ZERO-BASED BUDGETING

A Primer On a Transformational Alternative to Traditional Budgeting

Is it possible to transform the budgeting process by strategically prioritizing investments, integrating process/performance improvement, and reducing costs on a significant scale? In an effort to achieve these goals, some organizations are considering new possibilities from an old approach: zero-based budgeting.

Created by Peter Pyhrr for Texas Instruments in the 1960s and used by the federal government in the 1970s, zero-based budgeting was developed to logically invest while examining the necessity, efficiency, effectiveness, and appropriate service level for each potential expenditure. The approach fell out of favor because of the amount of information and paperwork required to effectively make a budget. By the 1980s, zero-based budgeting was largely abandoned because it was complicated, time-consuming, and not predictably effective at reducing costs.

Since then, the approach has taken varying forms and the demands of collecting and analyzing data can now be largely automated and quickly optimized through scenario simulations. Now, given the need for comprehensive cost controls, some organizations are using zero-based budgeting intermittently as a periodic review to shake up operations or, in its truest form, as an ongoing approach to change budgeting behaviors.

But the approach is a challenging proposition for most organizations. It requires process management maturity, advanced analytics savvy, and complementary organizational structures including a well-established integrated business planning program. Beyond the considerable prerequisites, the act of zero-based budgeting requires thoughtful and strategic re-investment of the cost savings gained. “The history of zero-based budgeting shares some cautionary tales in terms of actual practice,” said Steve Player, senior research fellow, financial management for APQC.

For the 10 percent of businesses currently experimenting with zero-based budgeting, the potential for cost savings up to 25 percent is very appealing. This article is an introduction to zero-based budgeting and what to consider before adopting the approach.

WHAT IS ZERO-BASED BUDGETING?

The zero-based budgeting approach requires justifying all expenses within each budgeting cycle, thus starting with a base budget of zero. Every spending request must be justified. This is different from traditional budgeting in which budgets are set relative to what they were in the previous cycle, with incremental increases or decreases and close examination of only new expenses. For zero-based budgeting, there are no preauthorized, assumed, or committed expenditures. (For example, although an organization would pay its employees’ salaries, positions are examined against their contributions and available process improvements and
Every expense receives a cost-benefit analysis, and expenditures are ranked for resource allocation according to strategic priorities. Notably, service levels are not expected to remain consistent across budget cycles.

Importantly, the approach requires repeatable processes for rigorously reviewing and justifying costs, which in turn feed processes for preparing cash flow budgets and operations plans. An organization would need deep visibility into the marketplace and its cost drivers, as well as a structured schedule, process controls, and aligned incentives for multiple levels of management to debate each expenditure. An organization would also need a flexible management approach that can comfortably and significantly scale up or down spending in response to changing priorities and cost drivers.

In addition to these considerable prerequisites, the zero-based budgeting approach requires thoughtful and strategic re-investment of cost savings. As imagined by Pyhrr, the zero-based budgeting approach is an opportunity to more strategically invest in operations. “But in practice, many just use this approach to strip costs from the balance sheet,” said Player. “This removes long-term, value-creating aspects of the enterprise. The P&L may not take an immediate hit; but by neglecting to reinvest those savings in activities such as training and R&D, some companies have significantly diminished their brands’ value.”

WHAT ARE THE ADVANTAGES OF ZERO-BASED BUDGETING?

Organizations often find zero-based budgeting to be a compelling option for reducing operational costs. Most are under pressure to outsource, automate, and streamline as many processes as possible. And by setting a consistent focus on strategic alignment when scrutinizing expenditures, zero-based budgeting should help decision makers avoid cutting costs at the detriment of reaching strategic goals.

But zero-based budgeting also has the potential to enable process and performance improvements at a transformational level. For example:

- **Culture shift**—Functional leaders typically see the budget process as a game to beat, rather than a cooperative planning process. Zero-based budgeting instead requires everyone involved in budgeting to have an understanding of the cost drivers and how the organization operates. Stakeholders are encouraged to question long-held assumptions and re-evaluate their relevance. Staff is motivated to justify the expenditures they believe are most critical. And everyone must focus on what investments will best serve strategic goals. The systematic approach aligns participants on a shared purpose, creates accountability for resource demands, and signals the organization’s receptivity to a transformative reallocation of resources in pursuit of strategic goals.

