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Beyond Cost Cutting

Six Steps to Achieving Competitive Advantage Through Cost Excellence



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Beyond Cost Cutting

*Six Steps to Achieving Competitive Advantage Through
Cost Excellence*

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AT A GLANCE

As global economic pressures intensify, corporate leaders must focus on creating a competitive and sustainable cost structure.

EFFICIENT COMPANIES OUTPERFORM

Research shows that companies with lower costs than their competitors systematically generate higher shareholder returns.

ACHIEVING TRUE COST EXCELLENCE

Companies that aim to deliver a sustainable cost structure must focus on both the efficiency and the effectiveness of their operations.

SIX STEPS TO ACHIEVING COST EXCELLENCE

A six-step program can deliver significant and lasting cost reduction, including building a consensus about the scope and goals of the effort and identifying the best methodologies to execute the program.

THE LIST OF CHALLENGES facing corporate leaders today is lengthy. It includes globalization, rapidly shifting market dynamics, fallout from the European debt crisis, and a potential slowdown in Asia. It is unclear how these economic trends will play out and what impact they will have on industries and countries. Companies will also be faced with unexpected turbulence, whether in the form of adverse changes in their business or the arrival of tough new competitors. All this makes it more critical than ever before for corporate leaders to closely scrutinize the cost side of their income statement.

It is typically not enough to slash costs through short-term measures such as squeezing suppliers, shuttering facilities, and reducing head count. What is required is a move away from endless rounds of cost reductions and toward true cost excellence. This effort centers on reducing costs in an intelligent and sustainable way in order to protect against another upward creep in costs in the future.

Achieving True Cost Excellence

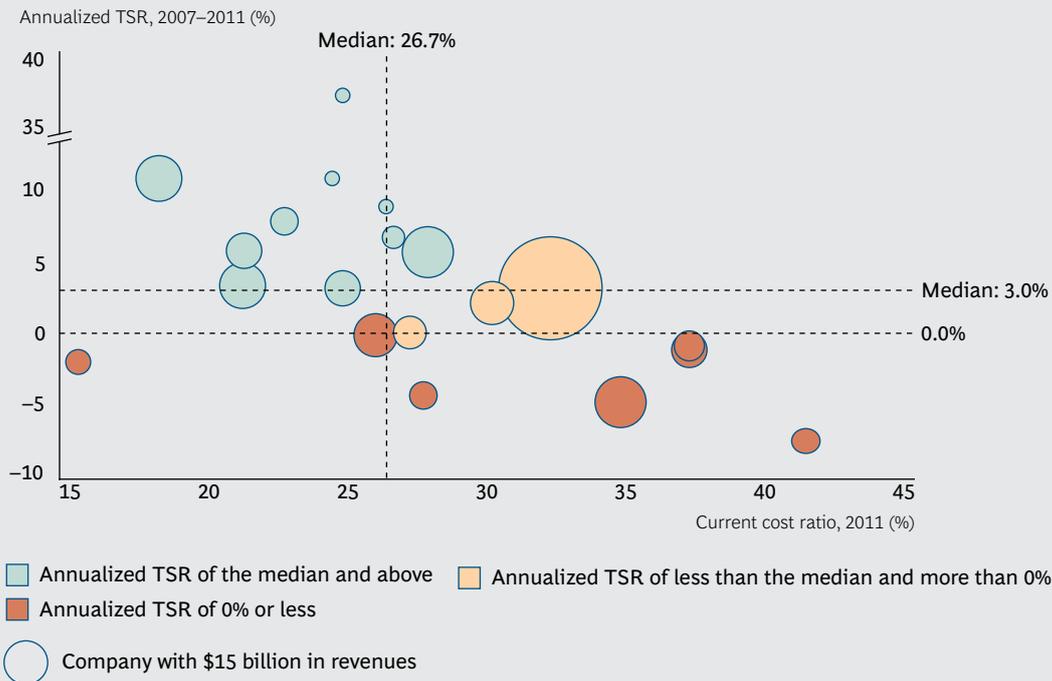
An effective cost-excellence drive focuses on closing gaps and eliminating shortcomings, addressing both the input (necessary resources and costs) to produce a product or service and the output (the quality that the customer requires). At the same time, such a drive often results in a host of other benefits, including increased transparency and accountability, higher employee morale, and faster decision-making processes. Furthermore, it lays the foundation for ongoing improvement by putting policies and controls in place that prevent a reversion to old, unproductive practices.

