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Zero-based cost management

A holistic approach to managing budgets

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Contacts

Beirut

Georges Chehade
Partner
+961-1-985-655
georges.chehade
@strategyand.pwc.com

London

Andrew Clark
Partner
+44-20-7393-3418
andrew.clark
@strategyand.pwc.com

Milan

Giorgio Biscardini
Partner
+39-02-72-50-92-05
giorgio.biscardini
@strategyand.pwc.com

Moscow

Ekaterina Kozinchenko
Partner
+7-495-604-4100
ekaterina.kozinchenko
@strategyand.pwc.com

Paris

Douwe Tideman
Partner
+33-1-44-34-3127
douwe.tideman
@strategyand.pwc.com

São Paulo

Arthur Ramos
Partner
+55-11-5501-6229
arthur.ramos
@strategyand.pwc.com

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Executive summary

Though world economies show some signs of emerging from recession, cost management remains a top priority and a key performance driver for most companies. Many businesses have weathered the downturn by addressing easily accessible cost reduction opportunities. However, making significant and sustainable cost reductions without threatening performance and competitiveness is more difficult because many companies are unable to systematically identify and analyze the full range of activities undertaken by the business and the associated costs and business impacts. For that reason, there is increasing interest in the concept of "zero-basing" cost and activity levels, an approach in which costs are tackled at the root by reexamining each corporate activity as if it were brand-new. Although the concept of zero-basing is understood in theory, it is often misapplied. A structured and pragmatic approach to zero-basing can help achieve sustainable cost reduction while protecting key activities.

Key highlights

Sustainable cost reductions are difficult for many companies because they are unable to systematically identify and analyze the full range of activities undertaken by the business and the associated costs and business impacts.

Zero-based cost management is a holistic approach that tackles costs at the root by assessing expenses for all organizational activities in a structured, pragmatic, and dispassionate way.

Zero-base analyses target costs in a department, a group of projects, or across organization units, offering greater opportunities to identify structural budgetary problems and required cost interventions.

