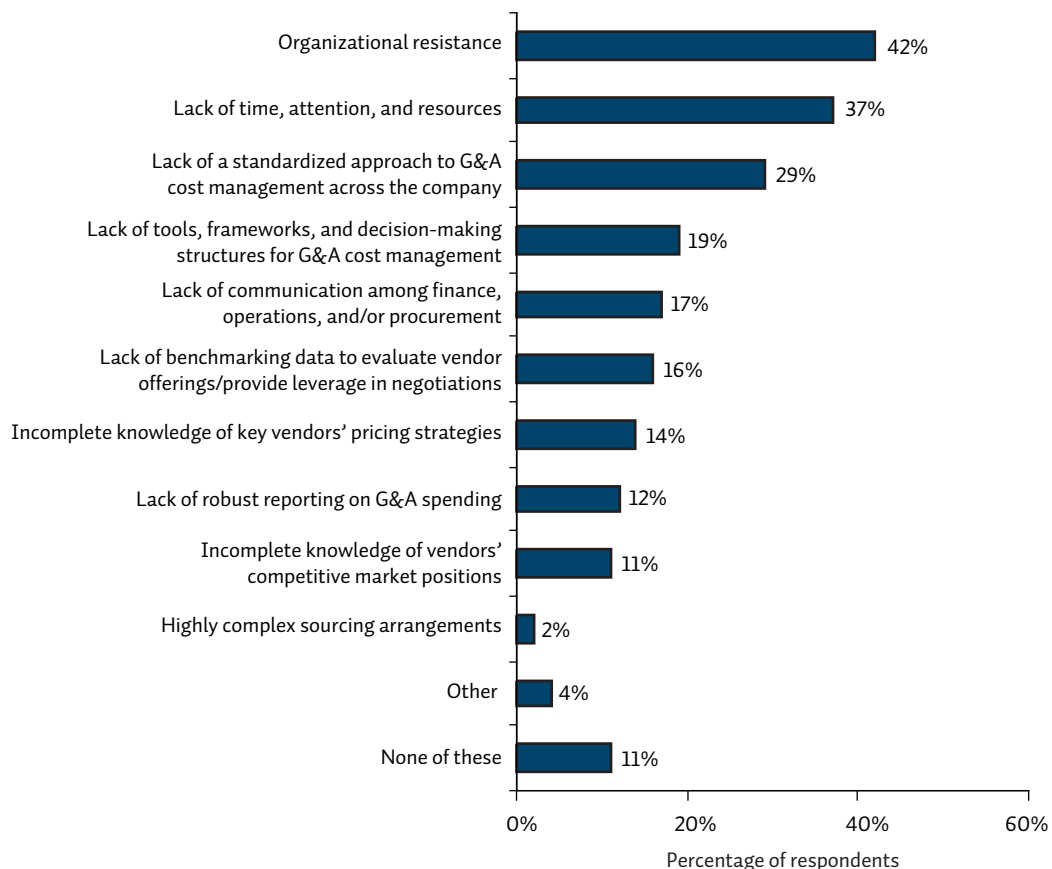
These results are especially striking because in past CFO Research Services studies, resource scarcity has almost always been the most frequently cited obstacle to management improvement initiatives. That respondents to this survey cite organizational resistance as an

obstacle more often suggests that finance executives are deeply concerned with organizational behavior and its role in G&A cost management.

In a separate question, we asked finance executives to evaluate their performance at a variety of cost management activities, and 42% of respondents identify room for improvement in “helping employees adapt spending behavior to business circumstances.” These results suggest that many finance executives recognize they still have work to do when it comes to molding more disciplined spending behavior. So the current downturn, while undoubtedly challenging, may have at least one silver lining: it has provided individual employees with clear incentives to change the basis of their spending decisions. Companies that are able to help employees recognize the connection between more resource-conscious spending behavior and tangible business benefits at this critical juncture may reap the value of a thriftier company culture throughout this downturn—and well into the next recovery.

FIGURE 7. RESPONDENTS FREQUENTLY CITE ORGANIZATIONAL RESISTANCE AND RESOURCE SCARCITY AS BEING AMONG THE GREATEST OBSTACLES TO IMPROVING G&A COST MANAGEMENT AT THEIR COMPANIES.