These improvements help companies become more agile and less vulnerable to the impact of unfavorable economic forces—a fact that is not lost on investors. Companies with a low cost base, measured by selling, general, and administrative (SG&A) expenses as a percent of revenues, tend to generate higher levels of total shareholder return (TSR). An exhaustive analysis by The Boston Consulting Group across numerous industries including, for example, the medical-device and medical-equipment industry, consistently found this inverse relationship to be true. (See Exhibit 1.) In addition, our research has shown that companies with steadily decreasing costs tend to generate higher levels of TSR than companies with stable or increasing cost levels.

BCG has a battle-proven approach to help companies achieve true cost excellence. This approach focuses on improving efficiency and effectiveness, two complementa-

Companies with steadily decreasing costs tend to generate higher levels of TSR than companies with stable or increasing cost levels.

EXHIBIT 1 | The Medtech Industry Exemplifies How Cost Discipline Benefits Shareholders



Sources: S&P Capital IQ; S&P Compustat.

Note: TSR = total shareholder return. The sample includes a selection of listed medical-device and medical-equipment makers. The period is from December 2006 through December 2011. Annualized TSR is calculated as compound annual growth rate (share price at the end of the period, including dividends paid within this period, minus share price at the beginning of the period) divided by the share price at the beginning of the period. Cost ratio is calculated as selling, general, and administrative expenses divided by revenues. Data shown here do not include R&D.

ry aspects of the operations of a company or business unit. Efficiency is the effort or cost of producing a company’s product or service, ideally with a minimum amount of waste and expense. Effectiveness is the degree to which the product or service produced meets the needs of the customer, whether the customer is a unit within the company itself or another corporation or organization.

BCG’s cost-excellence approach is not a simple one-size-fits-all tool. Instead, it creates a cost reduction plan that is tailored to fit the culture, structure, and goals of the organization. Done well, this approach can fundamentally transform a company and provide it with the ability to be continually vigilant and proactive in ensuring a viable cost structure. This, in turn, can create real competitive advantage and superior shareholder return in an era of great uncertainty.

Certain fundamental principles are critical to making such an effort successful:

- Focus on eliminating costs at their source, independent of their allocation within the company.
- Keep an eye on interdependencies within the organization—linkages that must be addressed in any cost-reduction plan. Elimination of a specific report pro-

duced by one department, for example, might make sense from that department's perspective because it saves time and money. But such a move needs to take into account how other groups within the company use the information or data from that report.

- Tailor the analysis, targets, and tools to fit the business unit in question. This should include matching the approach to the organization's current—and targeted—culture and its maturity in its business cycle.
- Set bold targets early on. Do sufficient research up front to make the targets defensible and then stick to them. Make sure there is clarity at the top of the organization about the goals of the program.
- Strive for early wins in implementation. These are critical to building momentum and excitement throughout the organization and helping to convince employees that change is possible. They can also generate quick savings that may help to fund other projects in the cost excellence effort.
- Ensure executive commitment and accountability. Clearly delineate ownership of key elements of the effort among C-level executives. Make sure that the most critical initiatives are led by top talent.
- Communicate as early, openly, and consistently as possible about the goals of the effort and the process being undertaken. Keeping your organization in the dark—or worse, misleading people—can produce morale-sapping surprises later.

Six Steps to Achieving Cost Excellence

Six critical steps can enable companies to deliver significant—and lasting—cost reductions. These steps, executed consecutively, can be carried out separately for various categories of costs, including personnel and nonpersonnel costs. However, the time frame devoted to each step depends heavily on the level of urgency to reduce costs. If costs have to be cut right away, the first steps can be taken rapidly. And efforts to reduce costs in different categories can move at different speeds.

Step 1: Build consensus and commitment on goals and scope. Ensuring that company leadership and top management are in agreement about the need for change is probably the most crucial point for the success of the whole program. To do this, management needs to outline two factors at the start: the overall goals and the scope of the program. Before they begin, company leaders should clearly state what they hope to achieve—with firm, measurable targets whenever possible—and then rank these goals by level of importance. The aim is to ensure that the cost reduction plan addresses these prioritized goals.

