Why do Companies Overspend?

By Ben Lapscher

The main purpose of a business is to increase shareholders value, providing increasing profits and return on the invested capital. In order to improve profitability and increase shareholder value, companies can pursue three basic strategies: a) Increase Sales, b) Reduce Costs of Goods and/or c) Reduce Expenses. Each of these strategies has its advantages and challenges, however, the third one, Reduce Expenses, has one clear benefit. Every dollar saved goes directly to the bottom line. As Benjamin Franklin would say: *"A penny saved is a penny earned".*

Executed with care, expense reduction won't affect the quality of product or service provided, contributing to maintaining sales with higher profitability. A reduction in energy consumption, payroll processing or liability insurance will not affect the product/service. However, it will help increase business profits very rapidly.

Despite this clear advantage of the Expense Reduction strategy, many businesses still overspend in many categories. Our experience shows that 100% of the companies we have been involved with, have at least one expense category where they consistently overspend, even those running a tight ship. It seems logical to think that keeping an eye on expenses should be a must for every company. Given that this is not the case, the next logical question is why isn't this happening? The purpose of this article is to explain the reasons behind this fact.

Our experience dealing with multiple companies in different industries, shows a distinctive pattern that can help explain why companies constantly spend more than they should. We can group the main reasons in four buckets. They don't all necessarily apply to every company, however, we have found that at least one of these causes can explain each particular situation. Those are: *1) Time constraints, 2) Lack of Industry Knowledge, 3) Focus on Sales and Direct Costs and 4) Inertia/Lack of Will.*

<u>Time constraints.</u> In today's hyper competitive and dynamic environment managers and employees in general are extremely busy keeping up with customer demands, information overload, internal processes and changing regulations. This competitive environment forces businesses to work with limited personnel and resources, increasing the workload across the workforce. The main goal is to "get the work done", and cost remains a second priority to which there is rarely time to analyze or improve.

Time/Resource Constraints

As an example, a law firm needs to make sure the documents are printed and delivered on a timely manner and there is not enough time to look for the most economical options to print and ship these documents. As long as the printer or copier works fine and the courier picks up and delivers on time, the person in charge will meet the goal. A manufacturer manager needs to complete his production plan and devotes his time to all the necessary steps to meet this objective: Procure materials, assign and supervise the required personnel and have the equipment ready to complete the runs. The manager will most likely have no time to research the best options to save on energy, insurance or garbage removal. As long as the services are provided on a timely manner to complete his production plan he will meet his goal.

Lack of Industry Knowledge. Even if there was sufficient time available, the next challenge is to know who should be selected as the service provider: Which vendor provides reliable service at the best cost? Which services should be selected? What are the best plans for the company or department given their specific needs? Are there any incentives the company can take advantage of? What type of agreements, if any, should be committed to?

Lack of Industry knowledge

If we multiply these complex questions times many vendors and times several categories, we end up with a ton of information that is almost impossible to gather and understand. Deciphering all these variables is what we call *Industry Knowledge*: The Who, What and the How. The lack of it is what in many cases pushes companies to select an inappropriate vendor, service or particular plan.

Every business has its own particular knowledge required to be successful. For example, a company that manufactures cleaning products has to constantly develop new products to differentiate from its competitors. It also needs to find creative ways to market them. Adding the *Industry Knowledge* for services becomes a complex task that distracts from the main goal of the business.

As a result, most managers go for the safe options like selecting the best known vendor or just renewing existing contracts, leaving thousands of dollars on the table.

Focus on Sales or Direct Costs. In a very competitive environment with significant time restraints, managers tend to focus their limited resources and attention on strategic matters like increasing sales or reducing direct costs. Direct costs are those associated directly with the product or service. They typically comprise raw and packaging materials as well as direct labor. Direct costs can represent between 30-70% of revenue and are very specific to the business.

Focus on Sales or Direct Costs

For example, the active ingredient on a medication is a key component of a pharmaceutical business. Same can be said about the packaging and labor required to produce this medication. As a result, managers spend considerable resources in acquiring them at the best possible costs.

However, there is another group of expenses known as *Indirect Expenses* that are not directly related to the product or service. These comprise multiple categories including: Insurance, Energy, Payroll Processing, Courier Services, Telecommunications, Office Supplies, Garbage Removal and Maintenance among many other. Given the fact that indirect expenses are fragmented in many categories they represent individually a small portion of total spent. However, collectively they can account for a third of the expenses pie.

As a result of the lack of time, industry knowledge and relatively low individual impact, indirect expenses tend to slip under the radar and lots of money is left on the table every day.

Inertia/Lack of Will. Lastly, even if managers had the time, knowledge and awareness of the importance of indirect expenses, there is one additional factor that explains why companies overspend. We call it *Inertia*, which is a term borrowed form physics and is commonly defined as *"a tendency to do nothing or to remain unchanged".*

Inertia/Lack of Will

Change involves additional work, time and risk, so many managers tend to avoid it, in particular, where there are no incentives to change. In these cases, an additional force or motivator is required to make things happen. It could be internal pressure to improve results or just an outsider that helps drive the process, inspiring confidence and making it easy to absorb by the organization.

Our experience shows that most of the times, these changes require very little effort from the staff and the return on time invested is extremely rewarding.

Recently, we were asked to look for a new supplier for a specific item for a warehouse. After doing our analysis we found a vendor that could supply same item for 15% less than their current cost. Later it was brought up that this vendor has been offering the company the same option for months. Just needed the chance to be tested, which took just a couple of hours. As a result of an external intervention and only two hours of their staff time, the company is now saving thousands of dollars.

Final Thoughts

In summary, there is a lot to be gained and value to be added to shareholders by reducing expenses, in particular, the indirect ones that tend to slip under the radar. Any expense reduction will most likely not affect the product/service quality and sales, improving directly the bottom line. Experience shows that the return on time invested by managers and employees will more than justify the limited effort required.

Ben Lapscher is a Principal with Expense Reduction Coaching (ERC) in South Florida. Since 1993, ERC has helped multiple businesses save millions of dollars in indirect expenses. Before ERC, Ben accumulated extensive operational experience in different industries and positions in local and multinational businesses. Ben holds an Industrial Engineering degree from Universidad Catolica Andres Bello and an MBA from IESA, both in Caracas, Venezuela. He has also completed extension programs at Harvard Business School and Kellogg School of Management. Comments: blapscher@ERCcoach.com.