Cost Reduction in the Time of Crisis

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The 2008/2010 period was very difficult for both employers and employees, all over the world, as well as in Serbia, and it is expected, according to estimates of experts, that the effects will be felt until 2014 and even later in some industries. Surprised with the crisis situation, without proper cost management, most companies resorted to rapid cost reduction strategies. As revenues fell, and cash flow was reduced, the companies of all sizes have established a stringent controls of every major expense as the first answer to the crisis. The strategies that companies have implemented in this period had a more or less profound effect on their business. This paper analyzes the most frequently used strategies for cost reduction applied during the 2008/2010 crisis in companies around the world, describes a logical sequence of events and consequence, which follows their implementation, and proposes that a new proactive approach to cost management and cost reduction in companies be introduced, which should support stable business in good times as well as in bad times.

1. Introduction

Cost reduction is a normal activity in any company and means the activities of cost tracking and evaluation performed by the manager for the purpose of their reducing. These activities can be part of a formal programme established in a company as a whole, or they may be of informal nature and restrained to one depertment or one individual. In the periods of crisis, it is the cost reduction that managers pay special attention to, as a basic strategy of business survival. The period of recession is characterised by the fall in incomes and in cash flows, which forces the companies of all sizes to impose a strict control over any large expenses in their struggle to survive. The question is, however, to what extent thus developed cost reduction strategies implemented in site in the course of the crisis can bring benefits for the companies implementing them. This paper presents the most frequently implemented cost reduction strategies to which companies resort in the recession times, highlights the negative aspects of their implementation, as well as proposes possible solutions and change in the approach to cost reduction in companies, in order that optimum results be achieved in different conditions of business doing.

2. Most frequently implemented cost reduction strategies during recession

The basic strategy the managers of all companies in the recession period resort to is the cost reduction strategy. Surprised by an unexpected crisis situation, the fall in cash flows and in revenues, pressed by the time and the need to react promptly, they are in a situation of an imminent need to make the company survive by reducing costs.

The most frequently implemented cost reduction strategies in the 2008/2010 recession are as follows:

- The reduction of infinite expenditures such as training and education, fixed expenses, IT expenses, etc.
- Freezing and/or reducing compensation, i.e., earnings, bonuses, insurance, etc.
- Dismissing employees.
- Postponing and/or cancelling capital expenses and/or investments.
- Reducing the costs of marketing, sales and product development, such as research and development, economic propaganda, travels, promotional materials and events, etc.

These strategies result from the so-called reactive approach to crisis situations, where the management of the company finds it most important to instantly reduce the costs of their operations in order to ensure the company survival. This is the case of a classic top-down approach to cost reduction where the top management defines a sum in terms of the amount of money by which the costs should be reduced, discusses the main cost categories and advises the lower level management to perform adequate reductions to achieve a necessary target amount of savings. The selection criteria in such situations include primarily the answers to the following questions:

1. Will the costs be reduced low enough?
2. Can their reduction be performed promptly enough?
3. Will the company be able to survive that reduction?

The selection criteria rarely include the following question:

1. Will the company profit in a long term if it performs a short-term cost reduction now, due to the recession?

3. Effects of the most frequently implemented cost reduction strategies in a recession

The implementation of reactive strategies in facing the consequences of a recession is mainly oriented towards short-term effects and a short-term gain for the companies implementing them. Namely, viewed in a long term, none of the mentioned cost reduction strategies earns the company any benefits. On the contrary, in a long-term perspective, companies face problems caused by the lack of necessary resources, primarily human resources, and then the consequences of the existing employees' reduced productivity, their inadequate education and innovation of knowledge, lost enthusiasm, and finally, the negative effects of lagging behind technological development, undeveloped or weakened market position, reduction in the income profitability, all of which in the long run increase the costs necessary to pay to make up for what is missed.