The scope of the effort—the business units or functions that will be included—must be clear and spelled out, at least among senior managers. In some cases, such an effort may cover every facet of the company, while other programs may target only certain business units, cost items, or specific functions such as HR or finance. Any

Communicate as early, openly, and consistently as possible about the goals of the effort and the process being undertaken.

specific cost-reduction measure that is a “must” or a “no go” should be outlined, too. At the same time, the areas that are off-limits have to be defined and agreed upon.

It is helpful to keep a couple of things in mind when defining the scope of the program. First, the largest cost categories should be included in the effort unless there is a very compelling reason to exclude them. And focus is critical: if there is a small division with a separate organization and cost structure, for example, it may make sense to leave that unit out of the program to avoid unnecessary complexity.

Once the scope and goals are clear, management must decide when and how employees will be involved in and informed about the program—and how their participation will evolve over time. This means establishing clear rules for how the process will move forward, making sure all managers are in agreement, and providing a steady flow of information about the program’s progress. This does not mean, however, that everyone will have access to the same level of information at the same time.

In addition, a compelling message describing why the effort is critical for the future success of the business must be crafted and communicated to employees, unions, and other employee representatives, as well as to investors, suppliers, and customers. Since many organizations suffer from fatigue from prior cost-cutting efforts, this message should explain what will be different about this initiative.

Underlying the whole effort must be an unwavering commitment from management. If management’s firm commitment is not made clear from the start and not reinforced over time, chances of success are slim. (See the sidebar “Getting Leaders on the Same Page.”)

Step 2: Select the right methodologies. In order to sort out exactly how cost reduction opportunities will be identified and quantified, companies can select from a number of well-proven methodologies on the basis of the goals and scope of the program. (See Exhibit 2.)

Pulling together the right group of methodologies is not a simple task. There is a well-established set of battle-tested and standardized methodologies and a wide variety of tools available for executing each of them. The trick is to tailor that mix of methodologies to meet a company’s specific needs and challenges. Two major factors in this determination are the industry sector and the type of expenses that are on the table—which might include personnel and nonpersonnel costs, SG&A expenses, the costs of manufacturing the company’s product or delivering its service, the cost of goods sold, working-capital costs, and capital expenditures. The company’s culture, the urgency with which cost savings need to be achieved, and the way in which management wants to drive change—through a centralized or decentralized effort, for example—will also lead to the selection of the right methodologies.

These methodologies can be used to scrutinize cost and quality levels by tracking certain key performance indicators (KPIs) of core processes and to closely examine the organization’s structure. Benchmarking against competitors or against other business units within the company can be a particularly effective way of identifying

The trick is to tailor the mix of methodologies to meet a company’s specific needs and challenges.

GETTING LEADERS ON THE SAME PAGE

Creating unity across management can take hard work. Consider the recent case of a large European bank. It had attempted significant cost cutting in the past, but the reductions proved fleeting. Meaningful and lasting cost reduction could be achieved only with the commitment of senior leaders.

In fact, at the beginning of the process, there were major differences of opinion among the top five senior managers. The disagreements centered largely on the extent to which outsourcing should be used to cut costs, which areas should be left out of the initiative, and how quickly the cost reductions should be implemented.

To address those differences, the managers took part in an intensive two-day workshop—not in the office but in a nearby location. In that neutral setting, with no distractions, the senior managers spent the first day hashing out the financial goals and timeline for the effort and devoted the second day to how the program would be conducted. Throughout both days, there were open discussions about the various

possible approaches. Managers challenged one another and debated intensely about a variety of issues, including what the various options would mean for different parts of the organization, whether certain areas would be off-limits, and whether or not the goals should be communicated openly. By the end of the second day, consensus had been reached on both the financial targets and the principles of implementation, with the details written up and all board members literally signing off on the plan.

The full plan outlined by those five senior leaders was communicated to all managers and parts of it to other employees within the bank. Bank employees later said that this cost-reduction drive felt different from previous ones because company leaders had reached a consensus. This time, employees said, it was clear that senior management “really meant it.” The result: 100 percent achievement of the stated cost-reduction goals and major strides in reducing complexity within the organization.

