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Zero-based budgeting revisited: Why this time is different

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This budgeting concept allows senior-leadership teams to put their money where their strategy is, aligning resources with business priorities and setting the example from the top.

In this episode of the *McKinsey Podcast,* McKinsey partner Kyle Hawke and senior McKinsey external adviser Jan Perkins speak to Simon London about why zero-based budgeting (ZBB)—an idea that's nearly 50 years old—is having a bit of a renaissance in companies looking to reset their resource-allocation methods.

Simon London: Hello, and welcome to this edition of the *McKinsey Podcast* with me, Simon London. Today, we're delving into the world of finance and budgeting—specifically, the set of practices known as zero-based budgeting. Now, zero-based budgeting is making something of a comeback. There are a few reasons for this, but probably the biggest is companies are realizing that, when done well, zero-based budgeting can be a very effective way to free up cash for reinvestment.

In other words, it can underpin a more dynamic approach to reallocating resources across the company. However, as we'll hear, zero-based budgeting is not for the faint hearted. To discuss the issues, we're joined today by Jan Perkins. Jan is a senior adviser to McKinsey and a former senior executive in the consumer sector. We're also joined by Kyle Hawke, who's a McKinsey partner based in Washington, DC. Jan and Kyle, thanks so much for joining today.

Kyle Hawke: Thanks for having us, Simon.

Jan Perkins: Good to be here.

Simon London: Zero-based budgeting is definitely one of the more quasi-technical topics that we've tackled on this podcast. Kyle, if you don't mind, maybe start by giving us a quick overview of what zero-based budgeting is.

Kyle Hawke: The concept of zero-based budgeting is not a new concept. It was actually introduced in 1970 but is experiencing a bit of a renaissance in recent years. If you go back and you look at the definition of it in 1970, it was purely about the budgeting process and breaking down the budget into small pieces so that management can make decisions on where to invest. But it was purely a budgeting technique.

In the last five years, it has experienced a bit of a renaissance because it's become much more than that. It's really a new way of working that allows companies to put their money where it matters most, align resources with their business priorities, and do that on a repeatable basis.

It's a process that's embedded in the normal financial-planning and management routines. It's a set of systems that, first, give you visibility to where you're spending money and where your resources are today and allows you to compare that to where they should be [Exhibit 1]. Then it provides better visibility to where you're spending, so that you can have better dialogues with the management team.

It's a [form of] governance that makes cost management and resource allocation really part of everyone's job rather than just finance.

Exhibit 1

Building a cost culture involves more than just budgeting from zero.

Transparency

Make costs visible and accessible by grouping them on two dimensions—type and owner

Process

Set aggressive top-down targets, establish a common fact base and analogous cost comparisons across operating units, and insist on monthly checkups

Governance

Make a conscious effort to introduce tension in the process to ensure category owners take concept seriously (eg, CFO challenging CMO)

Incentives

Measure cost performance (in addition to growth and profit) and align managers' compensation to costs they control

Mind-set

Stop proving why things are the way they are and start thinking about how to make things better

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Simon London: The obvious follow-up there is why the renaissance? Like you say, as a concept this has been around for quite a long time. What makes it especially relevant today?

Kyle Hawke: Resources get stuck where they have always been, and we've done a lot of research on this. We studied the resource reallocation of 1,500 companies over a 20-year period, and what we found is that 90 percent of the dollars stay where they were the year before. So only 10 percent was actually reallocated across business units, geographies, or brands.

