

Get up to speed
Building Better Finance Functions

Leader or follower?

The role of the CFO in cost reduction



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The role of the CFO in cost reduction

Many CFOs are helping their companies achieve significant and sustainable cost reductions – are you leading your business through the downturn?

In a very short time, the CFO's agenda has inverted from control at all costs to absolute cost control. The celebrations following the achievement of statutory and regulatory compliance, SOx sign off, or Basel II compliance are a faded memory now that the pressing issue of business survival is at hand.

Many have described the role of finance as helping the business to understand the financial implications of operational decisions. This is certainly true, but now there is a new perspective: helping business to understand the operational decisions required to improve its financial position.

Undoubtedly, CFOs should take a leading role in re-positioning the business's finances. So how can the CFO, as a functional leader, and indeed the finance function as a whole, provide the compass from which companies will navigate to a more profitable future?

Five lines of attack are key:

1. **Earn the mandate to lead by demonstrating competence:** Leading from a position of strength requires having, or building, a reputation for the finance function as a great service and at low cost – in the current environment, the focus is on information.
2. **Develop a plan:** Assess the value as well as the cost to the business of all operational and support activity. Manage the realisation of any programme returns or benefits achieved.
3. **Address the short term fixes decisively:** Review quickly those costs inherent in the business that can be rapidly addressed without compromising value.
4. **Tackle complexity:** Long term sustainable cost reduction is achieved by eliminating unnecessary complexity that adds cost but no value.
5. **Communicate:** Ensure that actions taken are understood, supported and sustainable through effective stakeholder management.

1. Earn the mandate

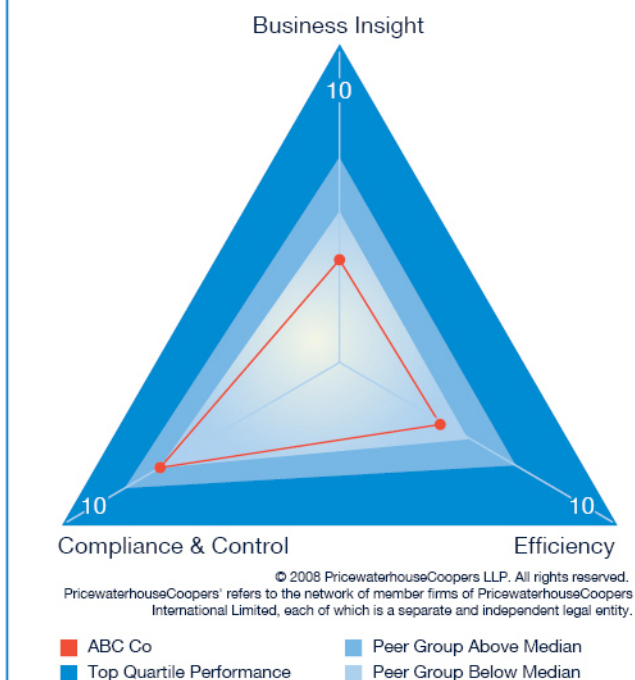
To gain the business's permission to look at structural and wider business change, make it clear that your own house is in order:

- **Know yourself.** The cost of the finance function may not be significant when compared to other organisation costs, but a lean and efficiently run function is a more compelling platform from which to launch.
- **What do customers want?** Information. “Stop, standardise, simplify” has become a mantra for many on a cost-reduction mission. How much of this thinking applies to the finance function? It's vital to listen to the voice of your customer, to focus effort and identify non-essential activities. The world has changed, at least for the time being, and many services, seen as ‘must-haves’ before, are now luxuries. As you focus the team, the priority will become the nature and detail of information required by the business to manage through the downturn. What many operational leaders lack is information on which to base their decisions. This is where finance plays a crucial role.

The pre-requisites to getting the mandate from the business:

- **Credibility** – get your own house in order first. Demonstrate to the business that finance has gone through – or is undergoing – the same cost reduction pain.
- **Diplomacy** – be aware of the sensitivities, the ‘sacred cows’, and deal with them appropriately. What can be done to demonstrably prove that some sacred cows are being sacrificed and some value enhancing services being preserved? Are you working behind the scenes to get full stakeholder commitment?
- **Advocacy** – be visible in driving the management of cost in the business. Is it clear that this programme has the backing from the top of the organisation?
- **Decisiveness** – act now and draw away from the competition. If you can cut cost and drive up value at the same time, then the business will benefit from the change.

Leading finance functions are highly efficient, are on top of risk, compliance and control issues, while providing world-class business insight for decision support.