- **Streamlined operations**—Especially for large organizations, costs can get sunken into redundancies and increasingly ineffective legacy investments. By systematically justifying each investment, rationalizing each cut, and transparently reviewing expenditures from top
to bottom against strategic goals, organizations can eliminate redundancies, consolidate operations, streamline processes, and review re-investment opportunities in-depth. No other budgeting process encompasses planning what to do and how to do it. And no other cost-reduction program creates sustainable solutions by focusing on capabilities and a closer understanding of operations.

- **Data-driven cost optimization**—Managers are held accountable, in a very visible way, for justifying expenditures and exploring opportunities to cut costs. The budgeting process becomes an opportunity to examine cost-cutting alternatives with consistent standards. The budgeting decisions are then centralized, with the expectation that each spending request includes data-driven justification and a comprehensive look at what has succeeded/failed so far and the trade-offs among options. Funding cuts and re-investment opportunities receive equal scrutiny.

- **A more responsive organization**—Organizations need to be able to nimbly respond to the fast pace of change in the marketplace. Zero-based budgeting provides the financial bandwidth to prioritize spending on whatever most aligns with strategic goals. New and legacy projects receive equal consideration. This enables an organization to more easily pursue new initiatives—*as quickly as its budgeting cycles occur*.

For these reasons, zero-based budgeting can reduce costs by **up to 25 percent in just six months**. The average cumulative costs savings for this budgeting approach is a noteworthy **15 percent**.

**WHAT’S THE BIG PICTURE?**

So there are some tantalizing motivations for adopting a zero-based budgeting approach. Let’s break those down to compare them to the approach’s equally notable disadvantages.

**Pros**
- A detail-oriented process, with every expense analyzed and justified
- Resources allocated based on need, cost-benefit analysis, goals, and current conditions
- Challenges assumptions, arbitrary favoritism, and the status quo
- A structured process for analyzing costs by each line item, data source, and/or cost driver
- Shifts the focus from past spending habits to short- and long-term goals
- Highlights inflated areas of previous budgets, as well as waste and stagnant performance
- Data-driven decisions keep the focus on numbers and cost benefits
- Eliminates “use it or lose it” overspending
- Increases opportunities for process improvement and streamlined operations (i.e., integrates budgeting with eliminating inefficiencies)
- Enlists staff in justifying costs and aligning efforts with strategic goals
- Forces functions to define their missions
- Process prompts functions and business units to coordinate and communicate
- Can keep budgets lean over the long term
- Avoids indiscriminate, across-the-board cost-cutting
Requires active management participation

**Cons**
- Process favors areas that generate revenue and thus are easier to justify
- Difficulty in creating standardized terms in which to consistently judge need
- Difficulty in estimating costs and demonstrating ROI for intangible benefits
- Difficulty in justifying long-term investments and analyzing complex portfolios
- Difficult for most complex organizations in grasping, much less standardizing, their cost structure
- The pervasiveness of the cost-cutting exercise could inadvertently shift organizational culture
- Pervasiveness of cost-cutting exercise could inadvertently strip value-creating activities
- Can add a layer of bureaucracy through additional reporting, meetings, and deliberation
- Staff needs training in justifying expenditures in a consistent manner
- Management may be less inclined to revise budgets between cycles
- Some costs, such as those set in a contract, must remain fixed costs for the budgeting cycle
- Does not necessarily account for the customer’s perception of what is valuable
- A time-consuming process that some businesses take years to conduct across every function
- Even with automation for data collection and modeling, still time-consuming for staff
- Just to reiterate, very time consuming compared to all other budgeting processes
- Cost savings are not guaranteed for this significant time investment
- Requires active management participation (which is hard to manifest if cost justification is resented)

**WHAT ARE THE MOST COMMON MISTAKES MADE IN ZERO-BASED BUDGETING?**

Some of the disadvantages as mentioned earlier for zero-based budgeting are a matter of inadequate preparation, structure, and attention to change management. This budgeting approach is more complex than just updating numbers from the last budget cycle; zero-based budgeting challenges established modes of operation and has implications for how the organization operates. It requires a fundamental shift in how an organization approaches cost management, investing, process/performance improvement, and strategic decision making (or else old spending patterns quickly resurface).

The most common mistakes concern the focus, structure, and staff preparation for zero-based budgeting.

In terms of focus, some organizations neglect to fully examine cost and growth drivers. Zero-based budgeting requires managers to justify expenditures, conduct a cost-benefit analysis, and explore cost-effective alternatives. So the focus is not only on cost reduction but also on strategic investment. That investment may be into technology, but it more often involves
investing in performance/process improvement and value generation through new products, a pursuit of emerging markets, and other such opportunities. The focus needs to be on the most strategic means of allocating resources to drive growth. “It’s critically important for savings to be reinvested, rather than distributed to shareholders,” said Player.