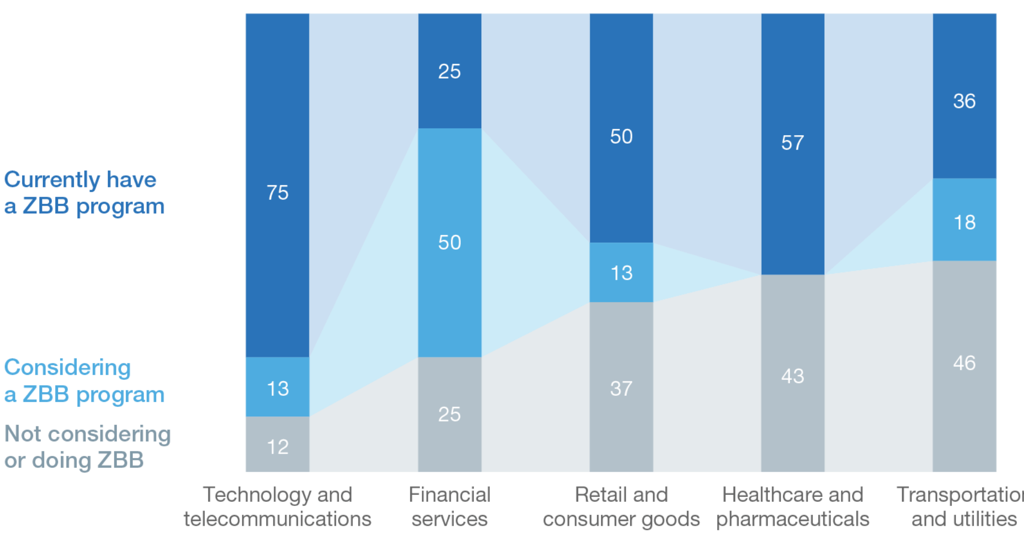
However, some companies are moving dollars more fluidly. If you look at those companies with [a] more dynamic resource reallocation, they actually grow their total returns to shareholders by 10 percent, whereas the more dormant reallocators grow at only 6 percent. What that means, over that same 20-year period, is that the market cap of the more dynamic resource reallocators is actually twice that of the dormant reallocators. It sounds good, right? But the question is how do you unlock that tight grip that managers have over their budgets? We believe a large part of that lies in zero-based budgeting.

Jan Perkins: I would add to the rationale behind the renaissance: companies have years of productivity initiatives trying to unlock those resources. And I believe there's a portion of companies that became quite successful at zero-based budgeting, making it more than just a cost-reduction or a budgeting exercise and getting some pretty outstanding results. That caught the attention of your external financial analysts, in addition to some of the other competitive companies [Exhibit 2]. People became more excited about what is the magic to zero-based budgeting and can we use it? Will it work for us?

Exhibit 2

Zero-based budgeting is expanding across industries.

Zero-based-budgeting (ZBB) program implementation by sector, % of respondents



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Simon London: And the criticism was that to do this well, you need a level of granularity—where costs fall, who the "owners" are, where the possible efficiencies are, and so on in a more manual finance world. That was a huge level of effort. But in a world where we've got very good cloud-based finance systems, a lot of that infrastructure is there to track all this. Is that, broadly, the way to think about it?

Kyle Hawke: If you look at some of the criticisms of zero-based budgeting, one of them is that it's not a repeatable process and is something that you can only do on a periodic basis. What we've seen is that digital tools actually facilitate the process end to end and make it easier for companies to make it part of the way that they work rather than this one-time or periodic event.

Historically, budgeting from zero is very manually intensive and required thousands of spreadsheets from across the organization, both to build the budget and then to monitor performance at the required level of granularity. But now there are cloud-based solutions that—off the shelf, for the most part—can support the majority of the process and be ingrained in the normal way that you work and replace those thousands of spreadsheets that existed before.

Jan Perkins: And they enable more than just the budgeting. They're also enabling the ability to govern it, and governance, I think, is a key piece of the sustainability of this sort of initiative.

Simon London: Just say a little bit more about that, Jan. What do we mean when we talk about governance in this context?

Jan Perkins: Governance is the opportunity to really maintain that level of visibility and ensure that you are spending according to the transformational targets and the policy revisions that have been put in place. [The failure to do] that, I think, would be, in my experience, one of the key faults of some of the prior initiatives. You make the changes. You post them. You communicate them. You put it in the budget, and then over the months, the quarters, and the years to follow, you lose visibility as to whether people are adhering to the policies, and the spending starts to creep back up.

The governance, when you're using the tools to lock into the budgeting, can also connect to other tools that help you report against what you're spending. Are you adhering to policies? And are there other opportunities to look at?

