COST CONTAINMENT

The Ultimate Advantage

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To Bill and Olga

Preface and Acknowledgments

Cost management is central to sustained corporate profitability. In spite of this fact, it is one of the least talked and written about issues facing management today. This situation has arisen in part because of management's perception of the task as routine and mundane and in part because very tough decisions lie at the heart of an effective strategy to manage costs.

In fact, meeting the cost challenge is one of the most critical tasks facing Canadian and U.S. executives during the next decade. Traditional approaches have proved inadequate in the face of intense international and domestic competition, and executive leadership and inspiration are called for if corporations are to find new ways to reduce costs. This leadership is embodied in symbolic, strategic, and operational actions necessary to inspire other corporate employees to involve themselves in cost reduction. The outcome of these activities will be corporations with a lean and keen profile.

Undoubtedly, executives face some tough initial decisions when they decide to face up to the cost challenge. Whole businesses may have to be divested, employment levels substantially reduced, and many perquisites of executive privilege sacrificed. Even for those corporations taking these actions, effective follow-up is necessary, however; otherwise the initial gains are soon dissipated. This book describes a strategic approach to cost reduction intended to build on these initial successes.

A variety of costs have to be managed if cost reduction is to be undertaken strategically. Traditional approaches that have focused on direct, operational costs are extremely limited in scope. The book demonstrates that an effective approach must encompass strategic as well as operational factors and must deal with intangible as well as tangible costs. Potential cost reductions exist throughout every corporation, and there are no areas that can be ignored.

The book is written for executives who must decide on how to manage cost reduction in their own corporations. Key formulation questions are addressed in the first part of the book. Why is a strategic approach necessary? What is a good cost management strategy? What are the principal sources of cost reduction? What information is needed to manage costs effectively?

The second part of the book, which is based largely on personal experience, deals with implementation and the creation of a lean and keen corporation. How should an initial, tough, quick-hit cost-reduction program be implemented? What actions are necessary to create a cost-conscious organization? How should a strategic approach be initiated and maintained? How can more employee involvement be obtained? What specific techniques and organizational processes are there for reducing costs? How should employees be rewarded for obtaining cost savings? These are some of the questions to be dealt with in the latter half.

Through the use of examples and cases, the book demonstrates that cost management can be one of the most exciting and fulfilling challenges facing all corporate employees. Some Canadian and U.S. corporations have been highly innovative in finding ways to meet the cost challenge, and many approaches that they have developed are described in the following chapters.

Acknowledgments

The book owes much to a variety of ideas formulated by people in industry and academia. Without the interest and support of Dr. William James, chairman and chief executive officer of Falconbridge Limited, many of the ideas and strategies described in the book would never have been implemented. Although never afraid to make personally the tough decisions necessary for effective cost reduction, Bill provides all his employees with opportunities to make their own contributions to meeting the challenge. He provides an outstanding example of executive leadership in this area. During the past ten years he has provided me with a unique opportunity to try out many cost-management ideas in a practical setting.

During this time, many people in industry have contributed to the elaboration of the cost-management strategy concept. In particular, Jim Corrigan, Jim Moore, Chuck Murray, Richard Osborne, Karen Stockdale, and Wigo Svensen deserve special recognition. These individuals were all outstanding champions of cost-management activities in their own organizations. I would also like to thank my fellow PIG (profit improvement group) members at Falconbridge with whom I have enjoyed working. I learned much from all these people.

I have also benefited from the creative contributions of a number of my academic colleagues. Wickham Skinner, professor emeritus at the Harvard Business School, has over the years encouraged and rewarded me with his interest in my work and was generous enough to read and comment on drafts of the manuscript. John R.M. Gordon, dean at the school of business at Queen's University, has taught and worked with me for many years, and his ideas have influenced my thinking in many parts of the book. Donald V. Nightingale, also at Queen's University and Professor Thomas Cawsey of Wilfred Laurier University have provided many comments and ideas on the behavioral aspects of the work. Eric Cousineau, now at Cornell, and Oyvind Hushovd, chief financial officer at Falconbridge Limited, provided insightful comments on Chapter 4.

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The Cost Challenge

The Cost-Management Challenge

Cost management is the cornerstone of successful corporate performance. Ignored by executives for many years, cost reduction is now viewed as the central challenge facing Canadian and U.S. organizations.[1] Executives in manufacturing and service corporations are recognizing that future viability rests on reduced costs. Cutting costs improves income, provides increased margins for reinvestment in research and development and new products, and provides enhanced value for the consumer. Although external forces, such as price and demand, dominate other performance parameters, costs remain within management control.

