'Zero-based costing': a new approach to cost

Nowadays, cost rationalization is a priority for any company. But the traditional top-down approach seems to be insufficient and often not effective

Managing a company in a time of economic growth can be easy. However, mistakes made during periods of crisis may be fatal. During such periods executives often have to make unprecedented drastic decisions. Their decision-making skills can be pivotal in the company's ability to underpin market competition in both the short and long term.

What is the best approach for cost optimization?

During the current unstable economic environment many of the decisions companies must make concern cost optimization.

Strict top-down processes seem to be the easiest solution to the problem: Top executives impose their decisions on operative resources in an undifferentiated and mechanical way, giving them top-down targets.

A bottom-up approach, often disregarded despite having recognized effectiveness, is an alternative way to address the problem. **The bottom-up approach depends on the active involvement of middle management.** In fact, top management and operative resources must both correctly analyze potential opportunities and define together the consequent course of action.

This approach is successful in practice. Thanks to the prominence given to operative resources involvement, the time needed to achieve cost-reduction goals is considerably reduced. Operative resources are strongly disposed and motivated to achieve shared and realistic objectives, as occurs when a bottom-up approach applies. Consequently, this approach has high success rates, with tangible and long-lasting results. Even execution times are faster compared to traditional top-down approaches.

A drastic personnel reduction is an example of a top-down approach that is frequently adopted. During times of economic crisis this strategy has a strong impact on the media and it is well-appreciated by financial analysts. But taking into account its execution complexity, especially in a rigid labor market like the Italian one, it is neither easy to implement nor ensures lasting results.

Besides, companies applying this strategy expose themselves to many risks. First of all, they lose a key asset that could give them a competitive advantage once the economy stabilizes. Moreover, widespread layoffs expose the company to high negotiation costs (i.e, with unions, etc.), detracting from cost optimization. Finally, it causes a climate of resistance and mistrust between top executives and operative resources.

Given these considerations, is relying on traditional top-down approaches the best strategy for dealing with the current economic crisis? Furthermore, is undifferentiated cost-cutting, such as drastic layoffs, helpful in the short and long term?

Zero-based costing approach

We believe that an alternative to the top-down approach does exist: zero-based costing. This

optimization

By Paolo Cervini and Marco Occhetta

method enables the weaknesses of the traditional approach to be overcome by implementing bottom-up logic that builds concrete, immediate, and lasting results. **The zero-based costing method evolved from the zero-based budgeting theory and is practical and useful.** Its ultimate goal is to implement cost-saving opportunities that already exist within the company.

In addition, the zero-based approach provides a "breaking point" toward the reengineering approach, the goal of which is to simplify interdepartmental and horizontal (across the company) processes. The zero-based approach aims to minimize inefficiencies throughout every cost center. It detects vertical inefficiencies (inside a cost center) that would be neglected by a process-reengineering approach.

Top-down *approach*	***Bottom-up*** *approach*
Undifferentiated and "one-way" approach.	Specific and analytic approach.
Targets given by executives.	Executives set the direction and define the mission.
Employers follow instructions (push).	Employers involvement in identifying and delivering optimizations (share).
Typically, long execution time.	Typically, short execution time.
Typically, short-term impact on company's *status quo.*	Strong impact on company's *status quo* in the long-term. Tangible and lasting results.

The zero-based approach emphasizes cost optimization through an analytical, creative, and shared approach

