What Is Cost Efficiency? Definition and How to Achieve It

In order to compete effectively, secure the resources they need to grow and innovate, and generate a healthy bottom line, businesses need to find the best possible return on every dollar they spend. One of the most important pieces of any sustainable business strategy is finding ways to achieve and enhance *cost-efficiency.*

As one of the more widespread business efficiency strategies in use today, cost efficiency methodologies can be effectively used by businesses of all sizes and types. Paired with the right software and digital technologies, cost efficiency strategies can help companies make more strategic decisions that drive innovation, shift procurement to become a value creation center, and reduce operating costs while increasing operational efficiency and profitability.

What is a Cost Efficiency—and How Does it Relate to Cost Effectiveness?

The simplest definition of cost efficiency is "saving money by improving a process or product." Companies measure their cost-efficiency by comparing the business costs incurred against the output produced (for a product) or the revenue generated (by a process). It has very powerful longevity and potential built in, as there’s literally always room for improvement.

Over time, companies can continue to find new ways to manufacture higher quality products for lower costs, or refine their workflows through the use of continuous improvement and process optimization. When it comes to cost-efficiency, the sky really is the limit.

While cost-efficiency is often compared to (or confused with) cost-effectiveness, they’re not the same thing. Understanding the difference between cost-efficiency and cost-effectiveness is as simple as considering the difference between efficiency and effectiveness (also called efficacy).

- **Efficiency** focuses on the maximization of return as compared to resources invested. Return on investment (ROI) is the classic example, although it should be noted that ROI can be optimized through the reduction of waste as well as securing optimal pricing. Cost-efficiency is calculated using a cost-benefit analysis (although it can also be called a *cost-efficiency analysis*), and becomes increasingly important as a core business efficiency strategy as an organization, and its need to achieve optimal profitability, grows.
- **Effectiveness** (Efficacy) focuses on accomplishing a specific purpose within predefined parameters. Within the context of cost management, effectiveness is generally measured using a value metric such as Total Cost of Ownership (TCO). Cost-effectiveness is generally measured using a cost-effectiveness analysis.
  It’s important to note that the most cost-effective solution may not be (and, in fact, frequently isn’t) the most *cost-efficient* Understanding this difference is essential in crafting cost management strategies that incorporate both maximization of cost savings and generating long-term value.

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Tips for Achieving Cost Efficiency

All businesses have their own unique goals and needs. But achieving cost-efficiency is a goal that matters to *every* business. Following a few simple best practices can help organizations identify opportunities to achieve, and, over time, enhance their cost-efficiency in all areas of their business.

1. Perform a Cost-Benefit Analysis

Every spending decision has the potential to help or hinder the growth, competitive strength, and profitability of a business. Running a cost-benefit analysis lets you compare the relative advantages and disadvantages that come with different business decisions. These analyses are generally performed for one of two reasons:

- A business decision is reviewed to determine whether its associated benefits outweigh its costs (and if so, to what degree) and if, based on that information, it should be pursued.
- Two or more business decisions are compared to determine the total benefit each provides as compared to the total costs associated with pursuing it.

A very basic cost analysis follows a simple series of steps.

1. For each potential business decision, prepare a list of the associated costs, as well as a separate list of the associated benefits. Both lists should be as comprehensive as possible.
   Potential costs include:

- **Direct costs**, e.g. raw materials, labor, inventory, etc.
- **Indirect costs**, e.g. rent, utilities, overhead, etc.
- **Opportunity costs**, e.g. necessary time commitments that may prevent the pursuit of other opportunities, the relative costs of manufacturing a product internally vs. outsourcing production, etc.
- **Intangible costs**, e.g. reputational impact, employee health and safety impact, etc.

- **Risk-related costs**, e.g. Environmental impact assessment, regulatory compliance requirements, existing competitive threats, etc.

Potential benefits include:

- **Tangible benefits**, e.g. higher sales or revenue.
- **Intangible benefits,** g. faster/more accurate processes, higher team morale, improved customer satisfaction, greater customer benefits, etc.
- **Greater competitive advantage or market share.**

2. Apply a monetary value to each item on both lists. You can avoid costly under- or over-estimations by drawing on existing spend data. A comprehensive procure-to-pay solution such as PLANERGY simplifies the process by providing a centralized data environment and powerful automation and analysis tools.
3. Total and compare the values for each list to determine whether the net benefits outweigh the potential costs. If they do, then proceeding with the decision will likely help you meet your goals. If they don't, it's time to look for other solutions or revisit each of the associated costs to determine if they can be reduced.