Strictly speaking, the following effects can be expected in case the mentioned cost reduction strategies are implemented:

- The reduction of infinite expenditures such as training and education, fixed expenses, IT expenses, etc., results in short-term savings that may be sufficient to ensure the company's survival at the moment of crisis, however, it limits and denies the employees further development and consequently the development of the company as a whole. Restrictions on technologies and employee development will be felt in a weakened competitiveness of the company in this domain, especially so if the competition manages to further invest into this segment of their operations, despite the crisis.

- Freezing and/or reduction of compensation, that is, earnings, bonuses, insurance, etc. will also result into short-term savings for the company, however, it will directly be reflected upon the employee motivation and will directly affect their performance. These will be reduced to a certain extent, however, not as much as in case of the employee dismissal strategy which may result in ever larger losses manifested in reduced production, increased waste products, failure, breakage, wastage in relation to the savings achieved by implementing this strategy.
- Employee dismissal as the next step in reducing costs in a recession has a dramatic effect upon a general state of employees in the company in the time of crisis. It producess by far the most negative consequences for the productivity and business operations of the company in general. It is reflected in the fear and uncertainty felt by the employees and, accordingly, in a dramatic fall in productivity. A tense, uncertain and stressful work environment results in reduced creativity and enthusiasm in the employees. The lack of ideas and the opportunities for their realization may result in the talented individuals leaving the company, which most often is the case, and this means a massive loss for the company, one that it will have to compensate later.

- Regardless of the fact that it supports the efforts to achieve short-term savings, postponing and/or cancelling capital expenses and/or investments may have the effect of a missed or expired investment, where a larger loss results from the effect of a missed investment, one that the competition managed to realize first and thus was in a position to reap success in the post-crisis period. The loss suffered by the company in this case equals to the missed profits it would have earned had it been the first to realize the investment, whose results are now enjoyed by the competition. In case of an expired investment, that is, an investment that loses value and importance with the end of the crisis, the only loss suffered by the company equals the amount invested by the time the recession started.

- Reducing the costs of marketing, sales and the product development, such as reduction in investments into research and development, economic propaganda, travels, promotion materials and events, etc., whatever the short-term savings, may directly result into a weakened market position of the company and the loss of a future race with the competitors and this is the largest and the most dangerous fundamental loss the company can suffer. This is especially true for a company that happens to be relatively young or insufficiently affirmed, built, well-known or present in the market. In implementing this strategy companies have to find a balance with the competition. Market is a dynamic category and this especially applies in case the competition is in a position to have a more powerful campaign even in a recession period and to invest into research and development. The company that lags behind the competition due to having implemented this strategy will face an increased danger of the loss of its market position, even during a recession.

The longer the recession, the more serious the above described long-term consequences of the implementation of the above listed strategies.

4. Effects of the most frequently implemented cost reduction strategies in a recession and challenges in the postcrisis period

With the recovery of the merket, companies are in such a situation that they have a growing need to increase their income, however, due to having implemented the most frequently implemented cost reduction strategies during a recession, they no longer have the necessary human and technical resources to achieve that. The cost reductions performed by some managers in a crisis period were aimed at survival or at achieving certain savings by the top management, not for the efficiency purposes. The reduced productivity can well be raised to a higher level in certain business units, however, it is neither sustainable nor efficient. The departments with insufficient staff or finances may do business successfully in the present period, however, they are incapable of growing further. The budgets, the personnel and the plans for long-term projects in marketing, technology, infrastructure and other areas are rather poor at the moment. They are not inadequate only from the aspect of achieving their pre-recession levels, but also from the aspect of the time required. There is no zest any longer. Knowledge is lost. Some of these is lost forever, most part will take more time to be created anew. In a recession, too, the market share may have fallen in importance to the second position on the company's list of priorities, however, with the recovery, management again faces the challenge to retain or increase the market share. In an inreasing number of business segments the competition becomes fiercer. Weaker businesses perish, the stronger become even more aggressive. The traditional sources of capital, lenders and investors are still cautious, which makes it even more important for the company to earn revenues. After a great gap, nothing can be continued where it stopped. In the simplest cases, it needs time to only bring the employees into the pre-crisis condition. In a large number of cases, however, teams are disbanded and building them again may prove to be a very difficult task. Training the staff again takes time ... months, years. The time elapses. The postponed project may now prove to be unnecessary, useless. At least the returns on investments changed, as the competition and substitute products went on. Cutting the marketing and sales budgets means the loss of presence in the market and this needs time to build again. The consequences of the reactive approach to crisis are serious. The companies are in a situation that they have to just forget what is lost and are forced to invest more resources only to raise the business to the pre-crisis level. Not to mention that the competition may have gone further on during the recession period.

