Build a reinvestment machine with zero-based budgeting

When zero-based budgeting makes investing as rigorous as saving, the result is a reinvestment machine that supports growth year after year.

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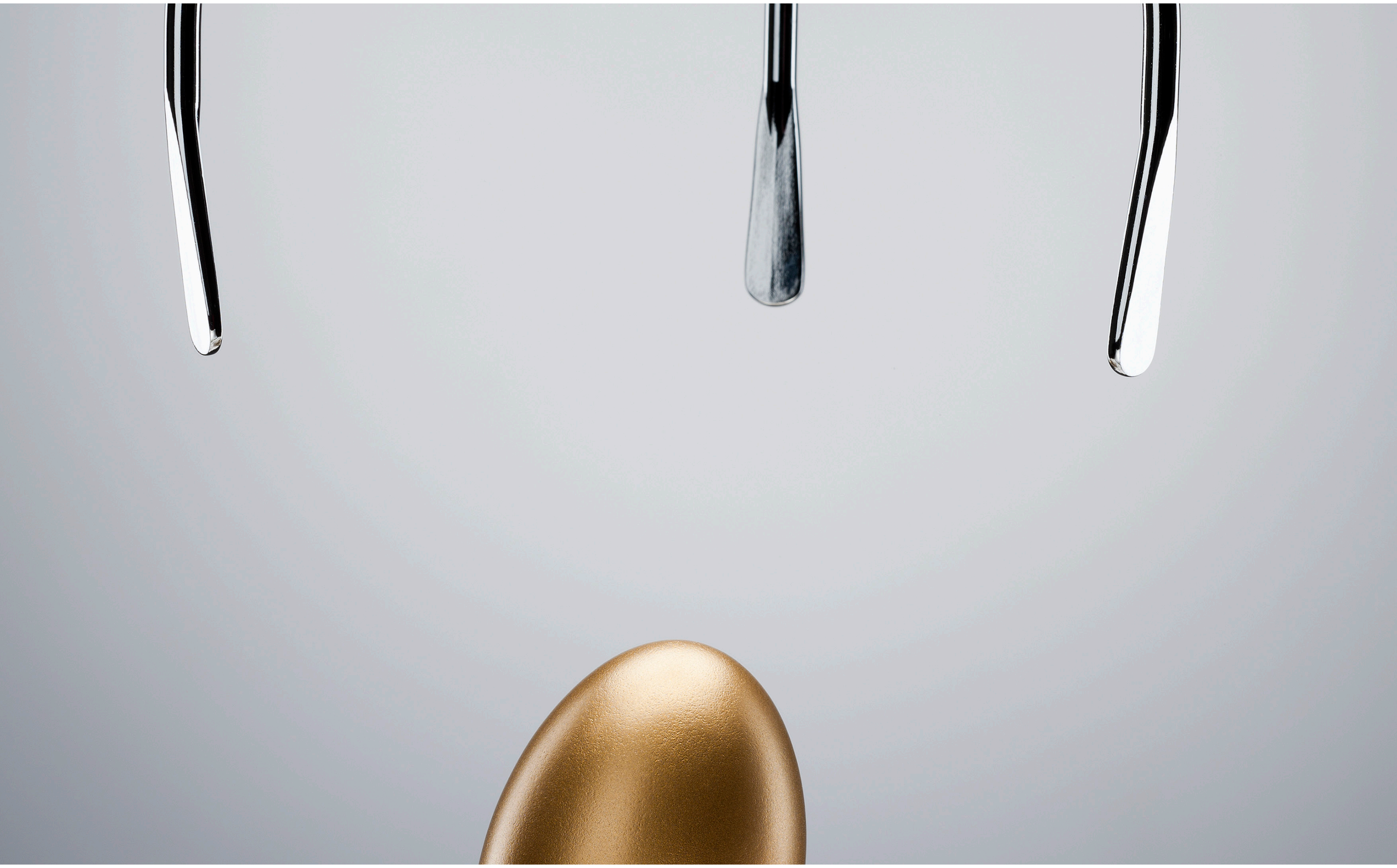

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Zero-based budgeting (ZBB) takes commitment. Given the effort ZBB requires—the time, the money, the managerial attention—treating it as a one-time project leaves an awful lot of potential return sitting on the table. If a year's worth of savings were all a company wanted, a standard cost-cutting program would likely do the trick.

Instead, ZBB generates the most value for companies looking for significant, long-term, sustainable gains—not only by reducing costs and rethinking needs, but also by freeing up resources for more productive use. And because ZBB creates an entirely new perspective on a business, even organizations that launch ZBB with a bottom-line focus discover new ways that ZBB can unlock growth.

That means turning savings into investments, so that "cutting the fat" morphs into "greasing the wheel" for innovation and opportunity. But despite the rigor organizations follow when they apply ZBB to the cost side of the ledger, too often the investment side follows an entirely different script, typically the one that the organization sought to change with ZBB.

