



**ALLIANCE COST CONTAINMENT**  
*Discovering Efficiency. Delivering Results.*

# Mind The Gap



## The CFO's Guide to Cost Containment

*By Jason Smith*

Alliance Cost Containment  
T. 502 805 0978  
E. [jsmith@alliancecost.com](mailto:jsmith@alliancecost.com)

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## Executive Summary

Uncertainty, slower revenue growth, and lower profit margins caused by an economic break-down places greater demands on both the Finance Departments and Purchasing Departments to control costs. In order for the CFO to contribute to corporate competitiveness, broader business limitations must be addressed while establishing the cost containment activities. This report provides insights into the necessity of cost containment auditing, together with its strengths and weaknesses from the viewpoint of finance managers and CFOs.

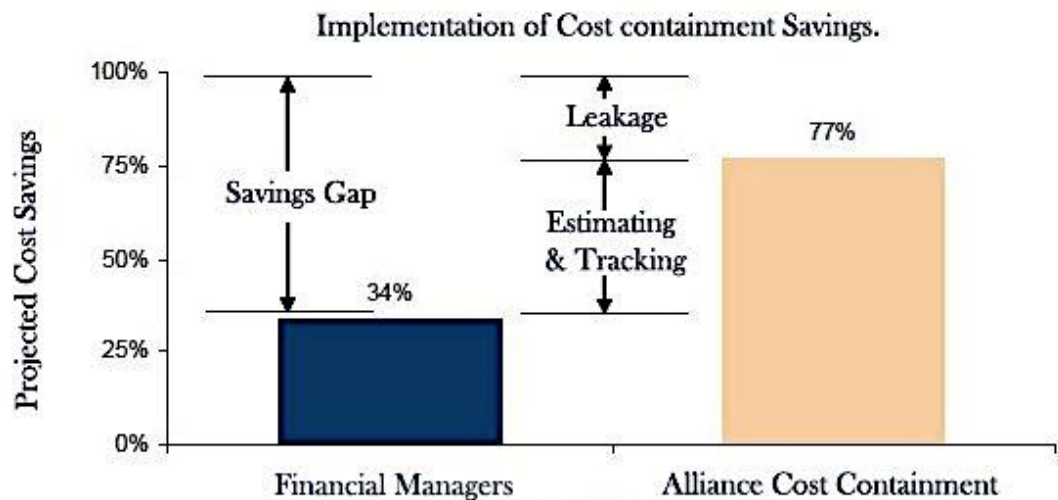
## Key Business Value Findings for the CFO

No surprise, one of the CFO's primary concerns is to improve the bottom line. Alliance Cost Containment finds that without formal cost containment staff, an organization will implement only around 34% of the projected cost savings that is negotiated with its vendors. This is dramatically lower than the savings capture rate realized when formal measurements are in place. See Figure 1.

The four underlying limitations that are likely contributing to the savings gap are:

1. Lack of company-wide guidelines to calculate, track and budget for the savings;
2. Various functional interpretations of the term "savings";
3. Passive involvement of finance in cost containment activities; and
4. Limited use of formal cost containment plans that link to business plans.

**Figure 1:**



## Company-Wide guidelines to calculate, track and budget for the savings.

CFOs must illustrate to their entire company or organization the specific impact cost containment activities will have on key financial metrics as the basis to drive savings to the bottom line.

By creating standard cost savings guidelines, there is a common definition for the term “savings” across the corporation. The goal of these guidelines is to ensure that the savings negotiated in a vendor contract actually flows through to the bottom line.

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A strong set of guidelines addresses the following needs:

- It defines methodology for classifying cost reduction versus cost avoidance, and for calculating expense, capital and cash flow improvements.
- It identifies treatment for other recognizable cost containment benefits such as productivity, resource reallocation, risk mitigation, etc.
- It indicates the milestones, systems, or reports that will be used to validate, audit, or verify results and maintain vendor accountability.
- It allocates savings and benefits by period, business unit, division, and geography.
- It designates individual approvals required for recognition of the savings; i.e. is it realized or not?

## What Do You Mean By Savings?

The term “savings” is often interpreted differently across an organization by the various disciplines involved (or those that should be involved) in cost containment activities. For example, if an organization is currently paying \$20 per widget and a new vendor promises \$15 for the exact same widget then the savings are \$5 per widget or 25%. But if that new vendor has hidden costs associated like minimum size order, for example, then the actual savings could be less than the 25% savings that was anticipated. See Figure 2. for some common definitions of savings, by disciplines.

