

### What Is Your Definition of Cost Savings?

Different people have different definitions of “cost savings.” Therefore, it is helpful to think in terms of “contractual,” “annualized,” and “YOY” (short for “year-over-year”) cost savings. This example may help clarify the differences. Let’s say that a company with a fiscal year of January through December buys an item on the first day of every month. In 2014, it paid \$1,000 each time it bought the item. In the first six months of 2015, it also paid \$1,000. In the middle of June, the company signed a 30-month deal with a new supplier at a price of \$900 per unit beginning on July 1, 2015.

If you were the buyer that struck this deal, you might be inclined to claim cost savings of \$3,000, citing a savings of \$100 per unit multiplied by the 30 units bought under the contract. This would be “contractual cost savings.”

Some feel that cost savings should be limited to a maximum of one year. These folks would only claim \$1,200 in cost savings – the maximum 12 months multiplied by the \$100 saved per unit. Cost savings that is expressed on a 12-month basis, regardless of whether those twelve months are in the same fiscal year or not, is called “annualized cost savings.”

To calculate “YOY cost savings,” first look at the amount spent on the item in fiscal year 2014: 12 units multiplied by \$1,000 per unit for a total of \$12,000. Then, look at the amount spent on the item in fiscal year 2015: 6 units multiplied by \$1,000 per unit plus 6 units multiplied by \$900 per unit for a total of \$11,400. Finally, subtract 2015’s spend from 2014’s spend to calculate a “YOY cost savings” in 2015 of \$600. Similarly comparing spend in fiscal years 2016 and 2015, you’d recognize an additional “YOY cost savings” of \$600 in fiscal year 2016. Repeating the process for fiscal year 2017 vs 2016, you wouldn’t recognize any additional cost savings in 2017, even though 2017’s price is less than 2014’s price.

Especially when dealing with executives like CEO’s and CFO’s, it is important to understand your audience’s definition of cost savings. Being able to distinguish contractual from annualized from YOY cost savings can help.

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