Organizational inertia, often a product of cognitive bias and corporate politics, leads managers to shift money based on habit, instinct, and approximation—misallocating resources that could be used more effectively elsewhere. Costs are reduced in one place only to show up again somewhere else, in a constant cycle of squeezing the balloon. At a matrix-heavy multinational company, for example, some of the initial savings that ZBB generated wound up in the budgets of units that weren't yet included in the ZBB effort. When those units weren't required to follow ZBB processes in using the reallocated funds, resentment grew among the managers who had dedicated so much time to ZBB.

Conversely, applying ZBB to reinvestment enables faster resource reallocation, breaking many of the bad habits that cause opportunities to be underfunded while resources are wasted on pet projects, many of which may have been too small to notice in pre-ZBB budget processes. One industrial-goods maker, for example, discovered that much of its marketing spend was hidden in other budget lines, funding minor, ineffective initiatives dictated more by personal relationships than strategy. Combining hundreds of $500 charity-golf sponsorships and small-town newspaper ads into a single pot of money let the company place much bigger marketing bets with much bigger payouts.

Zero-based reinvestment

The long-term success stories illustrate four actions that make ZBB-based reinvestment work on the ground and keep it working over time. The first step focuses on facts: creating the most accurate intelligence possible about where money is moving, when, and why. Second, with that foundation, the organization can start judging all spending according to a single standard. The third step applies the new approach even to long-term capital spending, again with a view to understanding all uses of funding based on expected returns. Finally, the fourth step provides reinforcement by adjusting savings and return targets more closely to actual business performance.

Move money in real time

For reinvestment to build organizational confidence, it has to have the highest chances of success. Under ZBB, managers are expected and enabled to be much more intentional about what they're spending at any given point in time, and what they should see in return. That means basing decisions on the freshest information possible: real-time data rather than annual budget cycles. And it means delving into far greater detail than traditional processes allow, so that managers can make more intelligent trade-offs and take advantage of the growth opportunities that granularity creates.

Today, leaders usually focus on just a few high-level numbers at the end of the quarter or year, with the understanding that all of the over- and underspending underneath will just cancel each other out. But markets and customers don't wait for reporting-period end dates. What organizations instead need is a system that lets managers quickly subtract capital in areas that generate no customer value and add it to new areas of growth, according to market, customer, and competitor conditions.

The technologies underpinning some of the most successful ZBB programs provide the necessary transparency, converting lump sums into dozens or even thousands of clear prices and quantities. What previously was an annual budget line item reading "Brand X—South Africa—promotions" becomes "15 campaigns for Brand X in South Africa at $250,000 each." If a movie star in Lagos tweets a surprise shout-out hyping Brand X, the manager can catch the moment by reassigning a couple of promotions from South Africa to Nigeria.

Judge by a single standard: ROI

One of the primary reasons that reinvestment has historically been so opaque is that organizations have long treated investment and spending as different. But through a ZBB lens, all "spending" is fundamentally "investment"—after all, the question ZBB requires managers to address for every spending item is "what is the expected return?" Viewed this way, the main difference between spending and investment is the time horizon for the return.

Moreover, the data ZBB generates allow operating and capital expenses to be judged by the same criteria. This helps break arbitrary barriers between budget entries that are fundamentally for the same spend and should be considered from the same return-on-investment (ROI) perspective. For example, real-estate costs may be classified differently according to whether particular locations are owned or leased. Starting with the basic question—"how much return are we getting on our real-estate outlays?"—requires an organization to view all of its real-estate spending as a whole. It can then make better decisions not only about whether to lease or own but also whether to keep certain real estate at all. A low-cost lease that's generating little return for the business may not be worth keeping if that capital could be better deployed elsewhere.

The ROI standard applies with even more force to decisions about where to spend—sometimes guiding decisions to spend more rather than less. One global enterprise found that a test of new IT equipment for its sales team had such a dramatic effect on revenues that it made sense to purchase the devices for the entire sales force. To make up the difference, the company cut spending on low-ROI marketing activities that no one missed.

Apply a new lens to capital expenditures

Once an organization accepts ZBB's view of spending and investment as differing only in the time involved, the next logical step is to apply the same trade-off-enabling transparency to capital expenditures as well. In smaller cases, as between leased and owned cars, the distinction between operating and capital expenses matters less than that both are for the same type of expense. Clear ZBB-informed trade-offs are essential to find savings. But even for the largest capex projects, ZBB helps reinforce a different type of trade-off, based on the concept of a "hurdle rate"—a minimum expectation of the rate of return that the investment must yield.

Roughly speaking, the more urgent the capex project, the lower the hurdle rate, estimated according to what shareholders might otherwise expect the company to do with the capital. The lowest hurdle rate applies to capex required for basic maintenance or legal compliance, such as a new filtration system to reduce particulate pollution in response to tighter air-quality standards. A more speculative capex investment, such as a rebranding effort or a highly experimental area of research, should meet a much higher hurdle rate (exhibit). And, of course, all of the projects must be carefully analyzed in order to assign them to the right category based on accurate estimates of their projected cost and impact.