**Figure 2:**

Role	Definition of Savings
<b>Sourcing Manager / Buyer</b>	Incremental discounts negotiated from the supplier's first quote or otherwise benchmarked market prices across anticipated purchase volumes
<b>Business Manager</b>	Pricing that is an improvement over prior-year price paid or agreements
<b>Financial Manager</b>	Direct cost or expense reductions reflected as a positive variance or working capital improvements in the budget
<b>CFO, Controller, Treasurer (Corporate)</b>	Business plan financial impacts that affect earnings or cash-flow plans, including financing and global exchange implications

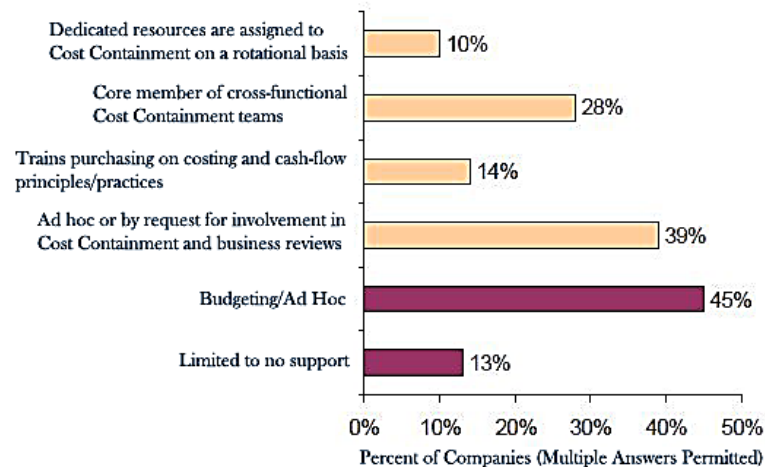
## **Passive Involvement of Finance in Cost Containment is of limited Help.**

Purchasing and business managers are not solely to blame for the difference between real and fictitious savings. Financial involvement is often “ad hoc,” not that of a fiduciary steward. It is not unusual that the finance department’s involvement in a cost containment program takes place almost entirely during budgeting cycles or the negotiations with vendors. Sometimes, CFOs themselves are the problem. If a CFO is not willing to change vendors in search of greater value, then they are hurting their organization. Only around 10% of organizations provide dedicated resources to support cost containment, perform costing, cash flow and other working capital analysis. (See Figure 3.)

*The Finance Department should be involved, to some extent, throughout the whole Cost Containment Project.*

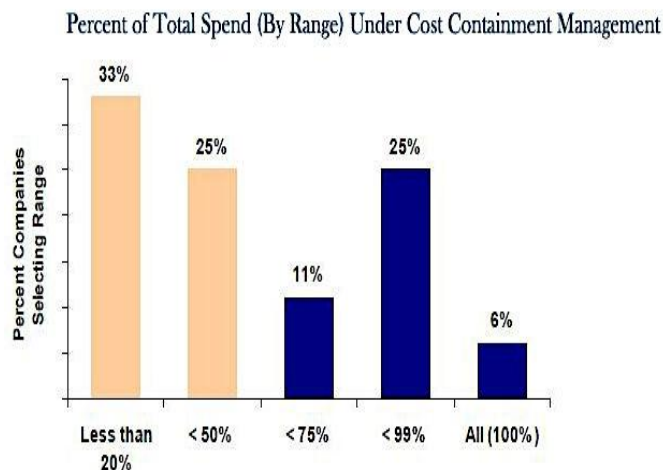
**Figure 3:**

**Level of Finance Involvement Within Cost Containment Activities**



**Scope of Cost Containment Project.**

**Figure 4:** *Discovering Efficiency. Delivering Results.*



Most mid-sized companies lack the purchasing power and category expertise required to effectively manage indirect, non-strategic expenses. Very often, significant dollars are left on the table in categories like office products, express mail, freight, payroll processing services, utilities, insurance, MRO, and telecommunications.

Although business managers may address these strategic and “relationship-based” categories individually, the broader systemic issues of estimating and reporting the savings still remains.

## **Watching the Savings Appear and then Disappear.**

Alliance Cost Containment believes that only about one in five companies has standard company-wide guidelines in place to calculate savings. Even fewer companies audit or validate the savings that have occurred.