5. Remedy to the consequences of the most frequently implemented cost reduction strategies in a recession

The post-crisis world is changed, the markets are changed, some of them to such an extent that the company may never be able to return to them [2]. The companies that implemented a number of, or all the most frequently implemented cost reduction strategies in a recession are now facing three biggest problems: the lack of resources, the insufficient profitability of income and the loss of zest in the employees. In a post-recession period, therefore, companies must first aim to find remedy to the consequences of implementing reactive cost reduction strategies in a recession period, in order that they should be able to continue further business.

In order to optimize the resources, the primary task for the managements of the companies is to redesign the key business processes and carefully define priorities in order that they should include some earlier profits. It is also necessary that they should change priorities in their work, implement resources where they are needed and when they are needed. The management must not rely on previous assumptions. It is in this phase that the management has to identify and eliminate the losses of all the seven vital resources: time, people, space, energy, knowledge, finances and materials. They should include their employees throughout the company into a formalized continual improvement programme and train them in the fields of efficiency concepts and tools, after which they can plan the next business cycle.

In order that profitable income be increased, it is necessary that the company management should continue the process of the income flows analysis and identify the most and the least profitable ones. They should be oriented to the most profitable ones and correct or abandon the least profitable. Here, good acquisitions may also prove to be a good solution, including the acquisition of businesses and the production lines. Every industrial segment accepts consolidation to a certain extent. Agressive promotion and sales with an absolute accuracy in terms of market segments upset by industrial consolidation and change will significantly contribute to achieving this goal and increasing the income profitability. It is in this period that the companies that have survived should pay special attention to customers who were left alone, take the advantage from the customer confusion and help them choose these companies, as their previous or alternative supplier left the market. They should present themselves as the only solution to the customers' problems, as the companies that will take care of them and their requirements. A re-assessment of the market will reveal new income flows and new opportunities. The markets underwent changes and the company management has to be aware of that; certain markets have even lived through dramatic turmoils and now present an entirely new situation the company faces and has to develop an adequate business strategy for.

In order that the zest and enthusiasm in the employees should be awaken again, it is important to know that during the recession, the employees have lost trust into the company and its management. The zest is lost. Hence it is urgent that positive connections and relations with labour force should be re-established. This may be difficult, nevertheless, it has to be done. In order to achieve this, the manager has to face the disturbances the employees have suffered. He has to listen carefully to what his team are saying and observe their feelings. It may take the employee a considerable time to overcome the stress of being made redundant as it results into the loss of trust. It is necessary that steps be taken with a well analysed plan of recovery, before things are left to their own course. The key element is a proper selection of priorities and the provision of resources to make progress with, as well as creating appropriate work conditions in which each employee will have clearly defined goals and tasks, followed by adequate resources necessary in their unobstructed accomplishment. Enthusiasm and collaboration are necessary so that new zest should be born again. Good management will result into trust and enthusiasm building again. Of great help can be the launching of ambitious projects. Instead of only restarting the usual technological, marketing, manufacturing and other business projects, the company management should turn them into the next generation projects, overcoming the previous goals and setting the new goals, which will enhance motivation in the employees. There is a danger in this phase from linking to the infinite costs of the existing, outdated projects that will not bring anything good in the future but will only hinder the growth and development of the company. It is the task of the management to prevent this in that they will devote some time to determining what is currently the best and change the project goals accordingly. It will, of course, be necessary to run new calculations of returns on investments and make adequate adjustments. New decisions made on the basis of new information are the drivers of growth and development in this phase.

