

## Collegium Antropologicum



Coll Antropol

ISSN 0350-6134 (Tisak)

UDK: 572

CODEN: COANDS

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International Journal Collegium Antropologicum is the official journal of the Croatian Anthropological Society and is jointly published by:

Croatian Anthropological Society

Institute for Anthropological Research, Zagreb

Croatian Association of Medical Anthropology

Commission on Medical Anthropology and Epidemiology of the International Union of Anthropological and Ethnological Sciences

The journal was founded on the occasion of the 1st Congress of European Anthropologists held in Zagreb, Croatia in 1977.

The journal is published with the financial support of the Ministry of Science and Technology of the Republic of Croatia.

With the numerous international recognition of co-operative experts, the Journal represents a relevant reference source in the fields of cultural and biological anthropology, sociology, ethnology, psychology, demography, history, archaeology, genetics, biomedicine, human ecology, nutrition and other fields related to multidisciplinary character of anthropology.

Učestalost izlaženja (godišnje): 6

Područja pokrivanja: Kliničke medicinske znanosti; Javno zdravstvo i zdravstvena zaštita; Stomatologija; Etnologija i antropologija;

Prava korištenja: Gudielines for authors, any further information as well as the complete archive of Collegium can be found on the official web page of the journal:

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# The Impact of Cost Cutting and Zero-Level Budgeting on the Organization Management in Crisis Situations

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## ABSTRACT

*Managing and optimizing the costs is the key aspect of affecting the competition and keeping a sustainable business of a company in modern business conditions. Managing the expenses in a quality way is a feature of successful organizations as well as of educated and motivated management. This is especially true when it has a function of managing the crisis situation or a preventive approach by avoiding it. In that context, two approaches (methods) of cost management policies will be analyzed. One policy is the policy of »cost cutting« that has the function of improvement and sustainable business. The other policy is a zero-level budgeting with the purpose of preventing and optimizing the process of cost cutting which is often primarily being used in a crisis management.*

**Key words:** *Cost cutting, zero-level budgeting, crisis management, resources, process*

## Introduction

With the development of modern company management concepts, one of the management tasks is the improvement of better understanding of costs and the whole concept of cost management. Costs are a part of the entire company business and the skill of managing them is of special importance. Good cost management is a feature of successful organizations as well as the educated, motivated and ethical management. To be able to successfully manage, we need to understand well the nature of costs and their »behavior«. In order to manage costs, first we have to recognize them, collect them and then correctly classify, record and finally analyze them. The idea of business optimization with the objective of business sustainability through good cost management should be transferred to all the employees, and there should be constant effort towards their motivation and will to keep track of costs in their own work and beyond. Nowadays, crisis environment is dominant in business situations, so the costs are cut without any objective criteria or far-reaching consideration, salaries are decreased, cheap raw materials of questionable quality are purchased, trainings and marketing activities are cancelled, and worst of all, linear methods are used without taking into consideration the need for business and manage-

ment optimization. Short-term effects of such measures can decrease costs, but in the long run they have adverse consequences. Managers in charge for cutting costs, that is for implementing cost cutting method, are not aware that many costs that arise in society can be seen as potential investments. Therefore, especially in the crisis time, costs are cut without any selection and without necessary understanding of the real needs and places for cutting costs. The objective of this thesis is to analyze the importance of cost management and also to examine how objectively and rationally the management reduces costs in the crisis time by using the cost cutting method. Furthermore, our purpose is to point out the importance of zero-level budgeting method which plays a significant role in cost optimization and management in sustainable business, as well as in cutting costs during the business crisis period. Research methods applied in the thesis are a descriptive method (describing and defining terms), and the analysis of former researches in the area in order to substantiate the thesis objectives and the laid-down hypothesis. Thesis research hypothesis is: implementation of cost cutting and zero-level budgeting methods affects the quality of organization management in crisis conditions.