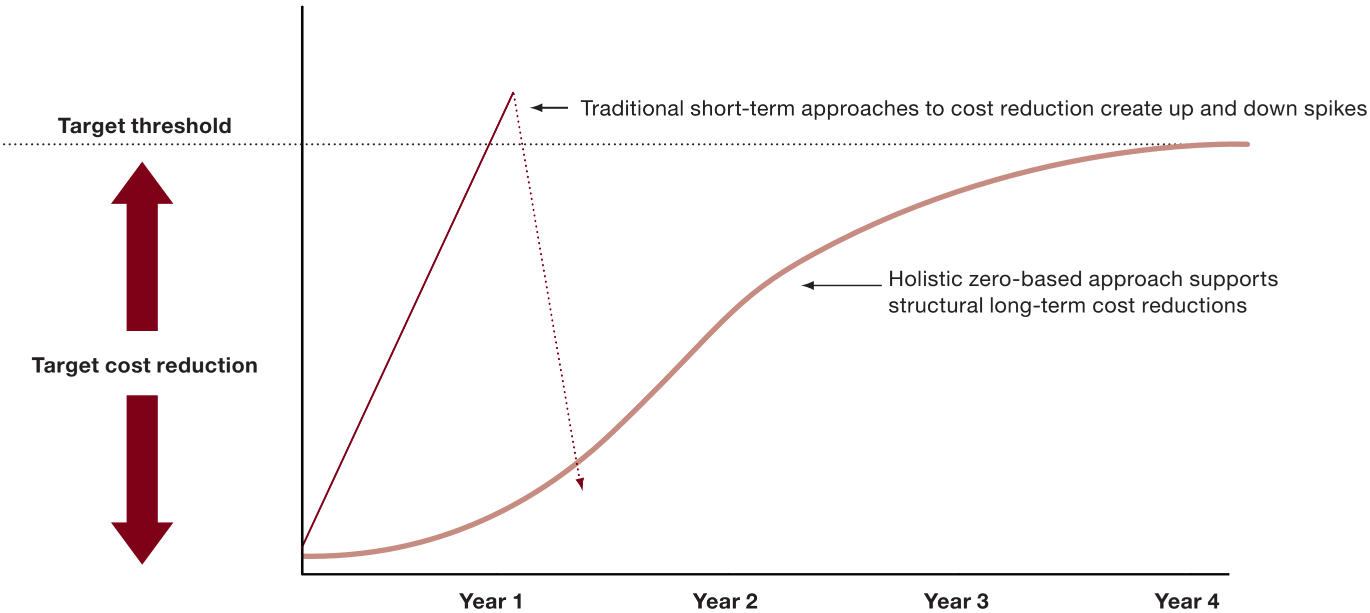
Looking at costs the wrong way

Even when business is good, no company consciously intends to be inefficient. But after two years of recession and a hesitant recovery, today's business environment leaves no room for error: Demand lags in nearly all markets, placing unrelenting pressure on the top line; new competitors from emerging markets are entering global markets; and capital funding is still difficult to come by. For virtually every company, the need to manage costs is therefore an imperative, not an option.

More often than not, companies attack costs the wrong way, by settling for intermittent top-down interventions such as across-the-board percentage spending cuts, deferral of investments, snap reorganizations, or layoffs. These approaches typically yield short-term results, but the benefits are difficult to sustain and the actions stress the organization (*see Exhibit 1, next page*). In fact, before long, companies often find that significant increases in expenditures — replacing aging equipment, building up depleted inventories, launching new products and services to differentiate, recruiting workers to staff expansions, and rehiring ex-employees as expensive contractors — are required to remain competitive. This drives the organization back to where it started — needing to slash costs again.

To end this cycle, companies should adopt zero-based cost management, which provides a long-term strategic approach to minimizing costs without the up and down spikes. Under this approach, the expenses for all organizational activities — everything from the way books are kept in accounting, to specific marketing campaigns, to IT, legal, and maintenance, to communications in the executive suite, just to name a few — are rigorously assessed, and funding for these activities is recalibrated.

Exhibit 1
Cost management improvement trajectories



Source: Strategy&

Zero-based cost management

Most managers are reasonably familiar with the zero-based concept in theory — it's often known as zero-based budgeting because it is typically attempted only in the annual period when budgets are being reassessed — but few understand how it is successfully implemented in a comprehensive manner.

At its core, zero-based cost management involves a fundamental reexamination of the activities and associated costs necessary to achieve specific business outcomes. A holistic approach to cost intervention, the zero-based method requires analyzing each aspect of the business carefully — and then repeating this exercise annually. A zero-based assessment can target costs in a department, a group of projects, or across organization units.

There are four steps to a successful zero-based approach (*see Exhibit 2, next page*).

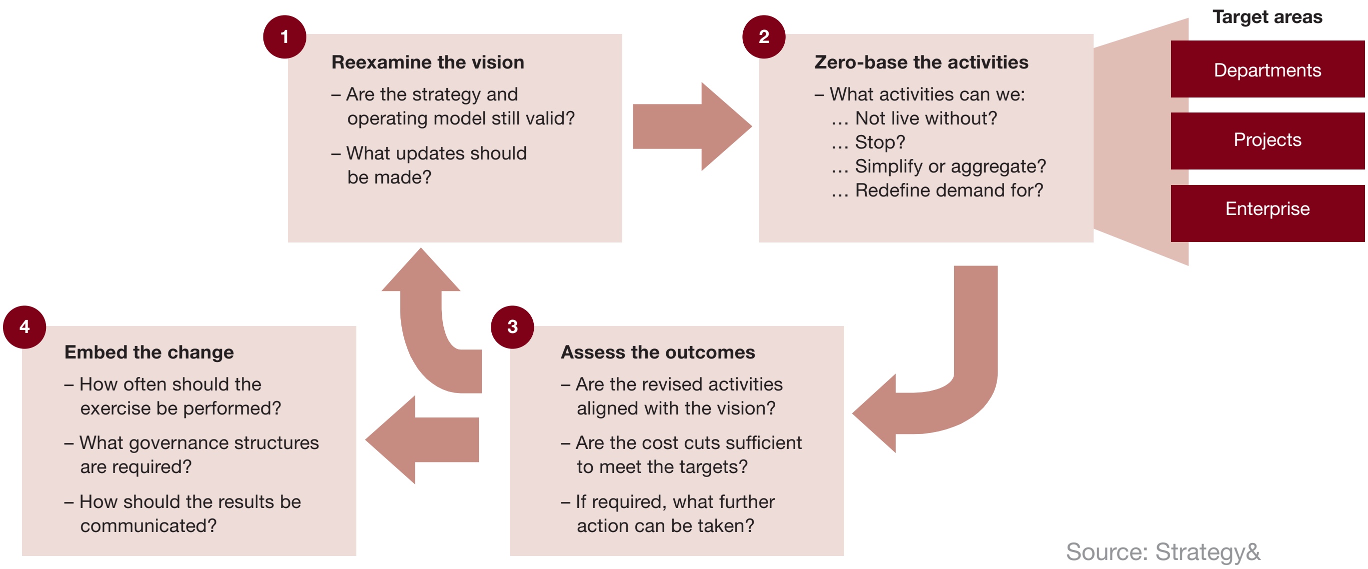
A realistic assessment of the near-term performance and priorities for the business is an essential prerequisite.

