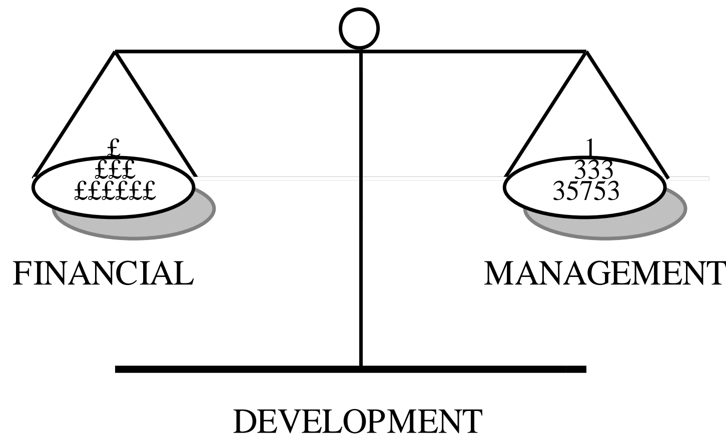
FINANCIAL MANAGEMENT DEVELOPMENT

Decision Making

Management Accounting

NO 312

THE COST CONSEQUENCES OF A MATURE MARKET PLACE



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

THE COST CONSEQUENCES OF A MATURE MARKETPLACE

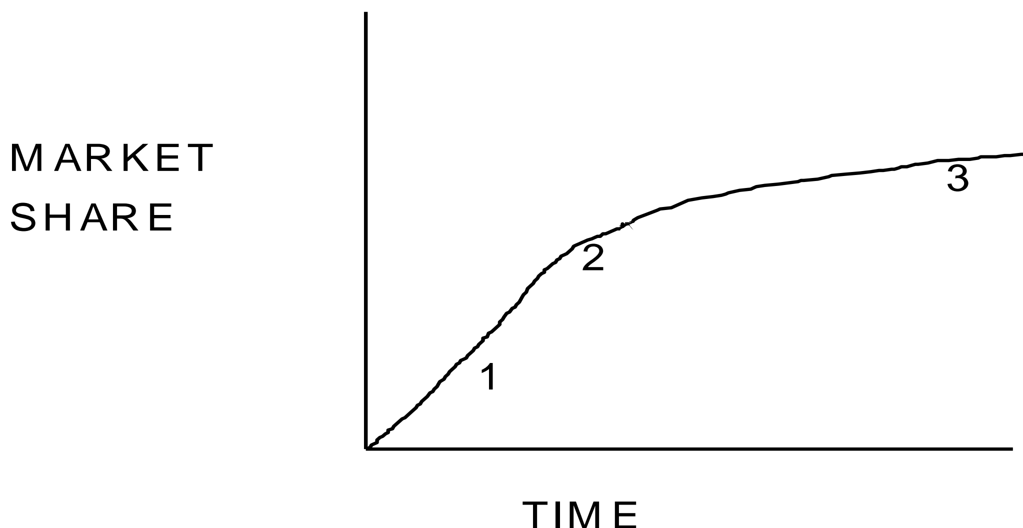
Overview

There is an appropriate level of costs. This is a key strategic issue which is often forgotten when businesses move through phases of their business cycle. The level of indirect costs often owes more to the power of inertia than any conscious management attempt to achieve value for money. Zero-based budgeting is merely common sense applied to the cost structure with a view to forcing a realistic appraisal of the minimum level of cost required to achieve true corporate objectives. However, the correct approach is not merely a tactical one year budget exercise. It must be considered as part of the strategic corporate plan.

There are times for investment in overheads and times for disinvestment. The fact that these may not coincide with times of prosperity and times of famine should not deter the good manager from the correct course of action.

The greatest investment in overheads should possibly occur when times are hard e.g. start up situations and to arrest a decline in the market. The time for cutting back may be when sales are good and there is less need for marketing, research, etc. This paper examines some of the cost issues for organisations in mature markets. There is no need for a cost cutting approach to be restricted to the post-take-over situation. Having no fat to cut out makes an organisation more immune to take-over as well as more profitable.