## Material and Methods

Successful managers and their ability to be competitive on the market includes the choice of good strategies with the objective of positioning the company on the market, with strengthening competitive force and the choice of competitive advantage that is meant to be accomplished. Companies will hold a certain competitive advantage on the market by providing the so called superior value which their competitors can hardly reach. There are two main sources of company competitiveness: differentiation, or a difference in a positive sense of using comparative advantages of quality distinctions in relation to the competition and cost leading. However, what happens when a company gets into crisis, how do the companies achieve competitive advantage and successful positioning on the market. For many companies, global crisis consequences are reflected in the loss of existing markets. The crisis stopped some companies from finding the way to new customers through new projects and investments into new technologies, while for some others the crisis has reflected in financing problems and illiquidity. If a company gets stuck in crisis, it is recommended to perform some of the following activities in order to survive the situation they are in: revising short-term and long-term financing and business strategy, cutting costs and strengthening operative efficiency, improving cash flow management, keeping customers' trust, turning the crisis into opportunity, and so on. Something that companies should definitely not do in the time of crisis is: letting go a great number of people without defining vision and mission criteria, neglecting existing situation and continuing doing business like nothing has happened and ignoring the changes in business environment, cutting costs of products development and innovation, and so on. Cutting costs is exactly the first step that companies take when they find themselves in crisis, whereas they haven't researched or analyzed what really has to be to cut all costs proportionally, and that trend is difficult to change once when the crisis is finished.

### Zero-level budgeting

Harsh competition and not very favorable macroeconomic market conditions have led the companies into situation which requires consideration of new ways and methods for getting out of crisis. To protect themselves from external effects and to survive on the market, each company has to be good at cost management. Good cost management means that you can distribute your inadequate resources in a quality way through planning process which will set strong grounds for future company's decisions. The purpose of planning is to consider how to arrive at desirable objective while having the least possible obstacles or deviations. Also, a goal of planning is to create the grounds for plan realization control: by controlling the planned and accomplished we can see the possible deviations and then change the planned so that the company could in time and with minimal costs continue its path towards realization of a goal. Well constructed plan, as well as the implanted plan realization control, can already in early stages point at future problems of company's business. Planning is a process that

begins with objectives, with defining strategies, policy and further plans for their realization; it is the process that establishes organization for decisions realization and it includes success rate and feedback for starting the new planning process (Figure 1)<sup>1</sup>. There are various kinds of plans that the management draws up to achieve the company's vision and mission. One of the most important plans is the company's budget. The budget states

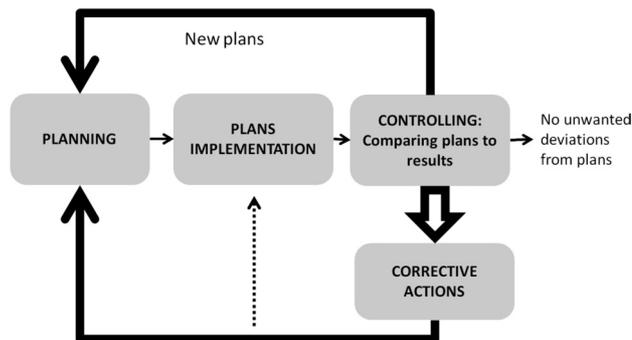


Fig. 1. Connection between planning and controlling.

the company's strategy in a numerical form. One planning method is the so called zero-level budgeting method or zero-base budgeting, which first appeared in the seventies of the 20<sup>th</sup> century in America when J. Carter was the president of the USA. Those were the years of great crisis for American economy. A large trade deficit was made, whereas oil shocks, all the greater unemployment and prices growth contributed to even slower economic growth. Then, with intention of strategy and decreasing public expenditure, president Carter with the assistance of advisor Pyhrr, who is also the creator of zero-level budgeting idea, starts with the reform of public sector and introduces new planning concept which is based on the assumption of planning from the »zero base«. The method of planning from zero base is the budgeting process that actively involves manager in the entire process, where the key feature is to plan business activities from zero as if the previous year never happened. Until this method appeared, the planning process used to be a routine and monotonous process of budget adoption. The only innovation compared to the previous year was a certain percent increase of each cost item in relation to the previous year execution. However, in the new economic situation of the '70s when the prices were going wild and the employment was falling, such politics was considered unsustainable. Therefore, public sector reform was started by introducing zero level planning as a way of saving. The planning procedure from zero base in theory is divided into four steps<sup>2</sup>:

1. Determining budget units based on which decision will be made
2. Forming 'decisions packages'
3. Evaluation and ranking of all decisions packages according to the cost-benefit analysis
4. Operative budget preparation in line with the decisions package rank

First step serves the managers to divide the company’s activities into important business segments. Each organization has to determine which activities those are. The activities are then divided into budgetary units for making decisions. An example of such unit can be an organizational unit or a project. Once the budgetary units are determined they can be examined and analyzed separately. The assumption is that they are organized based on already defined organizational units or determined programmes. When the management determines the units that are vital for making decisions, they are obliged to explain the concept of »decisions packages« to all management levels. The key thing is good communication between top management and other levels, and it is extremely important to give clear planning guidelines which contain the procedure of ranking and consolidation process.

