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ZERO-BASED BUDGETING FOR THE GROWTH-ORIENTED CEO

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They say you can't cut your way to growth. The same is true for value creation. While plenty of companies are generating significant savings with zero-based budgeting (ZBB) programs, to date most of their results have been limited to the cost side of the equation. Our experience shows that there is a better way.

Zero-Based Blues?

ZBB continues to be a hot topic, especially in the consumer packaged goods (CPG) industry. Many CEOs are either already attacking their cost base or feeling pressure from their boards and investors to set big cost reduction objectives. They have good reasons: the slow-growth economic environment, high-profile activist investor initiatives, and eye-opening projections from major companies, some of which have targeted nine-figure cost reductions in the areas of selling, general, and administrative (SG&A) expenses; productivity; cost of goods sold; distribution; and organizational simplification.

As the results of those moves roll in, however, a mixed picture emerges. The cuts can be impressive, and that's a big win. At the same time, evidence of accelerated growth is hard to come by, and several big companies that have implemented ZBB programs have actually experienced falling revenues. Some are calling into question ZBB's heavy-handed approach, which targets certain functions and departments, and asking whether the cuts that ZBB dictates are sustainable over the long term. And when it is applied clumsily, ZBB can have a demoralizing impact that distracts the organization from growth and value creation.

A Better-Than-Zero Approach

Our work with clients has shown that ZBB can create significant value. The approach involves rethinking the budgeting process, decision rights, targets and incentives, and company culture. But to be most productive, ZBB programs need to be tightly integrated with the company's strategy and with growth levers for the business. Most important, ZBB is not a one-size-fits-all system; each company needs to develop its own version and align it with the company's particular circumstances and goals.

Our approach, which we call "margin reset," helps companies achieve new operating margins and cost structures for the future. It seeks to differentiate between expenses that result in high added value and costs that add little or no value—and to reduce the latter permanently.

It establishes a new cost culture and its critical enablers: the right accountability structure, supporting tools, and tracking system, as well as strong incentives that reward hitting targets. It challenges companies to think about how they operate across functions, geographies, divisions, and business units to do things in a more efficient and value-focused way. And it reinvests excess cash to drive growth.

Here are several areas in which our approach is different.

Growth. Sustainable value creation is substantially a function of growth. To produce maximum impact with ZBB, it's critical to have a clear view of the overall saving ambition and how much money will be reinvested in value drivers of the business. The end result of a successful ZBB program should be a virtuous circle that improves both bottom-line and top-line performance by shifting spending from where it is wasteful or has low impact to where it generates top-line growth. Our first rule of ZBB is to do no harm by cutting value-adding activities. Our second is to reinvest savings (at the same time as they are realized) in the activities that drive new sales. Timing is important. Cuts and reinvestments should take place concurrently to avoid a situation in which investors think they see savings being realized—but then see costs creeping back in.

Differentiated Costs. We have helped companies achieve sustainable cost reductions of as much as 25% (sometimes even more) by going beyond reducing head count and slashing budgets. Instead, companies differentiate costs and focus on cuts that will have a positive impact on performance while causing little or no collateral damage. We use a company's own strategic priorities to define the principles that will govern choices during and after a project. Companies can then develop a comprehensive overview of spending, an important aspect of which is creating data transparency. That includes collecting and cleaning data from enterprise resource planning and procurement systems and translating it into actions rather than reports.

Three ways to make cuts have a sustainable impact on costs while safeguarding growth and value. The first is to reduce spending that doesn't directly deliver value to customers or have an effect on the top line (facilities and supplies, for example).

The second is to decrease costs by approaching the drivers of the top line—such as advertising, promotion, and the sales force—with an eye on ROI. Many CPG companies, for example, can rationalize advertising and promotion expenditures as well as consolidate market research budgets by disaggregating market research expenses, separating routine testing from strategic research projects.

The third, and most important, way to make cuts arises from differentiating costs within expense categories. Most companies can cut indirect spending by going paperless or by evaluating travel expenses according to the purposes of the trips—for example, visiting customers to make sales versus traveling for internal meetings. They can also use technology (such as social media, e-learning, and videoconferencing) to replace routine travel and conference attendance, rather than requiring their employees to stay in less expensive hotels or even share a room. We have found that when CPG companies cut areas of spending that either fail to generate revenues or produce only low returns, they can reduce indirect costs by 10% to 30%.

