

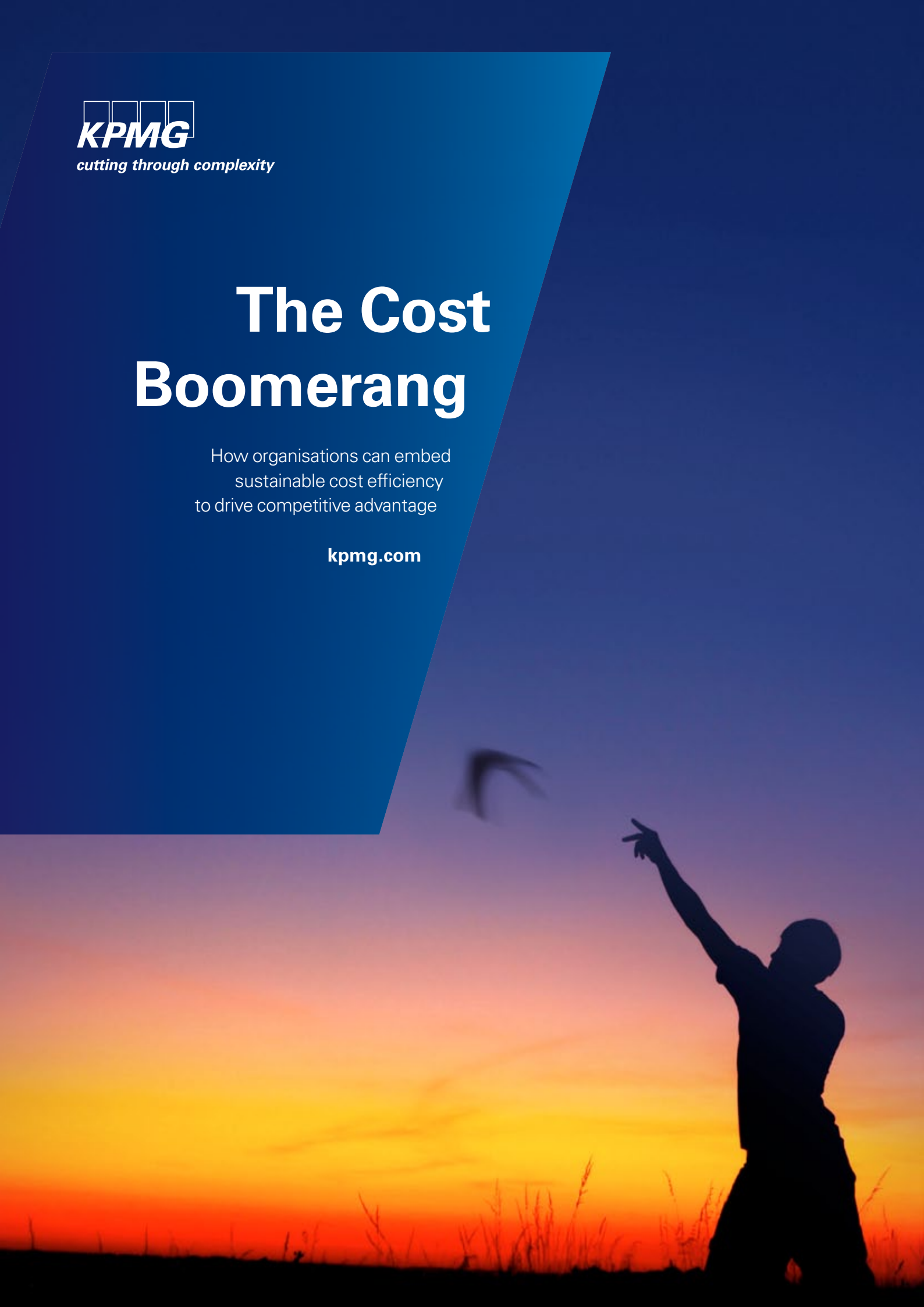


*cutting through complexity*

# The Cost Boomerang

How organisations can embed sustainable cost efficiency to drive competitive advantage

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# Foreword

As the world economy starts to slowly move towards growth, many companies are finding that the deep cost cutting measures they undertook to survive the financial crisis are looking increasingly unsustainable.

As the recession gripped the economy, many businesses took immediate action to reduce costs and shore up balance sheets. But in reality, the majority of these cost-cutting actions often focused on chasing short-term benefits without due consideration of long-term sustainability.

As a result, cost efficiency has quickly become one of the key opportunities for organisations seeking to gain competitive advantage in a predominantly slow growth economy. But to achieve this, organisations will need to turn their recession-induced diet into a sustainable lifestyle change.

Amidst this rapidly changing business environment, KPMG conducted research into organisational cost-cutting measures across a number of EU jurisdictions (the UK, Germany, the Netherlands, Switzerland, Spain, and – to a lesser degree France, Italy, Austria and Belgium) to highlight some of the best practices and opportunities facing companies as they strive to sustain their cost-efficiency gains.

What we found was a massive opportunity for those organisations that are able to significantly raise the cost efficiency bar by examining more strategic options for cost-cutting, fundamentally changing their business and organisational models, and instilling a cost-conscious culture throughout their workforce.

For CEOs, CFOs and COOs in particular, this research provides valuable insight into the challenges faced by their employees and their peers across Europe, and sets a clear benchmark for leveraging cost consciousness to drive financial results.

These findings hold important implications for companies in this post-recession era, and highlight the clear and present danger of what we are calling 'The Cost Boomerang'. And while changes may be painful to implement, organisations that get this right will enjoy sustainable and efficient cost management that will almost certainly deliver a significant competitive advantage.

On behalf of KPMG, I would like to thank the respondents that participated in this important research. We hope these findings encourage organisations across Europe – and the world – to re-examine their cost structures and make sustainable changes to ensure long-term corporate viability.

**Martin Scott**, Partner  
Performance & Technology  
KPMG LLP (UK)

July 2011

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## Executive summary

During the turmoil of the financial crisis, most companies across Europe were single-mindedly focused on cutting costs in an all-out effort to survive the recession.

But today, corporate costs are roaring back into the business. And while a certain level of cost will inevitably be expected to return to the business as growth picks up, many of the effects of the cost boomerang may – in fact – be avoidable.

Taking a closer look at the figures one quickly realises that not all companies are seeing costs increase at the same pace. For a few organisations across Europe, the recessionary-fuelled cost cutting exercises of the past three years have offered a valuable opportunity to identify and execute cost efficiencies that are proving resilient in the face of growth. And today, these organisations are starting to see the fruits of that labour in the form of higher margins, more flexible working capital and – ultimately – greater competitive advantage.

For the rest, this data stands as a clear imperative for executives to re-examine their approach to cost-efficiency by turning their recession-induced diet into a sustainable lifestyle change.

Our survey highlights a number of critical findings for European executives. For example, we found that:

- The vast majority of cost reductions made during the recession (93 percent on average) are not believed to be sustainable;
- costs are quickly creeping back into the business as many companies turn their back on cost-cutting measures to refocus their attention on growth;
- most executives believe that costs will return across the board, with significant increases expected in the cost of finance, salary inflation and rebuilding headcount; and
- around 45 percent of respondents suggested that their organisation did not have a clear enough view into their component cost base to make sustainable cost-efficiency decisions.

While these findings provide a significant challenge to executives seeking to make their organisations more efficient, keeping costs out of the business for good will require companies to focus on creating a high level of cost-consciousness in their workforce that encourages employees to contribute towards active cost management. Here too, our research has identified a number of critical challenges facing most European organisations. These include:

- a Grade Fade effect where frontline workers display a diminished level of cost-consciousness versus senior management and middle managers;
- a significant percentage of employees claim to understand the direction and strategy that has been set for cost management, but also report encountering a Knowing-Doing Gap where they do not feel empowered to make suggestions or effect change in the company's cost performance; and
- many employees, particularly on the front line, identified a Capability Gap, suggesting that they do not feel they have the proper tools, skills or training to foster significant change.

But the return of cost is not inevitable. In fact, as more organisations begin to focus on creating sustainable cost efficiencies, cost management will continue to be an area of competitive advantage that will be keenly fought over by executives around the world.

As this survey and accompanying analysis clearly demonstrates, there is an immediate need for executives to maintain their rigorous focus on cost management and take fundamental measures to embed a cost-conscious culture within their organisations. The prize for those that are able to do this successfully is the ability to release cash to re-invest funds in the most profitable areas of the business, and ensure they are in the most competitive position to grow during a recovery.

To achieve this, organisations will need to take a hard analytical look at their organisation to identify where profits are generated. For many, this will mean taking an 'external investor approach', viewing their organisation through the eyes of a potential investor to generate a rapid view of where value is created within the organisation and the opportunities that result from that.

Based on these survey findings, we have developed five key recommendations for driving sustainable cost-efficiency in the post-recession business environment:

- 1) Maintain cost management as a strategic priority**  
Do not allow cost efficiency to drop down the priority list and align cost management with your other strategic priorities
- 2) Adopt an external investor mindset**  
Challenge your own organisation in the same way a potential investor would, unconstrained by current organisational boundaries and perceptions
- 3) Create profit and cost transparency**  
Continually seek to improve your organisation's understanding of where profit is generated and cost is consumed
- 4) Engage front line workers**  
Seek to instil a greater sense of ownership within your front-line staff and line managers
- 5) Equip staff to 'walk the walk'**  
Invest in the tools and training to enable your employees to fully participate in creating cost efficiencies

We believe these findings have important implications for European companies and provide a unique benchmark for organisations seeking to turn their cost savings initiatives into real and sustainable competitive advantage.

# Section 1

## The Cost Boomerang

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Costs that were only recently eliminated as a matter of survival are starting to fly back into the business at an incredible pace. Few companies believe their recession-driven cost measures to be fully sustainable during times of growth, and a significant number don't have access to the right information to make sustainable cost efficiency decisions.

Whilst growth prospects remain uncertain across most European countries, many organisations are facing a real risk that mounting costs will quickly erode their already tight profit margins and eliminate bottom line growth.

In this environment, businesses that are able to identify and exploit sustainable cost-efficiencies will enjoy significant competitive advantages over their peers: better profit margins, more flexible working capital and a greater alignment for future growth.

Those that aren't, however, seem destined to remain at the mercy of the economy, doomed to a cycle of market driven cost-reductions and reactive, knee-jerk survival strategies.



# Section 1.1

## The Return of Cost

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As the global financial crisis turned into a deep recession, most companies looked for quick-hit cost-cutting measures that would maintain profit margins and sustain the bottom line.