Unless certain key measures are in place the process of measuring and tracking savings is wrought with gaps that give the suppliers the ability to escape accountabilities for delivering the savings. The measures often change from spend category to spend category, project to project, with each team (or helpful supplier) selecting the savings categories that get included in the calculation.

Savings guidelines or standard methodologies are often thought to be in place only to protect the credibility or performance of purchasing. But, clear guidelines assist the entire organization to not only estimate and report cost containment related savings, but also apply these savings appropriately to the financials as they get booked (or not booked).

*Savings Guidelines or standard methodologies must be in place to ensure savings are actually booked.*

It is commonplace for a new vendor to ramble off a list of qualitative and quantitative benefits associated with the “deal” but there has to be a clear distinction of the hard-dollar savings that impact financial measures and the softer business benefits that provide value but are not seen on the bottom line. One recurring example is the treatment of cost avoidance as opposed to cost reductions, on direct cost and expensed purchases. Cost avoidance often gets rolled into savings estimates. Yet, unless sources and timelines are clearly identified in a business plan, evading certain outlays now is no guarantee of a financial windfall in the P&L.

Although direct and indirect expense cost reduction and avoidance are generally easily taught to and applied by the various managers involved in cost containment decisions, other more complicated or strategically sensitive elements tied to cash flow — such as working capital, trade financing, and payment terms — are not as easily understood and therefore not adequately factored into cost containment efforts at all.

## **Sizing the Real Gaps that Exist**

Not only is the gap between projected and implemented savings significant, but low spend under management further hinders cost containment performance. Depending on the industry, from the financial manager’s perspective indirect expenditure can be anywhere from 1% to 15% of revenue.

**Figure 5:**

### Overall Cost Containment Savings Gaps

Improvement Area	Lost savings potential
Estimating and tracking	30 – 40%
Internal/supplier compliance	20 – 25%
Lost negotiation effectiveness	5% - 7%
Unaddressed spend	18.5% (average indirects)

Best practices are not a guarantee of success, but they demonstrate the required competence to become successful. Companies that reported the highest confidence in implemented cost containment savings and had the highest levels of expenditure under management consistently demonstrated four best-in-class traits:

- The CFO champions the cost containment cause.
- The finance organization provides dedicated resources to cost containment or participates as a core member of sourcing teams.
- Use formal, preferably multi-year, cost containment plans to project, audit, and validate cost containment savings.
- Position financial systems to complement purchasing applications to improve visibility and compliance.

The overall gap in cost containment savings far exceeds the functional discrepancy on how savings are calculated or reported. The four process limitations collectively present a savings gap that, in most cases, exceeds the actual savings implemented!

## **The Solution? - Audit your Cost Containment efforts and Audit regularly!**

### **Step 1 Establish a true baseline cost for each expense category.**

Many companies consider the baseline cost to be the total dollars spent in a category each year. This is a flawed approach, since it does not allow one to measure real savings, if any, within that category. For a true and accurate baseline cost in any given category, it is important to collect and review all of the line items purchased within a category and track them against future variances.

Vendors will often reduce pricing on one sub-group of items, only to make up for it by increasing the pricing on different, less visible sub-groups of products. By highlighting the price reductions, your purchasing department may take a “victory lap” and claim that savings has been achieved, when, in fact, it has not.

A true baseline cost measurement requires a comprehensive review of invoice level detail to ensure that all relevant information is documented as part of the baseline analysis. At Alliance Cost Containment, we generally analyze 6-12 months of historical line item spend data and input that information into custom cost databases for each expense category. This can amount to scores of man hours and thousands of line items of data review.

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**Tip:** Don't rely solely on electronic line item spend reports from vendors, as they often don't provide all of the information. Ancillary costs such as fuel surcharges often do not show up in an electronic report, but will be itemized on an invoice. It takes much less time to download an electronic report than it does to manually review line items, but without full and complete information, it is impossible to quantify true costs.

### **Step 2: Create savings Audit report templates**

A successful savings audit is going to measure four basic components:

1. Exact item matches
2. Billing errors
3. Non-matches
4. Substitutions.

**Exact matches** - this is a straightforward comparison of old prices to new prices for exactly the same items. For some categories, there is little variation month –to-month on the items or specification of services purchased. The key to verifying exact item matches is the part number. Vendors will sometimes change part numbers on a random basis to make it more difficult to audit exact items, so it is also important to capture description and product number or UPC code that is provided on the invoices.

