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Seeing Six Sigma in a New Light

Six Sigma's Role in Enterprise Cost Reduction

The world of quality improvement shuddered in early 2004 when a noted corporate strategist who had been involved in the legendary Six Sigma initiative at General Electric questioned the relevance of the methodology.

In the quite public forum of a Reuters news story, Jay Desai provocatively suggested that Six Sigma's strong focus on discrete process improvement could constrain innovation, the essential requirement for sustaining competitiveness in today's marketplace. Supporters of Six Sigma strongly defended it in the article, pointing to the impressive returns the approach continues to bring in improving efficiency and lowering cost.

Innovation versus efficiency made good wire service copy. But it's hardly the whole story.

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Equally important in today's still struggling global economy is whether an organization can develop and implement a broader, transformational cost reduction approach that ferrets out structural or out-of-line costs throughout the enterprise, while providing a framework for sustainable improvement through proven methods such as Six Sigma.

A comprehensive approach to cost reduction can in fact free the very resources needed to innovate and gain market leadership.

Conditions call for more comprehensive cost containment

As the ongoing Six Sigma successes at GE, Caterpillar, Timken and other industry titans demonstrate, organizations continue to benefit from the continuously evolving Six Sigma quality improvement process. The latest iteration, Lean Six Sigma, combines quality improvement with increases in process speed to help address both time-to-market and customer-satisfaction demands, while containing costs.

Clearly, Six Sigma continues to play an important role in operational improvement. At the same time, conditions that many companies now face suggest the need for a faster, broader and more encompassing approach to cost reduction.

Companies in mature businesses may find their growth rates at or below expected GNP growth. Barriers to entry continue to fall in industry after industry, while international competition puts pricing pressure on enterprises of all kinds, new and old, large and small. These factors, coupled with tectonic shifts in the business landscape of industries such as telecommunications and utilities, and ongoing, merger-driven consolidation, are compelling companies to make fundamental changes in their business models.

In such an environment, even as economic and business conditions improve, an intense, rigorous focus on cost structure, use of working capital, and global cash flow is essential. Companies need an approach that is tangible and practical, yet comprehensive enough to catch global cost reduction opportunities beyond those provided by point solutions such as Six Sigma.

Too often, however, companies attack the problem simply by letting people go or pursuing the fuzzy business of operational restructuring. Witness recent announcements of headcount reductions at companies such as EDS, Nortel, Delta Airlines and others. Even after several years of downsizing, these companies continue going back to the human "well" to meet Wall Street expectations.

Other companies tackle massive operational initiatives, including supply chain reengineering, IT infrastructure overhauls and changes in sourcing. These types of initiatives offer both immediate and long-term savings, yet even they can benefit from a more encompassing perspective. Only then will they generate the transformational and structural cost savings that companies need today.

Enterprise cost reduction: taking a broader view

Rather than fixate on finding silver bullet solutions, companies can take a more thorough look at cost containment in the same way they are taking a broader view of revenue generation and market share expansion. Inefficiencies and inefficient cost structures often span organizational and geographic boundaries within an organization. In such cases, only a truly enterprise approach can unlock the savings potential.

Enterprise cost reduction is a wide-ranging approach to reining in expenses and positioning the organization for ongoing improvement. Rather than focus on specific operational processes that are confined to one or two functions, enterprise cost reduction addresses a range of key cost drivers that span the enterprise, including:

- Business configuration
- Organizational structure and design
- Business and process complexity
- External spending
- Benefits

Addressing any one of these drivers can produce impressive cash flow improvements. But beyond their individual effect, the greatest opportunities for transformational cost reduction lie in examining all of these areas and identifying savings possible both within and between them.

Such an approach focuses on the strategic cost drivers not typically addressed through process-specific disciplines like Six Sigma. These drivers determine how far an organization can go in reducing cost without a negative impact on the organization's culture and strategy.

An enterprise approach also catches many of the tactical cost-reduction opportunities that otherwise fall between the cracks in more traditional programs that are narrowly focused on a single area or process. Cost reductions achieved in one area through such programs can be offset by increases in another as work is actually shifted between functions instead of being eliminated.