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**Respondents expect a 6% increase in their cost base this year**

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**The majority of organisations have not implemented the more radical and sustainable cost efficiency measures**

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**Smaller organisations are 3 times more likely to have discontinued unprofitable business lines than their larger peers**

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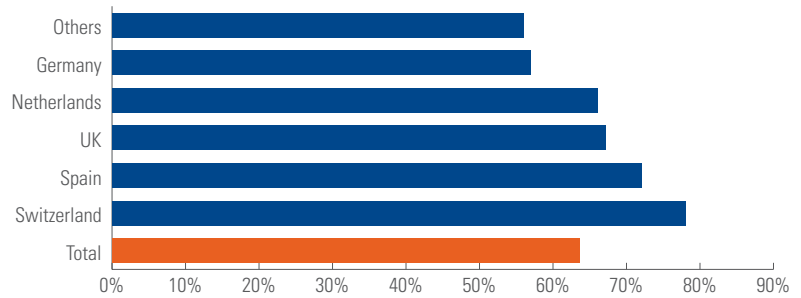
Our research indicates that – while more than 60 percent of European companies cut costs during the recession – these measures tended to be applied inconsistently across countries and sectors.

For example, Swiss respondents were at least 20 percent more likely to say they had reduced costs than their neighbours in Germany (the country with the lowest rate of citing cost cutting measures). This is likely due to a more flexible Swiss labour market and a tendency towards larger international footprints.

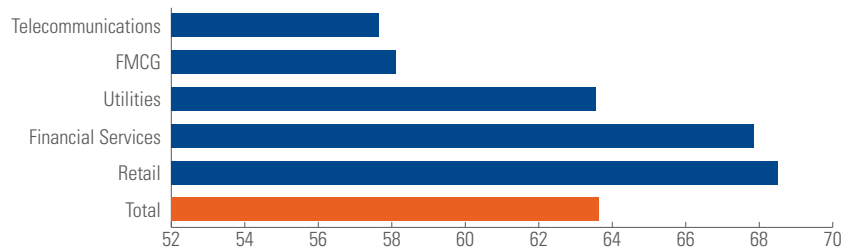
However, across sectors, cost-cutting measures were somewhat more uniformly applied. Even so, respondents in the Financial Services and Retail sectors reported a higher reliance on cost efficiencies during the recession than those in the Telecommunications sector where cost-efficiency measures rarely involved fundamental reviews of business models and therefore did not significantly impact the mix of services that were offered. Of course, the recession took a particular toll on financial institutions and consumers, making these two segments more vulnerable to the impact of cost. Retailers may well have had a ‘double hit’ as consumers moved to online sources to achieve lower cost purchases.

According to our survey, European companies focused much of their recessionary cost-cutting measures on reducing service levels, simplifying the use of technology and conducting better risk management. However, many of the longer-term (and more sustainable) measures such as outsourcing (both domestic and offshore) and the divestiture of unprofitable businesses were less likely to be cited by respondents. Our findings also show that companies of less than 10,000 employees were – on average – three times more likely to have discontinued unprofitable business lines than their larger peers, possibly indicating a lack of visibility on the part of larger organizations into the areas of the business that drive profitability, and a tendency towards less decisive decision making than their mid-sized peers.

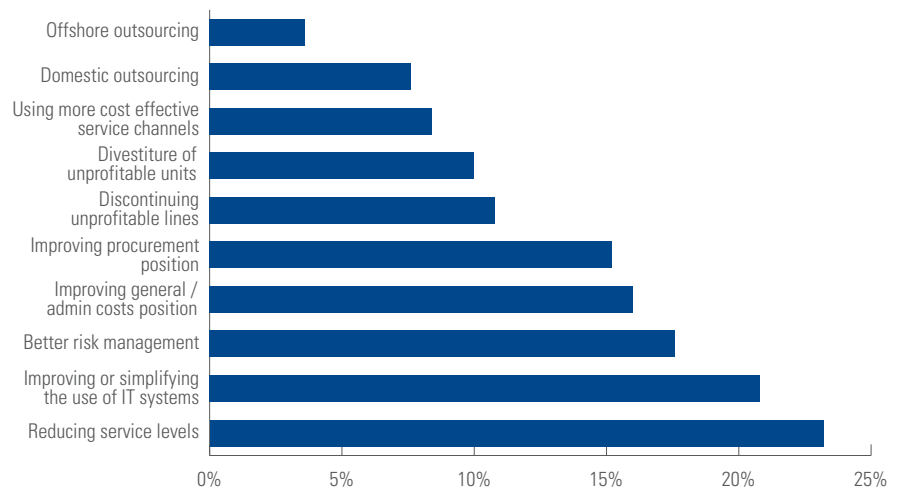
**Percentage of organisations that said costs were reduced during recession (by country)**



**Percentage of organisations that said costs were reduced during recession (by sector)**



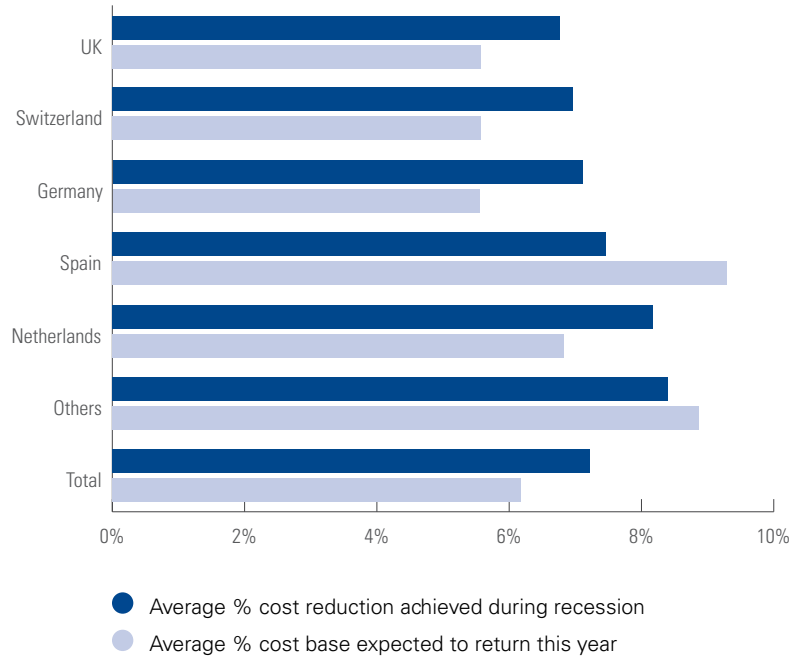
**Sample of measures identified as ‘major cost saving area’**



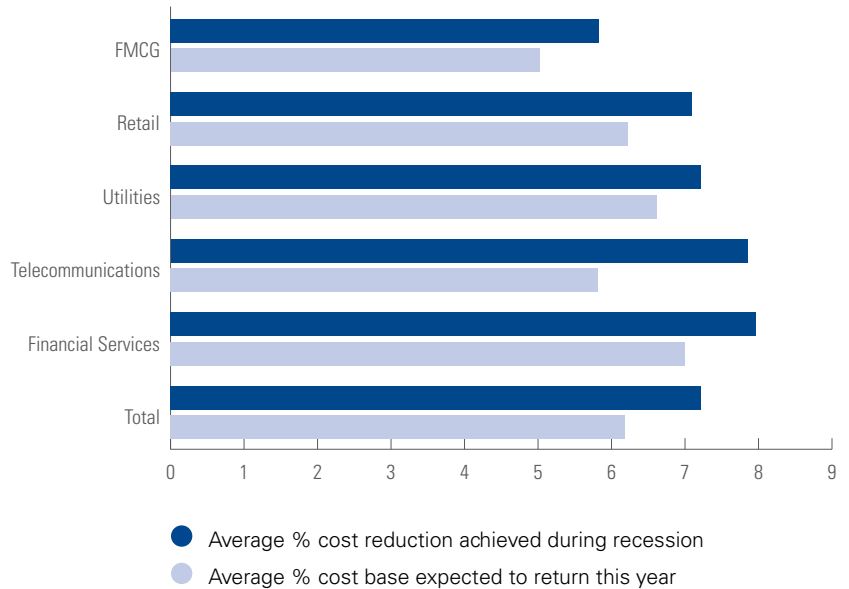
Across the board, costs are widely expected to creep back into the business. When looking at the expected percentage of cost increases against the reported cost savings, some countries, notably Germany and the Netherlands, seem to expect cost increases to settle at a level slightly below the savings they gained from cost reductions. But others are less confident in the sustainability of their actions. Spanish respondents, in particular, expected costs to increase above their pre-recessionary levels between 2010 and 2011.

In this regard, respondents from the Telecommunications sector seemed to indicate a slower return of cost than their counterparts in other industries. At the other end of the spectrum, Utilities respondents were much less optimistic, and seemed to suggest that most of their cost savings will roar back into their business in the short-term. For Utilities in particular, however, many of the massive capital expenditures (such as infrastructure development) that were delayed during the recession are expected to be brought back online, which will likely result in a significant level of cost increases in the short-term.

**Comparison of average percentage cost savings made during recession and average percentage of cost base expected to return this year (by country)**



**Comparison of average percentage cost savings made during recession and average percentage of cost base expected to return this year (by sector)**



## KPMG VIEWPOINT

Clearly, the hard-earned cost savings of the past are now being exposed as largely unsustainable, and respondents expect a sizable chunk of these costs to come back into the business in the short-term. Faced with uncertain growth prospects, executives will need to maintain some of the strong cost disciplines seen during the recession and gain a stronger understanding of where value is generated within their organisations. Armed with this information, they can then ensure that additional costs are invested in the strategic priorities of the business.

In our experience, many businesses (particularly the larger organisations) find it difficult to generate objective analysis and take more radical decisions that are required to make a step-change in the cost base. For example, it is telling that only one in

ten respondents indicated that they had discontinued unprofitable lines or units of their business, exactly the type of action that results in sustainable cost efficiency. The increased likelihood of smaller organisations to have discontinued unprofitable business lines (at 12 percent versus 4 percent for larger organisations) illustrates the difficulty that larger organisations have in understanding profitability at a granular level, and their tendency to be slower at taking more radical decisions. This is often due to the complexities of the decision making process and multiple layers in the organisation. An evidence-based understanding of where value is created is critical to inform and speed-up the decision making process.

As executives face up to the challenge of redoubling their cost management efforts, we would

urge them to look at their organisation in the same way a prospective investor would, which is in our experience, one of the most successful techniques to identify, quantify and prioritise potential value creation opportunities.

By taking this stance, executives can identify target areas where a potential buyer would either expect to achieve cost savings or add additional investment to raise productivity. Using a mixture of analytical techniques (such as internal and external comparisons of the overall cost to serve, benchmarked against competitors, and qualitative comparisons of different ways of working), we have found that organisations can identify significant and sustainable cost efficiencies (typically in the range of 15 percent and above).



