

# Zero-based productivity: The power of informed choices

Extending the tenets of zero-based budgeting across the full cost base can transform performance.

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Executives increasingly are recognizing zero-based budgeting (ZBB)<sup>1</sup> for its ability to extract cost savings and transform a company's culture related to its spending approach. This process then reallocates funds to higher-value priorities that focus the organization—from top to bottom. One element that sets ZBB apart from other cost-reduction measures is that it enables the organization to make active, well-considered choices about spending rather than merely revise the ongoing trajectory of prior spending.<sup>2</sup>

Zero-based productivity is a comprehensive approach that extends zero-based-budgeting principles to spending categories across the enterprise. This approach has helped companies to reduce costs while jump-starting growth, improving financial performance, and instilling a culture of vigilance among managers with spending authority.

When senior executives assess zero-based productivity programs, they typically express a number of misgivings that can prevent or delay their decision to adopt one: they have concerns about the negative impact on employees and culture, and they believe that zero-based principles are contrary to (or at least a distraction from) growth. They also share a perception that their level of ambition for boosting productivity is already appropriate.

Executives that have undertaken thoughtfully designed zero-based productivity programs, however, cite two main lessons: their initial concerns were much greater than the reality, and their company is better off for having pursued the program. The resulting increased transparency and benchmark-driven insights often lead executives to set and achieve more ambitious targets.

As zero-based productivity approaches continue to gain acclaim and momentum, leading companies are finding new and innovative ways to apply intelligent zero-based productivity across their cost base.

In this article, the first in a series, we examine the distinctive elements of zero-based productivity. Subsequent installments will highlight how an intelligent zero-based approach can be applied to specific spending categories across an enterprise.

### **Applying zero-based productivity across spending categories**

When implemented throughout the enterprise, zero-based productivity can not only create a fit-for-purpose cost structure but also free up funds to invest in strategic growth initiatives. The key to spending efficiency is greater transparency, which enables leaders to track impact and intelligently redirect funds.

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The payoff is well worth it. When zero-based productivity is rolled out as an overarching philosophy to promote a high-performance culture, an organization can achieve cost savings of 10 to 40 percent (depending on the spending area) while allocating more resources to strategic priorities.

### How zero-based productivity is different from traditional cost-savings methods

Companies have numerous levers to pull to reduce operational costs and most have already been hard at work extracting costs. So what is new and different about a zero-based approach?

Zero-based productivity distinguishes itself by acting as a platform to identify low-value-added spending and enable better choices. In simple terms, zero-based productivity combines greater visibility on spending and investment decisions, intelligent targets for spending and performance, and a philosophy that empowers leaders and encourages them to allocate the company's resources in the best possible way. When done thoughtfully, this approach can more effectively support a company's business strategy—including growth agendas—while also creating a healthy and sustainable culture.

**Improved visibility.** Zero-based productivity starts with a strong fact base, to help assemble a granular view of how an organization is spending its money today. For external indirect spending, companies typically create a robust database that cross-references general ledger data with invoices, contracts, and accounts payable data. This effort often requires some data cleanup and analysis to paint an accurate picture of spending by category and cost and profit centers. In the end, the goal is to provide management with one source of the truth—a detailed view of current spending in a way that can be compared with alternative decisions, benchmarks, budgets, and targets.

**Intelligent target setting.** Defining intelligent targets involves challenging decisions that affect spending throughout the organization and

rethinking constraints and choices. Benchmarks are an important input to target setting, but they should not be confused with the actual targets.

Internal and external benchmarks, from relevant peers as well as across internal markets and functions, are used to intelligently challenge current spending levels. These comparisons provide business leaders with the perspective to gauge the full potential savings available to their company and turn that potential into year-over-year targets. The full savings potential can be allocated over time (for example, how ambitious do we want to be in year one?) as well as to specific functions or markets.

**Strategic budget building.** With visibility and intelligent targets in hand, owners of spending categories are required to build budgets that either meet their targets or explain the need for more resources. Building from zero enables managers to completely reevaluate the assumptions, choices, and requirements that have influenced prior spending—often delivering surprising step-change improvements. Moreover, at regularly scheduled intervals throughout the year, the spending category owner is required to monitor actual spending versus the current budget using the newly acquired visibility.

The key to success in zero-based productivity is providing the business leaders best positioned to interpret the baseline with budget variances to targets and actual spending versus budgets. This transparency supports spending choices that are more in line with the business's strategic priorities.

### Thoughtfully extending zero-based principles across the cost base

As mentioned, companies are seeing great benefits from extending zero-based principles across the enterprise. Successfully doing so requires a tailored approach that aligns costs with a company's strategic objectives. Applications in four areas of the enterprise reinforce zero-based productivity's relevance and effectiveness in different situations (exhibit).

## Exhibit

### Zero-based productivity applies a combination of granular transparency, intelligent targets, and cross-functional decision-making to spending.

