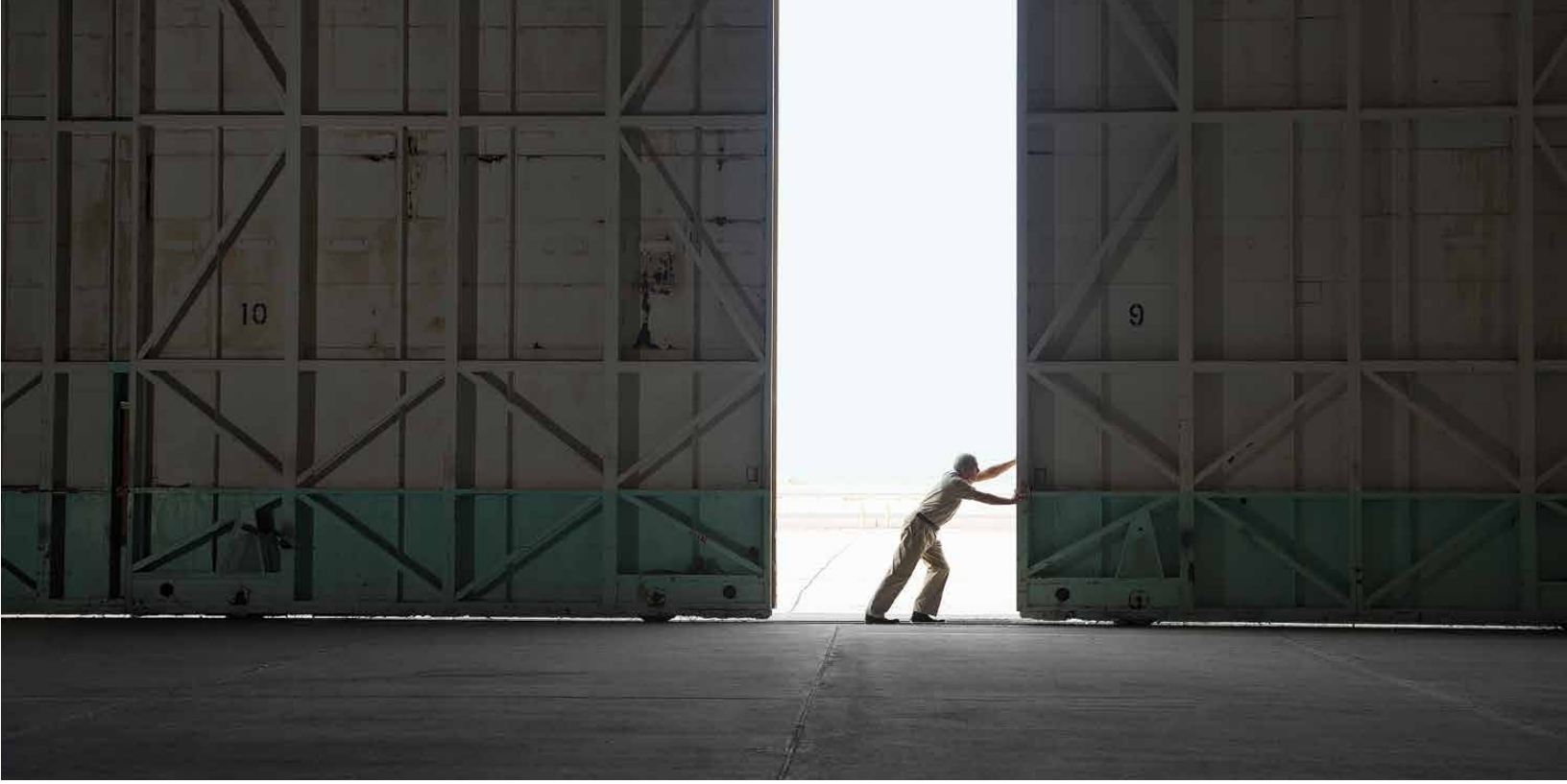


The return of zero-base budgeting

The venerable technique has vaulted back into the consciousness of corporate leaders—for good reason. But getting it right is not easy and depends on five key elements.

Matt Fitzpatrick and Kyle Hawke

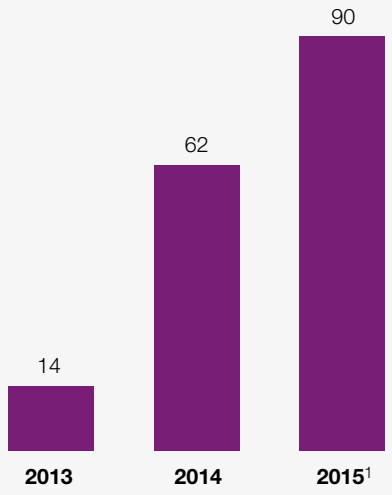
"Zero-base budgeting" (ZBB) was first introduced to the public in a 1970 article by Peter A. Pyhrr in the *Harvard Business Review*[1] and soon gained a following. However, over the last half century, the tool became dogged by misperceptions and faded into obscurity.[2] Today, it is enjoying a renaissance. The number of companies publicly referring to zero-base budgeting has exploded over the past few years, including such disparate companies as Alcoa, Boston Scientific, Jarden Corporation, and Quiksilver (exhibit). It's not only big companies that have taken to ZBB; businesses of all sizes are taking the leap. For example, B&G Foods—a US-based multibrand company with $850 million in annual sales and less than $100 million in sales, general, and administrative (SG&A) expenses—has recently adopted ZBB. It's becoming clear that ZBB can be effective across industries, in companies big and small, and under both public and private ownership.

