Delivering Profitability

A Consultant's View

Chapter 6 - Expense Savings and Cost Recovery as Tools in Driving Expense Efficiency

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Expense Savings and Cost Recovery as Tools in Driving Expense Efficiency

In this chapter we shift our focus from strategy to tactics. If you have been following along, by now you've reviewed your strategy, understand the value of customers, considered ways to enhance leadership and organizational structures and you've even used financial analysis to better understand financial performance. If you're still not hitting or exceeding your financial goals, it's time to roll up your sleeves and review the details of your expenses: category by category, vendor by vendor, contract by contract and line item by line item. Reviewing these details with a simultaneous high level and detailed approach is important because often, results of a high level review impact the details or, vice versa, something seen in the details will reveal an opportunity at a higher level. Expense savings and cost recovery are two valuable tactics used to reduce expenses and boost net income.

Expense savings is a method of reducing the total expenditure of a company. The savings component typically refers to the opportunity to reduce future expenses. Depending upon the company's goals and objectives, these savings may include salary and benefits, external purchases and capital expenditures.

Cost recovery projects typically focus on the past rather than the future. They seek to obtain a refund on expenditures already made and paid. These efforts are often difficult in that they require not only identifying an error but also getting the vendor to agree that an error was made and they over-collected funds based on that error.

> As a simple example, if we reviewed the utilities category for a client and found they had a big hole in a pipe that was leaking natural gas, our finding the leak would be considered an expense savings because the client could take actions to stop the leak of future income. Either the client could contact the utility company or, if the client was responsible for the repair, they could do so, ending the leakage of gas and reducing future gas bills.
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> If the utility was responsible for the leak, we could identify that it had occurred over several years, and we were able to obtain a refund for the increased costs due to the leakage, this would be considered cost recovery.

Why does a business need to spend time, energy and money to do a deep dive on expenses? Isn't it someone's job to review these things every month? The answer is "Yes" and "No." Yes, companies expect that each bill that is paid is reviewed by one or more people before being paid. Typically, these reviews are done by the person who ordered the product or service and an accounts payable clerk. This is of particular importance to larger companies, because generally speaking, employees fulfill a single specific role within that organization, and these issues typically span more than one person's job. Often issues develop that one person cannot address, because they do not have the "big picture" view and those people with the "big picture" view don't have time to drill into the details to uncover cross departmental issues.

For example, whose job is it to make sure every line item in a legal contract is being followed?

- Is that the legal department who helped write the contract?
- The procurement (or sourcing) department that helped negotiate the contract?
- The business unit manager for whom the work or product is being purchased?
- The AP clerk who processes the bill? Or
- The tax department who may be responsible for sales tax?

In larger companies there are many moving parts and most people view their job as fairly specific to their role. Without someone taking a broad view of how all these elements fit together, some important items are bound to slip through the cracks. Generally, those who have a broad enough view to see how everything fits together are too busy managing the big picture, their time too valuable to spend drilling into details. In fact, in my 20 years of consulting experience, I have yet to see a company that wasn't overlooking a number of important issues that were costing them significant net income.

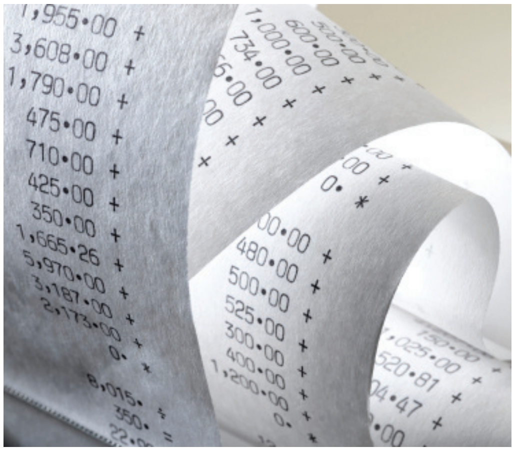
Conducting a Cost Recovery and Expense Savings Project

To begin exploring opportunities for expense savings and cost recovery, one should begin with the big picture. Gathering sufficient context before drilling into the minutia of details will save time and resources in the long run. Team members who understand the big picture, yet are willing to drill deep into the details, are essential to a successful review. Often, when many seemingly disparate dots are connected, the value of the opportunities that are uncovered is remarkable.