EXHIBIT 2 | Well-Proven Methodologies Can Identify Ways to Improve Efficiency and Effectiveness

Methodologies and tools

Benchmark against industry competitors
Client and management interviews and workshops
Delaying and organization structure analysis
Internal and external surveys
Activity-based optimization
Nonpersonnel cost analysis
Functional KPI analysis

Cost excellence

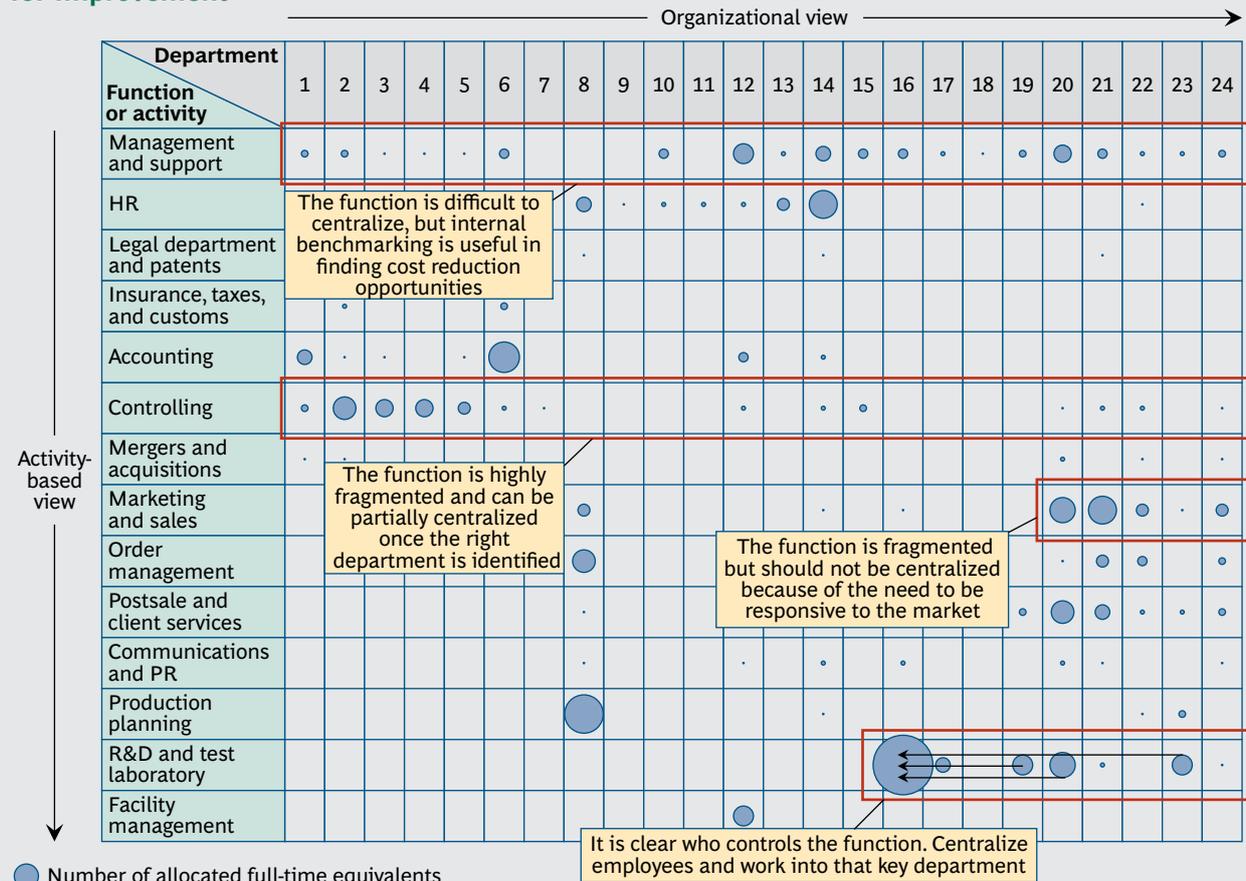
Improve efficiency <ul style="list-style-type: none"> • Identify how best-practice companies are functioning differently • Identify organizational slack • Find opportunities to bundle activities and synergies
Improve effectiveness <ul style="list-style-type: none"> • Identify organization pain points • Identify gaps in functional performance • Identify quality and service issues

Source: BCG analysis.

strengths and weaknesses. The goal of all these methodologies is to produce a comprehensive and clear picture of where deficiencies—and, therefore, opportunities for improvement—exist.