# Section 1.2

## Sources of Cost

Where will costs boomerang back into the business? The simple answer is everywhere.

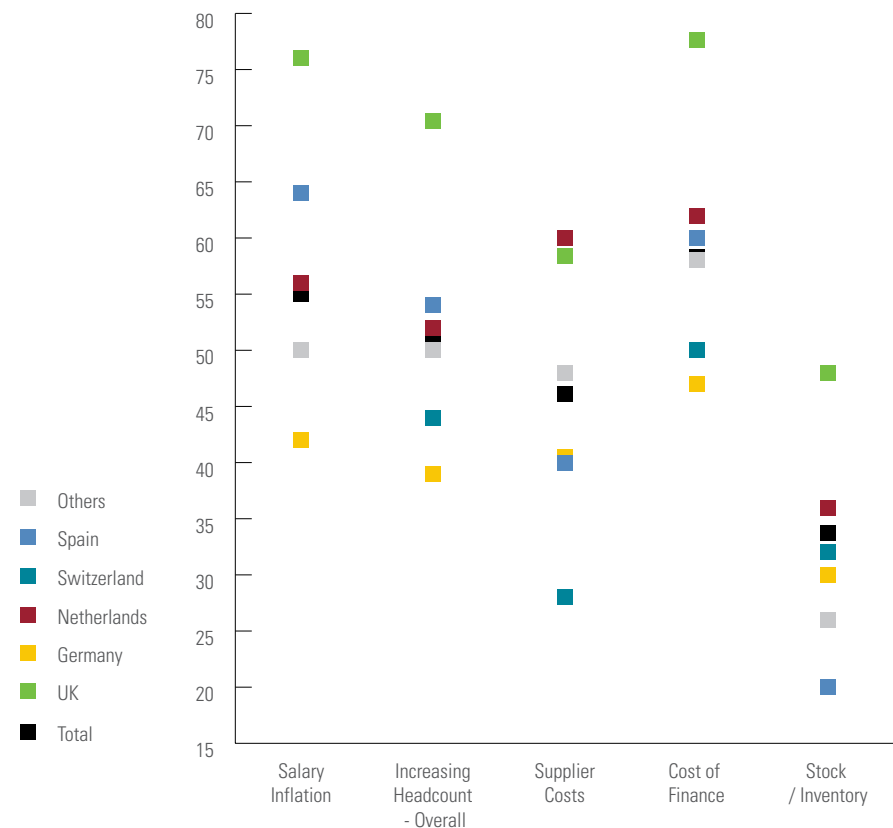
**58% expect the cost of finance to be a very or quite significant source of cost increase**

**Salary inflation also expected to be a challenge by 55% of respondents**

Respondents to our survey were fairly evenly split as to where they were likely to see the most significant sources of cost increases: many pointed to the cost of finance and increasing headcount, suggesting a growth strategy; others cited external pressures such as salary inflation; somewhat fewer identified items such as stock / inventory costs and supplier costs, which are more indicative of a re-establishment of pre-recession stock levels.

Across the region, the expected sources of cost increases varied. In the UK, more than two thirds of respondents felt that costs would return through salary inflation and a higher cost of finance, while 70 percent expected cost increases in headcount. In contrast, less than half of the respondents from both Germany and Switzerland expected significant cost increases in any of the five categories. The majority of Dutch respondents cited either the cost of finance (62 percent) or supplier costs (60 percent), possibly belying the trade-based nature of the Dutch economy, while Spanish respondents demonstrated a clear concern about significant cost increases through salary inflation (64 percent) and the high cost of finance (60 percent).

Percentage of respondents citing the cost area as a 'very' or 'quite' significant source of cost increase for 2010 – 2013 (by country)



For respondents from the FMCG segment, cost concerns seem centred around the potential for salary increases in the aftermath of the recession, and the spectre of heightened supplier costs as the impact of higher raw material costs percolates through the supply chain.

Retailers, however, are concerned about most sources of cost, particularly in salary inflation, headcount increases and the cost of finance. This is most likely due to a growth strategy that – for retail – is heavily dependent on real estate and personnel costs. The Retail sector also tends to be a closer-knit ecosystem, where employees move from one retailer to another, leading to lower levels of ‘cross-germination’ of ideas and best practices from other industries, and higher salary costs as senior members are ‘poached’ from peers by way of higher wages. Retail respondents were also the most likely group to expect significant cost increases in inventory, which – in our experience – indicates the sector’s ongoing struggle to build efficient and lean supply chains.

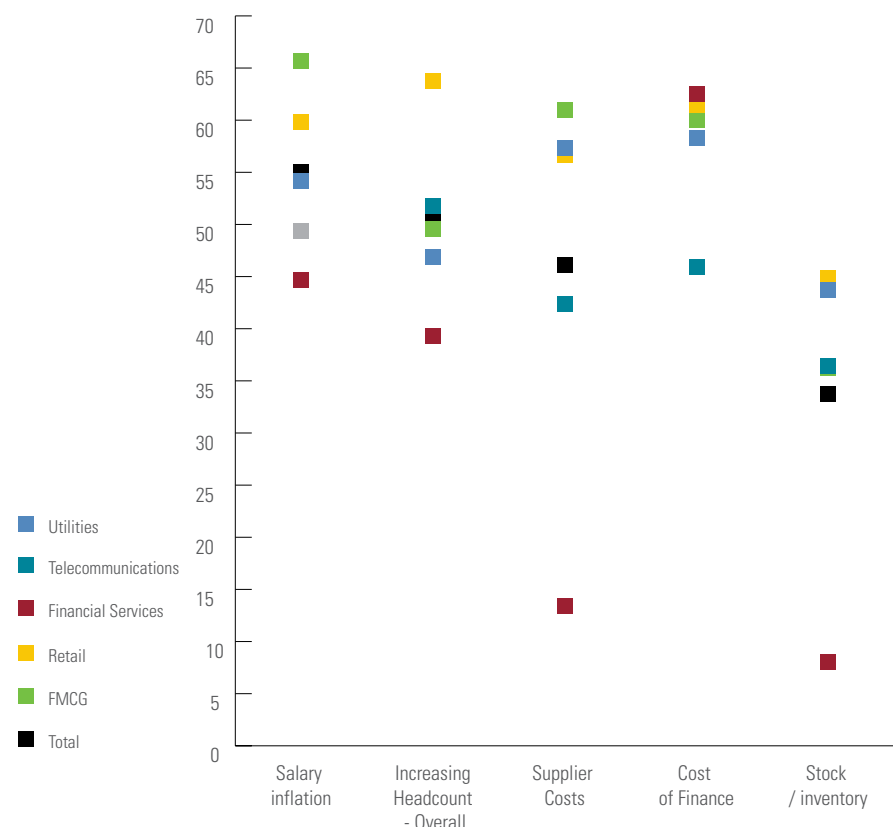
Respondents from the Financial Services industry were very clear about where they expected to see significant cost increases. The high cost of finance, obviously a critical component of profitability for banks, ranked as the most common concern in this sector. Indeed, for the Banking sector in particular, the cost of finance is a fundamental issue as the entire business model is based on their ability to borrow and lend money, the cost of which has a direct impact on their margins. Headcount increases and salary inflation were also noted. For insurance executives, however, the increased cost of regulatory compliance is also driving up operational and salary costs as organisations seek to streamline their processes and recruit accountants and finance professionals with experience in regulatory change programmes. And as can be expected for this sector, concerns over supplier or inventory costs were extremely low.

Telecommunications respondents were more likely to cite increased costs from headcount and salary inflation, indicating the high reliance on human resources to grow the business. However, supplier costs and stock and inventory costs were also frequently cited, likely as a result of the proliferation of mobile devices and the perpetual drive to implement better technologies (such as 3G and 4G networks). And while many telcos are already restarting their capital investment projects that were put on hold during the recession, consolidation in the industry (such as the merger of T-Mobile and Orange in the UK) will mean significant change for cost bases. With almost two-thirds of respondents indicating increased costs in new

product development, telco executives will continue to see a shift in their cost base as they move away from infrastructure and towards service-focused applications instead.

More than half of Utility respondents cited the cost of finance (largely related to the large number of capital expenditure projects that are in the pipeline), supplier costs (symptomatic of the rapidly increasing cost of commodities) and salary inflation (resulting from the need to attract and retain scarce highly-skilled employees, particularly to support large infrastructure projects). However, given that expansion in the Utilities sector is often extremely capital intensive, and the prices of raw materials is clearly on an upward trajectory, these results may also signal a growth strategy for this sector.

Percentage of respondents citing the cost area as a ‘very’ or ‘quite’ significant cost increase for 2010 – 2013 (by sector)



## KPMG VIEWPOINT

Understanding the sources of potential cost increases is a critical first step in creating a more sustainable cost environment, allowing organisations to take a longer-term view of cost management. While some of these costs – particularly those stemming from external forces – may be impossible to mitigate, executives that are able to achieve a clear vision into the cost base will be better prepared to eliminate costs that are either unnecessarily or are not aligned to the company's future growth strategy.

So, for example, rather than 'restocking the warehouse' to meet expected demand, executives will want to carefully consider their existing supply chain and distribution processes to understand where the greatest costs lie or where more efficient opportunities may deliver sustainable cost savings.

Organisations will need to redouble their cost-management efforts to make sure that their recession-driven cost improvements are not lost in the exhilaration of renewed growth. This may mean, for example, maintaining some of the tight headcount controls enforced during the recession and ensuring that any headcount increases are focused on the business units or functions that deliver the most value and achieve the highest margins, rather than instinctively staffing up the traditional growth areas such as Sales & Marketing.

And, while many industries and countries reported lower concern for some of these sources of cost, this may actually be a symptom of a lack of clear insight into the actual cost of these sources rather than a pervasive belief that their impact will be insignificant.



# Section 1.3

## Driving Sustainable Cost Efficiency

Why are costs returning so quickly? Most believe it's because past cost cutting measures were conducted unsustainably.

