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How CFOs can make the most of cost optimization

While inflation in the US has cooled off in recent months, chief financial officers continue to contend with rising costs in a number of areas—from raw materials to shipping to wages. But what they may not notice in their efforts to control spend: cost-cutting can come at a higher price.

Traditional approaches to containing costs—lean manufacturing and offshoring, for instance—can backfire in an increasingly volatile environment. Consider what happened during the COVID 19 pandemic. Part of the pandemic's legacy included product shortages, fragile supply chains, and other costly fallout. Given those circumstances, it was not uncommon for some finance leaders to zero in on the most visible targets, from reducing headcount to deferring planned investments. The challenge? By focusing on short-term—and easily quantifiable—cost reductions, some CFOs may have overlooked how their choices might hinder future value creation.

If the marketplace rebounds quickly, such companies can end up in a weaker competitive position, lacking the resources they need to pursue growth. Downsizing, for example, can create a shortage of employees whose skills may be critical when investment picks up. Replacing the workers can also be costly. Likewise, squeezing suppliers for rebates and price reductions may help companies address immediate earnings concerns. But it can add costs later. Those same suppliers may be less responsive, or even less capable, when it comes to meeting delivery requirements. Instead of lopping 10% off of the supply chain costs, companies might get better outcomes by looking for cost reductions that also create opportunity—in this case, by forging alternate third-party relationships that can potentially add value in the form of innovation.

In the 4Q 2023 *CFO Signals*™ survey, 36% of the 124 CFOs cited cost management as among their top-three priorities for 2024. Cost *optimization*, however, may offer a smarter approach than straightforward cost cutting, which tends to focus on more-immediate impacts to cost of goods sold.

Cost optimization offers a strategic approach to managing costs while preserving agility. Even as finance leaders drive out costs, they can do so with an eye toward freeing up capital that can help the business maintain its adaptability and reinvest in strategic growth opportunities. In short, improving operational efficiency need not compromise longer-term value. In an ultra-competitive environment, with pressure bearing down on pricing and profit margins, companies can't afford to hamstring their own ability to fund growth.

In this edition of *CFO Insights*, we'll explore how cost optimization can help improve business performance and resilience. What's the key to locating a balance between short-term fiscal relief and long-term growth opportunities? How can companies ensure that cost reduction in some areas, such as capped travel budgets, won't resume climbing after a couple of quarters?

Cycle life

With their profit margins squeezed by higher operating expenses—a product, in recent years, of rising inflation—many companies have looked to take out costs.

By standardizing data across different businesses and product lines—and making the data easily accessible—CFOs and other leaders can uncover cost-reduction initiatives that won't hinder investment in future growth.

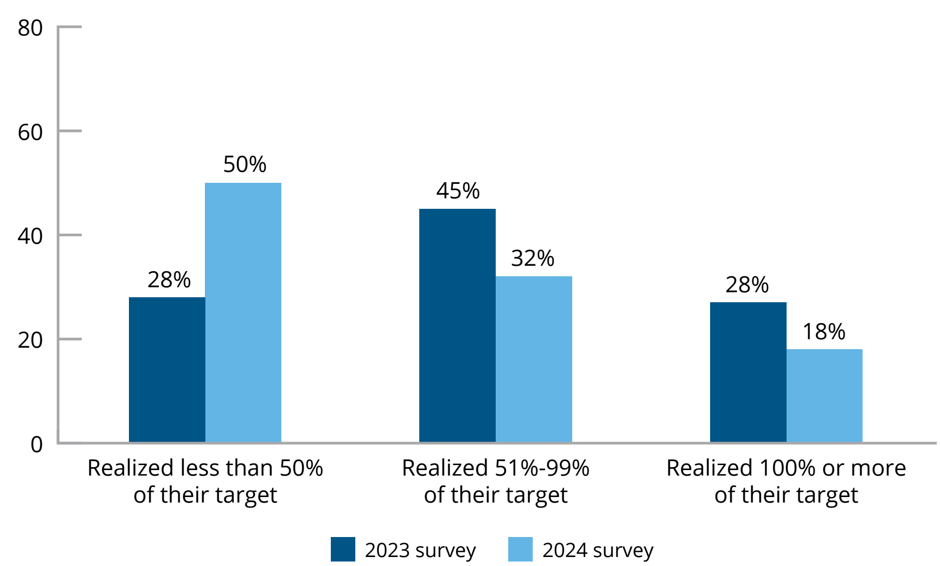
But after spending several months doing so, they may soon find themselves devoting a few years to rebuilding capabilities they need to serve a suddenly revived marketplace. Dismounting from that dizzying ride calls for envisioning what's over the next hill.

Moreover, cost-cutting measures—often seen as fairly straightforward exercises—don't always deliver the expected results. Consider this: in the 2024 MarginPLUS study, more than four out of five companies that participated in the survey, 82%, reported that they had fallen short of their cost-reduction targets. That represented a significant increase from the 2023 survey, when that proportion reached 73%. In addition, half of these companies achieved less than 50% of their set targets, a 79% increase relative to the previous year's survey (see Figure 1). More than half of the 300 surveyed senior business executives cited "challenges with technology infrastructure" as their chief internal barrier to cost control.