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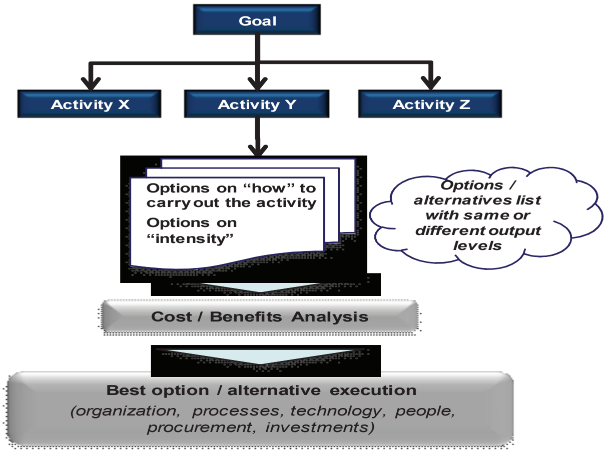
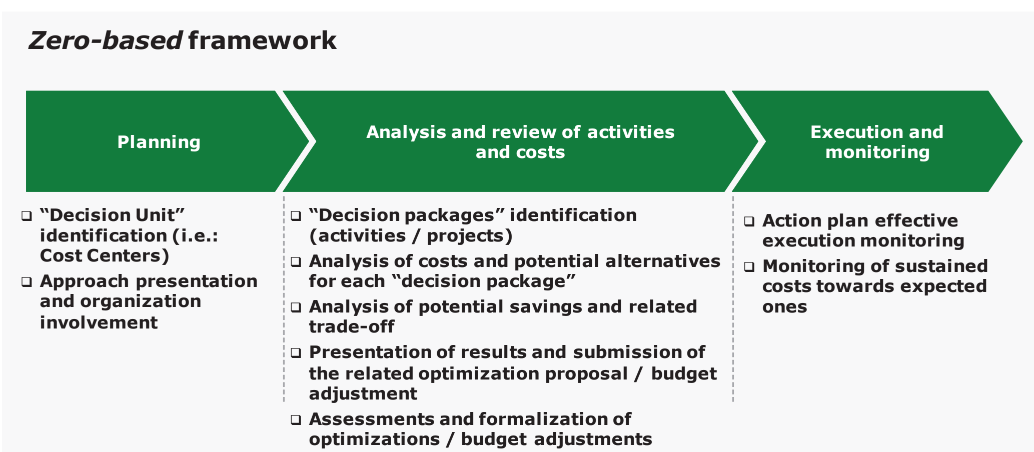


In particular, cost reduction is achieved by forcing managers to seek alternative ways of carrying out their responsibilites. The zero-based approach requires the organization's involvement at all levels: Top executives are committed to coordination and sponsorship activities, and mid-level managers focus on operative tasks.
The innovative side of this approach has two main characteristics: a detailed analysis of available alternatives and a strong "action orientation."

Why should a zero-based approach be adopted?

The zero-based approach is based on a detailed analysis of various options for the cost structure. First of all, a detailed analysis gives a better understanding of real needs regarding the actual cost structure and a grasp of the "optimal" level regarding attainable benefits (cost-benefit analysis). Consequently, internal resources are encouraged to identify alternative ways to carry out different activities, strengthening the foundations for a radical and lasting change of the company's "status quo." Internal resources will be motivated to undertake a creative process that is consistent with the company's goals.
Furthermore, the analytical approach reduces the likelihood of selecting optimization actions that don't fit the company's characteristics.

The bottom-up method of operative resources has many advantages over the traditional top-down approach. Indeed, thanks to their deep knowledge about the company and its cost structure, operative resources are encouraged to suggest tangible and easily implemented ideas. "Forced"



to propose and carry out specific optimization actions, internal resources develop a strong sense of commitment toward the achievement of expected goals. This active involvement enables significant goals to be attained. Optimizations consist of many small opportunities that only internal resources are able to discover.

Our zero-based approach could be defined as a "catalyzer" of easily achieved opportunities.

To assume that the zero-based approach is only appropriate for specific opportunities would minimize its effectiveness. As a result of internal resources' organic involvement, the zero-based approach **also enables the detection of otherwise neglected interdepartmental optimization opportunities.** Furthermore, by avoiding undifferentiated cost-cutting imposed by top executives, two benefits are obtained: (1) the creation of efficient cost centers, and (2) the distancing of managers from operative resources. The zero-based approach, due to the organic involvement of operative resources, enables the workload required of every single resource to be controlled. Indeed, as experienced during projects developed by Tefen with large energy companies, the internal resource involvement has been adapted (resulting in focused interviews and workshops) according to availability. Consequently, the impact on day-to-day activities is minimized.

Ultimately, the zero-based approach can be considered innovative from a consulting point of view. Indeed, it is quite different from traditional approaches since it requires, from the beginning of the project, hands-on and active involvement of consultants who, while interacting with internal resources, are directly involved in detecting optimization opportunities and achieving the company's goals.

The zero-based approach in practice

The zero-based approach, due to its characteristics, is relevant for many kinds of industrial businesses. It has proved to be extremely effective where fixed costs play a major role. Tefen Italy has used this approach several times to develop strong skills, mainly in the oil and energy industry (large refineries and thermoelectric power station). Working on one of our recent projects, this approach enabled us to identify more than 30 specific opportunities in more than 20 cost centers. The overall benefit was quantified to be greater than 5 percent of the considered baseline.

In such kinds of projects, investments in consulting fees are quickly paid back thanks to large and easily delivered results.

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