**93% of costs made during recession are not expected to be sustainable**

**34% agree that, with hindsight, the cost of rebuilding capability will be greater than the costs they saved with cuts**

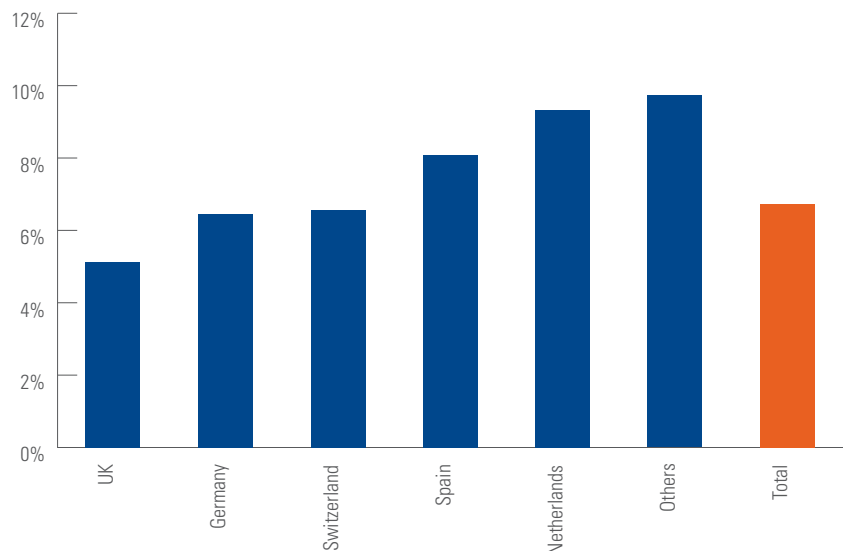
As the full impact of the recession started to take hold in the minds of European executives, many organisations took a 'cut at all costs' approach: IT projects were put on hold; R&D sat idle on workbenches awaiting new funding; travel and training budgets were cut; and headcount reduction targets were mandated across the enterprise.

But none of these strategies delivers sustainable or long-term cost efficiency. In many cases, executives are now finding that the cost of rebuilding or reinitiating those projects may actually cost more in the long run than was saved through their cost cutting measures.

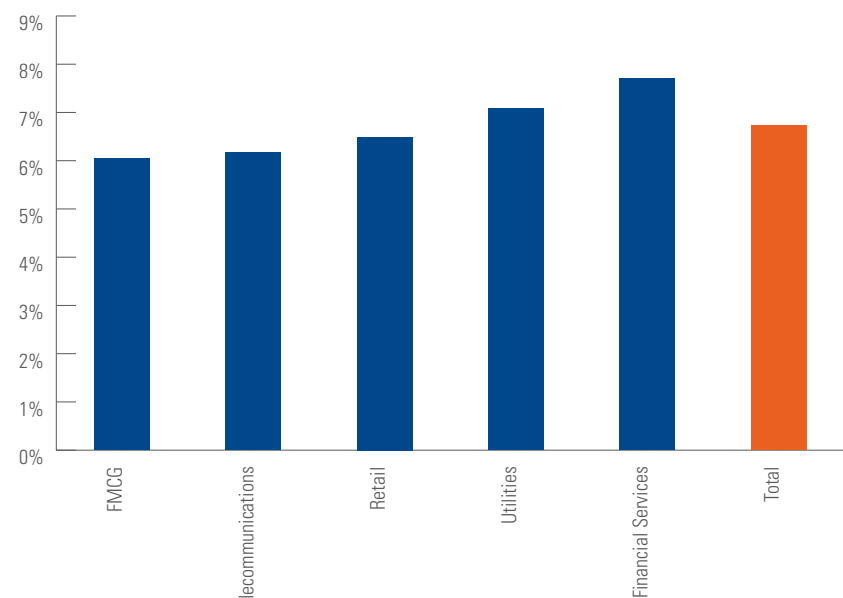
In fact, no country or sector in our survey expected to be able to retain more than 10 percent of their earlier cost efficiencies. Respondents from the UK seemed particularly bleak about their ability to retain earlier momentum, and overall expect to sustain slightly more than five percent of their savings. In this regard, the Dutch seemed the most optimistic with respondents suggesting they may be able to sustain almost ten percent of reductions in the long-term.

Interestingly, when these statistics are examined across sectors, it becomes painfully clear that the cost boomerang phenomenon is widely expected to cross sector lines. Almost across the board, respondents felt that only around seven percent of their cost reduction measures would prove sustainable in the long-term.

Average percentage of cost reduction likely to be sustainable in the long term (by country)



Average percentage of cost reduction likely to be sustainable in the long term (by sector)

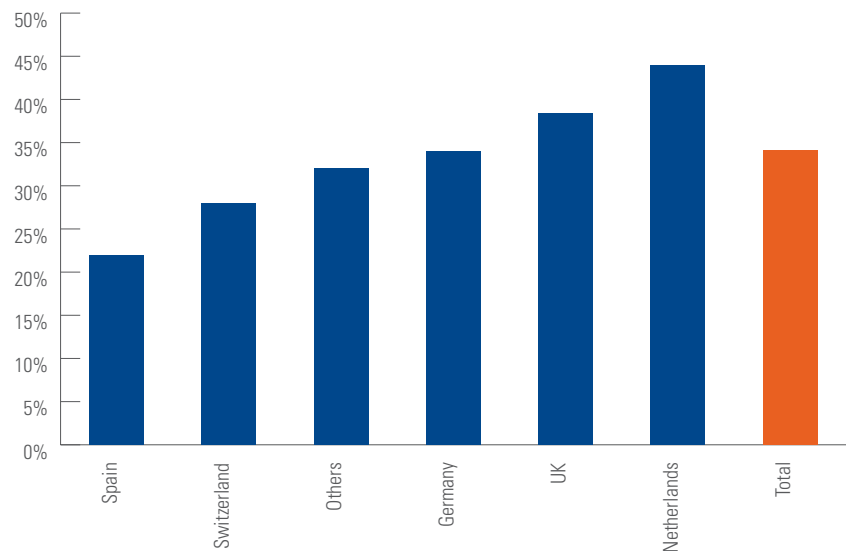


And while respondents from the Financial Services sector seem somewhat more bullish in expecting cost-efficiency measures to be sustainable, further cost-efficiencies related to headcount reductions will be difficult to achieve without severely impacting service levels, meaning that banks will increasingly need to focus on adjusting their cost structures to focus on profitable lines of business in order to gain sustainable cost-efficiencies in the long-term.

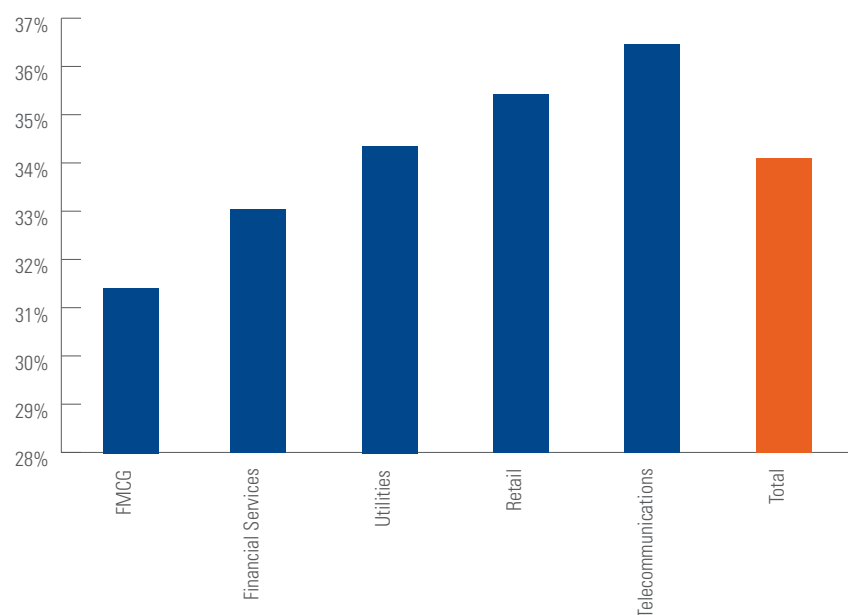
Indeed, many executives may already be feeling the sharp side of the cost boomerang. More than a third of executives surveyed for our report admitted that, with hindsight, the cost of rebuilding capacity will be greater than the costs they saved with cuts. And while only one in five Spanish respondents agreed with the statement, this may be a result of ongoing debt concerns in that market at the time of the survey.

From an industry sector perspective, respondents in the FMCG segment, and – to a lesser degree – the financial services sector, seemed to be more optimistic about their ability to manage costs overall. On closer inspection, however, this may be a result of a lack of visibility into the actual costs of the business. A typical FMCG company, for example, bears between 60 to 70 percent of their costs in their supply chain (including product development, manufacturing and product delivery), but – with a lack of visibility into the specific granular costs – are largely unable to make key decisions on how to reduce them. As a result, the more visible costs (such as people) tend to be targeted even though these are a comparatively small proportion of overall costs. And given that both the retail and telecommunications industry rely heavily on investment to grow, it is not surprising that they stand out as the most likely to suggest that costs will surge back in greater strength than they left.

#### Percentage of respondents who agreed with the statement “With hindsight, the cost of rebuilding capability will be greater than the costs we saved with cuts” (by country)



#### Percentage of respondents who agreed with the statement “With hindsight, the cost of rebuilding capability will be greater than the costs we saved with cuts” (by sector)



## KPMG VIEWPOINT

If businesses are really serious about reducing their cost base and making that reduction sustainable in the long-term, then they must be prepared to challenge the accepted business model orthodoxy which underpins everything they do.

But to truly achieve this, businesses will need to take a different perspective on their organisations. If not, the pervasive inability to see beyond long-held operational constraints will continue to restrict businesses' ability to make real inroads into their cost base.

Without objectively challenging these embedded ways of working, businesses are limited in the scope they have to make substantive changes in areas which could deliver real cost efficiency — such as their operating models, geographic footprint or product mix. This is especially true for organisations that have been forced through a number of rounds of cost efficiencies, as many are reaching the laws of diminishing returns within their current operational constraints. For some, this will create a number of challenges such as knowing what assets to sell, what to outsource,

choosing more cost effective channels to market or using more efficient tax strategies.

And while reducing headcount is a highly visible and transparent cost-efficiency measure, many executives — particularly in the FMCG and Retail sectors — will often find that a one percent improvement in supply chain costs will have a far greater impact than a one percent reduction in people costs.

But stripping out cost is hard, dirty work. And while those that lose focus may well still achieve growth, it may be unprofitable growth. But those that persist with cost as a Board-level strategic concern will create space within which to grow their margins and secure a real competitive advantage.

This will require a longer-term redistribution of funds to squeeze greater value from the organisation. Releasing cash through cost efficiency initiatives enables organisations to free up and then re-invest funds in the most profitable areas of the business, and ensure they are in the most competitive position to grow during a recovery.



# Section 1.4

## Alignment and Information Flow

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How do organisations develop sustainable cost-efficiency measures? With greater alignment to their cost base, and more timely and accurate cost information throughout the organisation.