The message is clear. An initial investment in technology could boost the odds of successful cost-cutting initiatives. By aggregating and analyzing data across different businesses and product lines, CFOs and other leaders can uncover which potential cost-reduction initiatives are likely to offer the biggest return on investment in terms of protecting future investment in growth. By standardizing data across different businesses and product lines—and making the data easily accessible—CFOs and other leaders can uncover cost-reduction initiatives that won't hinder investment in future growth. Past that, CFOs can leverage a variety of tools, ranging from advanced analytics to automation solutions, to drive improvements through automation in functional process areas such as procurement, tax compliance management and reporting. Data visualization tools can help finance leaders share the analysis with C-suite colleagues.

Keep in mind, however, that cost optimization requires an enterprise-wide, panoramic view. Taking a siloed approach can result in actions that boost results for the next quarter but do little to preserve options for the long term. For some CFOs,

Figure 1. Amount of cost-reduction target realized



Source: "*2024 MarginPLUS study: Refocusing amidst uncertainty*," Deloitte Development LLC, 2024.

that may require investing in replacing walled-off networks with holistic systems that can make information instantly available throughout the organization.

Understanding the intertwined relationships between company functions is a critical part of cost optimization. Spending cuts in one part of the business might have an unwanted impact downstream. Generative AI may also help in assessing the impact certain cuts will have on the larger value chain. Ideally, CFOs could use the aggregated and analyzed data to proactively identify areas where technology may help improve efficiency.

Found money

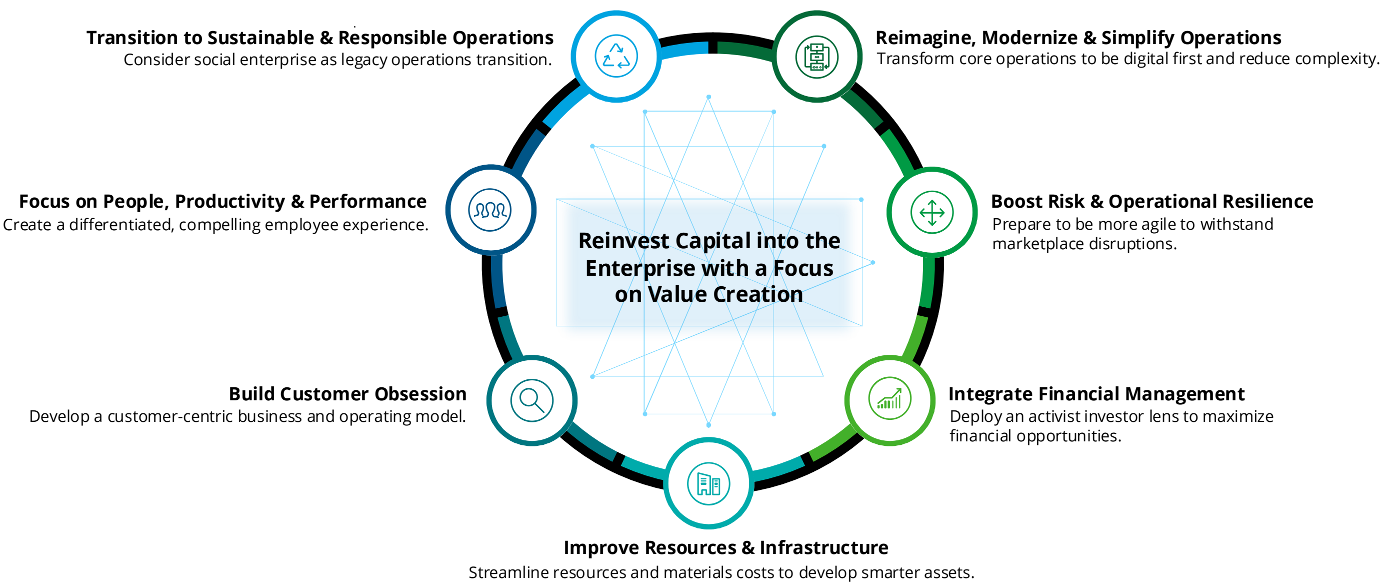
With costs from an entire company to choose from, how do CFOs pinpoint areas that are ripe for optimization? And what tools can serve them best in freeing up capital for reinvestment and growth?

The answers differ depending on the industry (see accompanying story, "A tale of two industries"). Deciding which areas to focus on requires knowing what drives long-term success in that particular sector. Banks may prioritize standardizing and streamlining data flows or using strategic pricing more effectively. Manufacturers might be drawn to rethinking product engineering or asset maintenance and management. No matter the industry, the overall approach to cost optimization changes less than the exact steps it takes to implement it.

After identifying which project to take on, CFOs will want to take a look at a set of drivers that could boost results. Indeed, these seven levers (see Figure 2) can go a long way in helping to achieve gains from cost optimization.