Simon London: Can we put some numbers around what's the upside? And what sort of results have we seen for companies putting in zero-based-budgeting processes and doing it well?

Jan Perkins: So companies have achieved between 10 and 25 percent reductions in aggregate. As you drill down into certain cost categories—and depending on how aggressive and transformational you want to be—you can certainly see 50 to 60 to 75 percent cost reductions in particular cost categories.

But these results are pretty immediate. You can see them hit the P&L [profit-and-loss statement] in four to six months. Some of them that are transformational can take longer. It can take a couple of years. And you can see the savings on any type of costs. Overhead, of course, organizational supply-chain manufacturing costs, marketing, distribution, within cost of goods sold, capital expenditures. You can apply this approach to any type of cost category.

Most importantly—beyond unlocking these resources, though—a key contributing factor is a new way of working. And it's going to build a culture of cost management and an ownership mind-set so people are thinking very much along the lines of “why should I spend this dollar?” versus historically saying, “where can I cut?”

Simon London: You talked at the top, Kyle, about incentives. What’s the role of incentives in this, and what do we mean? Is that giving department managers incentives to really take this seriously and building that into compensation?

Kyle Hawke: Every company has a few metrics in the incentive calculations for executives. And there’s always something around growth, and there’s always something around profit. But there’s rarely something around cost as an explicit metric. The assumption is that if we have growth and we have profits, then cost is in the middle of those two, and it takes care of itself. In zero-based budgeting, the mind-set or the approach is that cost is the one thing that managers have complete control over—especially fixed costs. And therefore we should incentivize managers, or measure the performance of managers, based on that as an explicit metric rather than an implicit metric by measuring the other two.

“The clarity of ‘what we report and what we measure, we deliver’ is an aspect of accountability that you cannot do this without.”

Jan Perkins: Kyle, your comments on the operating profit are exactly right. Most P&L owners would say, “If I hit my operating-profit target, clearly I have met my cost targets also in overhead costs.” To hold us accountable to how much we’re spending, and the assessment of “is this dollar spend necessary,” you need to have cost built in as a separate metric.

The incentives can be tied to the operating profit or to the annual bonus. There are several ways to do it. But the clarity of “what we report and what we measure, we deliver” is a message and an aspect of accountability that you cannot do this without.

Simon London: What are the other success factors, do you think, Kyle? When you look at the key things you have to get right here to do this well, what would you pick out?

Kyle Hawke: I can think of five success factors. One is that you need to align the approach to the organization’s culture and objectives. This is not a one-size-fits-all approach, and there are many dimensions on how to customize it. For example, the level of focus that you have on reinvestment versus target setting or the degree of granularity in the budgeting are all choices that a company can make to make it fit for purpose.

A second success factor would be to have an intelligent approach to target setting. Not every dollar is created equal, and there are areas that you want to protect and invest in, which are aligned with the value drivers of the business. There are others that you want to eliminate completely or cut to the bone. And you need to be able to distinguish good dollars from bad dollars, or productive costs from unproductive costs, so that you can address them intelligently.

The third would be to have an equal focus on where to invest as there is on where to reduce. If you overemphasize the cost-reduction or the target-setting aspect, you have the risk of losing the organization along the way and having them believe that you've gone too far and you've swung the pendulum and you've forgotten about growth.

> "You need to have a serious and visible commitment from top management as you're embedding the new ways of working."

But if you can engage the organization in identifying where to reinvest those dollars, it's an incredibly inspiring moment for them to say, "That was hard, but it was worth it because we are able to do these things that we weren't able to do before." A fourth would be to focus on changing the mind-sets and behaviors in the frontline operators and not making it just a financial exercise or a productivity initiative. And then, finally, you need to have a serious and visible commitment from top management, especially during the activation phase as you're embedding the new ways of working.

Simon London: Say a little bit more about senior-leadership commitment. It's something that we hear is necessary, of course, in any big transformational change. But for zero-based budgeting, what does it mean in practice?