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**77% of respondents have plans to significantly change their cost base in line with their future growth strategy**

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**Only 66% believe that accurate, timely cost information is available at an appropriate level of detail to the Finance community**

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**Just 56% agree that there is clear visibility into the component parts of the cost base**

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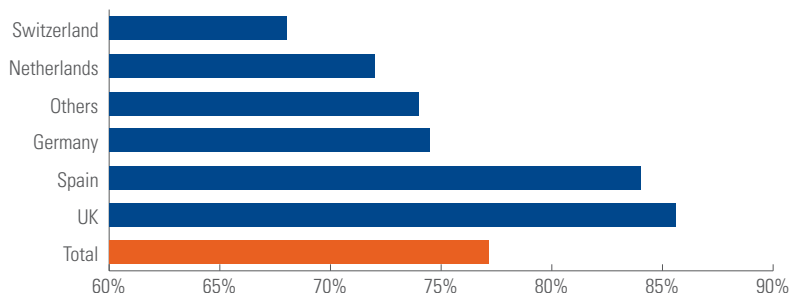
Creating sustainable cost-efficiency is about more than just cutting costs. It requires organisations to create greater alignment between their cost base and their growth strategy to ensure that increasing costs are targeted to areas that support and facilitate growth. The alternative is tantamount to throwing good money after the bad.

For the vast majority of respondents, creating alignment to future strategy is a critical imperative. In particular, respondents from the UK and Spain were most likely to suggest that their cost base required significant change to align to their future growth strategy. This indicates that these respondents are either more keenly aware of their current lack of alignment, or have more significant growth plans than their peers in other jurisdictions. On the other end of the spectrum, Dutch and Swiss respondents suggest that they are about 15 percent less likely to focus on cost alignment than their peers in the UK.

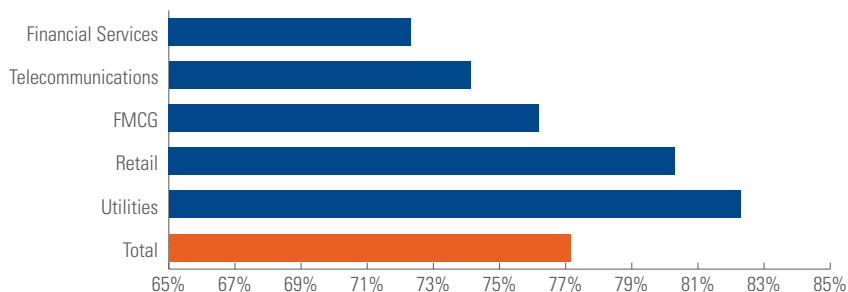
Similarly, respondents within the Utilities and Retail sectors were also very likely to cite a need for significant change to their cost base in order to align with their future growth strategy versus those in the Financial Services industry. This may signify the wider growth opportunities that face Utility and Retail respondents (arguably requiring greater capital investment than similar growth in Financial Services or Telecommunications). At the same time, many Financial Services organisations have traditionally put a low emphasis on cost management (in preference of revenue generation) resulting in a low level of capability around effective cost management.

Larger organisations tend to suggest a greater need for significant change in cost alignment than smaller peers. In our experience, this is often indicative of the heightened complexity (both operational and political) that tends to surround larger organisations, which often makes this type of alignment more challenging to accomplish.

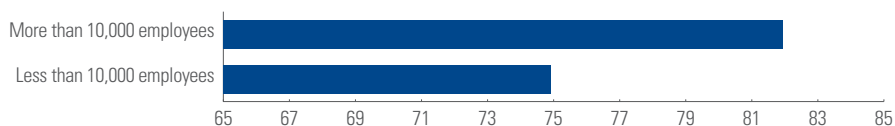
**Percentage of respondents who definitely or possibly plan to significantly change their cost base in line with their future growth strategy (by country)**



**Percentage of respondents who definitely or possibly plan to significantly change their cost base in line with their future growth strategy (by sector)**



**Percentage of respondents who definitely or possibly plan to significantly change their cost base in line with their future growth strategy (by organisation size)**



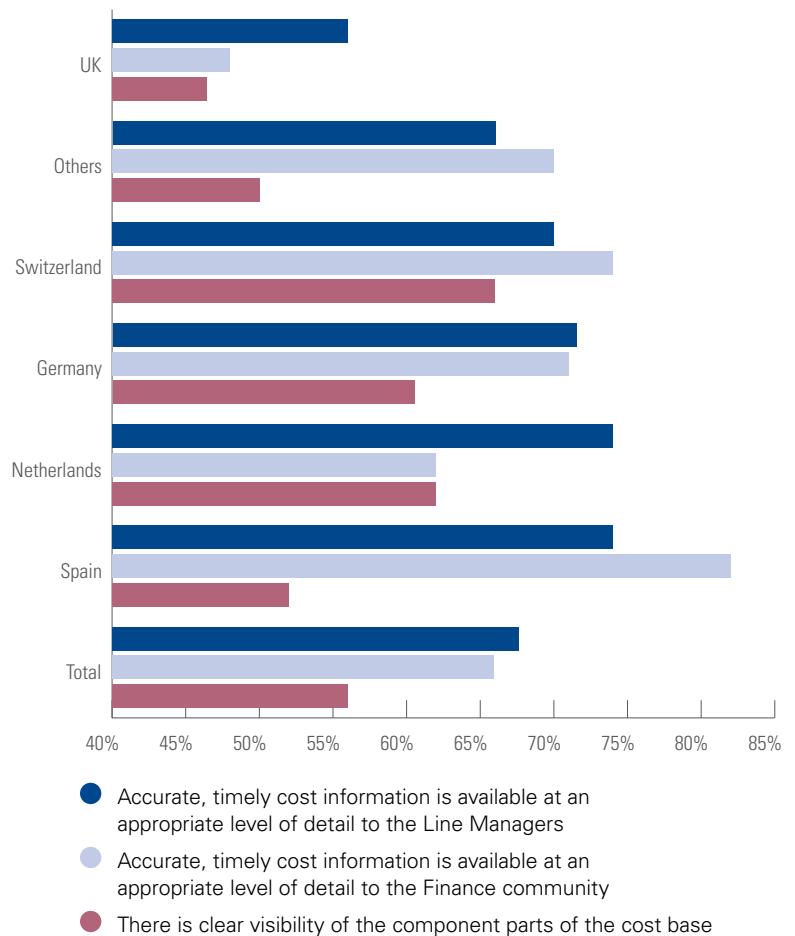
But to create truly sustainable cost-efficiency measures, companies must focus on providing accurate and timely cost information at an appropriate level of detail to support decision making. And based on our research, there is still some room for improvement across the board.

For instance, only two thirds of respondents believed that their finance community had the appropriate level of information to make sustainable cost-efficiency decisions. This belief is particularly prevalent in the UK, where less than half of respondents agreed that information to finance was sufficient. Line Managers were generally thought to have better access to this critical information than their peers in Finance. In the Netherlands, for example, 62 percent felt that Finance had the right level of cost information, while almost 75 percent believed that Line Managers were privy to the right level of information.

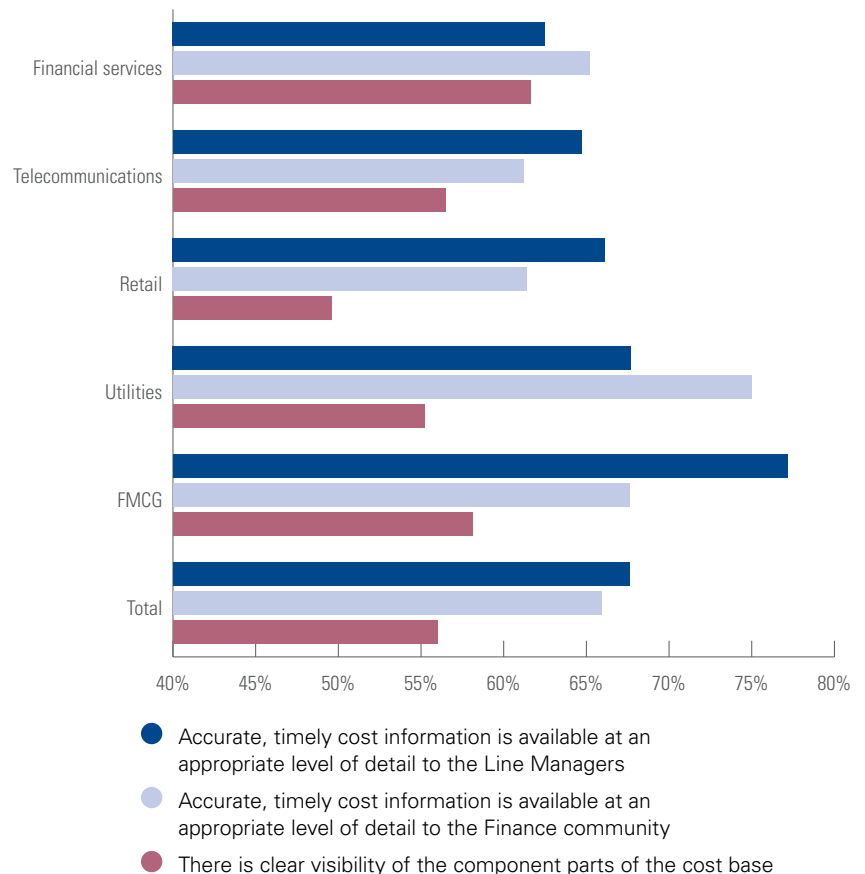
However, the most telling finding to come out of this section of the report was that only slightly more than half of respondents felt that there was an appropriate level of visibility into the component parts of their cost base (such as internal charges) or that the proper cost component reports were being made available to the responsible managers. The situation is particularly dire in the UK where only 46 percent felt that the right level of visibility was available and slightly less so in Spain where just 52 percent suggested the same.