A Product life cycle for Overheads



Once products (or companies) become established there tends to be an expansion of overhead departments to support the needs of the enlarged structure. In particular Stage 1. above normally sees the expansion of the Sales Force, the Marketing department and the Research facility. As the market share growth slows these departments frequently find themselves under-occupied.

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The "hunting" side of selling is reduced, the "farming" of existing products and customers is the main activity and is not so time consuming. The market place is aware of the product and the brand leaders. The activity level decreases as the need to educate has declined. The research into customers' needs, product development and refinement of working procedures becomes less urgent and more difficult. The obvious improvements have been identified and implemented. At Stage 2. the law of Diminishing returns becomes more noticeable. Stage 3. is where the political and behavioural aspects start to cause problems. Key departments are now over manned with people under-utilised. However, there are entrenched managers with a vested interest in ensuring that this is not apparent to the outside, or the inside world. Thus the emphasis turns to "finding things for people to do."

New products are developed, new customers chased, acquisitions undertaken, branches opened overseas. Many of these are one-off attempts; many fail. More and more small product lines are created, losing the benefit of economies of scale and increasing cost per item sold. In addition the cost of complexity adds to the problem as the range of products, its variety, associated services and non standard terms proliferate. Fragmentation of effort is compounded by the search for innovation and the larger, less exciting standard bulk products are ignored.

It is at this stage that a thorough review of strategy allied with a large amount of common sense - often called Business Process Re-engineering, Activity Based Costing or Value Chain Analysis - can assist management to identify ways of improving profitability. Three main areas are worthy of note:-

- Customer profitability
- Product rationalisation
- Cost driver identification

Each of the three areas require in depth review but in summary the review should cover certain key characteristics:

Customer Profitability

The Pareto principle(80:20 rule) applies with dangers at both ends of the scale. The smaller customers, taking low volumes with high delivery costs or production set up times may not be bearing their true share of costs. Look at what causes costs and the cost of complexity. There are dangers in too many products being priced at the margin, when the true variable costs are not known.

The larger customers, whilst providing scope for economies of scale, probably demand special treatment - particularly with regard to discounts and payment terms. There is a danger that the principle "the customer is always right" has been taken to include even when he bankrupts the supplier. Look at special terms and the true level of profit being earned.

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Product Rationalisation

Again the Pareto principle applies with the small, specialist products often not providing a sufficient contribution to cover their fully allocated costs. Marginal costing and contribution analysis may have led to a proliferation of marginally priced products and activities with no regard to creeping fixed costs. An exercise is required to delist low volume lines or amalgamate products for similar markets to review break-even volumes and identify unacceptable contribution levels by concentrating on opportunity cost (the benefit to be derived from doing something else). This may reap considerable rewards on the bottom line. Consider turning away business or charging a premium price for low volumes and non-core activities. If there is a perceived marketing benefit then cost out the true price of obtaining it and ensure it is value for money.

Cost Driven Identification

The concept of Activity Based Costing is not new. Various approaches with differing, fancy names or acronyms have been promulgated over the years - and they have worked. By forcing managers and workers to stop and look at what causes costs (money or time) and then to invent ways of reducing these cost drivers, the profitability of the organisation can be improved dramatically. There is frequently no need for dramatic wholesale changes to the cost allocation system. A simple review of "what is the biggest cost - what makes it so large - does it add value - can we reduce it ?" can often yield considerable benefits. The law of diminishing returns must also be considered. 1% of the salaries bill is often worth saving; 10% of the stationery bill may not even recover the management time spent chasing it.

Each of the above are subject topics in their own right. However the approach is similar. "What are we doing, should we stop it?" is a valuable review process. It shouldn't have to be called Zero Based Budgeting to be acceptable to all management levels but politically very few managers even accept the objective of proving their department is not needed or could be reduced in size. They normally wait for the liquidator (unfairly called the hatchet man) to tell them.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

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