Finally, an enterprise approach can serve as a sort of "opportunity guidance system" that identifies and zeros in on discrete candidates for process improvement. Then, Six Sigma and its operational-improvement kin can be unleashed in a strategic, targeted manner, adding to the effectiveness and longevity of those programs. Furthermore, an enterprise approach almost certainly will include initiatives like supply chain reengineering, IT infrastructure overhauls and changes in sourcing. But the enterprise approach will add an entirely new dimension to those efforts.

Organizational structure and design: examining operational governance

Are we a holding company or an integrated operating company? How much autonomy do we want the business units to have? Do we want the flexibility to buy and sell entities quickly? Many organizations have found themselves precariously straddling these issues, with corporate center and business unit responsibilities ill defined and major decision-making processes diffuse.

Such circumstances may at first blush appear to be primarily a governance issue. But a lack of role clarity can be a critical factor in creating cost inefficiencies. Companies in these situations develop duplicative processes for the sake of "management." Analyses are created in the business units for the corporate offices that are not used in daily management of the business. Infrastructure is developed to gain more insight into the business units, yet many of these processes add minimal value to the enterprise.

Often these types of business configurations and organizational models evolve based on leadership's philosophy of how the business should be managed, which leads to such long-standing cost reduction strategies as shared services, outsourcing and leveraging of corporate purchasing power.

Conventional cost management wisdom would suggest that an integrated operating company is the only model in which centralized business processes would yield significant savings. Yet with creative structuring and deployment, these strategies are relevant to a variety of business models.

Six Sigma and other continuous improvement methodologies are not designed to address these types of structural cost elements. Enterprise cost reduction, on the other hand, begins by challenging the historical business configuration, organizational structure, legal entity and governance model. These challenges are not meant to suggest that there is a single, most efficient structure. Instead, they are meant to provide alternatives to embedded business practices that have evolved over time.

For example, some companies have recently established wholly owned procurement companies that specialize in purchasing raw materials and indirect supplies. By combining the purchasing power of the entire company, the procurement company is able to negotiate lower prices based on higher volume guarantees. This strategy can be used with any type of business model, not just the integrated model.

Business process and complexity: leveraging standardization and technology

Enterprises face myriad issues in their quest to improve process efficiency. In most companies, business processes have evolved over time based on technology and human capital constraints. While Six Sigma is designed to improve existing business processes, it is often narrowly focused and does not contemplate improvement across the entire enterprise. Improvements are usually confined to one or two functional areas that "own" the process, often not addressing the complexity of the end-to-end process.

Recently a leading retailer experiencing declines in sales sought to reduce costs to maintain current profitability. Rather than employing an enterprise strategy, each function acted somewhat independently, launching a series of Six Sigma improvement initiatives.

In store operations, the company sought to lower its overall labor cost by reducing the number of hours worked in each store. Yet store management did little to determine which activities would be eliminated to accommodate the reduction in labor. At the same time, marketing decided to increase the number of in-store promotions in an effort to increase the overall sales volume.

These two conflicting, independently developed efforts did little to improve the overall profitability of the organization. Rather they actually increased costs in the short term as the project teams worked to achieve conflicting objectives.

Enterprise cost reduction eliminates many of these conflicting objectives by developing cost reduction and profitability improvement strategies that take the entire company into consideration. By identifying the impact of cost management strategies on each function within the organization, and working collaboratively with the respective management teams in those areas, enterprise cost reduction is able to achieve the lowest overall cost if not necessarily the lowest functional cost for the organization.

Business configuration and product complexity: determining who we serve and what we offer

Many companies are constantly adding new products and customers. Yet often they don't take a step back and challenge the productivity or value of their overall business configuration. The array of products and services a company offers, and the customers and geographies it serves, will drive the scale, scope and complexity of the business.

Addressing business configuration and product complexity means identifying the winners and losers among offerings and markets through a deep examination of pricing and costs. Ultimately, streamlining the goods or service mix and homing in on markets or customers offering the greatest opportunity can improve asset efficiency and reduce asset commitment. The result can be significant savings.

One manufacturing company recently established its product offering for the upcoming year. Marketing and sales went through an extensive planning exercise to determine which products should be "hot" in the marketplace, without reviewing the sales history by product from the previous year. Sales and marketing relied on their instincts rather than facts to determine the depth and breadth of the product line. When a detailed analysis was conducted using the previous year's sales, a large number of products that had a negative contribution margin were included in the mix. Marketing argued that this type of mix was necessary to present a full product assortment to the customer. However, most of the products with the negative contribution margins were line extensions added over the past several years, rather than base products.