Step 3: Determine how efficient and effective the organization is and set targets for change. With the methodology and tools selected, the in-depth diagnostics start. Take the case of personnel costs. One of the most common methodologies for analyzing personnel costs is “activity-based optimization.” This involves determining what tasks people actually do in their jobs, a process that gives insights into the efficiency and the distribution of work in an organization. (See Exhibit 3.) This analysis—which is quite different from simply studying how work might appear to be handled based on the company’s organization chart—can be done in a matter of days for the whole business, including both support and operational functions. The results can be benchmarked against those of competitors, comparing, for example, what percentage of the total workforce is allocated to each function. This is a very powerful way to get an objective view on efficiency.

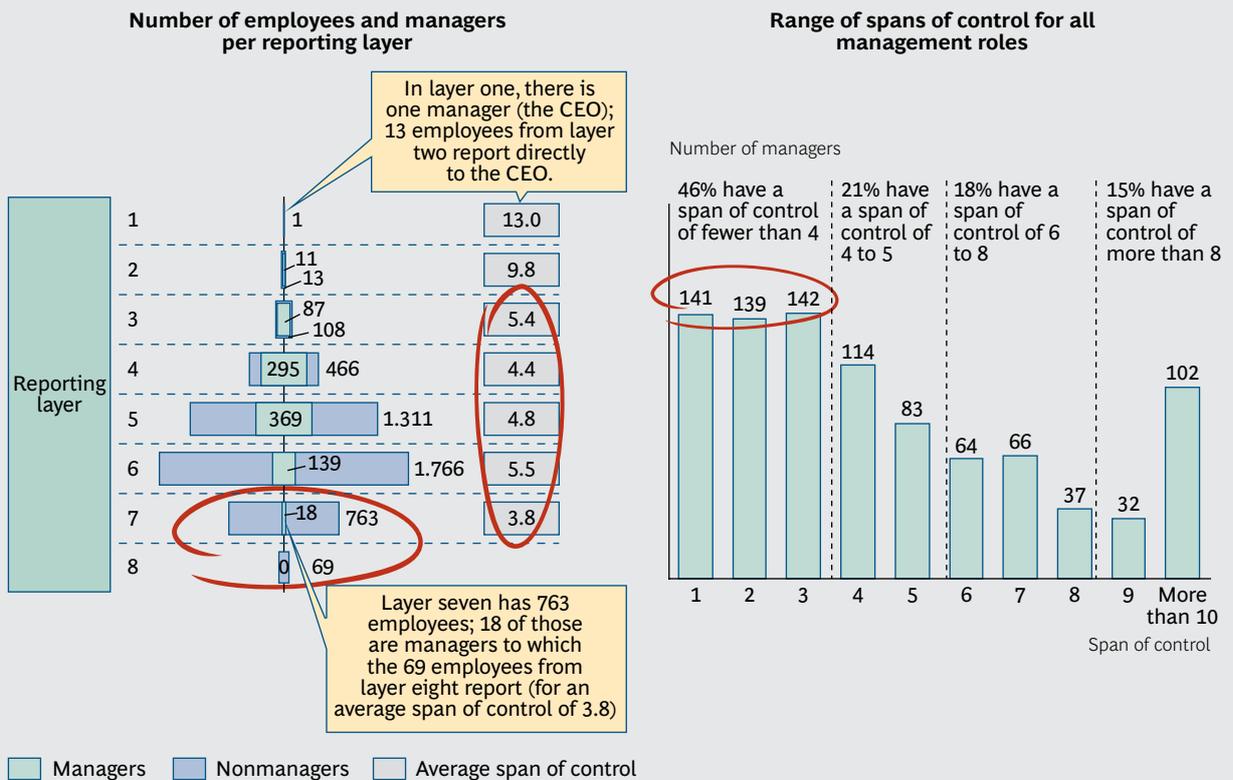
EXHIBIT 3 | Activity-Based Optimization Reveals How Work Is Handled and Offers Opportunities for Improvement



In addition, activity-based optimization will identify issues such as an unclear distribution of work across multiple departments or business units. For example, although management may believe that all HR work is done in the HR unit, other units may, in fact, be doing their own recruiting or training. The existence of this sort of “double work” is often a clear indication that certain activities could be bundled in one area to increase efficiency. Such moves may simultaneously address the quality issues that led to the duplication in the first place.