In your opinion, which of the following are the greatest obstacles to improving G&A cost management at your company?



Note: Respondents were asked to select up to three answers.

The upside of a down economy —a renewed determination to control costs

The finance executives who participated in this study overwhelmingly agree that cost management is a higher priority for them than it was a year ago. More and more companies have been forced to resign themselves to flat or negative sales in recent months. Their focus has shifted to cost control and to preserving the bottom line.

Some cost reduction measures have more serious—even potentially debilitating—consequences than others. As companies contemplate the full range of cost cuts available to them—including painful staff reductions—eliminating excess G&A expenditures seems not just appealing, but imperative.

That's when companies turn to Expense Reduction Analysts (ERA). Our professionals apply years of experience and highly specialized skills to lowering clients' G&A costs, while assuaging the internal resistance this effort tends to engender.

Is it too late?

No. Examining G&A costs makes financial sense in any economy.

In a strong economy, a reduction in non-core costs can instantly increase your profit margin and give your company a competitive advantage. In a weak economy, strategic cuts in overhead spending drop money right to the bottom line, strengthening the balance sheet and creating some of the profit you thought was lost—possibly even saving jobs.

G&A cost analysis can yield surprising results.

Reducing G&A costs can make a substantial, sustainable contribution to the bottom line.

If your company's G&A costs are 15% of your gross revenue, and your revenue is \$50 million, you're spending \$7.5 million annually on G&A. If you decreased that expenditure by 20% (ERA's average savings), you would reduce your costs annually by \$1.5 million. For companies faced with an extraordinarily challenging sales environment, a cost reduction of this magnitude can create a welcome compensating effect.

This report confirms that businesses across the board apply more resources to the management of direct costs than G&A costs. The secret to realizing savings concealed in G&A categories is not a perplexing one—companies simply need to give G&A the same attention that is habitually committed to direct costs.

Why companies turn to professionals to reduce G&A costs.

Organizational resistance is most frequently identified by finance executives in this survey as the greatest obstacle to improving G&A cost management. As outside consultants, we find that collaborating closely with internal staff and supplying missing resources enables us to earn their buy-in, cooperation, and commitment to G&A cost reduction efforts.

Lack of time, attention, and resources is a commonly cited obstacle to G&A cost management. This research shows that companies often dedicate fewer resources to G&A costs than direct costs. So it is not unreasonable to conclude that the full savings potential in G&A categories is not being recognized at many companies.

Since each of the dozens of G&A cost categories has a unique universe of suppliers, delivery processes, pricing models, and lingo, the application of specialized knowledge and expertise greatly improves cost-cutting results. ERA's proprietary procurement tools and access to extensive market benchmark data amassed from over 14,000 successful cost reduction projects are just two reasons we are well-positioned to maximize G&A savings. Your in-house staff could do what ERA consultants do, given enough time, data, and expertise. The fact is, your staff usually doesn't have enough of any of those.

It's hard enough to get a good night's sleep these days.

We can help. Expense Reduction Analysts will either cut your spending in G&A categories by up to double-digit percentage points—or we'll confirm that you're doing a great job and there are no additional savings to be found (in which case we'll charge no fee). Either way, you'll rest easier knowing that you're taking hard-hitting, proactive steps to invigorate your balance sheet.

For more information, visit
www.expensereduction.com



**Expense Reduction
Analysts**

Bringing the Discipline of Direct Cost Management to G&A Costs is published by CFO Publishing Corp., 253 Summer Street, Boston, MA 02210. Please direct inquiries to Jane Coulter at 617-345-9700, ext. 211, or janecoulter@cfo.com.

Expense Reduction Analysts funded the research and publication of our findings, and we would like to acknowledge Ken Hagerstrom, Dave Sundstrom, and Lisa Fine for their contributions and support.

At CFO Research Services, Celina Rogers directed the research and wrote the report.

CFO Research Services is the sponsored research group within CFO Publishing Corp., which produces *CFO* magazine. CFO Publishing is part of The Economist Group.

April 2009

Copyright © 2009 CFO Publishing Corp., which is solely responsible for its content. All rights reserved. No part of this report may be reproduced, stored in a retrieval system, or transmitted in any form, by any means, without written permission.