McKinsey&Company

Ronald Falcon,
Kyle Hawke,
Matthew Maloney,
and Mita Sen

How absolute zero (-based budgeting) can heat up growth

Operations January 2018

Businesses can't just cut their way to prosperity. The surprisingly powerful tool to help an organization grow? Zero-based budgeting.

Your company needs growth. You'll need resources to fund it. But with margins chronically tight, where can you turn?

The go-to strategy: making the margins wider by cutting costs. The CFO sends out targets, the organization meets them (more or less), and margins duly widen.

For a while. But not necessarily for long.

According to our research of 238 companies that announced cost-reduction programs between 2003 and 2014, only 26 percent were able to sustain the reductions for four years. And only 17 percent of the 238 were able to grow at the same time.

This is what people end up remembering. The cuts that backfired when they hurt growth instead of helping. The cost programs that were abandoned after everyone got comfortable again. And the next time cuts are needed, the memories make the CFO's challenge that much tougher.

So you think about zero-based budgeting, ZBB, which often sounds like a sort of cost reset button. But you worry that the organization will end up in much the same position: a big effort, some early results, and then people will either cut too much or stop cutting much at all.

You need long-term change. In fact, when done right, ZBB does exactly that. ZBB recognizes that sustained change isn't something the finance function can do by itself. It needs to be the whole organization, working with finance, thinking in much the same way, making decisions as if they were owners of the business as a whole.

The crucial caveat, of course, is in the words "when done right." We looked at the success stories to find out what made them different—how they sustained a culture in which cost trade-offs became a way of life rather than a periodic event. We also reviewed our experiences working with a wide range of organizations, including some that have made ZBB successful for a decade or more. We found a few lessons.

1. Go big. Companies that achieved 20 percent reductions in year one were four times as likely to succeed.

2. Go deep. The success stories embedded cost management in their process, systems, and governance, forcing it to become a way of life.

3. Go long. To reinforce the new behaviors, successful organizations incorporated cost management into their performance-management metrics and incentive calculations.

4. Go wide. In further research, we found that top performers reallocate resources across the business at a greater rate than their peers.

5. Go all in. Finally, an essential difference is whether leaders role model the behavior they want the rest of the organization to emulate; the most effective leaders made a point of reinforcing ownership behaviors that form the heart of ZBB: encouraging honest trade-off discussions, celebrating tough sacrifices, and giving managers the freedom to make thoughtful long-term investments.

While some of the individual changes seem small at first, collectively they have a big impact in achieving major savings that fuel growth. Year after year, these companies are driving continued savings and efficiency as ZBB helps them rethink how they do business and redeploy capital to directly align with their strategic priorities.

The 'investor's mind-set'

The point in setting budgets to zero each year is not to turn an old-school, company-wide 8 or 10 percent cost-reduction target into a 100 percent reduction target. The point is to get everyone in the company to think about what spending they really need, unburdened by the inertia of previous years. In reality, this is no different than what people do naturally with their own budgets, making trade-offs and choosing what they need based on their monthly income.

ZBB's combination of responsibility and freedom implies a new corporate mind-set, raising a different question: What if cost control were just one part of a larger shift, in which people throughout the organization understood that every spending decision should be producing a return?

That's the real value that ZBB can unlock, creating an environment in which everyone really does start to "think like an investor"—turning a business-bestseller cliché into a lived reality. Moreover, with the right support, people start to think like someone who's investing in the entire organization, not just in their little piece of it. "My brand," "my product," and "my resources" become "our brands," "our products," and "our resources."

Getting there requires executives to understand ZBB for what it is. It isn't just a tool for cutting costs. It's a lever for changing the culture, and it requires that type of investment in changing long-standing behaviors.

1. Go big: Replacing timid mandates with aggressive aspirations

Traditional cost cutting has a tough time taking flight because it's chained to a set of anchors, in the form of this year's budget and previous years' spending. Lacking detailed data on how much spending is truly required to keep the lights on in a business, leaders seeking cuts hold back, not wanting to suggest new spending levels that might seem foolish or risk hurting the business.

ZBB breaks this cycle by quantifying cost drivers from the bottom up, making it possible to separate productive from unproductive spending. The visibility allows leaders to set financial-productivity aspirations that are much bolder than a traditional "cut x percent" mandate, if the data justify it. And the fact that new technologies allow data to be updated continuously allows leaders to reassess much more frequently. A fiscal-year aspiration to move 20 percent of advertising spend to digital channels may look like a stretch goal in January, yet it proves too conservative by April if a new social-media campaign suddenly explodes. Or it might seem unachievable if sales fall in line with TV spending levels.