An example of the savings audit for exact item matches is listed below

**Figure 6:**

Category	Item #	Vendor	Descr	QTY	Inv. Unit Price	Inv. Total	Old Unit Price	Old Total	Saving Per Unit	Savings Total
Office Sup	STP135848	Staples	PPR.COPY, 20# 92BR	100	31.67	3,167.00	33.49	3,349.00	1.82	182.00
Office Sup	STP105809	Staples	PAD, SELF STICK, 3x3	50	1.75	87.50	3.98	199.00	2.23	111.50
Office Sup	MMM65524V	Staples	NOTE, 3x5 VALUE	50	21.71	1,085.50	21.79	1,089.50	0.08	4.00
Office Sup	STP744100	Staples	3TAB 14PT MANLTR	50	7.15	357.50	10.55	527.50	3.40	170.00
Office Sup	HEWCB435A	Staples	CTRG, TONER HP	50	57.87	2,893.50	67.99	3,399.50	10.12	506.00
Office Sup	STP105809	Staples	PAD, SELF STK, 3x3	50	1.75	87.50	3.98	199.00	2.23	111.50
Office Sup	GOJ365912	Staples	SANITIZER, HAND	100	4.67	467.00	4.95	495.00	0.28	28.00
Office Sup	MMMCG6000	Staples	TRANSFILM, 2x11	50	33.96	1,698.00	49.99	2,499.50	16.03	801.50
Office Sup	SAN30001	Staples	MRKR, SHARPIE FN	100	6.12	612.00	7.99	799.00	1.87	187.00
Office Sup	DXSSX125AGE	Staples	BOWL, PPER 12OZ	100	9.14	914.00	13.59	1,359.00	4.45	445.00
Office Sup	DXSSXP105AG	Staples	PLATE, PAPER 125P	50	16.35	817.50	28.13	1,406.50	11.78	589.00
Office Sup	SRP135848	Staples	PPR, COPY 20# 9BR	500	31.67	15,835.00	33.49	16,745.00	11.82	910.00
Office Sup	JOJ200414	Staples	SPLENDA 400CT	50	13.05	652.50	14.99	749.50	1.94	97.00
Office Sup	DRT16J165	Staples	CUP, FOAM, 16OZ	50	19.68	984.00	25.99	1,299.50	6.31	315.50
Office Sup	FOLO6239	Staples	COFFEE FLGRS REG	400	35.74	14,296.00	39.20	15,680.00	3.46	1,384.00
Office Sup	STP135848	Staples	PPR COPY 20# 92BR	100	31.67	3,167.00	33.49	3,349.00	1.82	182.00
Office Sup	MMMCG6000	Staples	TRANSFILM, 2x11	150	33.96	5,094.00	49.99	7,498.50	16.03	2,404.50
Office Sup	PIL31257	Staples	PEN G2, 1.00MM BLU	50	9.56	478.00	13.15	657.50	3.59	179.50
Office Sup	STP512215	Staples	SPLS 11x17 COPY CS	200	35.61	7,122.00	48.89	9,778.00	13.28	2,656.00
Office Sup	DXSSX12SAGE	Staples	BOWL, PPER 12OZ	100	9.14	914.00	13.59	1,359.00	4.45	445.00
Office Sup	DXSSXP10SAG	Staples	PLATE, PAPER 125P	100	16.35	1,635.00	28.13	2,813.00	11.78	1,178.00
Office Sup	GOJ365912	Staples	SANITIZER, HAND	100	4.67	467.00	4.95	495.00	0.28	28.00
Office Sup	STP116806	Staples	FLDR, HANG, LTR	50	5.16	258.00	9.99	499.50	4.83	241.50
Office Sup	ACC72100	Staples	BNDR CLIP #100 LG	500	1.79	895.00	5.87	2,935.00	4.08	2,040.00
Office Sup	NFC35110	Staples	CREAMER, COFFEM8	50	5.56	278.00	4.99	249.50	(0.57)	(28.50)
Office Sup	AVE68082	Staples	BNDR, DSGN EDGE 1	600	3.87	2,322.00	9.56	5,736.00	5.69	3,414.00
Office Sup	SMDC23H	Staples	FLDG HANGING LGL	150	7.45	1,117.50	11.49	1,723.50	4.04	606.00
Office Sup	ACC72100	Staples	BNDR CLIP #100 LG	250	1.79	447.50	5.87	1,467.50	4.08	1,020.00

**Billing errors**- billing errors are far more frequent than most people realize. Billing errors can take a couple of forms:

1. overcharges on individual items that are a result of incorrect data input; or
2. a mis-classification of an item that is out of compliance with a written contract. Items that out of compliance with a written contract are the easier of the two to recover credits.