Step 1. Reexamine the vision

The starting point, before embarking on an aggressive assessment of business activities, is to ensure that the current business strategy and operating model are still valid. This does not have to be a substantial reexamination; instead, it should be a rapid assessment of which assumptions are still true and which are overly optimistic in the current environment, as well as what will likely change in the future. As an example, in the oil and gas industry, many operating units are shifting their operational focus from developing new oil and gas reserves to managing mature oil basins. This shift in focus often requires a fundamental change to the operating model, which in turn impacts the approach to the zero-based analysis (*see Exhibit 3, next page*).

In addition, most companies embark on a zero-based exercise only when market conditions are expected to remain weak and current business performance is unsustainable. Therefore, a realistic assessment of the near-term performance and priorities for the business is an essential prerequisite. It is against this new analysis that decisions on funding

Exhibit 2
The zero-based holistic approach



Source: Strategy&

Exhibit 3
Comparison of growth fields and mature fields

	Growth fields	Evolution	Mature fields
Operating philosophy	– Growth operating unit, which must deliver production increases to support company targets – Scale structure to focus on greenfield assets – Project conveyor belt, with focus on schedule and technical delivery – Technical functions are critical for success		– Production heartland, focusing on production excellence and mature field (re)development – Scale structure to portfolio reality, ruthlessly focusing on brownfield assets – Obsessive focus on cost and the bottom line, including third parties (lean operator model)
Consequence	– Praised for production growth – Acceptance of increasing costs and manpower levels, as an outcome of growth – Operating culture focused on technical and project delivery excellence – Often new organization structures with unclear accountabilities; bottom-line ownership often unclear		– Low-cost operation structure – Refocus from greenfield to brownfield excellence – Strict risk prioritization of operations and support activity – Operating unit decisions primarily based on incremental value generation, with clear accountabilities

Source: Strategy&

activities can be made. In undertaking this analysis, operating units or service-providing functions within the business should also offer a clear vision of how they would respond to changes in strategy and the market.

Step 2. Zero-base the activities

Zero-basing activities requires a thorough examination of the cost base in terms of the activities that the company must continue to undertake and the priorities placed on each of these activities.

Convening a review panel as part of the zero-based analysis helps to short-circuit debate, make decisions, and move sharply to implementation. The panel should include people responsible for administering budget lines, subject experts, and internal customers. The panel should be identified early in the process and meet regularly to enable issues to be quickly addressed and resolved.

To determine which activities should be given the most attention in a zero-based analysis, business managers should answer four basic questions:

Question 1: "What activities can we not live without?"

Even the leanest organization must perform certain activities to "keep the lights on." For example, minimum standards are mandated for safety and legal compliance. Much of what organizations do, however, involves an implicit choice about what to do above and beyond these basic activities, and how. To sustainably address the activity base, this distinction must be made explicit. It should also be remembered that additional, "new" activities may need to be added in light of the future vision articulated in step 1.

Question 2: "What activities can we stop?"