6. Proactive approach to cost reduction

In order that the described negative consequences of the reactive cost reduction strategies implementation with the onset of the crisis be avoided, the best companies employ a strategically proactive approach to cost management and reduction which allows for steady business doing, without turbulences and negative effects, in both good times and in the times of crisis. In good times, a proactive approach of strategic management and cost reduction ensures companies an adequate stability and readiness for action in the times of crisis without the danger of facing the negative effects of a rash, aggressive, short-term and random, unplanned reduction of costs, the costs that are of vital importance for the company survival, growth and development [2]. The question is: which costs can be reduced? In a planned, proactive, strategic approach to cost reduction the companies will reduce only those costs that are clearly defined as unnecessary from the aspect of the customer value. Hence the strategic cost reduction should be approached from the marketing perspective in that if the management of the company wants to establish what is unnecessary, worthless, dispensable in the company, they have to know the customer perception of the value. In case the company really learns and knows what does not bring any value to customers, it will know precisely what it can get rid of. Otherwise, it will only reduce costs regardless of their importance from the ultimate aspect of business doing and the consequences this act may cause.

From the point of view of management as a scientific discipline it is necessary to stress the strategic importance of permanent programmes of cost reduction as opposed to spur-of-the- moment reaction to unfavourable events [4]. Top managers worldwide increasingly adopt this point of view and make decisions that cost discipline, in terms of a continual cost reduction, should be a programme that can even become a core competence of the company. The practice has shown that business doing with successful programmes of permanent cost reduction can result into earning as much as a half of the annual profit due to the very cost reductions. Besides, what is especially important in the conditions of recession is that such businesses stabilize faster in a situation of economic failure or deterioration. Also, companies with a strict cost discipline adapt more easily in the conditions of introducing new technologies in the fields of production or services, as well as in case competition has suddenly become fiercer [3].

The key domains in which the cost reduction methods can be implemented to achieve significantly good results are given by the following cost allocation [4]:

- Raw materials: 60%
- Fuel: 6%
- Labour force: 11%
- Advertising: 5%
- Logistics: 9%
- Taxes: 5%

Below are presented the major domains of cost reduction in a manufacturing company [1,4]:

1.Raw materials procurement:

- Bulk purchase – allows for obtaining discounts when buying a larger quantity of raw materials, semiproducts or products compared to their individual prices. Hence it is important to find a most favourable supplier and buy the largest necessary quantity of raw materials, semiproducts and products.

- Opportunity purchase – an opportunity to save by purchasing as you find goods at favourable prices, regardless of the current needs of the company for these particular goods. The disadvantage of this method of strategic cost reduction may be the increased storage costs, hence it is necessary that these costs be levelled with the potential savings achieved by opportunity purchase and that the profitability of such purchase be examined prior to the purchase itself.

- Make or buy – refers to the assessment of costs necessary to produce a product by the company itself and their comparison with the acquisition cost of this same product at other suppliers. The savings are achieved by opting for a more cost-effective alternative.

- Annual contracts with fixed rates – allow for the purchasing of raw materials, semiproducts and products on an annual basis and at a precisely fixed price. In this case, the procurement of raw materials, semiproducts and products is continual, throughout a year, however, at the same, previously contracted prices, regardless of their possible change over a year. The new, changed price will be of effect only for the new customers, not for the company that has an already signed contract with the supplier. In view of the fact that the seasonal price variations are characteristic of a majority of raw materials, semiproducts and products, the largest savings can be achieved by contracting the procurement of a largest required quantity of raw materials, semiproducts and products at the time their prices are lowest.

- E-procurement – this allows for substantial savings via an automation of the processes of identification, evaluation, negotiations and configuration of an optimum mix of suppliers, products and services using modern Internet technologies, which enhances the speed at which the company responds to newly arisen market conditions. By a simple announcement of a tender on the Internet the company can collect a large number of offers and select the most favourable ones. Savings can also be achieved by reducing transaction costs, reducing the costs of storing unnecessary stocks, shortening the time required to respond to the market demands, etc.