Match targets more closely to actual performance

When accounting and accountability both operate mainly on an annual cycle, any attempt at midcycle changes can generate resistance because they may be seen as making it either too hard or too easy for people to meet their performance targets. Creating systems that instead adjust people's targets based on what the business is actually doing helps keep everyone aligned and channels investment to where it's most likely to pay off.

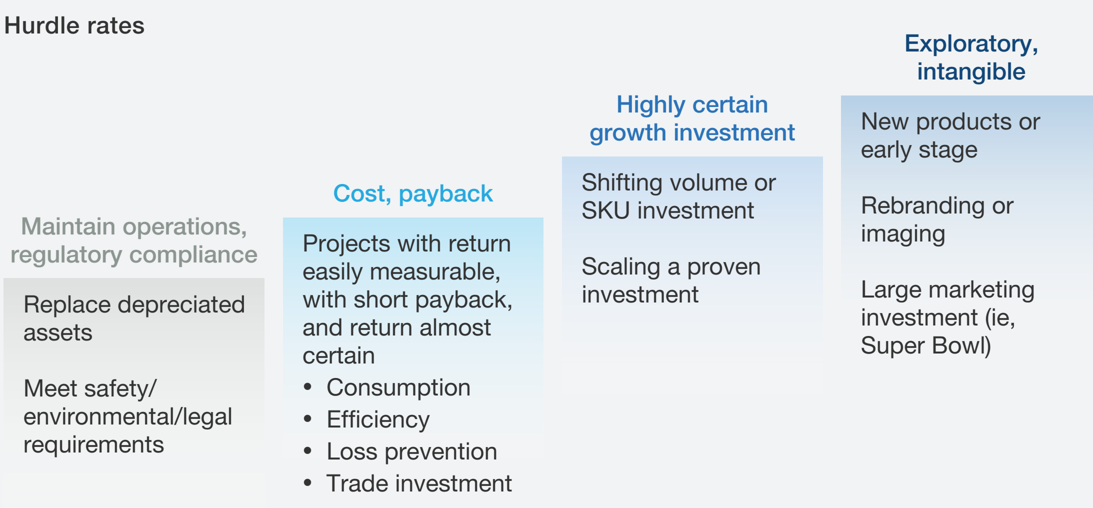
One multinational company built greater agility into its incentive system by keeping some investment funds in reserve until the middle of the year, then releasing them for successful initiatives requiring more resources in order to grow. In return for the funding, initiative leaders had to agree to raise their performance targets. Meeting the higher targets would, in effect, help repay the funding, which was more achievable because the ZBB systems gave managers much more information about their business's performance.

What ZBB reinvestment achieves

Reinvestment's most immediate effect is to free up resources that are essential for the organization's long-term ambitions. Its long-term effects on the organization are even farther-reaching.

Exhibit

Evaluate capital projects by applying hurdle rates based on needs and context, assigning the lowest rates to the most necessary projects.



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Creating a fund to support growth

For one multinational company, growth began spiking in one of its largest markets, but the local CFO couldn't find any more cuts to support new initiatives. The global CFO looked at the figures and agreed: any further subtractions would hit muscle that the country needed to support expansion. She instead asked the CFOs of peer units to find some cuts that would fund the country's new, more aggressive growth targets. Although it was hardly an easy process, ZBB had helped the CFOs understand that higher growth would help their business indirectly regardless of where that growth occurred. Within a few weeks, they'd found tens of millions of dollars in cuts that the country CFO turned into hundreds of millions in added profit.

Strengthening pockets of agility

Even at its most stringent, ZBB doesn't cut organizations to the bone. Instead, it promotes more honesty about where there are pots of money that the business can use when needed. The exercise of finding out just how much loose change has fallen between the sofa cushions can itself help the overall business, enabling faster reallocation of capital. The entire enterprise becomes more agile as money flows more quickly to where it can achieve the greatest impact.

At one organization, a business-unit head wanted to invest in a brand that the global CEO thought was declining. But while refusing to provide extra funding, the CEO also said that the unit was welcome to reallocate its own budget, which it did through a ZBB process. That revealed where the extra money was, so that future decisions in the business could be faster, more thoughtful, and more transparent.

Reinforcing a new culture

One of the most difficult challenges in convincing a company to embrace ZBB is helping people understand that ZBB won't destroy the culture but rather will bring it to its fullest potential. At the core, ZBB is about creating real accountability for (and ownership of) results so that managers deliver on their promises of higher earnings. As performance management improves, organizations can foster behavior that expands the whole business, not just individual units that may end up competing with one another as much as with the outside market.

When employees know that they'll have the opportunity to argue for reinvestment they have more incentives to think creatively about cost cutting. It gets the creative juices flowing. And it reduces feelings of inequality, as the entire company is playing by the same rules and is united under a single purpose, to free up money to invest in growth.

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ZBB has allowed companies to create visibility and ownership of how they spend money. The next horizon is for ZBB to create, track, and maintain new projects that will generate long-term growth, in a cycle that constantly looks for new ways to generate value. ■

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