Although many activities are at least tangentially necessary to the ongoing and successful operations of an organization, many others are discretionary. For instance, a business unit may have begun a creative development program for certain staff members at a time when there was an aggressive push in the organization for new products, or one department may have instituted a job-sharing program while much of the rest of the company embraces traditional work hours. In fact, quite often certain activities are continued and well funded year after year because that's the way it has been done historically at the company, even though these activities may have outlived their usefulness. Activities that at one time made sense might fail to stand up under examination when the organization asks, "Why do we still do that?"

Question 3: "What activities can we simplify or aggregate?"

Just because an activity is necessary doesn't mean it is performed efficiently. Processes can become excessively complicated over time as attempts to enhance decision making draw in ever more stakeholders. Alternatively, similar activities can become duplicated across functions. Such instances may be widely known but remain unaddressed because changing them would be complicated, time-consuming, or politically difficult within the organization.

Question 4: "Where can we redefine demand for activities?"

Even if an activity is delivered efficiently, costs can spiral if it is not managed carefully. Companies frequently struggle to understand why their overall cost competitiveness is poor while the results of benchmarking individual processes tell them that unit process costs are low. The demand for an activity, however, plays a critical part in total cost. To illustrate, a company's IT department may negotiate a great price on laptops, which on paper saves the company a substantial amount of money. However, if there are few constraints in the organization on who should get a new laptop — and if, as is natural, everybody requests the new equipment — IT spending can take off even though the department has done its best to keep a lid on costs.

Zero-based cost management can be implemented to target costs in many facets of the organization — a business unit or department, a project, or even the overall enterprise itself. Each circumstance requires a slightly different approach.

Departmental expenditures: When dealing with a department that is integral to the day-to-day operations of the organization — for instance, service delivery functions such as finance, human resources, IT, or health, safety, and the environment — list the activities that the department undertakes in order of necessity. The first set of activities encompasses those required to conform to legal and company rules and regulations (these are the "must haves"); beyond these, all other activities are essentially optional. By definition, stopping all optional activities would not impact the company's license to operate, though its competitive position may well be affected. Thus, retention or expansion of specific optional activities (and their full cost) must be justified by clearly articulated business benefits. Optional activities can be put in "ought to have" and "nice to have" categories. To help inform the thinking in the organization about the relative importance of discretionary activities, it is essential to fully involve stakeholders — mainly those who would benefit from higher funding levels — and openly discuss the merits of specific discretionary activities and the constraints required to keep them within budget.

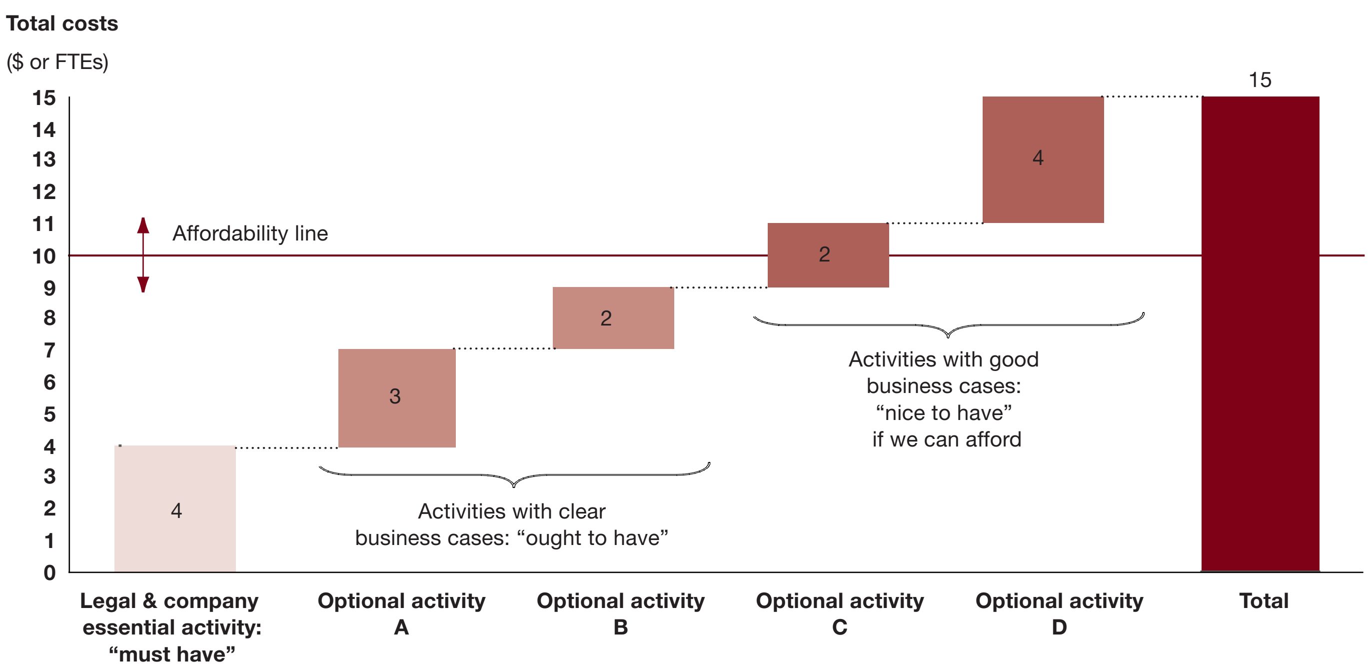
Zero-based cost management can target costs in many facets of the organization — business units, projects, or the enterprise itself.