2. Go deep: Changing governance structures

Unsuccessful programs, our analysis has confirmed, are founded on temporary structures such as project-management offices—or, worse, are just added to the already-burdened plate of the finance function. By contrast, successful ZBB depends on new and strengthened governance structures to make it a permanent part of the ongoing business.

The first requirement is the appointment of a credible *ZBB director,* not only for the initial setup of ZBB but also for guiding it over time. At a transportation company, for example, a senior functional executive with 20 years' experience in the business led the program for its first two years, reporting directly to the CEO. The appointment of such a respected leader, together with an explicit mission to challenge the rest of the organization, underscored the program's importance and the role it would play in fueling the company's strategic priorities (see sidebar, "Building understanding and conviction").

The director needs a small team of finance, IT, HR, and finance professionals reporting to her. This group, typically called the *"center of excellence" (COE),* requires a small ongoing additional investment to free up people's time, but the payoff can be substantial—particularly after the initial successes are logged, enthusiasm wanes, and the old ways start to look more tempting. The COE keeps managers honest when new challenges make ZBB discipline seem more difficult to follow. Instead of letting managers off the hook when, for example, mid-year currency swings play havoc with budgets, the COE acts like a war room, maintaining a library of tactical moves (tailored for each major market) that help unlock new cost-reduction strategies regardless of the circumstances.

Finally, one of the most important roles required to operate ZBB in a sustainable, continuous-improvement environment is that of the *cost-category owner (CCO).* This part-time, permanent role is assigned to the highest-performing individuals in the organization, who then spend about 20 percent of their time overseeing a few related subcategories of spend—such as, say, ad-agency and media-placement expenses. The job of these individuals is to set targets and guidelines, challenge their peers to reach the targets, spread best practices across the business, and drive continuous improvement in spend efficiency.

About two years into a bank's ZBB journey, one CCO helped uncover high spending on executive rotation into overseas markets. The existing program offered short-term, financially rich packages that were a strong incentive for home-country talent to transfer where skills were needed most. But the category owner found that many program participants ended up extending their stays, which generated additional costs in areas such as immigration, accounting, and tax compliance. Switching to longer-term contracts up front eliminated the need for a second round of compliance costs—and the promise of greater stability proved more important to participants than the expensive benefits promised in the old, short-term packages, reducing overall costs as well.

3. Go long: Aligning incentives for continuous improvement

A further structural change that helps cement ZBB is to build it into *new performance-review practices.* This step takes particular care, however, to ensure that the incentives fully align with the organization's needs—which evolve over time as its experience with ZBB deepens.

It's especially critical to think through how people will respond. Early in its ZBB transformation, a multinational retail chain redesigned its performance metrics to emphasize individual accountability for meeting budget targets. In support, the leaders considered offering an individual bonus to any manager who overperformed against the targets. But they ultimately rejected the idea, recognizing that it could create a powerful incentive for people to try to manipulate the target-setting process. Instead, leadership announced a potential organization-wide bonus if the company as a whole exceeded its collective budgetary and performance targets.

Over time, however, individual bonuses may become more important as a spur to innovation and further improvement, as the manufacturer cited above discovered several years after launching its ZBB program. A revamped bonus structure retained individual penalties for underperformance, while adding individual bonuses for overachieving targets by 10 percent or more. That was a tough challenge to set after several years of ZBB, but one that successfully encouraged managers to come up with entirely new practices for sharing around the company (exhibit).

Building understanding and conviction

ZBB's cumulative effect is to change expectations of everyone throughout the organization, reflected in actions both small (monthly company-wide email showcasing small ZBB wins by frontline employees) and large (redefining career paths to reinforce that ZBB is the way to advance).

Showing and telling

Stories play a critical role in resetting what people expect of themselves and one another. For a multinational manufacturing company, for instance, one of the most important was of the regional salesperson, who experimented by purchasing lower-cost, more-functional store displays. The new displays were popular with small retailers, who started contacting the company to have them placed in their shops. As sales grew by double-digit percentages, the salesperson became an in-house consultant for sales teams in other locations. His success confirmed ZBB's power in helping people at every level effectively reallocate resources where they could produce greater returns.

Stories are even more important in preparing teams to respond to challenges in ways that reinforce company values. Those challenges are more likely to surface with ZBB, whose discipline forces difficult conversations that in the past might have been postponed until the following year or avoided entirely.