2. Develop a plan

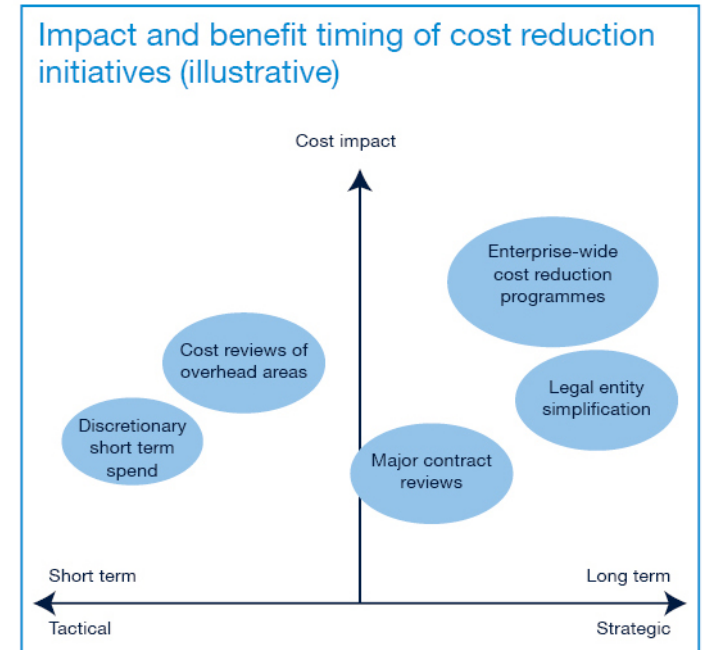
“If you don’t know where you’re going, any road will take you there.”

George Harrison, ‘Any Road’, 2002

Any cost reduction initiative needs its context, parameters and desired outcomes to be very clearly understood. Targeted cuts are far preferable to across-the-board reductions. Fundamental points to address are:

- **Baseline** – understand overall business costs, understand how costs break down. What is fixed and what is variable? What are the major cost categories? What contracts are due for renewal? Where are the opportunities? Which costs are addressable?
- **Outcome definition** – be clear about the outcome of a cost reduction initiative. What is the new level of annual cost that the business needs to achieve? What are the timescales to achieve that? What are the acceptable one-off costs that need to be incurred to get there? Be sure that you are not re-arranging the deck chairs on a sinking ship.

- **Cost drivers** – think through what levers are available to reduce volumes and complexities. What is driving the costs and how flexible are those drivers? To attain the desired income, how much do the drivers need to change? Which ones are going to give the biggest impact?
- **Value drivers** – be aware of customer value and do not destroy value by over-cutting costs. What qualities will the customer strongly want to preserve? What controls in the business cannot afford to be sacrificed?
- **Prioritise and balance** – your key role is to guide the organisation on the appropriate balance between cost and value as well as defining a clearly prioritised programme.
- **Track benefits** – ensure you realise the benefits of the cost reductions. As the costs are managed out, what measurement system is in place to assess impact against expected impact? Many companies have found it difficult to get credit in their share price if the benefits of cost reduction programmes can’t be directly proved to the market. Are individuals assessed on the level of achievement of the cost reduction targets?
- **Engage your team** – ensure your finance team are aware and engaged in cost reduction initiatives and are supporting you in driving these changes across the organisation.



3. Address the short term as well as the long term

Fixed, semi-fixed and variable costs are theoretically simple but practically difficult. The priority in the short term is for the finance team to help management understand the P&L from two perspectives: the cost structure and cost drivers, the value chain and value drivers – and the quantum of each. As an illustration, travel expense is a variable cost in most businesses and an early target for cost containment. However, the value to the business will vary considerably depending on who is incurring those expenses. A sales force that cannot travel is of little use to the company; but fewer internal face-to-face meetings may actually improve productivity.

Discretionary short-term spending and quick wins should be balanced with any potential negative impact on morale/culture. Cost reduction gains need to be sustainable, which demands culture change: a cost control mentality alongside cost-control mechanisms. Yet acting fast and getting the quick wins can make a big difference to long-term prospects, improving the outlook until longer term initiatives start to deliver. Low-hanging fruit should be identified – and taken.