Rethinking how the organization is structured and how employees are managed also reveals opportunities for efficiency improvement. (See Exhibit 4.) To identify these opportunities, management should examine several parameters, including the number of reporting layers within the organization, the number of employees reporting to a specific manager (the span of control), whether there are highly paid individuals at lower levels of the organization, and whether there are too many small teams that could more efficiently be merged into larger teams. This analysis can highlight any opportunities to take out layers, adjust pay levels to more accurately reflect the degree of responsibility held by managers, and rework the title struc-

EXHIBIT 4 | Structure Analysis Gives a Clear View of Reporting and Management Layer Problems



Source: BCG analysis.
Note: Examples are illustrative.

ture. The benefits of this can go far beyond pure cost savings, creating greater accountability and motivation, better communication, and faster decision making.

There is also the issue of effectiveness. To understand the effectiveness of a particular department, function, or operational unit, one needs to examine the value that group adds through its work. This examination can typically be done by asking the customers of that unit, a group we call the recipients, to assess how good that unit is at delivering its product or service. In general, the recipients will be outside customers. But in the case of SG&A costs, in which management is studying support functions, the recipients will be mainly internal groups such as other departments or subsidiaries. There might be, for example, reports that the recipient does not really need or an exchange of data among departments that is delivered in the wrong structure or format. In addition to questioning recipients, this process should include asking the employees of the business unit or function in question about their perception of their own work. Management interviews, online surveys, or both are typically used to collect this type of information.

This largely qualitative information is often supplemented by an examination of “functional KPIs” and the benchmarking of those indicators against competitors and comparable companies. In the case of an analysis of procurement, for example, functional KPIs could be the percentage of spending that falls under certain supplier agreements or average annual purchasing related to cost reduction opportunities as a percentage of total procurement spending. In the case of an operational unit, the KPI could be the time it takes to produce a certain unit or how long unfinished goods sit in inventory before being completed.

As management studies the business along these parameters, a clear and comprehensive picture of the organization and its operations emerges. It is imperative that these results, which will serve as the basis for decision making, be transparent and clearly spelled out for the leaders of the effort. These findings highlight critical deficits in the organization and clear opportunities for improvement—information that management then uses to create a comprehensive list of targeted changes.

Such targets will typically include quantitative goals, measurable directly as KPIs, as well as secondary, often qualitative, goals. Qualitative objectives may include driving faster decision making within the company, establishing clearer accountability in company roles, and improving the quality of the product or service delivered. It is crucial for top management to set ambitious but realistic target levels that are sufficiently challenging so that the organization is forced to think beyond existing or previously used approaches to achieve these targets. (See the sidebar “Diagnosing the Problem and Setting Bold Targets.”)

Step 4: Develop a plan to hit the targets. A bottom-up process is the best way to generate ideas about how to deliver the program’s quantitative and qualitative goals. As part of this effort, managers and employees further down in the organization outline concrete initiatives and programs that will allow them to hit the set targets. Sometimes, however, people within the organization believe that their targets are not achievable. In that case, they need to prove why they cannot hit their goals and outline what level of savings they can actually deliver.

Creating concrete initiatives to hit targets is often best achieved through a series of workshops during which managers and employees work out the details.

DIAGNOSING THE PROBLEM AND SETTING BOLD TARGETS

A global industrial-goods company wanted to redesign operations to substantially reduce head count and create a more collaborative and focused organization with greater accountability among managers. To diagnose issues within the company, management used multiple tools to assess the organization's efficiency and effectiveness. These tools included the benchmarking of activities, an analysis of the organization structure, a Web-based survey that analyzed the satisfaction of more than 150 internal customers, and interviews with more than 50 executives. This broad involvement throughout the organization helped spotlight the very complex problems presented by the existing structure, build management buy-in, and create momentum for substantial change.

On the basis of the diagnostic, top management was able to decide on high-level changes in the organization structure. At the same time, the team agreed on top-down targets for head count reductions for each department. Strong leadership from the CEO helped drive agreement on targets among top members of management, an effort that was buttressed by clear evidence of the need for change found in the diagnostic results. These ambitious targets were passed on to department heads, who then had the opportunity to argue for adjustments in the targets if they felt the goal was unrealistic. In the end, the program yielded a head count reduction of about 20 percent and led to the transfer of some activities to a central service center.