> At one company, the accounts payable department explained that sales tax was the responsibility of the tax department. The tax department, however, felt that sales tax belonged to the accounts payable department because it was collected on purchases. Later was revealed that responsibility had bounced back and forth between the departments and neither felt they had enough information to ensure that the company was paying the correct amount. Senior management's perception was that it was just a little dispute between two departments not wanting more work, but as our analysis progressed we found that neither department had fully been managing the sales tax issue, and many opportunities existed for reviewing and recovering from overpayments.

Although starting with the big picture helps to better understand what issues may exist as one drills into the details, there are more opportunities than can be identified through high level discussions alone. It's also important to let the data and line item details bubble up opportunities.

In conjunction with management and staff interviews, a review of previous studies and information prepared within the company may also point to opportunities. It not uncommon for a larger company to hire a firm to identify savings and recovery opportunities, but be pulled in a new direction before changes can be implemented and the savings fully realized. A client-oriented financial consultant should consider any previous work when preparing a new evaluation, in order to obtain as much value as possible for their client. This includes a



review of prior evaluations and gaining an understanding of why those opportunities were not implemented. Perhaps a business unit was being restructured and the time wasn't right, or perhaps a major new piece of technology was being rolled out that would somehow impact the opportunity. These are important considerations when examining present opportunities.

After speaking with key people and reviewing past studies and internal documents, it's time to drill into the numbers. Ideally, this examination should begin with the most detailed information available associated with each transaction, over the greatest period of time. It is not unusual to begin with a file that includes every transaction for several years, along with cost center code, cost center roll up, expense category, vendor name, data of transaction, payment date transaction, payment notes and other information. It's far easier to discard irrelevant information than it is to recreate needed information which isn't available.

The data is fed into an analytics program such as TIBCO's Spotfire which rapidly summarizes and sorts data by various fields of interest. Based on that information, along with information collected from interviews, external data, past experience, and clues which may point to issues and opportunities, we begin to prioritize expenses for review.

After the initial review, the team develops Opportunity Hypotheses, which are initial preliminary ideas on opportunities that might exist based upon the cursory review of the data. This helps identify what opportunities are likely to be of greatest value in reviewing, and allows us to bring together both the contextual information we gathered during interviews, review of past studies and the salient facts gathered through the data collected.

Once the hypotheses are collected, discussed and prioritized, the team conducts a more in-depth review of the related data. This may lead to gathering additional data to support or refute the hypotheses by reviewing contracts or original invoices and speaking with those responsible for the expense. Occasionally, with client approval, the team may contact a vendor to better understand a potential issue by looking for possible record-keeping discrepancies.

This additional information is developed into a business case, which states the background and context of the opportunity in simple, easy to understand language. Giving a detailed description of the change being recommended, a proposal is made of how to best recollect on over payments and/or save on future expenses. The business case includes financial data for the current situation and a forecast of the potential value of the opportunity to the client. It provides a roadmap for change and also indicates issues and pitfalls that the implementation team needs to consider.

The business case is presented to the management team for their review and discussion to determine which opportunities have the greatest value for company. They approve the business case, determine the resources necessary to help implement the opportunity and delegate responsibility to those tasked with implementation of the plan.

Prior to implementation, a best practice is to agree upon the metrics of key performance indicators to be tracked that will determine if the anticipated goals were reached. Assigning an individual the responsibility to track the outcomes of the project ensures that the full value of the opportunity is realized.

Is there a difference between the process for Cost Recovery and Expense Savings?

From the high level, both processes are very similar and are closely related. Both involve speaking with the same people in the organization, and the most of the data reviewed is the same or similar. The difference is in the details:

- Cost recovery projects spend more time reviewing past expenditures, with a focus on correcting past mistakes and oversights.
- Expense saving projects review past expenditures with a forward focus. Less effort is spent on past errors and more emphasis is placed on what can be done differently in the future.

> As CFO for a non-profit with approximately $5 million in annual revenue, I reviewed every line item of expenses using an approach similar to the one detailed above. One line item which came to my attention upon review was Workers Compensation Insurance. The organization was spending approximately $80,000 a year. The incumbent commercial insurance broker suggested the cost was fixed by the state and nothing could be done to reduce this expense. However, after further review and discussions with another vendor we found it was possible to have an audit of our state classification, which was established when the organization was initially formed in 1986. Over 20 years, the focus of the business had changed. After additional research to ensure there was minimal risk involved in requesting such an audit, we did so. The state audit resulted in a revision of classification and a massive annual expense savings of $72,000 – a clearly defined value to the organization.
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> In addition to the expense savings found, it was revealed that the state had a policy which allowed for a misclassified organization to receive an audit refund for the previous 3 years of over charges. This resulted in a cost recovery of over $210,000 – an amount nearly equal to all individual donations made to the organization during the previous 12 months.