Similar findings can be drawn from an examination of the various sectors. For example, line managers in the FMCG sector seem to indicate greater access to cost information than their respective finance departments, which is largely a result of heavy investment into ERP systems and Business Intelligence tools that deliver more information and control over data (however, this often leads to an overabundance of data that, paradoxically, diminishes decision making capacity). At the same time, less than half of Retail respondents felt that they had clear visibility into the component parts of their cost base and just over 60 percent suggested that their finance department had access to timely and accurate cost information,

### Timely cost information - percentage of respondents who agreed with the statements (by country)



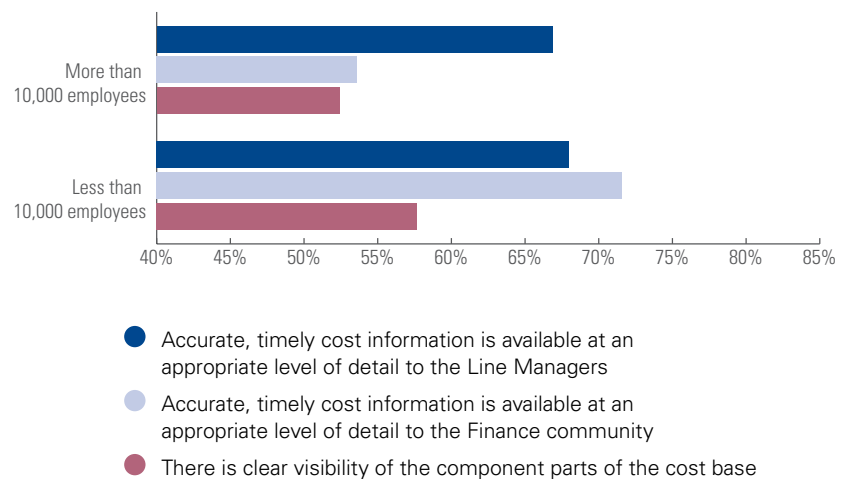
### Timely cost information - percentage of respondents who agreed with the statements (by sector)



possibly reflecting a historically low investment in business information systems as a result of low margins.

Not surprisingly, smaller companies tended to report an advantage in creating visibility into the component cost base and providing the right information to the right people. For example, 71 percent of respondents from organisations with less than 10,000 people told us that their Finance community had access to timely and accurate cost information, versus only 54 percent in larger organisations. Smaller organisations were also about five percent more likely to report clear visibility into their cost base.

### Timely cost information - percentage of respondents who agreed with the statements (by organisation size)



## KPMG VIEWPOINT

From this data, it is clear that many European organisations are aware that their cost base is not aligned to their future strategy. And while this certainly points to a dire imperative for realignment, executives may find themselves repeating some of their earlier cost-cutting mistakes unless their organisations are able to make accurate and timely cost information available to line managers and the finance department.

To create sustainable cost savings, companies will need to ensure that decision-making is driven by profitability, return on investment and quality of earnings. In other words, organisations will need to understand the true profitability of a customer or product account based on all business activities and overhead costs incurred to service a specific customer or get a certain product to market.

However, many larger businesses across sectors seem to have also lost much of that visibility,

especially those that have centralised large swathes of cost for efficiency purposes. These costs generally get ‘anonymised’, disconnected from the outputs, and often get out of kilter with the true level of affordability in the local markets. For example in the telecommunications sector, a historical preference for ‘bundling’ services and internal cross-charging has led to a complex web of cost allocations that is rarely understood or properly measured, and therefore makes cost-efficiency measures more difficult to identify and leverage.

Again, adopting a ‘transaction mindset’ can help overcome these challenges, leaving little to chance and ensuring all decisions are based on hard facts and driven by a detailed cost to serve analysis. This granular level of transparency helps inform often difficult, but necessary, cost management decisions in order to deliver more profit through sustainable and aligned cost management.

# Section 2

## Embedding a Cost Culture

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Creating a cost culture is about more than mandated measures and top-down initiatives. It requires everyone in the business to be fully engaged, cost-conscious, and pulling in the same direction.

To measure cost-consciousness, KPMG has developed the Commercial Engagement Index, a diagnostic tool that benchmarks and analyses employee attitudes and behaviours towards cost, and their understanding of the economics of the business.

In almost every situation, we have found that organisations that embed a culture of cost consciousness are significantly better positioned to identify and leverage sustainable cost management opportunities and – ultimately – reduce the cost boomerang effect.

But creating a cost culture is not always easy. In most cases it will require a fundamental rethink about how employees view cost, are empowered and rewarded for making sound cost-management decisions.

And while the casual observer will notice that the Retail sector provided more positive responses overall, this is largely a result of retail employees often being more engaged with the customer on a day-to-day basis and therefore enjoying a keener awareness of cost and product performance.

Across the board, however, our research has uncovered three main challenges undermining many companies' efforts to embed a cost culture: **Grade Fade**, the **Knowing-Doing Gap**, and the **Capability Gap**.



# Section 2.1

## Grade Fade

For cost measurements to ultimately succeed, employees across the organisation must participate in the cost management of the organisation.

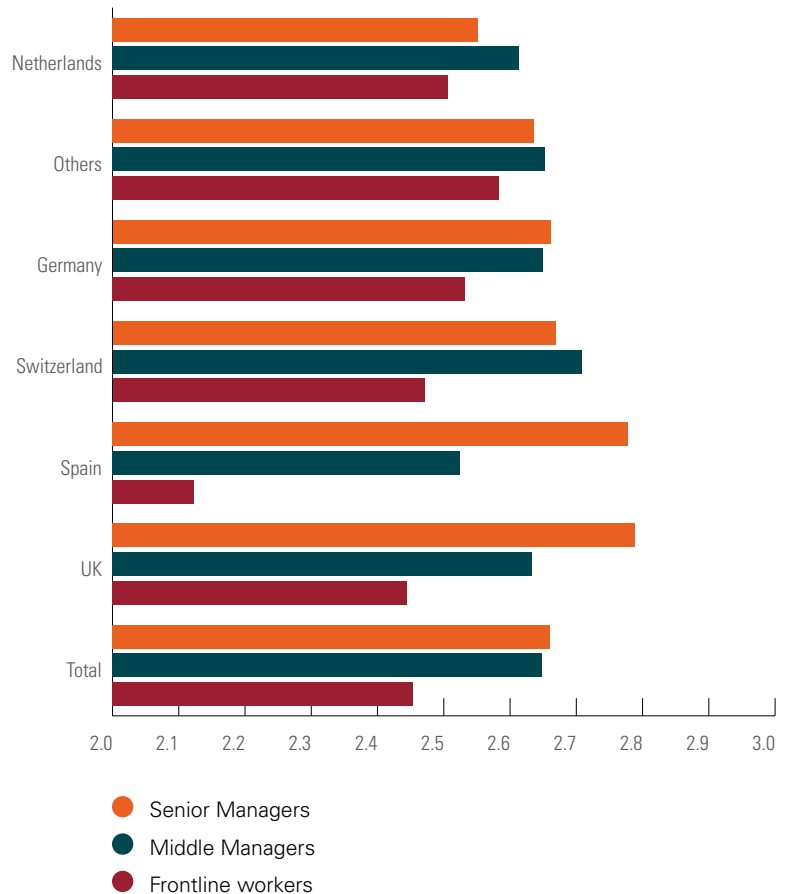
**62% of Senior Managers report having cost effectiveness measures written into their objectives this year while only 42% of frontline workers agreed.**

**70% of Senior Managers said they had put forward an idea for improved cost management within the last six months but only 45% of frontline workers said they had.**

Any cost-management effort that isn't adopted by employees is destined to fail. So it is critically important that all employees – from the frontline workers through to senior management – be aligned in the cost management process.

Our survey finds that – across all European countries – frontline employees report the lowest level of cost-consciousness, particularly in comparison to senior management and middle managers. In Spain and the UK, for example, engagement scores almost completely fall away within the middle manager and frontline employee segments. This imbalance is particularly pronounced in Spain, where senior managers report some of the highest overall engagement scores, whereas frontline workers returned by far the lowest scores of any country surveyed.

**Average overall engagement scores by grade (country comparison)**



Our Commercial Engagement Index tool scores responses on a scale of 1-5, where 1 is not engaged and 5 is highly engaged.

And interestingly, respondents from Switzerland, the Netherlands and 'other' European markets seem to indicate that middle managers may actually be more aligned in the organisational cost culture than senior management. However, in many of these markets, a strong culture of engagement within the business prevails, which may explain the disproportionately high responses for middle managers in markets where this is the case.

Looking across sectors, the challenges of Grade Fade appear to be most prominent in the Telecommunications sector where large 'field forces' are utilised and compensated by the hour or the number of house calls they complete, which often disincentivises employees to reduce costs. They are followed closely by the FMCG and Utilities sectors where frontline workers report being particularly less aligned. However, this may be indicative of the comparative distance between frontline workers and customers in these sectors. In the FMCG sector, for example, one hypothesis would be that frontline workers packing boxes on a production line are very unlikely to have any involvement with end customers and are therefore somewhat less engaged in understanding the cost implications of the business.

**Average overall engagement scores by grade (sector comparison)**



## KPMG VIEWPOINT

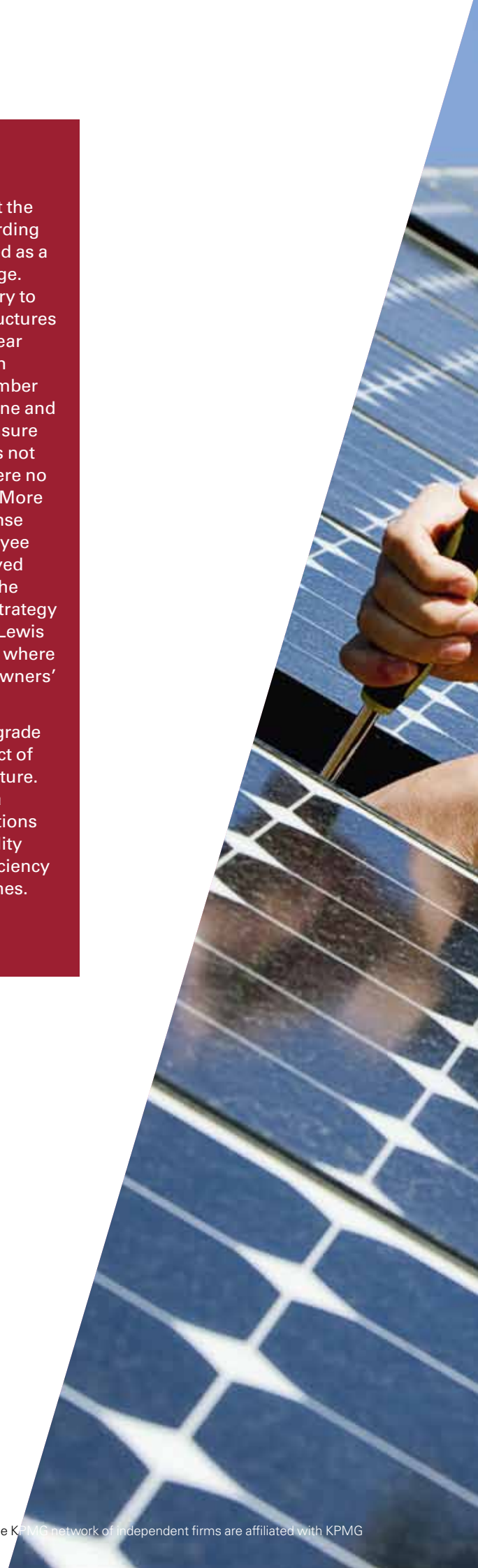
The development and execution of cost consciousness cannot be left to senior management alone. To drive sustainable cost consciousness, organisations will need to put a heavy focus on driving engagement throughout the organisation.