Figure 2. Unlocking the promise of cost optimization through 7 levers

The 7-levers framework is a way to operationalize and approach cost optimization in a more holistic way. The circular framework helps to show the interactions between the levers—pull on one, there's impacts across the organization. In the center, there is a focus on reinvestment back into the enterprise for growth.



Source: Operational Efficiency & Resiliency, Deloitte Global, 2024

Once in place, a cost optimization strategy can serve as an ongoing effort designed to identify and capitalize on efficiencies and weed out costs and processes that are holding back an organization.

Understanding the interplay among the levers is key. Management can't consider modernizing or simplifying operations, for example, without considering people, productivity, and performance.

In addition to identifying where to save costs across organization, finance teams may find it helpful to come up with an enterprise strategy for investing the capital. Depending on the industry, that may mean putting money into supply chain modernization or rethinking some products to improve sustainability and changing others to services.

Once in place, a cost optimization strategy can serve as an ongoing effort designed to identify and capitalize on efficiencies and weed out costs and processes that are holding back an organization. Pursuing such initiatives may put the organization on track to earn a higher market valuation, enable improved financial flexibility, and maintain a sustainable competitive advantage.

Stocked options

In the longer term, cost optimization can mature into a management process for allocating resources and continually improving the business. Cutting costs, typically a periodic event, hardens into a mindset. In a growth cycle, the business may be better positioned to unleash capacity to serve the market; come tougher times, it may be better insulated than it might otherwise have been.

For CFOs and finance teams, holding onto the new mindset requires adopting—and keeping—a big-picture perspective. Cutting costs in one functional area almost invariably affects the overall organization. In addition to factoring in price elasticity, companies need to consider what might be called "quality elasticity." Before a company opts to reduce its cost of materials, its leaders need to know whether the resulting drop in quality could cause consumers to flee or run up warrantee costs.

Recently, some consumer products companies who couldn't pass higher input prices on to consumers ended up changing the configuration of their products. Some decreased the sizes on their packages rather than raising prices. So-called "shrinkflation" drew enough public complaints that the White House earlier this year called for a bill that would authorize the Federal Trade Commission to use regulations to curb the practice.[1]

For companies, there may be preferable options.

A tale of two industries

Putting cost optimization to work in sectors with distinct challenges and priorities

A cost optimization strategy can be most effective in industries where companies are eagerly looking for opportunities to grow, despite challenges ranging from margin pressures to economic uncertainty and increasing competitiveness. In other words, just about every industry.

As examples, consider two widely different sectors: consumer-facing companies like retailers and consumer packaged goods manufacturers, and the energy, resources, and industrials sector, including power and utility companies, energy producers, and industrial manufacturers. Each has distinct challenges and priorities, yet these sectors have shared imperatives to increase operational efficiency in a way that fuels their longer-term success. To that end, many organizations in both sectors are laser-focused on objectives like working with strategic partners, optimizing physical assets, streamlining supply chains, capitalizing on advanced automation—including artificial intelligence—and more effectively managing their people.

Power structure

Under traditional cost management models, organizations often encounter a common pitfall: to achieve short-term profitability, they may sacrifice investments in the company's future. Electric utilities are navigating this issue by investing in advanced technology that can open new avenues for cost optimization.

The power sector has historically been asset intensive, requiring substantial investments in physical infrastructure, including power plants, transmission lines, and distribution networks. Traditionally, utilities relied on a centralized operating model, generating power and distributing it in one direction to customers. But now, many are moving to a more decentralized approach, in which energy moves to and from the customer as residential and commercial customers are becoming power producers. This change is underway due to increased investment in distributed energy resources, namely electric vehicles, rooftop solar, and digital technologies that allow bidirectional flow of power.

This bidirectional flow of data allows utilities to integrate these distributed energy resources into the distribution system and optimize costs across these assets. Real-time data on EV charging levels or power generation from rooftop solar panels can help utilities divert energy to where it's most needed and reduce curtailment. In some cases, the additional storage or generating capacity can offset the need for additional infrastructure spending.

The potential cost savings and efficiencies can be significant, but first, utilities may need to invest capital upfront in upgrading legacy data systems. Utilities are also investing in building out their AI toolkit to make their operations more resilient and mitigate costly risks.

Next-generation outsourcing

In retail, some companies are looking for partners who can drive transformation and provide continuous innovation. In other words, the focus has shifted from cost-cutting centered on transactional, non-mission-critical functions to driving better, shared outcomes in areas closer to the heart of the business.

Even what might be considered core capabilities may be outsourced. These may include tasks such as space management and the creation of schematic plans that retailers develop to display merchandise so as to maximize sales. Such tasks can be managed by external partners, who have dedicated resources and technology to help drive innovation and optimization.

Unlike the more traditional outsourcing models, which focused mostly on transaction processing, these sorts of strategic partnerships can help navigate the organization's future resilience while keeping costs from ballooning—which is, after all, the ultimate goal of cost optimization efforts.

End notes

1. "What is shrinkflation? Here's why consumers may be getting less for their money," CNBC.com, March 17, 2024.

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