»Decisions package« is the basis of planning concept from zero base. The determined budgetary units for making decisions from the first step have to be worked out into »decisions packages«, which is the next step of the method. Decisions package identifies and describes each budgetary unit so that the management can evaluate and rank it in relation to other units that »compete« for the resources, and then they decide which decisions package gets the resources. The purpose of decisions packages is to provide information on activities and programmes, and objectives, to give cost-benefit analysis, work force and efficiency measures, and alternatives for reaching objectives. The implementation of alternative choices into the total decisions package is of vital importance for zero-level budgeting success.

The ranking process answers to the key questions of how much money should be spent and where. The management has to rank decisions package according to the decreasing benefit for the company in order to be able to answer the above mentioned questions. After ranking,

future benefits are determined for each expenditure level. Also, decision consequences are analyzed in case a decisions package is not approved, or it is ranked below a certain costs level. Each decisions package stands for a different programme and different costs amount. A package has to comprise information on activity, the amount of needed resources, short-term objectives as well as their impact on the main objective, or the company’s strategy. The purpose of ranking packages according to increasing costs is to be informed about costs and know where they can be cut, which also means identifying consequences. Figure 2 presents proposals of budgetary packages for three situations A, B and C<sup>3</sup>. A management in charge for creating the budgetary unit A gave their list of priorities to the higher management. The higher level reorganized the proposed management priorities of the observed budgetary unit. The management of budgetary unit B also gave a proposal of budgetary packages which was unanimously accepted. In example C, the higher management level accepts the proposed decisions package from C1-C5, but C6 is not accepted in this case so it does not enter the further procedure. Each decisions package is stated in cumulative amount which represents a total cost by each proposed budgetary unit. After accepting the decisions packages, the top management ranks them according to the priorities of company’s strategy. The last step in planning from zero base is preparation of company’s operative budget<sup>3</sup>. Zero-level budgeting method was popular in the '70s of the last century and we can say that it has been at test since then. Since the world has been experiencing a global economic crisis, there is a need for introducing new management tools, or revising old methods. A recent research on using zero-level budgeting method was made by a professional association GFOA with the headquarters in Chicago. It consists of the states, districts, and local government finances officers in the United States of America and Can-

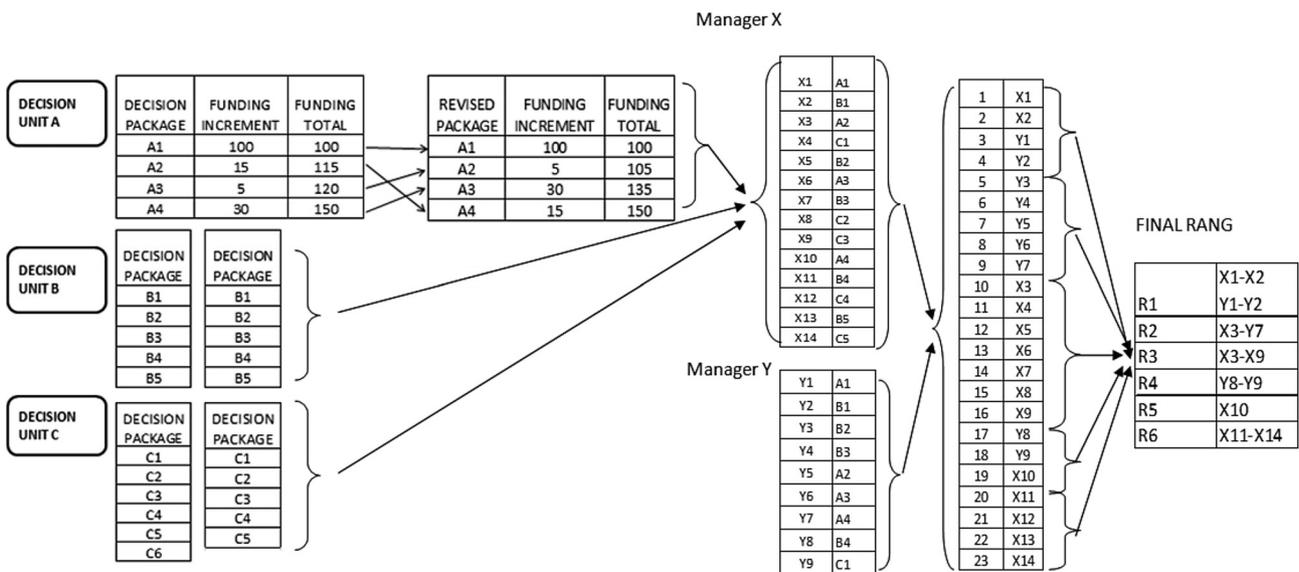


Fig. 2. The scheme of ranking decisions packages and consolidation process.

ada. The research was conducted under the title »Zero base budgeting, Modern Experiences and Current Perspectives«<sup>4</sup>. The goal of the research was to show the usage of planning method from zero base, as well as to answer the question who this method is intended for. Also, the thesis mentions possible existing alternatives compared to the observed method.

