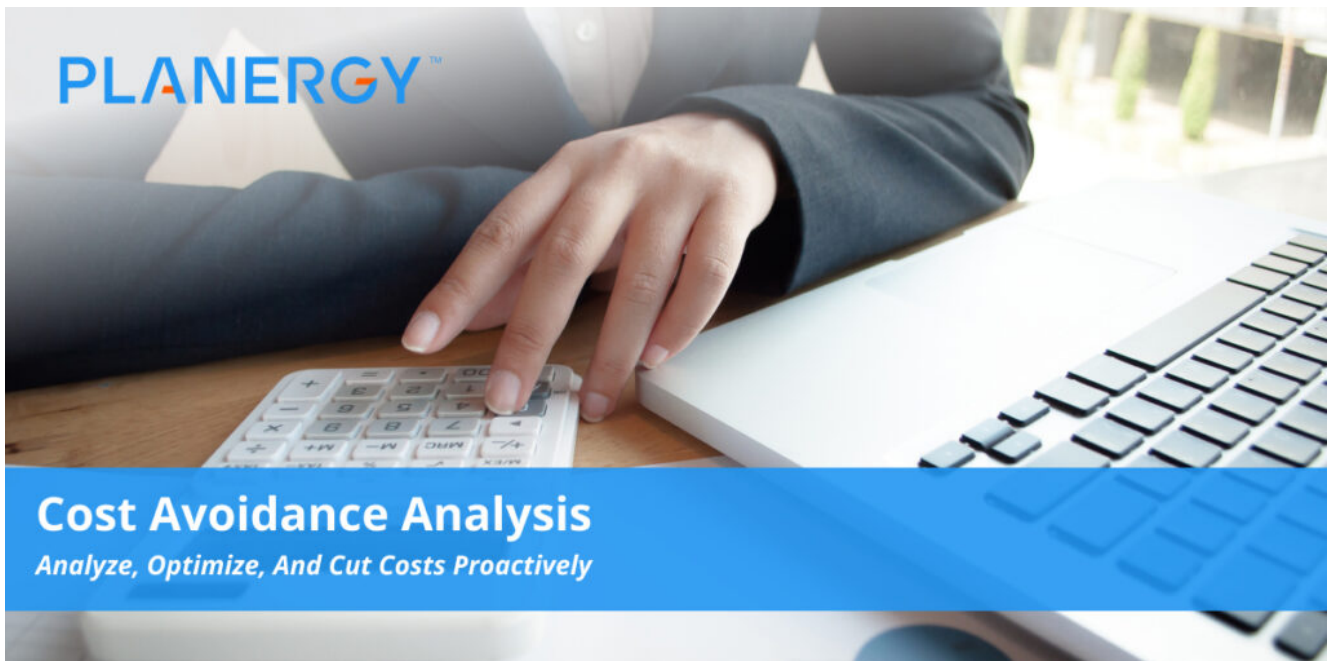


# Cost Avoidance Analysis



When you're looking to make every dollar stretch as far as possible, your financial strategy might consist largely of slashing costs wherever possible to achieve immediate and actual savings.

It's certainly appealing to see your debt levels drop and your bottom line increase in real time, but if your savings calculations don't include *cost avoidance* as well as cost savings, you might be sacrificing value *and* risking potential problems from higher future costs.

An important component of spend forecasting, cost avoidance analysis can help your procurement department stave off cost increases, improve value through higher return on investment and lower total cost of ownership (TCO), and leverage actionable insights to seize opportunities that provide indirect savings as well as strategic and competitive advantages.

## Why Cost Avoidance Analysis Matters?

Before you can analyze cost avoidance, it's important to understand what it actually is.

In seeking to achieve cost savings, many companies overlook the potential value inherent to avoiding costs. Unlike so-called "hard savings," where immediate

savings are realized by direct spend reductions, cost avoidance is a soft or “indirect” source of savings.

So while you can draw a straight line between this year’s financial statements and last years to illustrate cost savings, achieving and monitoring cost avoidance is a trickier proposition.

In essence, cost savings measures are *ameliorative*—a way to demonstrably improve your bottom line through hard savings.

Cost avoidance measures, on the other hand, are *preventative*, helping inoculate your business against financial uncertainty and helping you manage important processes like cash flow and strategic sourcing by nipping future problems in the bud.

A few of the most common examples of cost avoidance include “soft savings” from:

- Following a prescribed maintenance schedule to keep equipment in peak condition.
- Countering a vendor’s potential price increase with a lower increase (or no increase at all!)
- Using process improvement to optimize workflows and automate high-volume, repetitive, low-skill tasks to increase accuracy and speed, freeing team members to pursue more valuable tasks.

