OCTOBER 2014

Five myths (and realities) about zero-based budgeting

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Companies often shy away from the method because they fear it or believe it means "budgeting from zero." In reality, it's a structured process that can build a culture of cost management.

As many companies watch growth in sales, general, and administrative costs outstrip increases in revenue, controlling expenses has become an even greater priority. As a result, executives are under ever-increasing pressure to deliver productivity improvements, and almost all companies have sought to reduce costs, whether through traditional programs, such as outsourcing, offshoring, and strategic sourcing, or other one-off cost-reduction events. But in many cases, these are still not enough. Executives need bigger savings that can be sustained over time.

Unfortunately, the typical approach to identifying cost-reduction opportunities—examining operating expenses in the aggregate—is poorly suited to driving realizable, lasting, and significant benefits. The findings are often too high level to link to the actions required to unlock the savings. Moreover, managers can avoid action by refuting the underlying data or citing unique business needs. Given such constraints, when savings are required, executives often feel they have no choice but to slash and burn, making arbitrary budget cuts without any changes to the underlying work, regardless of how prudent or sustainable those choices may be.

Fortunately, there is a sustainable alternative to cost management that is appropriate for many companies: zero-based budgeting. We have heard of many versions of zero-based budgeting, including the literal interpretation of the words: "a technique for building a budget from zero." While that is certainly a fundamental part of the process, our experience has shown that effective zero-based budgeting is much more than that.

Five myths, five realities

Zero-based budgeting is a repeatable process that organizations use to rigorously review every dollar in the annual budget, manage financial performance on a monthly basis, and build a culture of cost management among all employees. A world-class zero-based-budgeting process is based on developing deep visibility into cost drivers and using that visibility to set aggressive yet credible budget targets. The annual budgeting process does in fact start from zero and is very detailed, structured, and interactive in order to facilitate meaningful financial debate among managers and executives. Throughout the year, multiple owners are tasked with managing performance and continuing the healthy debate on cost management. Through new system and process controls and aligned incentive programs, all employees make cost management a part of their daily routine.

One company recently realized 11 percent savings in its operating budget within the first four months of a new zero-based-budgeting program. In this instance, immediate savings came from increasing visibility into labor costs and executing new approval thresholds to control demand for contract labor, relaunching procurement initiatives to renegotiate prices, and changing "make versus buy" decisions. More than 40 percent of the savings were strategically reinvested in new teams and sales staff who spent all their time with customers. While this company chose to reinvest those savings in the customer-facing parts of the business, other companies use the savings to fund and therefore amplify the next wave of productivity. And, of course, some let the savings fall to the bottom line.

When properly implemented, zero-based budgeting can reduce sales, general, and administrative costs by 10 to 25 percent, often within as little as six months. Just how zero-based budgeting is capable of delivering and sustaining these results remains a bit of a mystery for many executives. The opaqueness of the term and the dire tone of media stories on the subject can be intimidating, sometimes causing companies to avoid the process as an option for improving productivity. What follows is an attempt to explore some common myths, debunking them and highlighting how a well-run zero-based-budgeting program can drive sustainable impact in leading organizations.

Myth one: Zero-based budgeting simply means building your budget from zero

Reality: Zero-based budgeting is a repeatable process to build a sustainable culture of cost management.

Zero-based budgeting is much more than building a budget from zero. World-class zero-based-budgeting efforts successfully build cultures of cost management throughout the organization by using a structured approach to facilitate cost visibility, cost governance, cost accountability, and aligned incentives. Fortunately, the culture shift isn't left to chance. We believe that there is a proven, step-by-step approach to implementing successful zero-based-budgeting programs, and when this implementation is done well, these programs make cost management a part of the way every employee works on a daily basis.

Myth two: Implementing zero-based budgeting requires cutting 'to the bone'

Reality: The degree of cost reduction is based on the company's top-down target.

Although very little has been written recently about zero-based budgeting, the published content that exists often associates it with cutting costs to the bone, using any means necessary (for example, eliminating mini-refrigerators in office kitchens to save electricity). While this may sometimes occur, it is by no means necessary. Simply put, the degree (and aggressiveness) of each company's cost cutting reflects the size of its top-down savings target. For instance, in the most aggressive situations, we've seen 30 percent reduction targets in year one versus other situations that aim for 10 percent reduction targets with an agreement to reinvest half of that into more productive areas, therefore only taking 5 percent to the bottom line.

Myth three: Zero-based budgeting will overwhelm your business and prevent it from doing anything else

Reality: Initial rollout of a new zero-based-budgeting program can be led by a central team and completed in four to ten months.

Recently, one executive we met with said, "I simply cannot afford to ask the entire company to stop what they're doing for the year to implement zero-based budgeting." The idea that the process requires dedicated focus from every employee for a year or more is simply not true. While it takes time to embed a new cost-management culture into any organization, the setup and rollout of a new zero-based-budgeting program has much more limited requirements.

During the initial setup, a central coordination team develops deep visibility into costs and sets detailed savings targets for the next budgeting cycle. That team also ensures that the company's systems and processes are in place for the detailed reporting, governance, and performance management that a world-class zero-based-budgeting plan requires. In our experience, this setup period could take anywhere from four to ten months and is primarily led by full-time support from finance and IT, with part-time involvement from profit-and-loss owners and cost-category owners across the company.

Organizations that are unsure about zero-based budgeting's upside are well suited to pilot the process. There are many ways to build these pilots, each of which can be customized to meet the company's objectives. One company, for instance, is piloting a zero-based-budgeting rollout across its global finance function. This approach builds capabilities within the team that will help drive the program across the enterprise while having the added benefit of helping team members achieve their existing budget targets.

Myth four: Zero-based budgeting only focuses on sales, general, and administrative costs

Reality: Zero-based budgeting can be applied to any type of cost: capital expenditures; operating expenses; sales, general, and administrative costs; marketing costs; variable distribution; or cost of goods sold.

The fundamental elements of a zero-based-budgeting program—governance, accountability, visibility, aligned incentives, and a rigorous process—form a comprehensive cost-management tool kit. However, certain adjustments need to be made when using this tool kit in particular areas. For example, when zero-based budgeting is applied to variable costs (such as cost of goods sold or variable distribution) the budget needs to be volume adjusted in monthly performance reports. When zero-based budgeting is applied to capital expenditures, costs are categorized by discrete investment choices rather than types of expenses, as they are with operating expenses.

Myth five: Zero-based budgeting is not designed for growth-oriented companies

Reality: Zero-based budgeting is successfully used by growing companies to redirect unproductive costs to more productive areas that drive growth.

Zero-based budgeting is a powerful tool for any company, whatever its orientation. Even if the organization's primary focus is on growth, profit, or talent retention, cost management remains crucial to its success. Eliminating unproductive costs allows the company to be redirected to more productive areas. As we mentioned in the earlier example, back-office costs can be redirected to customer-facing activities.

Zero-based budgeting is not a slash-and-burn exercise that cuts costs without regard for the expense. With deep visibility into costs, changes can be made to surgically cut the fat and help build up organizational muscle.

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Zero-based budgeting can drive significant and sustainable savings, but it is much more than simply building a budget from zero. World-class zero-based-budgeting programs build a culture of cost management through unprecedented cost visibility, a unique governance model, accountability at all levels of the organization, aligned incentives, and a rigorous and routine process. Zero-based budgeting frees up unproductive costs and allows those savings to be taken to the bottom line or redirected to more productive areas that will drive future growth.

The authors would like to acknowledge Greg Kelly's contribution to this article.

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