When every departmental activity has been placed into one of the three buckets, an initial affordability line can be determined that covers funding for both essential activities and those that deliver clear, unquestionable benefits for the department (*see Exhibit 4*). It would seem obvious that all optional activity above this line would be dropped, though this need not be the case if significant efficiency can be gained by simplifying or aggregating some activities. This allows management to make choices between retention of some “nice to have” activities and additional investment in “must haves.”

Project expenditures: Poor and uncertain market conditions make projects extremely attractive targets for zero-based review. Projects and programs are generally discrete, bounded activities with their own budgets, and they are frequently optional, even if highly desirable. However, care needs to be taken not to defang a project that may not be required from a legal standpoint but is essential to maintain aspects of the company’s license to operate or to ensure that operational standards and guidelines are met.

Exhibit 4

Mapping activity costs against a cost management affordability line

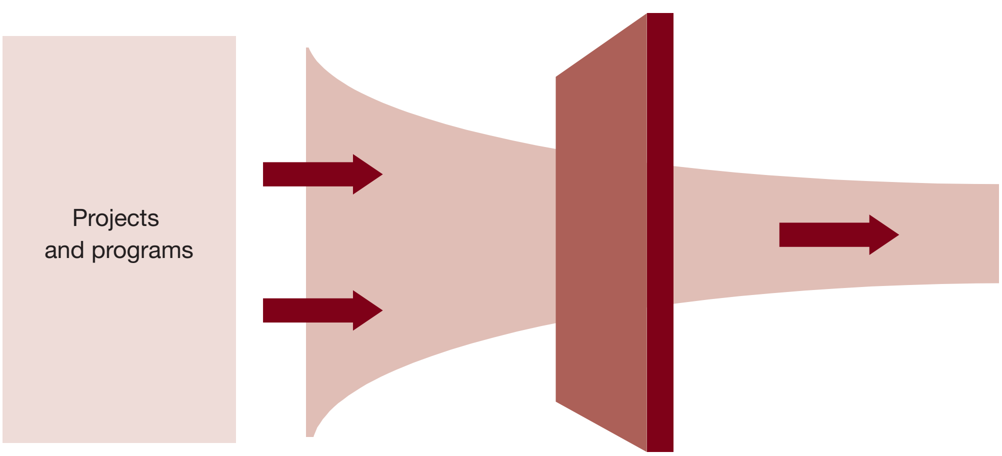


Source: Strategy&

In addition, a project often encompasses a wide range of activities — IT, engineering, design, development, personnel management, legal and safety compliance, and the like — aggregated into the individual effort. For that reason, substantial savings in activities throughout the organization can be gained by cutting out an unnecessary project, or at least lowering its budget.

The methodology for zero-based project cost management is similar to a departmental effort: First, create an inventory of all projects and identify those that are essential and those that could be stopped. All discretionary projects are then reviewed against a set of criteria based on the company's future vision (*see Exhibit 5*). This is an area in which the zero-based panel can be of real value, not only in scrutinizing budgets but also in choosing among projects. Once go/no-go decisions have been made, further examination of the efficiency and effectiveness of the retained projects can be conducted.