Creating concrete initiatives to hit the targets is often best achieved through a series of workshops during which managers and employees work out the details. The teams should consist of the individuals who know the processes or functions under examination, as well as representatives of the recipients and of the central team. When a process involves several divisions or functions, valuable instruments include value stream mapping, a technique used to analyze and design the flow of materials or information across multiple groups, and *kaizen* workshops, which involve employees from all affected divisions and functions. (See the sidebar “Creating the Plan to Make Change a Reality.”)

The involvement of employees from the lower levels of the organization in defining initiatives is often invaluable. It not only creates acceptance for the targets but also ensures the development of a detailed cost-reduction effort, one that may challenge established behaviors and incorporate new approaches. This stands in stark contrast to the pure top-down cost-saving approach many companies often employ by, for example, making deep cuts in overhead budgets that deliver only temporary savings.

Defining detailed measures is crucial for successful implementation. Predefined measure templates are typically used to detail the plans. These templates should capture all the critical information—but no more. Each measure should have a single manager, or “owner,” who is ultimately accountable for its implementation,

CREATING THE PLAN TO MAKE CHANGE A REALITY

A European logistics company that was undertaking a major cost-reduction effort found that interdependencies among its various units posed a real challenge. As one executive at the company put it, the operations “felt like a never-ending ball of wool, where you start pulling on one end and never find the other end.”

To address those internal linkages, business units first broke down exactly what they produced and how many employees were involved in each step. They then came up with a series of suggestions for improving efficiency through moves such as changing the service level or detail required for certain tasks.

Then came a thorough vetting of these ideas. Members of the business units, people we dub the “producers,”

met weekly with the “recipients,” the team that received the product or service. In those sessions, they further refined the ideas. For specific high-priority areas, two or three units worked together to come up with plans that could produce the same output but at 30 percent, 50 percent, or 80 percent of the original cost. And the recipients had a direct incentive to be as flexible and creative as the producers because they were judged not only on how they cut their own costs but also on how they were able to reduce the resources they required of other units.

Within six weeks, this process identified measures to reduce overall costs by 30 percent—a cost saving target that was ultimately delivered in full within 18 months.

and a measure should quantify the cost savings to be generated, the impact on cash flow, and the costs, such as severance, related to any reduction in head count. The measure should also detail any investments that may be necessary to accomplish the change. Milestones should be set that outline a measurable outcome (for example, KPIs such as a targeted reduction in man-hours per unit produced) as well as a date for hitting that target. The KPIs detailed in those milestones should be unambiguous measures of progress that also serve as leading indicators of whether each major initiative, as well as the overall program, are on track.

The measure templates are also the basis for tracking implementation of each initiative with a “no excuses” mentality. If a measure is behind schedule, timely intervention can be triggered. And if one set of initiatives does not deliver the expected savings, new plans should be developed to deliver the agreed-upon targets.

Once outlined, these measures, along with an overall plan for implementation, need to be transferred into a company’s systems, including the annual planning process or the HR database. This ensures that the planned changes, such as reduction in head count in a certain department, are incorporated into future planning and forecasts.

Step 5: Drive implementation of the changes. Once the program measures are outlined and have been kicked off, it is critical to keep the organization focused on completing these discrete components of the plan. Early wins and success stories in implementation generate cost savings to fund investments that will make the changes sustainable and build real momentum throughout the entire organization.

Maintaining the momentum and commitment can be a tall order, particularly when the whole effort stretches out over a period of years. To ensure that progress continues, all these measures and milestones should be put together in one comprehensive execution plan so that each one can be tracked over time and steps can be taken to address setbacks, shortfalls in cost savings, and delays.

A central project-management office (PMO) frequently monitors the implementation of the measures. This ensures that there is one central group that has the right tools to keep the effort on track and a process for correcting problems that threaten successful execution. (See the sidebar “Keeping Progress on Track.”)

KEEPING PROGRESS ON TRACK

During the 2008 financial crisis, a North American industrial-goods manufacturer was buffeted by a collapsing market environment and significant cash losses. Those pressures made it critical for the company to quickly lower its breakeven point.

The core functions of the business were broken into six areas, which collectively accounted for all the company’s costs and revenues. Each of those areas was given profit improvement targets, about two-thirds of which came from cost reduction and the remaining one-third from revenue improvements. A different C-level executive became the sponsor of the profit improvement program in each one of the six areas and retained this role for all three years of the program. This increased accountability and helped considerably to maintain executive involvement in the effort.