In recent years, a fashionable argument has been that Canadian and U.S. firms can survive and grow if they differentiate their products and services from those offered by foreign competitors. The events of the last decade have proved that differentiation alone is not enough. For example, as depicted in Figure 1.1, few firms in the automobile industry, except perhaps Rolls Royce, Mercedes and Ferrari (all European, incidentally) can afford to ignore costs. Companies with low differentiation and relatively high costs, such as American Motors, Fiat, and British Leyland, are in permanent trouble. Canadian and U.S. firms have to meet cost competition head on.

Relative Cost Position	Relative Product Differentiation: Low	Relative Product Differentiation: High
High	American Motors British Leyland Fiat	Rolls Royce Mercedes Ferrari
Low	Buick/Pontiac Chrysler Hyundai	Cadillac Volvo Toyota

Figure 1.1. Alternative Competitive Strategies: The Automobile Industry

Neither should Canadian and U.S. executives be mislead by apparent improvements in cost competitiveness brought about by currency devaluations. Temporary relief might be obtained by reducing the value of the dollar relative to its Japanese and European counterparts, but the resulting improvement in costs is unlikely to be lasting. Either domestic inflation or currency readjustments will erode the initial gains.

The cost challenge arises from many sources: intense international competition, declining margins as industries mature and the fight for market share intensifies, or in the case of government agencies, increased demand for funding in the face of a stagnant or declining revenue base. Meeting this challenge successfully requires tough-minded executive leadership of a very high quality.

Canadian and U.S. executives have traditionally viewed cost management as a purge or crisis activity, a view quite different from that of their Japanese counterparts. According to an automotive industry analyst Maryann N. Keller: "The Japanese regard cost control as something you wake up to every morning and do. Americans have always thought of it as a project. You cut costs 20 percent and say: 'Whew! that's over.' We can't afford to think like that anymore."[2] Executives have to start thinking of cost management as a strategic, continuous part of their corporate activities.

Executives who have recognized this threat to their organizations have already implemented tough programs aimed at reducing costs. As in the past, these responses are typically tactical responses to deteriorating financial performance. Cuts are made hastily on discretionary items such as research and development (R & D), market development, or plant maintenance that improve short-term results, but increase long-run costs. Across-the-board staff reductions can give immediate productivity improvements, but in the long-term they result in reduced service levels, employee burnout and lower morale unless appropriate management follow-up is taken.[3] A one-time improvement can be expected from these actions, but lasting benefits are unlikely to be obtained.

Executives now recognize that a strategic approach to cost management has to be implemented if short-term gains are to be made while also ensuring long-run improvements. Adopting this approach may require a revolution in behavior and attitudes among all employees in some corporations. Layers of middle management have to vanish, and ultimately cooperation rather than confrontation will come to characterize relationships with employees and unions.

Far from being negative activities, cost reductions in fact create business opportunities. Shared with consumers in the form of reduced prices, they can trigger market demand and generate massive volume expansions such as those experienced by the microcomputer and airline industries in recent years. They can revitalize stagnant markets for mature products such as automobiles.

Implementing a strategic approach to cost reduction is the subject of this book. Ten years of implementing and studying cost-reduction strategies in a variety of manufacturing and service corporations has convinced me that lean, keen organizations will dominate the economic landscape of Canada and the United States in the next decade. The growth of any such organization will be fueled both by market expansion and innovations made possible by virtue of its being a relatively low-cost supplier of goods and services.

In Darwinian terms, this outcome will be the result of a process in which the fittest survive the rigors of tough market competition which can be expected in this period. Government agencies will not be immune from this process, as they will face challenges from private-sector corporations determined to show that they can provide services such as health care, correctional services, and education at lower cost than the traditional public-service organizations.

Despite the prevailing pessimism about Canadian and U.S. industry, some corporations have already faced up to cost competition, and in the process have enjoyed financial success. Executives in these companies know well the tough decisions involved in becoming leaner, but paradoxically, they often describe the process as challenging and even exciting.

Business magazine articles and presentations at management conferences report how some companies have cut unit costs by more than 50 percent during the last five years. For example, to turn around Control Data Corporation, its new chairman cut employment by 25 percent in 1986, eliminated nearly half of the top-management jobs, and divested numerous unprofitable ventures. As a result, the corporation went from a loss of nearly $600 million in 1985 to a profit of approximately $75 million in 1987.[4]

What then follows in a few cases is a tale of innovation, communication, and widespread employee involvement in cost reduction, which can lead to a new approach for managing the business. In other companies, however, these one-time gains are not consolidated, and over time, costs creep back up, forcing a repetition of the process a few years later.

Executives and managers at all levels in public and private sector organizations need to know how to make their own corporation or operation a low-cost competitor. The purpose of this book is to set down a comprehensive strategic framework for implementing this process, and by using case histories, to provide practical insights into how to make this happen, and thereby arm executives to meet the emerging cost challenge.