Additionally, the manufacturer found that approximately 80 percent of the sales were attributed to 20 percent of the product line, a common finding among companies.

So what does this have to do with cost? In most companies, such decisions have significant hidden costs. Companies build inventories to support an expanded product set, which occupy more warehouse space, compete for manufacturing capacity, slow production cycles times, require more material handling and consume capital. Most of these items do not appear directly on the income statement, yet they are major contributors to excessive cost structures.

Because they are focused on process improvement, Six Sigma and other continuous improvement approaches will typically not address these strategic cost levers. Only a comprehensive, enterprise program can drive these types of savings.

External spending: identifying costs large and small

From the purchase of raw materials to the expense of a business trip, dollars that go out the door never return. Improved product sourcing and tighter expense controls can combine to produce dramatic cost reductions.

Addressing the sourcing issue requires an examination of what materials are being purchased, and from whom. Do we have an optimum mix of suppliers who provide quality goods at a competitive price? And, do they deliver what we need in a timely manner?

Many companies have spent considerable time focused on improvements in procurement. The most common activity is negotiating with vendors for greater unit price savings by competitively bidding goods and services. While many companies do a reasonably good job at the negotiating table, few put the processes in place to sustain the savings.

One airline company that prided itself on being a good negotiator competitively bid its office supplies. The company received a 55 percent "off-list" discount from a major national office supply vendor on 270 items included in the contract. When the accounts payable file was queried for purchases from this vendor, the company found more than 3,000 different products purchased. Ninety percent of the purchases did not receive the most favorable price.

While the company did a good job of negotiating price, it did not control demand by limiting the items that could be purchased from this vendor.

Process improvement methodologies will not capture this type of savings because they focus on ways to make activities such as requisition completion, purchase order execution, item receiving and invoice payment more efficient. Rarely do they challenge the "what" in the process, but rather focus on "how." In contrast, a more comprehensive solution such as enterprise cost reduction typically yields a greater return.

Medical and health benefits: the need to remain competitive

Benefits packages and health benefits are fertile ground for improved control. What executive hasn't awakened in the night to ponder the growing burden of healthcare and pension obligations? Is it possible to redesign programs to control potentially massive expenses while maintaining a workplace viewed as competitive and attractive?

As in the case of external spending, most companies do not comprehensively challenge cost management in benefits. Management often attempts to manage the cost by changing providers through a competitive bidding process. While this approach can help reduce cost in the short term or offset a projected increase, it does little to reduce the structural cost over time. Companies may need to restructure their benefit offerings to achieve lasting savings. The relationships between brokers and providers must also be examined to make sure that the company receives the best alternatives.

One leading company recently analyzed its benefits spend and benchmarked it to the local market and other industry competitors. While its costs were slightly lower than the market, the company decided to bid benefits competitively. The result was a reduction of $1.5 million based on "price."

However, when it analyzed the nature of the benefits offered and the structure of the plans, the company found that a savings of $4-5 million was possible, without significantly lowering the benefits offered to employees. Changing plan types and funding mechanisms helped to reduce costs more significantly than originally anticipated. Understanding the nature of compensation and benefits, rather than focusing on just pricing, was the real key to success. Continuous improvement approaches alone would not identify this type of savings.

Enterprise cost reduction: putting it all together

As these examples show, an organization can achieve dramatic cost savings by undertaking a broad enterprise cost reduction effort that addresses key cost drivers such as corporate structure, process improvement, discretionary spending and benefits.

Viewing cost reduction as an incremental, tactical activity is not enough. Instead, a strategic approach is needed to truly transform the enterprise. Six Sigma and other process improvement techniques, along with supply chain, IT infrastructure and sourcing initiatives, may still be a part of the mix. Such efforts can make important contributions, particularly in helping the organization adapt to and monitor the effects of changes necessary to achieve the cost savings identified by the enterprise approach. But ultimately, it is the broad, encompassing view of enterprise cost reduction - one that addresses the key drivers described here - that serves as the path to fundamental, sustainable improvements that companies need today.

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