The research conducted in public sector showed that 44% of all respondents are considering the possibility of introducing a planning method from zero. As well, about 20% of respondents are using the methods similar to the basic concept of planning from zero base. The results of research from 2011 have shown that more than 50% of public sector respondents use at least some elements of the basic zero-level budgeting method in relation to the observed period before the arrival of 2008 recession<sup>4</sup>. The main reason for increased interest for zero-level planning method is definitely bad economic situation, or the worst economic growth in the last few decades. A general situation has imposed a huge fiscal challenge upon local government in the sense of serious changes, and mostly when it comes to resources allocation. According to the conducted research, half of the respondents think that the reform was very important or important for successful fight in current financial troubles. A rational and overall consideration of budget decrease is an advantage of such planning method. The available references assign importance to the managers' role in planning because it requires a large involvement degree into the planning process itself and the process of determining »decisions packages« which are completed numerically by the expenditure types. Contrary to the line budget whose planning boils down to passive copying of last year data and whose drafting most often ends up in the hands of administration staff, zero-level planning method requires considering all elements involved in the business process as well as possible alternatives. In line planning, decreasing one cost type can not provide quality information on the impact of such decrease, except perhaps its amount in percentage. In zero-level planning, a manager has to justify each cost before the management. In order to do that, he has to clearly define a »decisions package« and explain it using cost-benefit analysis. This is how the company's management gets a deeper insight into costs structure of organizational units. A drawback of zero base planning is primarily the time frame needed to determine decisions packages and perform their analysis. Each budgetary unit can define an unrealistic number of decisions packages which in turn requires a lot of time from top management to choose and rank them. Compared to the year 1970, today it is easier to solve that problem, because each business activity platform is IT system integration which enables increased speed and possibilities, together with the simulation possibility in the sense of virtual model simulation. Another drawback is the complexity of introducing a new method which also results in primary employees' resistance because of introducing new method. Every year all organizational units start from zero base which includes a large effort

from the most of employees, whereas in line budget only a minor part of last year's budget changes and it requires effort from only a few people. The practice has shown that the effects of zero-level budgeting are significantly visible in a longer-term period, so there is a danger of the superiors' dissatisfaction due to less short-term effects. The emphasized advantages of zero-level budgeting method are the orientation towards efficiency and final outcome. As well, the method demands a high involvement degree of all management levels into the planning process, which creates awareness and responsibility in defining business politics. Therefore, company's objectives become clearer, together with the company's vision. Also, the method requires costs optimization and considering alternatives for each decisions package, and this enables business transparency as well as the overall management quality.

### *Cost cutting*

A fundamental objective of cost management is to achieve the best long-term benefit from the made cost, rather than to rationalize costs at any price, i.e. to decrease the costs which one can do without, which means you can influence the business results and company's competitive position with lower costs. The development of management also develops the concept of cost management which is particularly reflected in crisis business conditions. From the management aspect, cost management concept should enable, that is, ensure information for the managers for choosing between alternatives with the intention of achieving optimal economic results while keeping the costs in reasonable limits. Therefore, costs optimization enables minimizing costs with desirable outcome. It often happens that responsible persons don't know the real costs structure or the reasons of their appearance, so such behavior can unconsciously or consciously lead the company into numerous problems. Constant efforts to decrease unnecessary costs will provide for each company an advantage on the market as well as the possibility of fast adjustment on the market, and all that together makes up a precondition for successful business activity of an organization. Managing costs can be done differently by applying various methods too. One of these methods is cost cutting, an extremely important method for managing an organization in crisis business conditions. Cost cutting is a method companies use to decrease costs and increase business efficiency. It is one of business tools that can make a company more competitive on the market. In applying cost cutting managers have to think over the long term. Some cuts can save money in short period, which makes them an appealing choice, but in the long run they can create additional costs. Cost cutting as one of the methods oriented on costs decrease, can refer to the employees' salaries decrease, to letting go of the employees, cutting down monthly bills connected to business activities of the company, etc. In order not to 'cut' costs where it is not necessary and which can bring no improvement in the long run, it is important to give careful attention to overall