One Alliance Cost Containment non-profit client in the northeast was being overcharged for natural gas and didn't realize it until ACC conducted an audit. The overcharges were across the board and out of compliance with a written agreement. In addition, ACC discovered that the overcharges had been occurring for at least the past five years. As a result, ACC was able to negotiate \$175,000 in recovery credits for this client.

In most cases, vendors do not agree to pay 100% credit on overcharges unless there is sufficient invoice level data available and a clearly written agreement with the vendors.

**Non-matches** - separate one time purchases from recurring expenses within each area. For example, furniture is often categorized as office supplies. However, since it is not a repeatable purchase, then any negotiated reductions in pricing will not impact the bottom line and will skew the reported savings unfavorably.

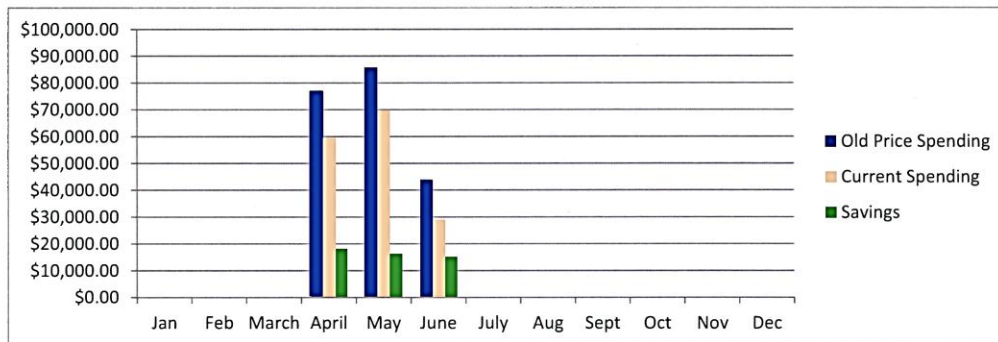
## **The Bottom Line**

Each month a report is generated that shows old spending, current spending and savings after just 3 months a report may look something like Figure 7.

In the example given – there is real-time savings of almost \$50,000 after just 3 months - and these savings go straight to the bottom line of the CFO's P&L. The CFO is now in an enviable position of not only maximizing his organization's profits and shareholder value but also able to adjust his cash-flow forecast and implements real-time decisions. Perhaps that may mean the difference between a dividend being paid out or not, or a round of layoffs no longer taking place.

**Figure 7:**

### Overall Summary Report for Acme.Inc.



The total you would have spent under your old pricing	\$207,219.84
The total you did spend with us	<u>\$157,756.00</u>
For a net total savings of	<u><u>\$49,463.84</u></u>

Monthly Breakdown

	Jan	Feb	March	April	May	June
Old Price Spending	\$0.00	\$0.00	\$0.00	\$77,261.30	\$85,870.09	\$44,088.45
Current Spending	\$0.00	\$0.00	\$0.00	\$59,298.50	\$69,455.00	\$29,002.50
Savings	\$0.00	\$0.00	\$0.00	\$17,962.80	\$16,415.09	\$15,085.95

But beware, a cost containment project takes hundreds of man hours – even when the cost advisor is an expert! If your purchasing and finance departments do not have an experienced professional at hand you run the risk of spending hundreds of hours on a project but still having a considerable savings gap in place. When a CFO is expecting to realize 15% savings but only implements 5% and has spent tens of thousands or even hundreds of thousands of dollars in resources then the project could end up being a loss for the CFO's organization.

## The Cost Advisor: A New Seat at the Executive Table

CFOs today are turning to outside expertise to assist them with their cost containment objectives. According to Patriot Research, US businesses spent approximately \$5 billion in fees for third party cost and supply chain consultants in 2010.

If, as the CFO you are looking to hire a cost advisor you would do well to hire the advisor on a contingency basis. This means that the cost advisor is shouldering all the risk rather than your organization and the savings gap – the difference between the anticipated savings and the actual implemented savings, while it may be disappointing if this gap is more than just a few percentage points, will not impact your ROI.

As the CFO's real concern is getting savings to the bottom line, this type of partnership, or Alliance, with a cost advisor may be the best Cost Containment solution available.