ZERO-BASED BUDGETING: REDUCING WASTE BY STARTING FROM SCRATCH

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Companies grow and evolve. They respond to the market and adjust the best way they know how to — at the time. The problem is that few companies ever revisit the decisions that they made in the heat of the moment — and they should. Zero-based budgeting forces companies like yours to do just that.

WHAT IS ZERO-BASED BUDGETING?

Zero-based budgeting, or ZBB, requires that you create a new budget, from scratch, every year. Top-down targets are set by individual category owners who have to justify each budget line item. The idea is that by going through this process every year, companies are forced to pay more attention to the cause of every cost and be held to account for each one. As a result, forecasts are more precise, and it is easier to see where costs could be better managed. In turn, you can apply these savings to areas that contribute directly to growing sales revenue, making for a more efficient and cost-effective operation.[1]

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WHAT IT'S NOT (OR COMMON MISCONCEPTIONS)

You might have heard about zero-based budgeting as a solution in a mergers-and-acquisitions situation. "Common, but flawed, wisdom ... says companies typically pursue ZBB in crisis mode in an M&A scenario to improve integration, speed results, and realize the integration business case," says Accenture. In fact, its research shows that M&A as a driver for ZBB is only the case for about 14 out of 100 companies.

Also, forget the influence of certain investors as a driver as well. Accenture reports, "The media is fixated on the pressure coming from private equity funds and activist investors to implement programs like ZBB. But only 8 percent of companies say this was a factor for [them]."

The reality is that there are some significant differences in the way companies use ZBB in practice. The budgeting philosophy is applicable throughout an organization, but its applications are often limited. While most companies that use zero-based budgeting do apply it to general overhead and other administrative expenses, some also apply the budgeting philosophy to the cost of goods sold, labor costs and marketing — and not always at the same time.[2]

MAXIMIZING CASH FLOW AND OTHER BENEFITS

Most companies take the leap to zero-based budgeting to improve profitability, often in the face of slow growth. ZBB helps to establish ideal targets and simplify accounting systems. It also helps align company strategy with its allocation of resources — and that can mean significant cost savings.

The process makes it easy to see which costs and activities do not add value to your operations. By reducing these expenses, you can better align your resources with your business strategy.

Accenture reports that companies with ZBB report "on average, a 15% cumulative annual cost reduction during their ZBB project implementation period (typically about 2.5 years), compared with a baseline (usually, spending in the previous year). That translated to average bottom-line savings of more than $260 million" — and those results are not isolated.[2] According to McKinsey & Co., zero-based budgeting can "reduce SG&A [sales, general, and administrative] costs by 10 to 25 percent, often within as little as six months."[3]

POTENTIAL DRAWBACKS AND CHALLENGES

Clearly, adopting zero-based budgeting has some significant advantages, but it also presents particular challenges. For example, the process may be expensive and time-consuming. You won't be able to apply a blanket increase in costs to account for inflation even for the smallest, most arbitrary expenses.[4]

"Zero-Based Budgeting analyzes which activities should be performed at what levels and frequency and examines how they could be better performed — potentially through streamlining, standardization, outsourcing, offshoring or automation," explains Bain & Company.

"The process is helpful for aligning resource allocations with strategic goals, although it can be time-consuming and difficult to quantify the returns on some expenditures, such as basic research."

It can also be difficult to justify the cost of performing ZBB itself, especially if the return on investment is unclear. Plus, zero-based budgeting can disrupt company culture if not done well. For instance, if your salespeople work so well because you provide snacks in the break room, but you cut the expense because you didn't realize how much they valued that little perk, you could regret ZBB.[5]

HOW IT COULD WORK FOR YOUR COMPANY

Zero-based budgeting is a useful tool for reducing budget bloat. If your organization has grown overly complicated, ZBB helps reduce unnecessary expenditures. The process makes it easy to see which costs and activities do not add value to your operations. By reducing these expenses, you can better align your resources with your business strategy.

To discuss these topics in more detail, please contact your PNC Relationship Manager or visit pnc.com/ideas.

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4 "Zero-Based Budgeting: Zero or Hero?" by Gabe Rodrigues, Josh Fien-Helfman, Emily Barber, and Allison Peck, Deloitte, 2015. Available at: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Process-and-Operations/gx-us-operations-cons-zero-based-budgeting.pdf

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