company's business. That way the cost cutting measure can be performed appropriately, which should then result in business efficiency increase. Costs decrease enables companies to recognize their current needs, estimate future trends and understand factors that assist or prevent them in their business success. Successful costs decrease is a strategy that involves the entire organization and all management levels. One successful way of cost cutting method implementation is supply and demand analysis in order to cut costs efficiently and to increase productivity. In so doing, it is important to have in mind the influence of external variables such as time, economic trends, population, etc. It is always good to perform the procedure in quarterly periods because of reliable planning, which can affect the quality and the places where cost cutting is necessary. Good strategy of reducing costs provides the company with one step ahead of their competition. Suggestions by employees could also play an important role in reducing costs and increasing productivity, since the employees have much more experience in business processes proceedings and they are able to know where the unnecessary costs appear, which can then be eliminated without harmful consequences. Cutting costs too often without prior conducted research and field analysis can have negative consequences on further company's business. Cost cutting method implementation helps us to save the unnecessary waste of money and to ensure investment in the right place in order to increase profit. However, the problem is that the organizations consider this only when their business gets into financial crisis. Instead, the ideas of cutting costs should be planned and implemented in all business periods, even in the time when the business is profitable. The managers' task is to familiarize themselves with the factors that start up costs of each and every activity. They should not use their knowledge of the cost holders only to save on costs in the overall business process, but they should also be significantly more inventive and dedicated than their competitors in achieving efficiency of cost saving that will provide the company with sustainable market and cost advantage.

## Results and Discussion

### *Zero-level budgeting and cost cutting implementation in crisis period*

How to survive crisis in today's economic conditions, that is one of the main modern challenges for both small and big companies, since all of them have to find ways of cutting their costs and at the same time increase production quality and their market. The first steps of crisis management in crisis situations are cutting or reducing costs. Usually, managers and owners of companies, whose expertise is thereby questionable, react hastily in a crisis situation, so they cut costs without conducting analysis of the situation and causes. In order for the companies to be successful in their business environment in the crisis period, organization management has to set the priorities and focus themselves on reducing costs (where that

is necessary) and increasing profitability. Reducing costs is an often made reaction by the crisis management to the fall of income and profitability. Cost cutting method can also be used regularly to strengthen a company's performance, even when the organization is at the level of its planned expenses. Crisis does not emerge suddenly, but it develops and can be seen from far away, although it does not seem so once when it hits us with its full strength. In such conditions, it is important to have a good management who will be able to recognize the crisis, react rationally and cautiously, and who will manage the company by using methods like zero-level budgeting and cost cutting in order to prevent intensifying the company's crisis business activities. In the time of global uncertainty and crisis, reducing costs should constitute a critical part of organizational strategy. However, this should not be a once-only action. Instead, cost reducing should be based on the process moved by efficiency improvement, which will create the organization's additional value. Therefore, it is highly important to establish connection between zero-level budgeting and cost cutting, where cost cutting performs a curative function, whereas zero-level budgeting politics performs a function of prevention and optimization of its implementation. The cost management task through cost cutting is to carefully examine each activity that generates costs, and finally determine what moves those costs. The findings gained from such analysis are the findings about cost holder, and they should be used for optimal and rational cost reducing of each activity. In so doing, cost-saving ways are sought for through the entire business process. Care should be taken that managers don't get carried away with a too aggressive cost cutting, which can eventually result in lower profitability rather than higher. In such situations most often there are short-term effects that are visible at the expenditure part of the company in the form of reduced costs, but in the long run, this can be fatal if cutting costs was performed without any deeper analysis. It should be emphasized that at cost cutting policy the employees often lose motivation for work, especially if they cannot see the positive effect of cutting. The first and elementary thing required by cost cutting method is a diagnosis of current situation. Quality implementation of cost cutting tool means selective cutting of costs. Selective cost cutting with the purpose of accomplishing a long-term success is possible by using zero-level budgeting method. This method has to define each activity in the company from zero, and according to the 'cost-benefit' principle, where there is a strict cost level below which a certain activity could not fill its purpose normally.