The Challenge: International and Domestic

So far, the cost challenge has been most noticeable in manufacturing. Across the industrial landscape, Canadian and U.S. economic viability has been challenged by international competition. Basic industries, such as steel, automobiles, and electronics, in which the United States' dominant position was once taken for granted, have been hit hard. Consumer-product firms such as Black and Decker have found their dominant share of domestic markets seriously challenged by higher-quality European and Japanese manufacturers and cheaper products from developing nations, such as Brazil and Korea, which have low labor costs and relatively new plants.

Japanese firms have taken over the leadership in industries such as semiconductors and consumer electronics largely through the competitive advantages gained from low costs.[5] These advantages were not derived solely from lower cost labor, but also from process innovations and quality control which provided higher process yields than those obtained by their U.S. competitors. European firms have taken large shares of some consumer markets by offering well-designed, superior-quality products at competitive prices.

A variety of explanations have been offered for this dismal picture, and depending on the situation, many apply.[6] One view is that a strong dollar and correspondingly undervalued foreign currencies such as the yen, French franc, and deutsch mark have put Canadian and U.S. firms at a serious disadvantage. Yet in almost every industry said to be hurt in this manner, healthy, profitable firms can be found, side by side with those in trouble. Zenith and Hewlett Packard continue to be viable, profitable U.S. electronics manufacturers while others struggle.

The unwillingness of many Canadian and U.S. corporations to invest in new technology has been cited as another important factor contributing to reduced competitiveness in industries such as automobiles and steel. The failure of integrated U.S. steel producers to invest in new technology in the 1960s and 1970s when Japan and Korea were introducing significant process innovations is well documented. At the same time, however, nonintegrated producers such as Chapparrall Steel in Texas have used the new mini-mill technology to compete profitably.[7]

Relatively slow growth in Canadian and U.S. labor productivity is also viewed as a contributor to the lack of competitive vigor. Wage increases, combined with a lack of investment in new facilities, have put many U.S. manufacturers at a cost disadvantage. Wage rollbacks, plant closings, and a frantic rush to implement Japanese manufacturing techniques are now being used to make up for years of complacency.

The challenge is not coming solely from overseas. Cost-based competition is also fierce in many industries in which foreign competition is minimal. For example, cost competition in the domestic airline business has been ferocious since deregulation.[8] New companies, such as Texas Airlines and People Express, operating with lower overhead and labor costs than the older, established airlines have revolutionized competition and forced prices down. Similar situations exist in other industries, such as packaged goods and furniture.

Pressures to reduce costs have also been felt in the not-for-profit and government sectors as sluggish economic growth, budget deficits, and increasing demands for services force these organizations to re-evaluate their activities. The cost of government has come under increasing scrutiny, and agencies from defense to welfare are subjecting their own activities and those of their suppliers to detailed reviews. Traditional cost-management approaches are likely to result in sharply lower levels of service, as programs and field activities are cut, while the real problems, bloated bureaucracy and high overhead, are not tackled.

Limitations of Traditional Approaches

A variety of corporate responses to the need for cost reduction have been implemented in recent years. Typically, they fall into five broad categories, all of which have significant weaknesses from a strategic perspective:

1. Technocratic/capital-intensive solutions
2. Lean-mean cost-reduction strategies
3. Retreat to off-shore sourcing
4. Merger/rationalization strategies
5. Diversification

Technocratic/Capital-Intensive Solutions

The dominant approach to cost reduction in Canada and the United States in recent years has been capital and technology intensive. For many executives, frustrated with years of having to deal with a unionized work force, the ideal of an automated, robotized, nonunion plant is most attractive.

Consequently, many corporations have attempted to drive down costs by closing old plants and replacing them with new, automated facilities. General Motors' Saturn venture represents the pinnacle of this approach, blending radical new technologies with a large capital spending program to cut costs to levels that would be competitive with Japanese producers.[9] General Electric has also made substantial investments in advanced manufacturing technologies, hoping to use its electronic and automation control expertise as the basis for a major new business. Both these ventures have not lived up to their early promise, and their economic returns are likely to be disappointing.

These approaches are not appropriate for many corporations, where the potential financial returns do not justify the additional investment. Massive capital investment requires large subsequent profits, and if life cycles are shrinking, a fast payback is unlikely to be realized in mature industries characterized by continual cost cutting. Radical new technologies are risky and often take a long time to be made operational and productive, especially if a work force feels threatened by the change.

Computer-integrated manufacturing systems also have drawbacks and are not a universal panacea for manufacturing cost problems. They require sophisticated technical support, are hard to improve and modify incrementally, and often have limited flexibility. Many small firms lack the sophisticated skills necessary to implement and support the electronic and information systems needed to derive the full benefits out of this high-tech approach to cost reduction. One small foundry spent four years, $5 million, and countless hours of executive time attempting to implement a manufacturing control system that was ultimately abandoned after never