Indirect spending	Organization	Supply chain	Marketing
			
<ul style="list-style-type: none"><li>• Granular transparency of spending (eg, travel, energy)</li><li>• Intelligent target setting by spending category</li><li>• Bottom-up budgeting and monitoring of spending</li></ul>	<ul style="list-style-type: none"><li>• Granular transparency of organization (eg, spending, number of full-time equivalents, activities)</li><li>• Buildup of an organization from scratch</li><li>• Intelligent targets and best-practice spans and layers</li></ul>	<ul style="list-style-type: none"><li>• Granular transparency of spending (eg, cost of goods sold, distribution)</li><li>• Benchmark-driven target setting by spending area</li><li>• Enterprise-to-enterprise specification and cost optimization</li></ul>	<ul style="list-style-type: none"><li>• Granular transparency and segmentation of spending</li><li>• Rigorous alignment of customer and channel priorities</li><li>• Reallocation of spending to obtain maximum return on investment</li></ul>

Source: McKinsey & Company

The application of zero-based principles to indirect spending (a common focus of ZBB) has been well covered to date.<sup>3</sup> The remaining three elements reinforce the effectiveness of a zero-based approach to generate value.

**Zero-based organization.** With zero-based principles as a lens to assessing organizational spending and capabilities, companies can address both effectiveness (What are we looking for our people to deliver for the organization?) and culture (How do we create a vision for our future organization that will inspire people and promote desired behavior?). Companies also have used zero-based organizational design to align talent to value, ensuring that the highest-value roles in the organization are clearly identified and staffed with the right level of capability. Applying this sort of zero-based thinking involves stripping down activities to what we call the “survival minimum,” then building the organization with choices anchored

in clear business value, and applying advanced practices such as automation.

**Zero-based supply chain.** In a supply chain for a physical product, the zero-based approach examines end-to-end supply chain costs, starting with visibility and intelligent target setting in four cost categories: materials (including yields), direct labor, indirect labor, and warehouse and logistics. Breaking free from a traditional view of costs and performance measurement can provide management with new insights and opportunities for improved end-to-end supply chain performance. For example, rethinking cleaning from a cleanliness standard (rather than a process standard) can result in improved product quality at lower cost.

**Zero-based marketing.** A granular fact base that shows which investments in marketing and trade spending generate the largest immediate and longer-term return on investment is an essential part of

an optimal growth strategy. This application of zero-based principles forces executives to focus on setting ambitious targets, making customer-centric investments, responding to shifting market conditions, and improving resource allocation at the granular spending level by category, market, and product.

### Zero-based productivity in action

Difficult market conditions can expose cracks in an organization's strategy and resource allocation. For one multibillion-dollar European food producer with more than 5,000 employees, the combination of increased price pressure from retailers, rising commodity prices, and local market upheaval forced its senior leadership to reassess growth and profit performance. Senior leaders had undertaken performance improvement programs in the past, and these efforts had generated incremental gains but failed to achieve a lasting impact. In addition, a deliberate external focus—that is, a focus on customers—had limited the company's scrutiny of operations and its ambition for reducing costs.

To secure the company's profits and confirm its ability to finance a growth agenda, executives launched a zero-based productivity program that applied all four components of zero-based productivity across the business in a structured sequence. An early milestone for the program was a weeklong, off-site "executive scrum," where the CEO and senior leadership team reviewed the integrated set of productivity improvement opportunities—and the associated implications and tough choices required to pursue them.

This process defined new operating models for support functions, which targeted—and achieved—a cost reduction of more than 10 percent while aligning with the choices to reinvest these funds in clear growth priorities. In addition, management committed to a program to reduce the company's spending on raw materials, direct and indirect labor, and logistics by more than 10 percent. Based on the program's initial

success, during the ensuing 12 months, senior leaders introduced zero-based principles across all of the company's production sites.



Zero-based productivity is an opportunity to realign a company's profit-and-loss statement with its strategic priorities—whether by operating with a smaller cost base or by redirecting spending to more productive investments. The structural and cultural elements of zero-based productivity help to guide organizations and their management teams to achieve performance improvements.

The journey toward productivity is more than a budgeting activity, however. Executives should view it as a significant mind-set shift that requires change management and system improvements to help employees deliver more than they ever thought possible. ■

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<sup>1</sup> Zero-based budgeting is a process that uses a strategic view to meticulously review each dollar in the annual budget, manage monthly financial performance, and foster a culture focused on cost-management practices.

<sup>2</sup> For more on ZBB, see Ronald Falcon, Kyle Hawke, Matthew Maloney, and Mita Sen, "How absolute zero (-based budgeting can heat up growth," January 2018, McKinsey.com.

<sup>3</sup> Hanspeter Hueter, Carey Mignerey, and Tao Tan, "Why zero-based budgeting makes sense again," January 2018, McKinsey.com.

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