In part, this will require organisations to instil a greater sense of ownership within their middle-manager and frontline staff. It will be critical for these employees to have a clear understanding of the commercial operations of the business so that they understand how their role fits into the overall strategy of the business, and where they can affect positive change in the cost base of the business.

To achieve this, executives will need to do more than just communicate their plans to their employees and hope for the best. Rather, it will require organisations to take a new approach to embedding cost consciousness through better defined roles and responsibilities, broader access to useful cost information, and cost effectiveness measures that are tied into employee objectives.

The results also suggest that the traditional methods of rewarding employees may be over-rated as a way of eliciting culture change. Instead, companies should try to ensure that organisation structures are based on establishing clear accountabilities and decision rights, with just the right number of levels between the front line and the top team. This should ensure that accountability for cost is not 'syndicated' to the point where no one is actually accountable. More powerful still is to instil a sense of ownership into the employee base which will drive improved performance right through the organisational hierarchy, a strategy well-embodied by the John Lewis Partnership model in the UK where employees are essentially 'owners' of the business.

It is important not to dismiss grade fade as simply a natural effect of a hierarchical business structure. When grade fade becomes a reality, it has major ramifications for the long-term sustainability of an organisation's cost efficiency and effectiveness programmes.





# Section 2.2

## The Knowing-Doing Gap

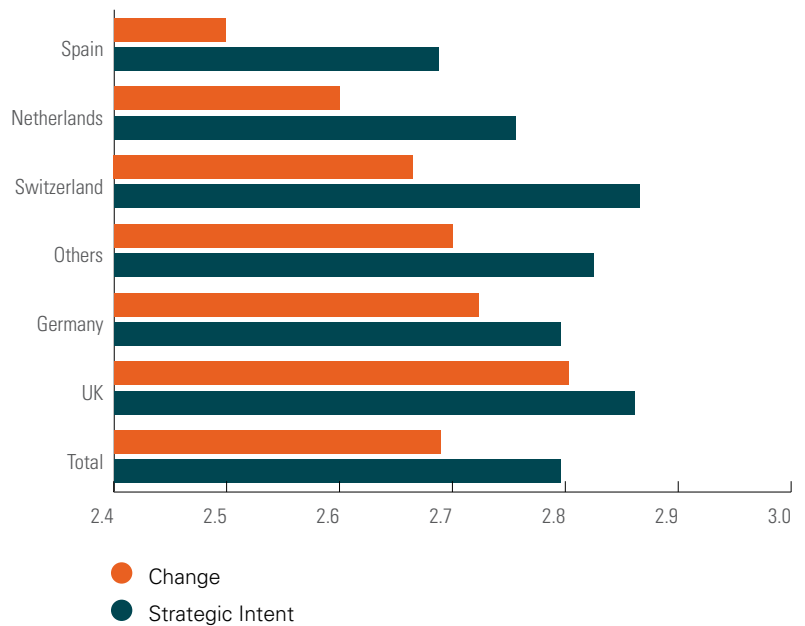
Your employees may know what is expected of them in a cost-conscious culture, but many do not feel empowered to take appropriate actions.

**88% of respondents understand how their job objectives relate to business objectives, but only 54% of respondents could boast that their organisation had created cross-discipline task forces to develop new ideas.**

It is clear from our survey that most respondents have a strong level of strategic clarity about the cost-related goals of the business and how cost management relates to business success. However, respondents were much less positive about their perceived ability to suggest innovative steps to transform cost management practices or to take action on issues related to managing cost.

This divergence between knowing what is expected and taking appropriate actions is clearly a challenge for respondents from Spain, Switzerland and the Netherlands. Spain, in particular, achieved comparatively low scores in the 'change' category, suggesting that Spanish employees feel much less empowered than their peers in other countries.

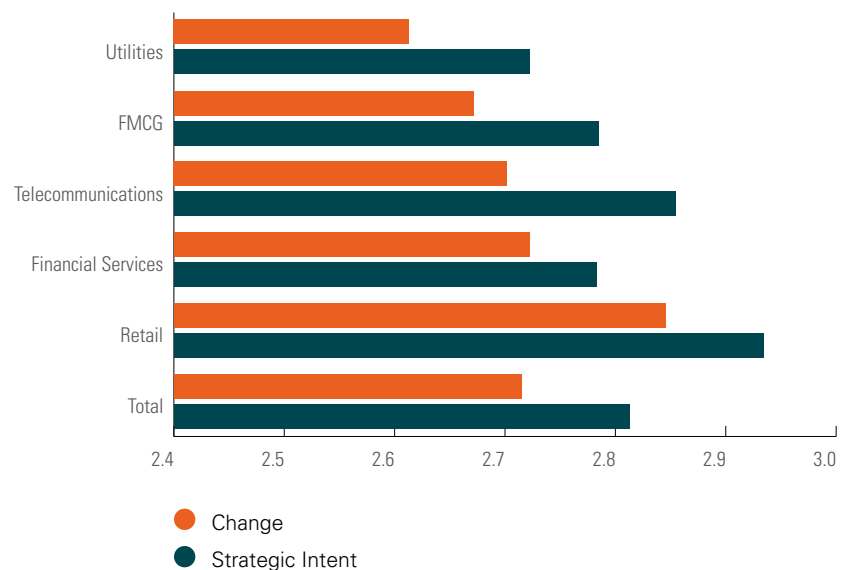
**Average engagement scores - Strategic Intent Vs. Change (country comparison)**



Once again, there seems to be a sizable knowing-doing gap affecting certain sectors, specifically in Utilities and FMCG. However, in most cases this may be indicative of a preference for safety and security of supply over cost-management initiatives. In a similar fashion, respondents in the Telecommunications sector also indicated a larger gap between their levels of understanding the strategic intent and their perceived ability to effect change.

However, for respondents in the Retail and Financial Services sectors, progress in this regard seems promising, with much smaller gaps reported in both industries. Retailers also claimed to have a higher feeling of ownership over the business overall, suggesting they might feel more inclined to make changes or suggestions that will result in cost savings for the organisation. For their part, Retailers are generally quite active in soliciting feedback from their employees with 'suggestion boxes' and other upward feedback mechanisms commonplace in retail organisations.

### Average engagement scores - Strategic Intent Vs. Change (sector comparison)



## KPMG VIEWPOINT

Across the survey, respondents have almost universally provided stronger responses to questions pertaining to strategic intent than to those that gauge their sense of empowerment.

This is a critical disconnect, and executives would be wise to focus on this challenge. Indeed, many businesses today struggle to translate strong awareness of a cost strategy into tangible action on the part of their employees and are increasingly questioning the effectiveness of their cost programmes.

In many sectors, this is largely a result of a disconnect between the person identifying the cost savings and the people executing the strategy. In response, a growing number of organisations are achieving more realistic cost

savings by ensuring that the individuals responsible for identifying cost savings are also executing the plans in order to 'keep their feet to the fire'.

But in reality, this gap is a strong measure of the difference between cost leaders and cost talkers. The high performing cost leaders are the ones who turn talk into action. The cost talkers are those for whom the talk remains exactly that – just talk.

What sets the two groups apart is the ability to execute. For many cost talkers, the compromised execution of cost strategy is, more often than not, due to excessively layered organisational structures which often affect the corporate line of sight and thereby diminish accountability. These organisations characteristically also suffer

from an over-syndicated sense of leadership and appreciation of risk that are spread so thinly across an organisation as to render them meaningless.

As a result, many organisations will need to refocus their attention on encouraging employees to be more empowered in their ability to drive change in the cost structure of the business. But to do this, they will need to feel that they have the appropriate level of accountability and freedom to operate and effect change.

# Section 2.3

## The Capability Gap

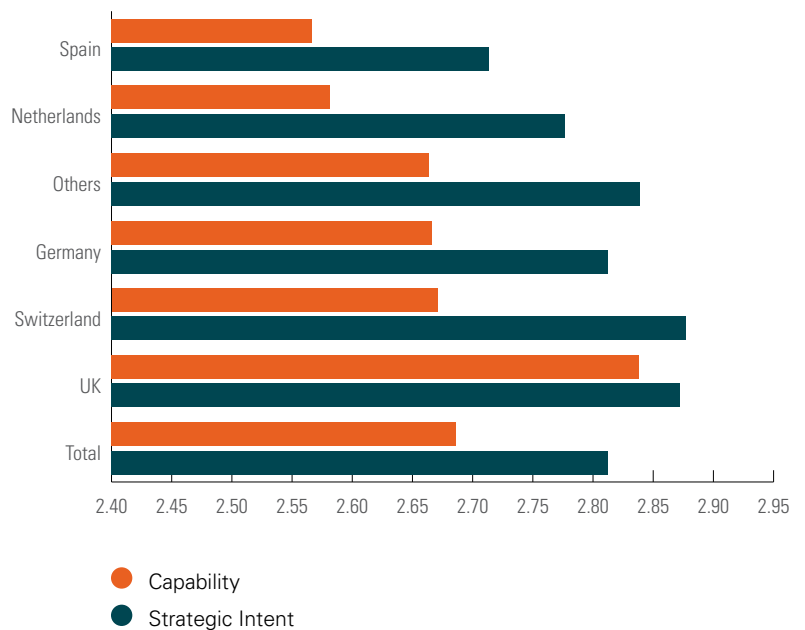
Organisations will need to properly equip their employees with the right tools, skills and capabilities to enable them to effect real change in the cost base of the business.

**Only 55% of respondents agreed that their reward and recognition is clearly linked to the cost management activities with which they are involved.**

Where empowerment is about motivating employees, capability is about enabling them. To achieve this, employees must have access to not only the right skills and tools to manage cost effectively, but also the necessarily feedback loops and measures to properly gauge the effectiveness of their efforts.

When comparing the respondents' levels of strategic intent against the reported capabilities of their organisation, it quickly becomes apparent that a wide gap exists throughout Continental Europe. And while Switzerland may seem to have the largest gap of any reporting country, it should be noted that their overall capability score was the second highest in the market. For their part, Spanish and Dutch respondents reported much lower capability scores and may therefore need to place a higher level of focus on this area to achieve a cost-conscious culture than the Swiss.

