

GETTING A FIX ON COSTS

Energy price rises are painful – but you're not helpless. It's time to overhaul how you account for expenditure.

I SAW A NATIONAL newspaper headline last month that proclaimed 2006 "the year of rising prices". While consumers may be unpleasantly surprised to learn costs are on the up, finance directors I'm working with have felt the pressure of an increasing cost base for some time.

The most obvious example is energy prices. During the run-up to the October 2005 contract round, the price for annual base load electricity went up to £57 per megawatt. This represents an increase of more than 200 per cent in two years. For many organisations coming out of two or three-year deals, these prices will come as a huge shock. And then there's gas: spot prices are hitting highs of more than 170p per therm. For companies used to paying a third of that, this is crippling.

Those price rises came at a time when most of you were performing your annual budgeting exercise. For many businesses, the ability to accurately predict or anticipate revenues is difficult at the best of times – whereas the costs incurred in running a business ought to be more certain, present and definite, even if the amount isn't always known to the last penny.

The way many of us in financial management look at costs goes right back to our student days. We were taught that there were fixed costs and variable costs. And many of us still use this bland classification, even though such arbitrary divisions don't help us to view the business in the most sensible way.

One corporate I have worked with is mad keen on keeping as "flexible" as possible. It's a growing and profitable business in a volatile



and cyclical sector, and self-funded with no outside shareholders. The management team works hard to maintain flexibility so they can control costs if – sorry, when – the expected, but impossible to predict, downturn hits. For instance, beyond a core number of "fixed" employees, the company uses freelance workers and contractors. When there is the work, the freelancers are used. When there isn't – well, there's no carrying cost.

The company's attitude is level-headed and requires a modicum of forward planning and clear thinking. But the management's attitude to cost control is one which many other corporates could learn from. Because, the more you think about "fixed" and "variable" costs, the more ludicrous the terms become. There is no such thing as a fixed

"ANY ATTEMPT TO CONTROL SPEND WILL FAIL IF THE BOARD BELIEVES CERTAIN COSTS MUST BE ACCEPTED, HOWEVER EYE-WATERING THE INVOICE"

cost, nor are there controllable and uncontrollable (or avoidable and unavoidable) costs. There are just costs which are controllable (or variable) over different lengths of time. So instead of thinking in terms of fixed and variable, perhaps finance directors need to start thinking of their cost base in terms of operational gearing.

The examples go beyond human resources. This particular company only takes premises on flexible leases in unfashionable locations. That's in sharp contrast to many other firms I've worked for: they carried hideous amounts of space they didn't need, or which were in the wrong place, or which just didn't work any more. Perhaps their finance directors should ask colleagues some challenging questions, not necessarily about what they spend on, but why they spend in a particular way.

There are no easy answers, of course. There are disadvantages of having great flexibility – for example, short-term control often comes with a premium price tag. So it may appear more expensive at first. And it also requires changes to planning processes and company culture.

And such extreme flexibility is

unpalatable for many companies. Even so, by carefully running through the profit and loss account, you should glean a framework for a strategic spending review. Just keep two key questions in mind. First, how do you present the data so the board knows how the costs are built up? And second, how do you go about cutting costs? The finance department has the major responsibility to answer the first question, whereas the responsibility for the second lies elsewhere.

The fundamental point is that any attempt to control spending will not succeed in the long-term if the board believes there are certain costs that can be constrained and others that have to be accepted, however eye-watering the invoice. It is this thinking that leads to certain expenditure always being cut the minute overall spending needs to be reined in. The most obvious examples of the first-for-the-chop are marketing and training, as well as (of course) the FD's FT and a recruitment freeze! Yet we all know that when times get tough, those are the things that should be kept up if the company is to keep moving forward.

To overcome a mindless traditional attitude to spending, we have to assess how we present the data in the management accounts. Once the company reassesses how costs are incurred and why, it stands a much better change of intelligently controlling them – even when prices are shooting up.

Peter Charles is a former FD who now specialises in turnarounds. In his next Gritty Detail he'll look at intelligent cost cutting. Peter@petercharles.com