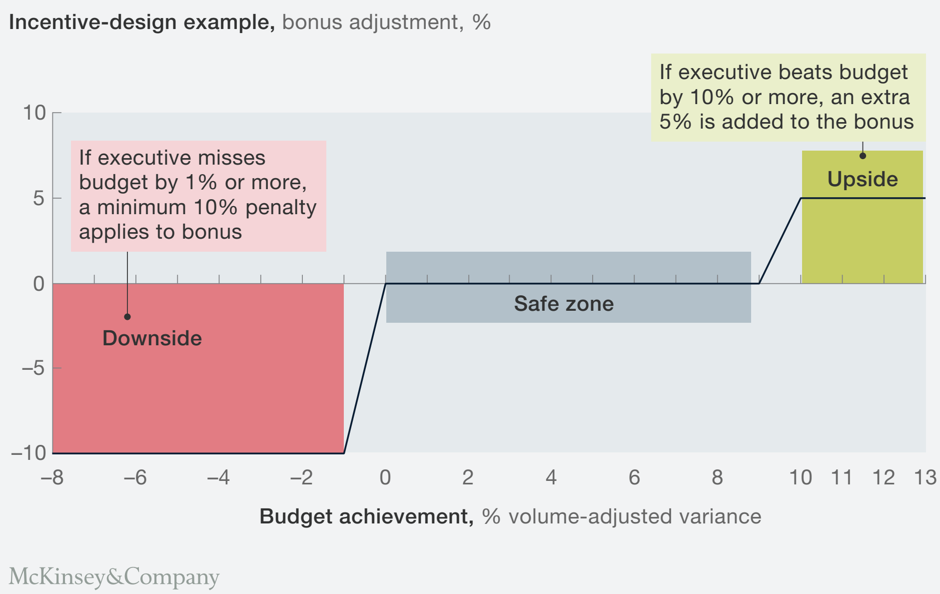
Reinforcing values

What ZBB recognizes is that even if the reason for exceeding a target is sound, the shortfall doesn't go away. Accordingly, category owners have a big incentive to get the budgets that they're responsible for back on track.

For example, a sudden reputational crisis, such as a claim that a product has quality issues, will generate significant unplanned costs for everything from inventory write-downs and refund expenses to inspection of affected facilities. In a zero-based environment, a business won't have spare funds to transfer into the relevant categories, so instead the business head and the category owners will convene the other unit leaders to see who might be able to find some cuts that will help make up the difference. There's no hiding of costs, and no avoiding of difficult problems. Instead, the constant conversation among leaders about where the money is going, and why, thereby turns into a very practical reinforcement mechanism for a new culture.

Exhibit

For an advanced zero-based-budgeting organization, new incentives helped encourage new rounds of innovation.



4. Go wide: Making targeted reinvestments wherever needed

The most successful ZBB organizations make their process of identifying, prioritizing, and proving reinvestments just as rigorous as the process of taking money out. For companies looking to fuel growth, this is the seminal change. But even for organizations focused more on productivity, reinvestment is an invaluable opportunity to build enthusiasm across the business to show people the fruits of their labor.

At one appliance manufacturer, leadership made it clear from day one that the transformation was not primarily about cutting costs but about freeing up funds to realign spending with strategy. They developed and deployed a new reinvestment process that gathered ideas—big and small—from employees across the company. Two-thirds of the reinvestment requests were quickly funded, but the remaining one-third were deferred or declined because they either showed no return on investment (ROI) or did not align with strategic priorities. The transparency of this approach not only ensured dollars were sent where they mattered most but also showed everyone that the new way of working was real and lasting.

5. Go all in: Changing from the top

The final requirement applies to the executive suite: make the changes visible and tangible to everyone in the organization. Some CEOs start with a big, symbolic decision, such as to ground the corporate-jet fleet. Or they launch a media campaign keyed to new behaviors, complete with custom hashtags and viral-video contests. These sorts of steps are important, but there's a lot more to do.

Over the long term, what matters at least as much is to support people at every level who are making tough decisions—especially ones that illustrate that ZBB isn't just cost cutting. ZBB's budget transparency makes ROI calculations more robust, giving leaders more confidence in signing off on investments with longer-term payouts. At the multinational manufacturer, managers used the ZBB process to build a case for installing LED lighting at all of the company's giant plants. The CEO signed off immediately because the payback calculations were so compelling. The question was no longer "why pay for this now?" but "why not get the savings now?"

These changes help everyone see that ZBB isn't a one-time event. It's a way of life whose annual, quarterly, and monthly routines become part of the fabric of how people get their jobs done. After a year, leaders at the highest-performing companies stop calling it ZBB: they call it "how we get work done."

■ ■ ■

When ZBB is only about cost cutting, cost cutting is all that ZBB can achieve. When ZBB is about changing the culture, it can keep finding growth and more improvements year after year. □

Ronald Falcon and **Matthew Maloney** are consultants in McKinsey's New York office, **Kyle Hawke** is an associate partner in the Atlanta office, and **Mita Sen** is an associate partner in the Zurich office.