New Operating Models. The hallmark of the typical ZBB approach is a top-down, process-oriented methodology that applies benchmarks, sets targets, creates budgets, and holds people accountable—in other words, it has a strong focus on the mechanics. Our approach concentrates more on how companies achieve the savings than on how they establish and enforce the targets. We seek to marry benchmarks with a bottom-up view of company-wide priorities and opportunities, thereby enabling cross-functional discussions and changes to the operating model as a whole instead of modifications of a particular line item in the budget. Put another way, rather than delivering a program of consultant-orchestrated cuts, we seek to present top management with a series of options for shifting costs, realizing savings, and reinvesting so that leaders can make choices about how to integrate ZBB with the company's business strategy.

Often, opportunities arise for executives to finally execute the win-win changes that they have long wanted to make but couldn't push through. These changes can include simplifying processes to focus spending on activities that add real value, such as streamlining bonus structures to rely on a few discrete metrics that are within employees' control or reducing variations in customer credit terms to necessitate fewer manual interventions and errors. Another example is rethinking the employee value proposition and replacing expensive but often undervalued mechanisms for recognition with more-valued employee rewards, such as flexible hours or job sharing.

We examined the cost of one CPG company's sales force from multiple points of view (including those of management and sales personnel) to gain a comprehensive picture of the non-labor-related costs, the drivers of current spending levels, and associated issues, such as employee satisfaction. This information helped us figure out which areas of spending were delivering value to customers and staff and which were not. The company was able to achieve major savings by remodeling career paths to reduce travel, cut meeting expenses, and eliminate frequent employee relocations, which both slashed costs and removed a major source of workforce dissatisfaction. What's more, the company was able to do all this without reducing sales force numbers or time with customers. In fact, the sales staff actually gained more time to spend with customers and deepen relationships.

Engagement. Success in these and other areas depends in large part on enabling the organization to capture value through the right governance and financial tracking models. More important than determining the actual source of the cuts, however, is achieving a shift in culture so that executives feel more like owners who are choosing how to spend their own money. Everyone with a stake in a particular area should be engaged in developing the solution to cut costs. Aggressive targets are good, but a greater priority should be to make owners accountable and give them control through a menu of options or choices about how to meet those targets. The process of selecting and implementing cuts helps create new channels for dialogue and expanded thinking about the best use of every dollar. We also believe that companies can achieve significant changes without some of the more draconian moves that have become part of ZBB lore, such as denying employee benefits or sacrificing service levels, which can lead to more costly errors down the road.

Our approach can result in cost reductions as large as those of any other ZBB program, without disempowering managers. For example, one program that we instituted with a recent client delivered SG&A cost reductions of 15% over three years—at least half of which were captured in the first year. More important, the work laid the foundation for a culture shift toward increased cost ownership and an owner-operator mentality throughout corporate and business unit management that accelerated the realization of benefits beyond expectations.

It is critical to make the reason for the exercise clear to the entire organization. Everyone can get behind an approach that emphasizes growth and value, but employees need to hear about the program's full goals and purpose so they don't jump to the conclusion that the company is adopting a slash-and-burn campaign. The company also needs to follow through and communicate concrete examples of progress, illustrating the payback from reinvestment as well as the impact of the cuts.

Continuous Improvement Processes. Change management includes embedding in the organization an owner-operator mindset based on the concepts of simplicity, efficiency, and effectiveness. Successful ZBB programs enable the company to manage costs more effectively than by relying on teams of axe-wielding consultants. The goals should be ambitious: not just making aggressive cuts but defining new models that reset costs to levels that can be sustained over time. Incentives and rewards are important: large upside bonuses for hitting targets (100% of base pay, for example) and equally high penalties for missing targets (even no incentive payout in some circumstances) intensify the focus on results.

ZBB CAN BE a powerful catalyst for rethinking cost structures and budgeting. But for CEOs who are seeking to boost growth in mature and competitive markets, ZBB needs to go further—targeting new operating models and ways of working that closely align with the company's growth strategy and culture. The overriding goal should be to go beyond unlocking deep savings to enable the company's overall growth agenda.

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