Jan Perkins: My experience was that the leadership commitment and role modeling were a critical success factor. You lead by example. Where that became very visible and impactful to the organization to start the cultural shift and the realization that things would be different, there would be a new way of working—it begins in the target-setting. Having a leadership team that's committed to being decisive and aligned on where you're going. Transformational on where they want to see things differently. Being committed to the idea that if it's one policy, it fits and applies to all of us. So that's walking the walk or leading by example.

We didn't write policies where you had the haves and the have-nots—if you were this level or above, you could still retain this benefit or this service, and if you're this level and below, you could not. If we really are going to be serious about the idea that every dollar matters, it matters no matter what level you're at in the organization. It could be something as simple as the commitment, as with [one company's] ZBB initiative, to use fewer printers and go paperless as much as possible. I would see executives come into the meetings and say, "Make sure you bring your laptop or put a projector in the room because we're not printing out copies." And as soon as you had an executive once or twice say, "No, thank you, I don't want that copy," it didn't take long at all before everybody got that message. Just small examples like those would contribute to showing that we're serious in a new way of working. And it's going to take some of the monies we used to spend and redirect them or allow us to redirect them and grow the business.

Communication also was critical. Leaders needed to continually communicate to employees, talking to them along the way. "Here's what we're looking at. Here's what we're changing. Here's what it means." Having the leadership be seen as the ones committed to that and sharing the message. People would hear that message being shared by the leadership and say, "Wow, they are serious about this, and this is going to be a new way of working. If they're going to adhere to the policy, I guess I shouldn't ask for an exception to the policy."

That was not an easy thing for them to swallow and say, "Yeah, OK, we're going to give up all of these benefits also because we're on the team." If there was a particular cost category that we were going after really aggressively, there was the ability to say, "Let's collect data. Let's stay fact based. Let's accumulate information on whether we think this is inhibiting us to be successful. So if after nine months, 12 months, this policy is punitive or it's not supportive of where we're going, let's agree that we can change it." Once we did that, you had more leaders saying, "OK, I can get on board with that. Let's try it. Let's do it. Let's collect the data."

Kyle Hawke: It sounds like there was a willingness to test and learn that may not have existed in other programs.

Jan Perkins: Yes, and to be fact based about it. It wasn't hearsay and sound bites; the willingness to do it was based on "collect the data. Let's see the real facts. And then let's continue to be decisive moving forward." That was a significant cultural shift and very eye opening, on several cost categories, to get us to where we needed to be.

Kyle Hawke: Are there other ways that leaders can role-model—just in terms of the questions that they ask, for example?

Jan Perkins: Part of the success of the total zero-based-budgeting transformation is to help them be strong leaders so that they can learn how to approach things differently and then teach their teams and their managers how to approach things differently. How do you handle all these constant confrontations and conflicts in negotiations? When you go about assessing a cost category or looking at it, what are the right questions to ask? How do you assess whether this spend is necessary? What do I do with a very strong-willed manager who says, you know, "Life will end if we can't have this spend"?

And sometimes just giving the managers the words, or even the sales reps. "How do I talk to my clients and my customers now when I have this new meal allowance I have to adhere to?" You can say to them, "Let's role-play a little" and talk about how do you explain to them that "this is where the company's going. And here's why. It's because we will now have this money to invest in these things that will grow both our businesses." Openness and willingness to have those dialogues were huge learning opportunities and gave us the foundation to build on to shift the culture.

Simon London: Something I read about in the literature is around having dual cost ownership or dual category ownership. I think that's a really interesting idea. So, Jan, what does that mean in practice? And how does it help?

Jan Perkins: The dual ownership of cost categories is extremely interesting, and it's hard, initially, to get your head around how that's going to work. As you talk to the leadership that owns a P&L, not only are you now, from a ZBB standpoint, analyzing all of the dollars being spent, you're also introducing another layer of governance looking over leaders' shoulders, making sure that they are adhering to the targets and the spend.

My experience was that dual ownership was met with some resistance initially, and it didn't work as well as we had hoped. Trying to understand the culture of the company and where the leadership was in the acceptance and acknowledgment of it, we stepped back and redesigned it. The leadership team needed to step right in and be the ones who did the cross-category ownership.