Exhibit 5
Screening projects in a zero-based analysis



– Continue
– Stop
– Simplify/aggregate
– Defer

Baseline

Selection criteria
– Fit with priorities
– Business case/benefits
– Robustness of plan & feasibility
– Competitive advantage conferred
– Extent of capability build
– Risk of not doing project

Recommendations

Source: Strategy&

For businesses that regularly undertake multiple significant internal projects aimed at driving growth, this is one of the most difficult areas to scrutinize. Often, significant cost savings seem possible from canceling a project, yet the potential negative business impact is also readily apparent — an argument that the project team can be counted on to make. Sunk costs can sometimes persuade corporate executives to keep projects alive, through the concept that shutting down a project essentially wastes the resources already invested in it. Still, as compelling as these notions may be, specific tough choices must be made for the full invaluable impact of zero-based cost management to be felt.

Enterprise expenditures: On its face, analyzing enterprise-level expenditures simply involves the aggregation of various zero-based analyses, but this approach risks overlooking critical comparisons of the budgets for the various functions and limits the ability to question whether the amount being spent on specific activities is in line with the overall strategic direction of the organization. For example, by examining IT and R&D activities separately, it may be possible to cut back on discretionary activities in each function and hold the line on budget increases, but the relative value of IT and R&D in the enterprise as a whole will not be assessed. And if, say, the two functions have equal budgets even though IT may be only half as important as R&D to the organization, the opportunity to adjust funding to match the needs of the company will be lost.

A picture can be developed that shows expenditures on value generation and support activities and what part of the overall enterprise budget each uses.

A more comprehensive approach begins with an inventory of all of the activities within the functions and business units or departments. Activities are then classified according to whether they directly support value generation (e.g., production) or occupy a supporting role (e.g., HR). People and costs are allocated to each of these activities, which are in turn linked back to their business unit or organizational entity. From this data a picture can be developed that shows the expenditures on value generation and support activities and what percentage of the overall enterprise budget each type of activity uses. With this perspective, budgets can be rebalanced according to their relative weight in the organization.

An additional benefit of an enterprise view is that unusual or historical placement of activities can be identified and logical regrouping established. An obvious example of such inefficient placement is shadow functional support activities in operating units, to some degree duplicating the services provided by a shared department such as HR, finance, or IT.

Step 3. Assess the outcomes

The assessment step gives managers the opportunity to step back from the cut and thrust of deciding what the revised activity set should be to see if the emerging picture both fits with the vision of the company, as articulated in step 1, and is significant enough to make the sort of cost reductions thought necessary. Clearly, any gap between aspiration and proposal can be resolved by looking again at the zero-based activity set to see what further action can be taken.

Where possible, it's a good idea to see what can be gleaned from external best practice benchmarks. This can help managers determine whether there is scope to reduce costs further, perhaps by better driving process efficiency, and where significant additional savings are unlikely.

In our experience, a staged "challenge" session, where peer managers present their plans, answer questions, and are challenged on what more they could do, helps both to drive out costs and to gain commitment for proposed changes. To prepare for such sessions, managers from each budgetary line in the organization must build a case for which business objectives their group plans to meet, the activities that will be executed in support of these objectives and the operating model, and the minimum resources required.

Step 4. Embed the change

None of the prior steps matter much if implementation is not done well. One of the key requirements for zero-basing must be sustainability, and lack of future planning is one of the common pitfalls. At the embedding stage, it is therefore crucial that these questions be addressed:

- Should the exercise be performed every budget cycle?
- What governance structures need to be put in place?
- How should the results of zero-basing be discussed within the organization?
- How much change can the organization handle?

The challenge session in step 3 offers a great opportunity for buy-in and helps to familiarize managers with the zero-based cost management process and the thinking behind the budgetary decisions.

Conclusion

The continuing global recession has forced businesses to do much more than simple, incremental cost cutting. Our experience is that a holistic zero-based approach, if performed thoroughly, enables organizations to make fundamental choices about how many resources to deploy in pursuit of business objectives and where these resources should be targeted. By pursuing this approach, companies can achieve meaningful and sustainable cost reduction. The approach is practical, pragmatic, and applicable in a range of business circumstances.

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