2. Logistics:

- Route mapping – refers to exploring possible means of transport of raw materials, semiproducts and products and the selection of the optimum one – optimum in terms of costs and the required time. It includes both internal and external transport. The costs are included in the raw material transport from the supplier to the factory warehouse. They can be assigned either to the supplier or to the customer. Furthermore, the transport of raw materials and semiproducts takes place within the factory during the work process itself, which also incures transportation costs. Final products are then transported to large distributor companies, then to retail objects and finaly to the customers. An optimum organization of the entire logistic chain is of substantial importance for the business.

- Full capacity – essential in saving is the transport of fully loaded containers and other means of transport. For example, goods are loaded into 12 ton containers, and a 30% loaded container is never dispatched.

3. Department stores and shops:

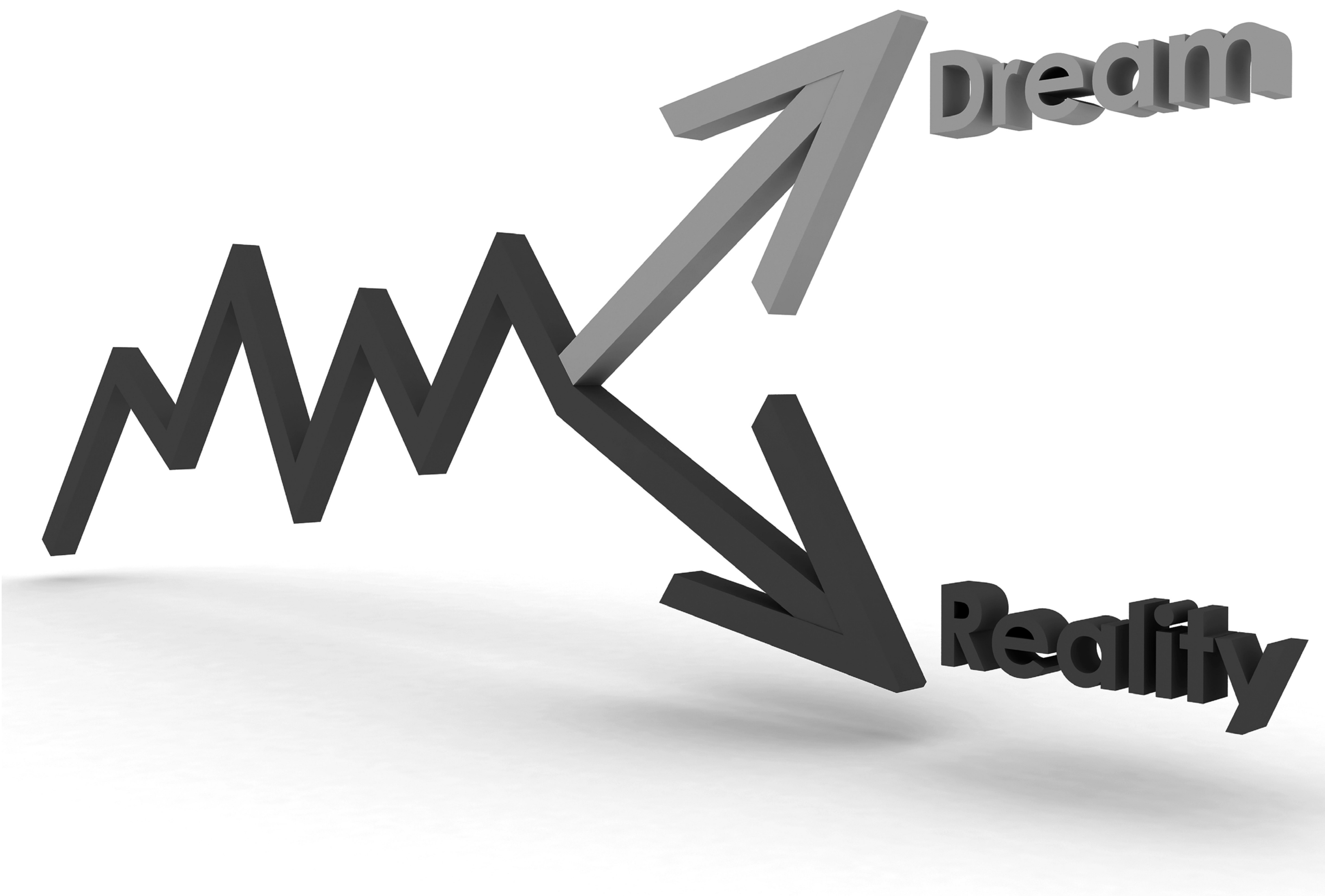
- Low stocks – result in automatically low storage costs, less storage room required, less maintenance of this space, less equipment to regulate temperature and other conditions in the warehouse, a smaller number of employees in the warehouse, a smaller number of transport vehicles in the warehouse, lower transportation costs in the warehouse, etc.