Zero-level budgeting and cost cutting methods as shown in Figure 3 are tightly connected, since the former determines the company's activities crucial for further survival and development, while the latter provides specific price of those activities. Implementation of these methods enables business transparency and the choice of key holders of further company's development. The objective of cost cutting method is to find the optimal cost level for

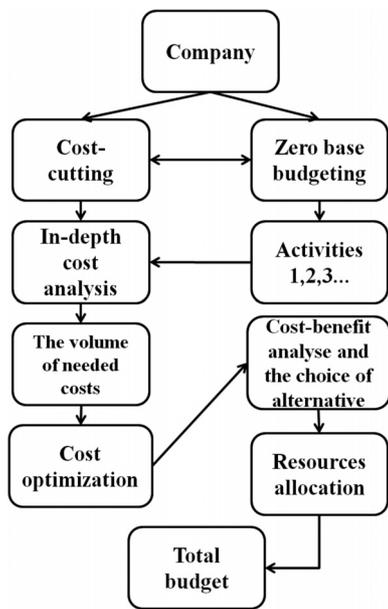


Fig. 3. Cost cutting and zero-level budgeting methods in a company in crisis conditions.

activities defined by zero-level budgeting method. After finding the minimal cost level necessary for the activity to function, zero-level budgeting method is a proposal of alternatives for each activity, which often include costs that are higher than the minimum level. The purpose of alternatives is to be aware of how much they cost and what is the return on investment compared to the invested money. The key to savings in the company is exactly the step where alternatives are proposed. After the lower management levels hand in their decisions packages, higher management will differentiate between the important and less important activities. Such proposal arrives on the top management’s desk, who then rank decisions packages in compliance with the company’s strategy and they allocate money to those units. In the end, all individually allocated resources get consolidated and they constitute the total company’s budget.

### Conclusion

The basic objective and task of modern management in crisis business conditions is rational cost management, rather than their cutting without the advance established criteria. The conducted analysis has proved the

set hypothesis of the thesis that applying »cost cutting« and »zero-level budgeting« methods affects the management quality in crisis conditions. Implementation of the two methods also affects the excellence of companies and organization management in regular business activities when there is no crisis. The zero-level budgeting method enhances awareness of the management about the necessary cost level in order for a certain activity to perform its function without obstruction. Thereby, awareness is raised about spending limited companies resources as well as their allocation. That way, efficiency is increased in accomplishing organizational objectives, but it also leads to increase of profitability and business optimization. Market conditions have become very unstable and the reaction time to changes is very short. Therefore, companies are forced to consider introducing new management tools which will help them recognize the first disturbances and turn a defect into future benefit at the right time. For the management strategic tools to become successful, that is useful, awareness about planning importance and cost management should be changed. It is important to understand well the movements out of and within the company so that we could react actively. Considering the fact that cost cutting method is used in the moments when crisis period has already begun in the company, the importance of the method is to apply it efficiently. If we raise awareness in the management structure about how it is important to act in time, we can say that we are still not in crisis. Thus, the company strengthens compared to the competition because it has time to prepare itself for crisis. Strategic plan preparation of company’s further work in such conditions is vital for its long-term success. In the planning process awareness should be raised to plan each activity as a future benefit which should be accomplished with the logic of reducing costs to the level of real needs. These tools are applicable both in private and public sector. In American companies’ practice there is an example of one company that uses the method in its original form, and other organizations who implement it most often use some elements of zero-level planning. A contribution of this method is that the planning process starts from the lowest level towards the top of the pyramid, which requires active participation of all organizational structures and levels. Such way of planning demands a great knowledge and effort by the managers concerning the implementation and realization, and it is sure to contribute to transparency and clearer defining of company’s objectives.

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## **UTJECAJ »COST CUTTINGA« I BUDŽETIRANJA NULTE RAZINE NA UPRAVLJANJE ORGANIZACIJOM U KRIZNIM SITUACIJAMA**

### **S A Ž E T A K**

Upravljanje i optimiranje troškovima ključan je aspekt utjecaja na konkurentnost i održivo poslovanje organizacije u suvremenim uvjetima poslovanja. Dobro upravljanje troškovima odlika je uspješnih organizacija te obrazovanog i motiviranog menadžmenta. Upravljanje troškovima ima posebno važnu ulogu kod izbjegavanja kriznih situacija. Jedan od ključnih aspekata na koji se fokusira krizni menadžer zapravo su troškovi i njihov utjecaj na poslovanje. U tom kontekstu analizira se utjecaj dviju politika (metoda) upravljanja troškovima: politika tzv. »cost cuttinga« u funkciji kurative i politika budžetiranja nulte razine u funkciji preventive i održivog poslovanja, kao i optimiziranja provedbe »cost cutting« metode koja se vrlo često koristi u kriznom upravljanju.