There’s a measure of mental athleticism required when pursuing cost avoidance, because like a vaccine, its value lies largely in financial benefits gained from things, well, *not* happening.

The hospital bill and associated fees that accompany a serious illness are very real costs.

But some vaccinated individuals who avoid those costs may not recognize the lack of a hospital stay as savings, even though not being vaccinated has a measurable cost in a scenario where they fell ill.

In order to analyze and track cost avoidance effectively, it’s important to know two critical terms:

- **Cost avoidance** (also called an *avoided cost*) can absolutely produce actual cost savings. However, those savings are predicated on avoiding a larger cost through direct action (e.g., vaccination, regular maintenance on important equipment, proactive contract management, etc.).
- **Opportunity costs** are the other side of the cost avoidance coin. For every decision made, a company benefits, but sacrifices potential financial benefits they might've reaped had the decision gone another way. Striking the right balance to ensure you capture the most actual savings, generate the most value, etc. is the important component in leveraging cost avoidance—and to do so, you need a smart and effective way to perform cost avoidance analysis.

New technologies—or, more properly, the latest iterations of extant technologies currently being applied by businesses looking to benefit from digital transformation—can help everyone from chief financial officers (CFOs) to strategic analysts in procurement departments gain a clear understanding of their historical, current, and future cost structures.

Advanced analytics, artificial intelligence, and process automation tools like those built into comprehensive procurement suites like PLANERGY make it possible to evaluate existing costs and gain financial benefits through regressive analysis, as well as through predictive analysis tools like *demand forecasting* and *demand management*.

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## **Demand Forecasting, Demand Management, and the Search for Soft Savings**

Buy only what you can use or sell; pay the best possible price, and don't fritter away your profits on inventory bloat.

These are the time-tested tenets of procurement, and now, in a data-drenched global marketplace, they are joined by a new one: Maximum value through low total cost of ownership and the highest possible return on investment.

In pursuit of these worthy goals, analytics have incredible potential for procurement teams who can leverage their powers in spend forecasting.

Cost analysis (as distinct from cost avoidance analysis) combines well with two applications of particular utility:

- **Demand forecasting** (also called *demand projection*), analyzes multiple data sets (internal spend patterns, market trends, etc.) to help teams understand whether demand for raw materials, goods, and services will be flat, increasing, or decreasing within a given period of time. Demand forecasting supports cost avoidance by helping provide a completely clear picture of how every transaction will actually affect the bottom line.

To take a common example, let's say you identify a product your company produces with demand that's increasing at an unexpectedly high rate: Doodad X. By performing both year-over-year and month-over-month analysis, paired with market trend analysis and consumer behavior, your team might discover that demand is actually tripling every month, on average, and is projected to peak somewhere around 150,000 units each month—and linger there for at least six months.

While this will certainly make the sales team ecstatic, it's also a golden opportunity for the procurement department, who can now approach vendors with this data and leverage economies of scale to lock down the best possible pricing and terms for the raw materials and other components necessary to produce Doodad X—or even supply key vendors who supply components with raw materials, eliminating the supplier's material costs for their orders and providing more long-term value and cost savings. You've seized an opportunity that might've otherwise gone unnoticed, and in avoiding future costs, have helped protect both your future budgets and the cash flow you'll need to make investments, develop new products, or cover unexpected expenses that simply couldn't be predicted by analysis.

- **Demand management**, which uses the insights you gather from demand forecasting to target categories where spend is on the rise, find out why, and rein in that spend for both immediate and long-term cost savings.

If (for example), your business is still using an elderly piece of specialized software, provided by a single vendor, who is charging exorbitant rates that take advantage of your being a “captive audience,” so to speak. Finding a new software application with a large user group that provides identical (or improved) functionality will help you save money both now, by eliminating the high fees for the outdated application, and in the future. You’ve effectively managed demand through process optimization and elimination of future costs—and created value by reducing TCO on an essential piece of software.

Ultimately, effective cost avoidance analysis, and spend forecasting as a whole, is much more effective, practical, and timely when you choose to use advanced analytic tools.

Without them, you’ll miss out on countless opportunities for indirect cost savings through cost avoidance, as well as value gained from making the best possible choice when faced with balancing opportunity costs.

## **Cost Avoidance Generates Not Just Savings, But Value**

Not spending money can land you some real bargains when you do it the right way.

By using cost avoidance analysis as part of their overall spend forecasting and management, your team can improve their decision making to free up resources (and cash flow), develop and implement an effective strategic sourcing strategy, and complement cost savings with value preservation and creation.

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