Are there differences in the value created from cost recovery and expense savings projects?

Both types of projects focus on producing specific, measureable results that impact Net Income. Strictly defined, cost recovery projects tend to only produce one time value - the value of dollars returned to the company - whereas an expense savings project can produce value for many years to come. Although expense savings projects tend to produce far more total value than cost recovery projects, some believe cost recovery projects produce a clearer value because receiving a refund check is more tangible than the concept of saving dollars not yet spent. While there is validity to this argument, expense savings can be clearly achieved and defined as well.

The specific opportunities found as a result of cost recovery and expense savings projects can vary widely and can be relevant to any line item. The key is to look from both the perspective of a high level and from the details upward. It's just as important to look across categories, across business units and at systemic company processes as it is to examine as specific errors in contracts or vendor agreements.

> The economy was down and the industry had just been through major changes. It would never be the same. Complicating matters, an internal study had shown that most of the nearly $300 million in the expense base of the company was relatively fixed. The analysis indicated that their expenses would remain relatively constant as their revenues declined, foretelling of increasingly large losses in the future.
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> The management team asked us to present various methods and approaches to reducing expenses. After further discussion the management team choose to have us focus on a General Ledger and Accounts Payable File line item expense review, where we would be paid on a contingent basis only for opportunities we identified and the firm decided to implement.
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> Within three weeks we had identified over $5 million in suspected opportunities. Upon presentation to the steering committee, some opportunities were passed on to an internal team, and others were marked for further expansion into fact-based business cases. On a bi-monthly basis, our project team presented business cases requested in previous sessions along with a new series of hypotheses.
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> At project completion 14 weeks later, we had identified over $40 million of suspected opportunities and had approval for over $1.2 million of detailed business cases. The management team implemented plans which were anticipated to save over $10 million in expenses, cost savings and even provided a few revenue opportunities. The company was also happy to have realized approximately a 2,000% return on its consulting investment (roughly 20 times project expenses).

Some key items to consider when conducting a cost recovery or expense savings project:

- Start with the largest expense items first
- Look for items overlooked by other departments or groups
- Use hypotheses to rapidly identify potential opportunities and solutions, then validate once management agrees in principal the opportunity is worth pursuing
- Consider expenses which seem to be regulated or beyond the normal scope of procurement or sourcing

Some other important details to look for include:

- volume of item(s) consumed or wasted
- rate paid for item(s)
- invoicing errors
- contractual errors or miss billing
- duplicate payments
- accounting and expense classifications
- fraud
- best match purchase quality, demand and pricing
- volume discounts

About ClarityFI

Clarity FI is a financial business management consulting firm offering Strategic and Financial Consulting, Part-time / Time Sharing Chief Financial Officer (CFO) Services and Financial Dashboards. We help organizations understand financial decisions and mine information and data to chart the clearest path to success. We partner with management to optimize customer experience, optimize product pricing, reduce costs, and engage employees and customers to produce tangible, achievable results. The bottom line? We want to help you increase income, save costs, and watch your profits soar.

About the Author

Mr. David Wagstaff has twenty years of leadership, financial management and consulting experience providing business insights, strategic financial analytics, and executive leadership.

He is the Managing Principal and Founder of Clarity FI, focusing on strategic financial management, CFO Services and financial dashboards, analysis and insights. He has experience working with companies that range from large Fortune 100 businesses to entrepreneurial start-ups. Previously, Mr. Wagstaff served as a Managing Consultant, Senior Manager, Enterprise Business Solutions. His corporate responsibilities have been well balanced with successful personal ventures.

Mr. Wagstaff earned his MBA from the University of Maryland, Smith School of Business in College Park, MD, with a concentration in Finance, Accounting and New Venture Creation. He earned his BS in Economics and Business Management from Ithaca College in Ithaca, NY. He is an outstanding member in his community as an active member of the social services organization having served on the Board of Directors and Executive Committee of the board at both Time Out Youth and Family Services of Montgomery County. He is also proud to have been a NJ Foster Parent.

He currently resides in Collingswood, New Jersey with his Partner. He enjoys hiking in the mountains, the beautiful scenery of nature, swimming, water and snow skiing and sailing.