**Average engagement scores - Strategic Intent Vs. Capability (country comparison)**

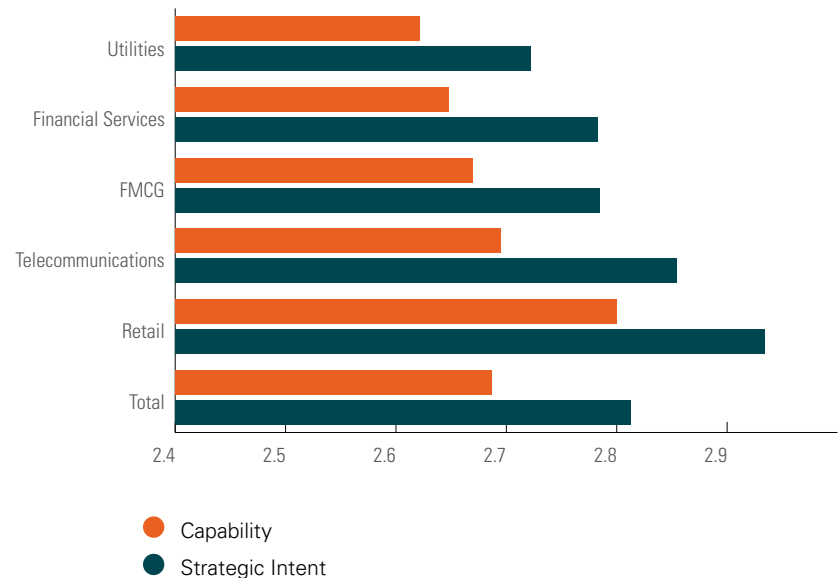


In this regard, respondents in the Utilities and Finance sectors also reported lower than average capability levels, which – in the case of the Financial Services industry – represents a significant gap from their strategic intent. For Financial Services, this is largely indicative of a lack of cost-focus through the ‘boom years’, which has resulted in an overall lower employee capacity to identify and embed cost-efficiency measures.

The Telecommunications industry also reported a sizable gap, although again their overall level of strategic intent and capabilities were higher than the reported average. However, this may be largely symptomatic of frequent changes to operating models that do not always trickle down to a level where employees know what they need to change in order to achieve different outcomes.

And while respondents from the FMCG and Retail sectors reported a comparatively smaller difference between strategic intent and capability, employees still report a sizable gap that can be closed to enhance the development of a cost-conscious culture.

### Average engagement scores - Strategic Intent Vs. Capability (sector comparison)



## KPMG VIEWPOINT

A decent feedback mechanism is essential for success. Broadcasting hopes and aspirations down to the frontline will never be enough. Management needs to understand their business from a frontline perspective, and the more junior ranks need to feel connected to the whole of the business.

In this regard, the cost leaders are those that are able to create feedback mechanisms that provide employees with a sense of how they are aligned horizontally to the market and vertically to the

business strategy. For example, many respondents to our survey agreed that more staff should be trained on cost management. And while that is an encouraging sign, the data also shows that only about half of the middle management and frontline staff have signed up for cost management training.

It will also be vital for organisations to create robust and effective tools and mechanisms to support employee innovation and awareness. To achieve this, management will need to work

closely with frontline staff and middle managers to form a better understanding of the types of tools and level of information that is required to properly activate employee engagement.

Put simply, without feedback mechanisms that give visibility to the progress that the organisation is making in terms of cost and value creation, then sustainable cost management will always remain an aspiration.

# Conclusion

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Clearly, there is an urgent need for companies to place a greater emphasis on cost efficiency and an increased cost consciousness in order to drive competitive advantage.

For many executives, this process will – by necessity – begin with a careful analysis of the existing cost drivers of the organisation in order to increase their understanding of where value is created and profit is generated, a task that our survey shows is much harder in larger organisations. To do this, organisations must be prepared to look across divisions and business units, compare themselves through robust competitive benchmarks that not only look at numerical comparisons but also highlight alternative ways of working, and then make some tough decisions which may challenge the accepted business models and transform their internal culture.

Success will require senior management to develop and execute strategies and programmes that maintain a clear cost focus. They will need to invest in tools and processes that enhance cost transparency and empower employees to manage costs more effectively.

But to achieve any of this, significant action must be taken immediately. The cost boomerang is undeniable and organisations that do not take firm and sustainable measures to stem the flow will likely soon find themselves dealing with ever tightening profit margins and a stagnant bottom line.

# 5 Recommendations for Driving Sustainable Cost Efficiency

## 1

### Maintain cost management as a strategic priority

Sustainable cost-efficiency targets are critical to maintaining profit margins and supporting growth strategies. Sustainable cost efficiencies should be high on the executive agenda of every company and must not be allowed to take a back seat to 'growth at all cost' strategies.

## 2

### Adopt an external investor mindset

Without a willingness to objectively challenge the organisation in the way that an external investor would, most organisations will never achieve a realistic understanding of where value is created within the business and where the opportunities for further efficiencies lie. This should be supported by a granular level of visibility into the true costs to serve, appropriate internal and external comparisons, and a willingness to look across current organisational boundaries for opportunities whilst taking the "difficult" decisions of divesting unprofitable units and lines of business.

## 3

### Create profit and cost transparency

Continually seek to improve your organisations understanding of where profit is generated and cost consumed. This will typically be a mix of longer term systemised solutions and immediate fit for purpose analysis, which often combines a number of existing data sources to provide new in-sight and challenge.

## 4

### Engage front line workers

For sustainable cost management initiatives to be successful, all levels of the organisation must be fully engaged in the cost-conscious culture. In particular, the support of front line workers will be critical in identifying and eliminating unnecessary costs and maintaining vigilance against new ones

## 5

### Equip staff to 'walk the walk'

Cost empowerment comes from having the right tools, rewards and understanding throughout the employee population to encourage and empower staff to embed cost efficiency measures into their daily lives.

# 10 Questions to Assess Your Cost Maturity

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## Tools

- 1 Is your business able to obtain relevant and accurate cost management information regularly and automatically?
- 2 Does your business's financial reporting accurately reflect your business performance in a consistent way?
- 3 Do you use appropriate tools to challenge the costs of your business on a regular basis? (E.g. Cost to serve analysis; internal / sector / out of sector benchmarks and comparators)
- 4 Do you regularly challenge your operating model to seek cross business boundary efficiencies?

## People & Culture

- 5 Are cost performance commitments linked to results with both rewards and consequences?
- 6 Does everyone in the organisation have consistent cost objectives as part of the performance management process?
- 7 Do you have the right skills in place to continuously improve cost management?

## Process & Controls

- 8 Are people accountable for managing and monitoring costs in the different areas of your business?
- 9 Are spend and cost containment policies and processes in place and enforced?
- 10 Does your business stop projects or spend that is not consistent with the agreed strategy

# About the Commercial Engagement Index

To better understand the underlying indicators of a cost-conscious culture, KPMG designed the **Commercial Engagement Index** to benchmark and measure attitudes and behaviours towards cost across an organisation.

Most often, the Commercial Engagement Index is used to help KPMG clients around the world to cut through the cultural complexity of their organisation to identify areas that need to be addressed in order to create a culture of active cost management.

For the purposes of this study, the Commercial Engagement Index was issued to a predefined list of 1,200 employees from Europe's largest firms as an online survey-based tool. Participants were asked a series of questions to gauge their attitudes and behaviours in four key areas related to cost:

## Running the Business:

This category measures the level of ownership and accountability for cost and the extent to which continuous improvement activities relate to cost management;

## Strategic Intent:

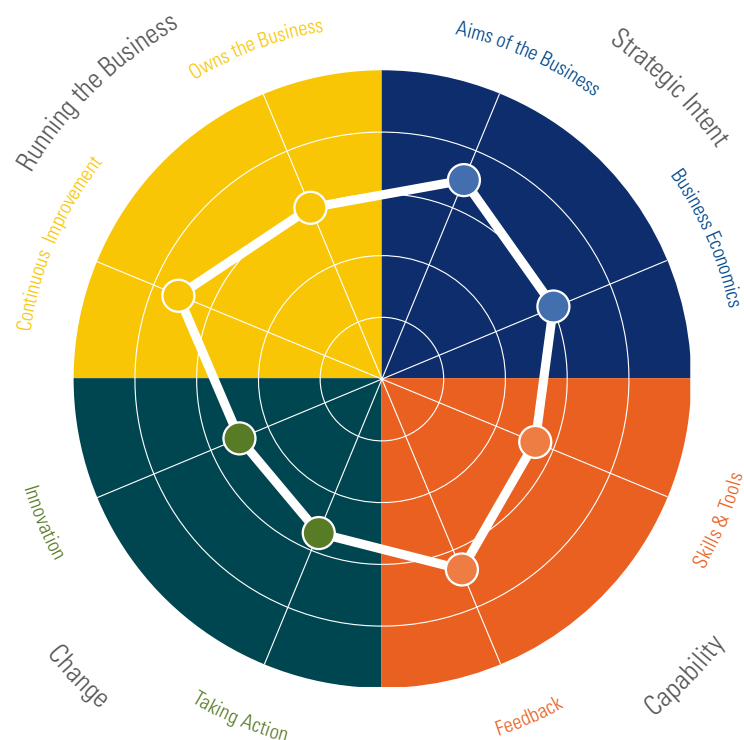
This relates to the level of strategic clarity about the cost-related goals of the business, and how cost management relates to business success;

## Capability:

This denotes to what extent the organisation has the skills and tools required to manage cost effectively and the necessary feedback loops and measures in place to enable cost management; and

## Change:

Captures a measurement of the extent to which employees are empowered to take action relating to managing cost and suggesting/taking innovative steps to transform cost management practices across the business.



For more information on KPMG's Commercial Engagement Index, please contact your local KPMG member firm or one of the authors listed at the end of this publication.

# About the Cost Boomerang Opinion Survey

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The KPMG Cost Boomerang Survey was conducted in late 2010 and early 2011 to provide insight into the sustainability of Europe's recent cost saving measures and to deliver a strong benchmark to help executives create more informed strategies and drive bottom line benefits.

The survey included respondents from Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Switzerland and the United Kingdom and represented an equal proportion of respondents across the FMCG, Retail, Utilities, Financial Services and Telecommunications sectors.

In all, 525 senior financial decision makers responded through telephone interviews, providing key insights and metrics to help us deliver this compelling report.

# About KPMG

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No matter where your company operates, KPMG professionals understand what it takes to cut through the complexity of cost management to drive sustainable and effective cost strategies for clients across Europe and around the world.

With hands-on experience and an unrivalled depth of global insight, KPMG member firms work collaboratively with clients to embed sustainable methodologies and best practices into the fabric of their clients' business structure and culture to deliver lasting change and competitive advantage.

And with dynamic tools such as the Commercial Engagement Index, KPMG leads the way in helping clients identify their challenges and respond to them efficiently and effectively.

We encourage you to contact your local KPMG member firm, or one of the authors listed on the back of this publication.

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