You would have a president of a business unit who had a complete P&L that they were accountable for but also oversaw the spending in a certain category. Inventory write-off is a cost category and something that, transformationally, you were looking to make some significant headway in the processes to, over time, reduce it dramatically.

That particular business-unit president would oversee that across the organization. They would have conversations with other business-unit owners, other supply-chain leaders, and anybody who was contributing to that overall spend as to how they were progressing, why they were off target, what things were being done to address getting back on target, and what help they might need to get there. Once we got to the point where the leaders were the ones accountable for help in overseeing, by cost category, it was much more impactful. Plus, they knew they had the resources under them to support that from a visibility and a governance standpoint.

Kyle Hawke: I talked earlier about this idea of adapting the approach to the company's culture and objectives. One of the ways to adapt the approach is to design this cost category on a role to be fit for purpose. So there's a spectrum of ownership that we see with our clients that can vary over time, and it can also vary by area of the business or cost category.

On the far left, you have this individual playing the role of a coach. And on the far right, you have this individual playing the role of a co-owner. A coach is there to inform or guide and help share best practices. A co-owner is designed to do all that but also to have joint accountability for, and a say in, the spend decisions in that area.

Simon London: This whole part of the conversation has brought home to me again that zero-based budgeting is not for the faint hearted. It does involve quite significant changes in the way that people work, including the executive team. So, Kyle, you must talk to a lot of companies about zero-based budgeting. How do you know, and how do they know, that they're ready to commit to something like this?

Kyle Hawke: So I definitely talk to a lot of clients on this topic. And I would say that, for every client I have the opportunity to serve, there are probably ten where we have the conversation and we explore it, and then we mutually agree that a ZBB approach is not for them. And this can be for many reasons, but oftentimes it is because there is just not the leadership commitment at the moment to drive it. That's OK because there are other approaches that you can take that are probably more fit for purpose, and they don't need to go all-in to really focus on changing the ways of working.

"You have to engage not just the senior leadership but also these influencers who are not necessarily at the top levels of the organization."

Simon London: For the one in ten where you do decide jointly to move forward with a commitment to zero-based budgeting, what can you do? And what can the executives do themselves to get ready to get this off the ground successfully?

Kyle Hawke: The first is to help senior leaders write their own personal change stories. This is their own interpretation or words of why the company is embarking on this journey and what it means for them personally. They can then use this change story to communicate and cascade with their team in a much more personal way rather than taking a script that somebody else gave to them.

The second is identifying other influencers across the organization. So you have to engage not just the senior leadership but also these influencers who are not necessarily at the top levels of the organization.

The third thing is something we've talked quite a bit about today, which is helping leaders role-model the new, very visible behaviors. Whether that's dropping the gold-plated IT service desk that was previously exclusive to the leadership team or just simply asking the right questions to the organization around what would it take to get there, it's helping them role-model those behaviors because we have seen that to be so critical.

Then, fourth would be cocreating the answer with employees rather than simply handing it down as a mandate. And this is incredibly important to drive conviction in the targets and that, yes, there is a way to get there. So that when you go start to build up from zero, you actually have a path on how you're going to achieve it rather than a bunch of plugs in the budget that you need to figure out throughout the year.

Simon London: Anything you would add to that list, Jan?

Jan Perkins: The other piece, once you do agree to go into this journey—and as Kyle mentioned, giving each senior leader a personal message—is incorporating in that a knowledge and a foundation on where the organization has been. There's no organization out there that hasn't already been through some productivity initiative and isn't going to be skeptical coming into this right off the bat.

So helping them relate to that, why would this initiative be different? Also, taking into consideration the company's culture and what is it that's going to help make this successful? And how you can get them to that point of being fact based and addressing some of the emotional reactions are really key.

Simon London: So I think that's all we have time for today. But, Kyle and Jan, thank you so much. That was really interesting.

Jan Perkins: Absolutely. Thank you for the opportunity.

Kyle Hawke: Thanks, Simon.

Simon London: And thanks to you, our listeners, for tuning in. To learn more about our work in zero-based budgeting, finance, growth, and organizational change, please visit us at McKinsey.com. □

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