Strategic Cost Management in Oil and Gas

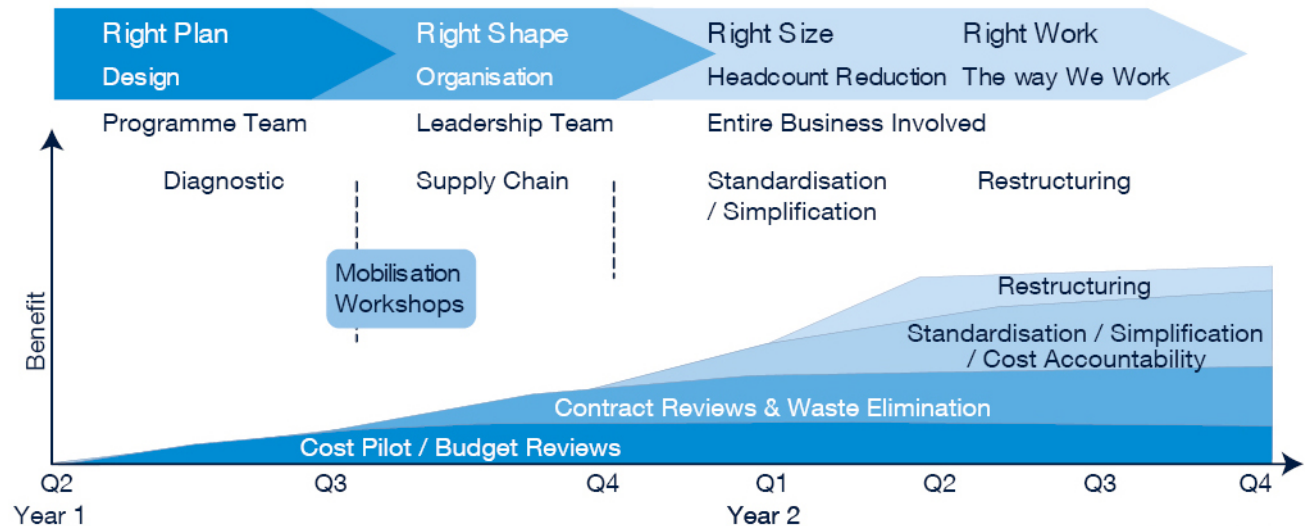
A multi-billion dollar oil and gas business was facing continuing downward pressure on margins and free cash generation was declining. The company needed to change into a sustainably cash-generative business.

Over a two year period, using the approach shown in figure 1, PricewaterhouseCoopers (PwC) helped the client achieve both quick wins and a move to sustainable cost reductions through a fundamental shift from alignment around assets to delivery functions. The project team tackled efficiency, planning and execution; it analysed governance, helping to define and implement simplified, standardised processes.

In Year 1, more than 300 people were engaged in building the case for change and in redesign. Immediate cash benefits and ongoing opportunities were identified, e.g. through audits of main contracts in all sectors. Cash costs were restored from a large forecasted overspend to being delivered significantly under forecast.

From Year 2 and onward, savings will continue, due to factors including: a 90% reduction in process complexity; a removal of one layer of management and reduction in head count; a step change in capability around cost and contract management; and continuous improvement plans embedded to simplify processes further.

Figure 1 – example project approach to strategic cost management



4. Tackle complexity and look to service providers

It may not feel like it, but there is today a window of opportunity that will close as the green shoots of recovery start to appear.

In many businesses, there has been a debate regarding complexity across products, services, target market, sales channels, legal structure, management structures and governance. These debates are always difficult and sensitive. The current business imperatives for change and cost reduction can provide the opportunity to address entrenched structures, behaviours or views – changes which will be of great benefit for the future. At this time people are most likely to accept that there can be no “sacred cows” in operations or structures.

Structural change review provides an opportunity to examine the portfolio of legal structures, with the aim of reducing the complexity of the corporate structure, unlocking benefits for the organisation as a whole.

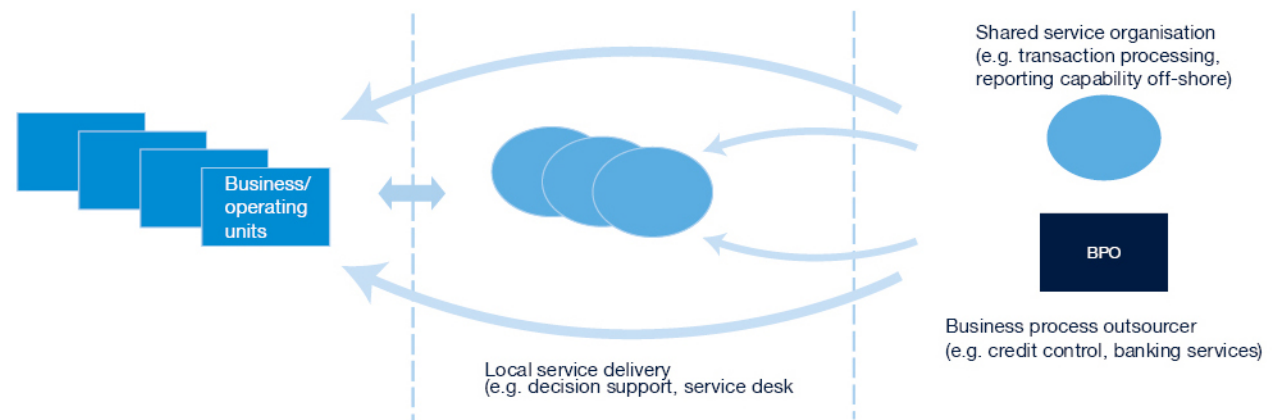
- Eliminate all dormant legal entities and minimise operating entities; consider single entity (SE) structure for European operations.
- Consider restructuring regional and global businesses to a ‘Principal’ and ‘Branch’ structure.
- Evaluate the tax optimisation benefits of locating ‘Principal’ entities into low-cost tax jurisdictions. If that’s not viable, evaluate tax optimisation of existing structures.

