TOOLKIT 32 – FIGHTING THE FLAB

- **Cut out all unnecessary costs.**
- **Get back to basics; get rid of the flab.**
- **Raise your own cash internally for investment.**

Once businesses move from the entrepreneurial stage, where they watched every penny, into the mature managed state they often build in unnecessary costs.

You will be familiar with the annual budgeting and planning cycle: last year's budget with a 10% sales increase and a lot of hope! Fixed costs are normally carried forward year on year and rarely re-examined.

You may even be in a business unit or department where a mandatory target is given to you without any thought of the issues that may be apparent to you in the next financial year e.g. increased regulation or decreasing consumer confidence. If this is the case then it is even more important that you focus on the areas of cost that you have a direct control.

By getting back to basics using a zero-based budgeting process, businesses can free up significant amounts of cash, which can then be reinvested in the areas of the business, which create the real profits.

STORY

The engineering division of a UK rail company spent £40m annually on maintaining engines and wagons. A new CEO wanted to cut costs and release cash for investment. He asked the engineering director how much it cost to maintain an engine. He replied, 'We have 300 locos and spend £15m annually so divide by 300 = £50k per engine.'

'No,' replied the frustrated CEO, 'you have just taken your costs and divided by the units. I want to know what it actually costs us to maintain an engine; not what your budget has been for the past five years.'

It was found that the actual cost was £35,000 per engine, the rest of his budget was made up of flab and unnecessary overhead costs which had never been questioned or properly reviewed for a long time.

The purpose of zero-based budgeting is to re-examine the assumptions built into the budgeting or financial planning process in order to cut out unnecessary costs and release cash for investment. You become your own venture capitalist!

Here is the principle of the process; most budgets follow this process.

Sales or cost forecast for the next twelve months (often broken down monthly)

E.g.,	Months	Dec	Jan	Feb	Mar	Apr
	Sales '000	100	120	90	180	110
Costs						
Variable						
	Wages	20	25	22	26	25
	Materials	30	36	25	40	36
Fixed						
	Heat	5	5	7	5	6
	Light	2	3	2	4	2
	Legal fees	0	2	0	4	0
	Salaries	20	20	20	20	20
	Water	1	2	1	0	0
Profit		5	8	2	10	8

Most budgets follow this process:

1. Sales forecast

2. Costs (based on last years performance)

3. Profits (what's left, then you take sales – costs)

In this approach the sales and costs are relatively fixed and the profit is variable.

Zero-based budgeting changes the assumptions to:

1. Sales estimate (fixed)

2. Profit required (fixed)

3. Costs = variable i.e., what we can afford

This process challenges Managers to question every cost and also to attempt to make as many fixed costs as possible vary with the sales level, e.g. by outsourcing, short term contracts, sale or return, just in time delivery, subcontracting etc.

Here is how to do it:

STEP 1 Establish monthly sales forecast for next 12 months. Or analyse the target that has been given to you by your head office.

STEP 2 Establish profit requirements based on your (or your head office) aspirations not historical results.

E.g., The construction industry (contracting) traditionally makes 1–2% net profit. Keepmoat Plc decided they wanted 4% and ended up achieving 3½%; they broke the traditional mindset of 'We are a 1–2% profit industry.'

STEP 3 Ask what **MUST** we spend in order to achieve the sales and profit targets. Cut out all unnecessary costs.

- Question and challenge every cost.

- Look for ways of making fixed costs variable e.g., make suppliers stockhold.

- Cut out unproductive overheads e.g., travel where tele or video conferencing is available.

- Consider outsourcing or sub-contracting non core activities like cleaning or IT.

- Get help from an internal creative accountant.

Overall seek to double your traditional profit levels.

HEALTH WARNING:

Cut out flab and waste, not muscle i.e., cut things that add cost and not value. Leave the paper clips and the people alone.

STEP 4 Establish your budget and monitor it carefully every month to ensure no slippages occur, i.e., variable costs become fixed again.

TROUBLESHOOTER

POTENTIAL PROBLEMS	*SUGGESTED REMEDIES*
Some Managers want to defend their department costs; it's their empire and they do not want it reducing.	– *Give them a share of the savings they make.* – *Make it mandatory.* – *Cut your personal overheads to demonstrate commitment to the process.*
People have their favourite suppliers	*Make it a company rule, get three quotes for everything.* *Example: Walmart forbid buyers to accept even a sandwich from a supplier. They want low costs not comfy (costly) relationships.*
Some Managers 'start counting paper clips' and details which de-motivates people.	*Focus on the real cost reduction opportunities.*

Area of focus	Value of savings to be achieved in the following month	Explanation of how this is to be delivered	Value of savings actually achieved	New target
(Example)Travel Monthly budget £15,000	*£1,500*	*Each member of staff to use video conferencing as the norm rather than the exception*	*£4,000*	*£11,000*

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