2. Invest in Procure-to-Pay (P2P) Software

Today's complex global economy is driven in large part by Big Data, and without the tools needed to collect, organize, and analyze that data, companies sacrifice their ability to compete effectively. Choosing a purpose-built procure-to-pay solution like PLANERGY provides several concrete benefits that simplify cost-benefit analysis and make it easier to implement the process and spend management enhancements that grow over time through continuous improvement.

Consider these benefits:

- **Cloud-based, centralized data management.** Crucial business decisions are based on more than just a single source of data. Connecting and standardizing the disparate data sources within your organization—both internal and external—ensures you have complete and clean data ready for analysis, whether you're evaluating an investment, sourcing sustainable materials for a new product, or optimizing your cash flow management.

- **Better risk management for reduced risk-related costs.** Centralized and secured cloud storage and access reduces the risk of business disruption. Automated processes improvements such as guided buying and full integration of vendor catalogs reduce both maverick spend and invoice fraud. Automation also improves contract compliance for both parties.
- **Reduced materials costs and a smaller environmental impact.** Eliminating paper and manual workflows generates substantial immediate savings for most organizations by reducing the need for materials, storage, and energy consumption. It also enhances a company's ecofriendliness by shrinking its carbon footprint. Process automation minimizes the need for human oversight and intervention and eliminates human error, driving efficiency up and operating costs down.
- Scalable, web-based and cost-efficient apps and data management minimize hardware and energy needs (since both apps and data can be accessed from any device or platform, and no local servers are required), reducing TCO for IT investment and increasing ROI.
- **Continuous improvement becomes S.O.P.** Artificial intelligence and machine learning help automated processes evaluate and improve their own performance over time, trimming costs and boosting efficiency.
- **Procurement becomes a value center and strategic powerhouse.** Optimized processes and skyrocketing ROIs are only part of the equation. Gaining full control over, and visibility into, spend data allows it to be more effectively (and efficiently!) analyzed, providing rich insights, revealing hidden opportunities, and helping shift your entire business to a more competitive footing through more strategic decisions.

3. Practice Proactive Pricing

Depending on your overall strategy, taking the position as a low-cost provider can significantly improve cost-efficiency. Offering goods and services at a lower cost, quality, or both can help you capture customers for whom pricing is the highest priority and establish a strong competitive footing within that space.

Alternatively, in the luxury space, it may be possible to charge higher prices without increasing costs or quality (and thereby improving cost-efficiency) by leveraging intangible value created by a brand name or consumer trend.

4. Contextualize Cost-Efficiency Within Your Larger Business Management Strategy

Cost-efficiency is absolutely critical to success, but it’s most effective when supported and informed by other business strategies.

The potential for value creation, for example, can add some much-needed context to your cost-efficiency analyses.

Consider this scenario:

Company XYZ is looking to invest in new materials for its new Widget. Investment A provides higher quality, sustainable materials and will be serviced by a trusted local supplier with whom Company XYZ has a strong existing relationship.

Investment B is cheaper, but uses more traditional, less eco-friendly materials. It is serviced by a well-recommended but as-yet untested supplier in another country. Supplier B also recently had some significant labor compliance issues that have since been addressed.

Based solely on ROI and short-term relative costs, Investment B seems more attractive. But Investment A has the potential to deliver significant additional savings in the long term in several ways:

- Better materials translate to a customer benefit by improving quality.
- Sustainable materials provide a reputational boost and secure more business from the ecology-minded consumer, a demographic Company XYZ is interested in securing. In addition, the company will avoid any potential reputational damage that might occur from associating with Supplier B.
- Locally-sourced goods are less susceptible to supply chain disruptions and vendors can respond more quickly during a disaster.
- The existing supplier relationship with Supplier A will likely be strengthened further by this purchase, and may lead to future opportunities to obtain lower prices by leveraging economies of scale or creating both hard and soft value through strategic partnerships and additional product development.

Having the full picture available makes it easier to choose the most effective *and* efficient option when planning your spend.

Make Cost Efficiency Part of Your Strategy for Success

It's only a single part of a larger spend management and financial planning paradigm. But for companies who understand its utility and embrace the power of digital transformation tools with a comprehensive procurement solution, cost efficiency can provide a firm foundation for procurement-driven value creation, greater operational efficiency, and better strategic decisions.

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