Some of the most talented and ambitious managers who reported

directly to those C-level executives were freed up to oversee the program. That team kept their units focused on executing the cost reduction initiatives while a new project-management office (PMO) oversaw the entire effort. The PMO was led by a high-level executive and had two primary tasks: to measure and report on the progress of the effort and to be an active driver of change. This latter responsibility involved identifying new opportunities, helping managers troubleshoot when problems developed with projects, and pushing for even more ambitious reductions when possible.

Relentless attention to execution combined with unwavering senior commitment produced efficiency improvements far in excess of what was originally expected. The manufacturer was able to lower its breakeven point by 50 percent and boost the bottom line \$2.5 billion over the three-year period.

The role of the PMO, however, is not restricted to tracking implementation and troubleshooting problems. The PMO should take an activist stance, continually looking for new opportunities for cost improvement and challenging the organization to do more, communicating with top management about the program's progress, and providing early insight into the impact that the cost effort is having on the company's financial results. In this way, the PMO becomes more of a partner of management and not just a unit tasked with executing one plan.

Step 6: Make the change sustainable. Just as important as the execution, of course, is the effort to make changes stick. After all, old habits are often cemented in a company's processes and can reverse hard-earned progress.

The overall process outlined here certainly goes a long way to prevent backsliding. But there are additional steps that can be taken to make the changes stick and that can be very specific to each company's circumstances. Manufacturing and service units can establish mechanisms for closely tracking certain critical KPIs, and processes can be continually studied for improvement. In other spending areas—such as SG&A, capital expenditures, and procurement—ongoing benchmarking against competitors can maintain the necessary focus on efficiency. Processes can be created for filling new or vacant positions to avoid an unwanted uptick in head count levels. And incentive compensation systems can be changed to drive higher quality. These steps—along with many other proven tactics—can embed the new, more efficient processes deep into a company's DNA.

At the heart of sustainability is the willingness to change any process that allows a reversion to old behaviors. That can be achieved only if the entire organization, from C-level executives to lower-level employees, is behind the program. (See the sidebar “Eliminating Backsliding.”)

A Corporate Transformation

The six steps laid out here require investment of time and resources from senior management. This process is not a simple one. Rather, it is a sophisticated approach that aims not only to reduce costs but also to transform companies on every level—from how employees work and how the company is structured to the quality of what is produced. In the end, this approach will lead to cost excellence and leave a company leaner, more nimble, and fundamentally more competitive.

This approach is more critical than ever before as uncertainty continues to cloud the outlook for many markets around the globe. The companies that prepare for the unknown—by focusing not just on top-line growth but also on cost excellence—will be well positioned to prosper in any environment.

ELIMINATING BACKSLIDING

Old habits die hard. Just how hard became apparent to executives at the North American industrial-goods manufacturer referred to in the sidebar “Keeping Progress on Track.” Management had cut overhead spending by large amounts in the past only to see it immediately rise again. The team knew, however, that the response to the 2008 crisis needed to be a lasting one.

An examination of what was behind the relentless upward march in costs revealed a major problem with the company’s budgeting process. It turned out that that process, while systematic and rigorous, was flawed. Each year, controllers and managers of the various business units would come up with a budget for their people, projects, and other expenditures based on the previous year’s spending, as well as a wish list of new expenditures. These plans, made up of hundreds of well-supported line items, were assembled into one package and presented to the executive committee, making them essentially a fait accompli. As one C-level executive put it: “You can argue for days, and you’ll be lucky to get one forklift out of the budget.”

The solution came by turning the process on its head. On the basis of the low spending level achieved

through its recent cost-cutting efforts, the company defined a base spending level for each corporate function. This amount will remain fixed over time except for slight adjustments for inflation. The annual budget process now starts with top-down guidance from top management on what overall level of spending will be affordable and which strategic priorities need to be funded. All functions then submit a two-piece request: must-have items that can’t exceed the base level set for their unit and proposals for additional funds—essentially optional spending—for specifically outlined projects or purposes. The executive committee reviews all those requests for additional funds in one meeting and prioritizes them for funding.

Along the way, the company also defined three levels of austerity measures, reductions that could bring spending below the current base level if necessary. Such plans will prove valuable should market conditions turn ugly. And the primary goal has been achieved: for two consecutive years, the company has been able to head off the usual increases in its breakeven point. Management time is now spent focusing on which projects or initiatives should be priorities and not on debating the base spending level.

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