- Facility management – refers to permanent savings and cost reduction by introducing an optimum system for handling raw materials, required physical devices and the optimum plan of space arrangement to ensure an unobstructed flow of material.

- EOQ – Economic Order Quantity – the value that determines the level of stocks at which the total costs of ordering and storing stocks are lowest.

4. Production process:

- Manufacturing – includes an adequate allocation of jobs, machinery and materials to ensure a cost-effective production where there will be no waste, failures, breakages, wastage or unnecessary waste



of time caused by a poor organization of the manufacturing process.

– Automation – the development of software industry brought forth new opportunities for permanent business cost reductions in the production process domain. Automation helped improve productivity, increase efficiency, reduce the labour force demand; it allowed for an early identification and correction of errors, safe operations, data collecting for the purpose of achieving better outputs, etc.

– OEE – Overall Equipment Effectiveness – refers to a hierarchy of measures focused on how effectively the manufacturing operation is carried out. The results are presented in a generalized form, thus allowing for comparison between production units of different industries. As such, the OEE measure is frequently used as a key indicator of performance.

5. Packaging:
   – refers to the optimization of the primary and the secondary packagings in order to ensure the safety of the product during the loading, unloading and transport, as well as the product attractivenes itself. Savings in the costs of packaging can be achieved in different ways, taking into account all the parame-

tres, such as the product shape and size, its toughness, waterproof qualities, user-friendliness etc. The savings in this domain are primarily achieved via the packaging design and the choice of materials.

6. Energy, fuel and water – cost reductions in this domain are possible to achieve by a correct selection, monitoring and optimization of the equipment used in this domain:
   - Engines
   - Lighting
   - Compressors (boosters)
   - Fuels
   - Recycling
   - Waste water management

7. Information management:
   - Company resources management – with the rise of new technology it is today possible to manage the company resources in an optimum manner, by installing the software such as Oracle, BAAN, SAP. They provide accurate information in the following areas: material planning, production planning, finance planning, sales planning, on the basis of which it is possible to select the best solutions.

8. Human resources:
   - Outsourcing – a significant source of permanent strategic cost reductions today, primarily reflected in the savings in fixed costs, maintenance costs, legal obligations, an easy change of partners, lack of restraint to one geographical region. The following business activities are most frequently outsourced to use the benefits of a permanent cost reduction: personnel services, bookkeeping services, manufacturing services.
   - One of the key elements of success in cost reduction is that this idea has to be acceptable. The idea is accepted when everybody who has to implement and support the idea are included in its generation and evaluation.

7. Conclusions and recommendations

Formulating reactive cost reduction strategies brings short-term effects. Urgent cost reductions are useful in reducing the money outflows, however, if the structural changes are not implemented in the manner in which companies generally function, they will not last. The results are often poorer than expected and the majority of these strategies will not result in a permanent, that is, sustainable cost reduction. Besides, history shows that a considerable percentage of companies that cut costs during a recession by cutting the major cost incurrers discover that their costs are even higher in the post-crisis period than they used to be before. The most successful companies implement the strategic cost reduction and increase profits before the crisis and change their method of business doing in order that they should become even more efficient when harder times come. The companies that are proactive in their approach to cost management and reduction in both bad and good times, achieve significantly better long-term outcomes in comparison with those whose approach to economic cycles is reactive.

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