ZBB of the 1970s was fundamentally about ascribing each company activity to a decision "package," evaluating and ranking these packages for their costs and benefits, and allocating resources accordingly.[3] Today's ZBB is much more than that—it's a repeatable process to rigorously review every dollar in the annual budget, manage monthly financial performance, and build a culture of cost management. What makes ZBB unique is not the budgeting methodology; it is the mind-set shift that upends managers' default assumptions. Rather than compare this year's spending to last year's,

Exhibit

Zero-base budgeting is back.

Number of companies mentioning zero-base budgeting on quarterly earnings calls



[1]Projected based on year-to-date mentions.
Source: Seeking Alpha; McKinsey analysis

ZBB looks instead for the most-efficient return on spending, from the bottom up. As one executive who recently made the transition to ZBB told us, "It was more effective to talk about every dollar spent in terms of efficiency, and ask if it was really necessary, rather than to compare it to last year. It resets the discussion."

ZBB is especially useful for private-equity firms. It aligns well with the return-on-capital approach that the industry favors. It can eliminate unproductive costs (often as much as 10 to 25 percent of SG&A in six months), allowing owners to reallocate capital to growth, through marketing, sales, and M&A. And ZBB is a standardized and replicable playbook that can be rolled out across a portfolio of companies, ensuring aligned processes, controls, cadences, and incentives. For private-equity operating groups seeking standardization (with a helpful degree of flexibility), ZBB is the perfect fit.

Five factors of success

Some executives ask us whether zero-base budgeting is the "secret sauce" for cost reduction. It is an important tool, but just as important are the organizational elements that must support it, such as management buy-in, the organization's willingness to challenge current thinking, and its tolerance of the risks that arise when making changes to reduce costs. In our experience, the following five factors are required to build the culture of cost management that distinguishes superior ZBB from mediocre efforts:

- *Deeper visibility into cost drivers.* Companies need a granular understanding of the drivers of costs so that managers can make better and quicker decisions on how to control them. Tactically, that means grouping costs into a matrix with two dimensions—the type of expense and the owner—to make the drivers clearer. Without this visibility, it's too easy to explain away "the way things are" and why they cannot change.

- *Dual-ownership governance model.* Two people, the P&L owner and a leader from a functional cost center (such as IT), should focus on driving down the expenses in a given "package." The addition of a second owner takes away autonomy from the P&L owner and results in an ongoing and healthy dialogue on cost management. This governance model helps spread best practices across business units and geographies. It also ensures that windfalls in one area do not get subconsciously reallocated somewhere else. That's the problem at the root of something we often hear CFOs say: "I don't understand—on paper we saved $100 million, but my EBIT is flat."

- *Rigorous processes for planning and monitoring.* Budgeting from zero is just one part of the planning process. Others include the setting of aggressive top-down targets by the C-suite (supported by detailed bottom-up analysis) and

Zero-base budgeting is an effective tool, and it is also a thorough process that takes time to execute.

structured budget negotiations across the company, with a common fact base and analogous cost comparisons across operating units. Monthly checkups on these plans ensure that savings don't slip away and unfavorable variances are quickly addressed by both cost owners.

- *Aligned incentives.* Adding an explicit metric to measure cost performance (in addition to growth and profit) aligns compensation to cost-management objectives. Metrics should consider only what is under each manager's control, to avoid penalizing managers in the field when, say, intercompany charges and allocations from the corporate center rise.

- *Mind-set.* Perhaps the most critical change is in managers' mind-set. ZBB is most successful when managers stop trying to prove why something is the way it is and start thinking actively about ways to make it better, the same way they do at home when the money is coming out of their own wallet. This includes a shift to "arguing things in" rather than "arguing things out," and the realization that no spending is too small to be reviewed. One hundred small changes that save $100,000 apiece still add up to $10 million.

A tool for all seasons

ZBB is an effective tool, but it is also a thorough process that takes time to execute and requires management buy-in. Before budgeting begins, management needs to build a highly detailed fact base, develop visibility into cost drivers, and put in the effort needed to support aggressive top-down targets with detailed bottom-up analysis. Given the high degree of change required—the new financial-planning process, modified incentives, as well as the execution of significant cost reductions—ZBB is most effective at companies with willing and able management (often newly installed) and a small and aligned investor group that has control of the company. ZBB is less successful in growth-capital investments.

More companies are taking up ZBB every month, in every kind of circumstance. In our experience, the following situations present an ideal time to begin the transition in a portfolio company:

- at the start of the first annual budget cycle under private-equity ownership

- at a change in management, with the opportunity it presents to reset the company's behaviors and practices

- when a company is underperforming and the need to exit is rising

- when a company's performance culture resists continuous improvement

- when a company needs funding for growth initiatives

In a 2014 McKinsey survey of private-equity operating groups,[4] firms agreed that a standardized playbook across their companies is highly desirable. While some firms have made some headway in several core processes, budgeting is often more ad hoc and company specific. ZBB gives private owners the standard but flexible approach they want for perhaps the most essential corporate process: the allocation of capital.

It is thus no surprise that, 45 years after its creation, ZBB is making a comeback. Private-equity firms and others are finding it a useful framework to reset a company's default mode of operating and drive sustainable cost efficiency. This time around, ZBB seems likely to stick: the new incarnation is more likely to become a widespread norm than to fade into the ether. For ZBB 2.0, this may be just the beginning. ■

[1] Peter A. Pyhrr, "Zero-base budgeting," *Harvard Business Review*, November/December 1970, Volume 48, Number 6, pp. 111–21.

[2] See Shaun Callaghan, Kyle Hawke, and Carey Mignerey, "Five myths (and realities) about zero-based budgeting," October 2014, mckinsey.com.

[3] Pyhrr, "Zero-base budgeting."

[4] Andrew Mullin and Alex Panas, "Private-equity operations: Inside the black box," *McKinsey on Investing*, Winter 2014/15, mckinsey.com.

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