Take a radical look at structures

By encouraging the tackling of structural complexity, the CFO can drive direct benefits including reduced internal administration costs; reduced external and internal audit costs; improved transparency; and aligning management structure with legal structure, reducing fiscal compliance risk. Additional indirect benefits are also there for the taking: potential tax benefits; GAAP reduction (e.g. conversion to IFRS); reduced internal support e.g. Directors; and access to trapped cash & optimising capital adequacy structure to rationalise funding & treasury structures.

Rethink service delivery: shared services and outsourcing

When looking at the operation of support services (finance, HR, IT, procurement) many companies have opted to move these activities into a shared services organisation. Others have outsourced. Many have done both. In many cases these moves go hand in hand – and go alongside IT rationalisation. Consolidation and simplification of operating processes and reduction of overheads can have a twofold benefit: boosting the balance sheet and reducing operating costs. For the CFO looking for a swift method to hit both of these goals, then both shared services and outsourcing warrant close inspection.



5. Communicate – manage your stakeholders

At times of change, it is important to optimise relationships with all key stakeholder groups. Successful management of communications with these groups is absolutely critical to success. Your goal is to retain business confidence and avoid surprises. Stakeholders need to be engaged in a positive dialogue about how the situation is being handled, the opportunities it presents, what is being done to address any underlying weaknesses in the business structure and the strengths that set the business apart from its competitors.

Successful businesses proactively structure activities and communications in a targeted way for each stakeholder group:

- **Customers** – Reward loyalty, ensuring any retention efforts are targeted and cost effective. Increase your focus on customer credit to reduce bad debts; ensure plans are in place to proactively capture customers from failed competitors; consider sales aid and customer financing opportunities.
- **Investors** – Proactively appraise the investor / analyst community about your financial projections / outturns. Regular scenario planning / modelling becomes critical as a source of strategic information; be prepared and ready to tap investor markets, as “windows of opportunity” open up.
- **Suppliers** – Categorise suppliers into critical / desirable groups and focus priority spend on priority categories. Review contract and procurement policies; optimise purchasing power with suppliers, aiming to prioritise spend and consolidate / reduce the supplier base. Communicate regularly with critical suppliers: they will want to help you reach your business goals to keep their key supplier role.

- **Management & Staff** – Focus attention on retention of highest value employees – those that must be retained as the growth engine of the business. Look at pay structures / flexible working time and benchmark remuneration against competitors; look at outsourcing opportunities; consider works council / union implications of any changes.

Closing the gap

Good stakeholder management during difficult times is crucial to businesses executing a winning strategy. In today’s often complicated business environment, the only way to manage these diverse relationships effectively is through good communication. Shareholders and lenders need to be kept informed and don’t like information to be kept from them or nasty surprises. Under these circumstances, it is almost impossible to over-communicate – and far preferable to overdo it rather than leave messages unsaid.

Taking out the wrong costs can be worse than taking out no costs at all

The skill and value of the finance function when considering cost containment or cost reduction activities cannot be over-emphasised. The CFO as an individual, and the function as a whole, have a unique view of the business across its costs, complexity and revenue drivers.

This information is fundamental to creating the focus to change the organisation into one that survives and prospers. No one would advocate the execution of a plan based on flawed or incomplete analysis. The finance function, so often the 'controllers' of the business may yet become its saviours.

How PwC can help

PricewaterhouseCoopers works to solve complex business issues – locally and globally. Our teams draw upon skills in finance, risk, regulation, people, operations and technology to capture opportunities, navigate risk and deliver lasting change across business networks.

We take time to listen to your situation and offer a range of smart choices to consider – choices based on independent and challenging insights, supported by facts and industry benchmarks.

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