Also, in terms of focus, organizations must ensure zero-based budgeting is comprehensive, rather than just focusing on the most expensive programs or those with easily measured ROIs or immediate cost savings. To sustain this budgeting approach as a cost management tool, high-level managers need to gauge the long-term value of decisions and weigh potential risks and disruptions in pursuing any investment opportunity. Some organizations make the mistake of only scrutinizing the largest or most discretionary expenditures, but this is how costs often swell in the first place; zero-based budgeting routinely examines all spending because all costs matter.

In short, the key to focused budgeting is granularity. Combing through all expenditures reveals hidden costs and new revenue streams, especially with the support of advanced analytics. By requiring a consistent level of detail for all spending requests, zero-based budgeting can also expose areas missing sufficient data to drive decisions. When expenses are examined in detail, managers have the information needed to make data-driven decisions on resource allocation.

In terms of the structure of a zero-based budgeting approach, some organizations neglect to standardize cost infrastructures, limit exceptions, or apply financial rigor and governance. It’s important to compare spending options using consistent standards that ward off politics, preference for legacy projects, negotiated compromises, and cultural resistance. Some managers make the mistake of thinking their organization is the exception that simply cannot standardize cost infrastructures. But standardized terms for scrutiny and performance measurement and a consistent budget governance structure prevent cost creep. Otherwise, too many exceptions to the zero-based budgeting approach undercut its legitimacy.

A zero-based budgeting approach needs both a cross-enterprise structure and care to ensure the approach doesn’t degrade into a collection of burdensome policies simply policing spending without a concern for what’s supporting strategic goals. Managers should not receive across-the-board cost reduction goals. With each manager justifying their expenditures, the organization centralizes resource allocation decisions based on strategic priorities. Rather than policing spending or requiring burdensome documentation, this is a matter of thoughtful cost prevention.

A comprehensive approach for zero-based budgeting is so important that some may consider a rolling structure—where different areas/functions are scrutinized each budget cycle—insufficient to adequately prioritize spending against strategic goals. When expenditures are examined in isolation, the budgeting approach overlooks cross-functional activities and cannot balance new spending requests against commitments made in the last budget cycle.

Finally, in terms of staff preparation, some organizations neglect to set expectations and instill the change management necessary to enlist all stakeholders. Zero-based budgeting requires
providing managers with sufficient time and motivation to participate, providing staff training, and a willingness for all levels of managers to get granular in their analysis.

Zero-based budgeting is not just another cost-reduction initiative but instead a new way to engage employees. Those stakeholders critical to the approach’s success need to be aware of how the approach will simplify strategic directions and support a results-oriented culture. And high-level managers, in particular, need to be open to examining spending requests and data analysis in granularity in order to wisely allocate resources. This requires training for all budgeting participants in the concept of zero-based budgeting, as well as role-specific expectations and consistent measures and standards.

The requirements for zero-based budgeting set forth by the U.S. Government Accountability Office may put critical success factors in the most succinct terms: “Success requires:

1. clearly defined rules,
2. design responsibility at sufficiently high levels to bring about change, and
3. incentives for managers to view the budgeting as an opportunity to win.”

HOW DO ORGANIZATIONS GET STARTED?

Because zero-based budgeting is a major cultural shift for most organizations, implementation requires common change management principles. That is, the approach requires a business case, executive support, a communication strategy, training, adequate funding, IT support, clear roles and responsibilities, and a robust governance system.

In addition to these generalized implementation requisites, zero-based budgeting requires advanced analytics, modeling capabilities, and whatever tools can help to capture and process a large amount of detail. This technology should be centralized on a planning and analysis platform, where participants can quickly generate insight into cost and growth drivers and easily access highly detailed data concerning activity volumes, productivity, and resource consumption.

With these enablers, organizations can create a zero-based budgeting process that may look something like this:

4. Chaired by a C-level executive, a team of senior vice presidents is assembled from finance, IT, and other relevant functions to oversee the critical challenge-and-review process for resource allocation. A director-level position oversees the budgeting process.
5. The organization standardizes the cost infrastructure through common units of measures, consistent process and performance metrics, and enterprise-wide standards for scrutinizing/prioritizing a spending request’s strategic worth.
6. The team establishes a continual cycle for planning, budgeting, and reassessment.
7. Managers prepare for the challenge-and-review process by identifying their mission/objectives, evaluating alternative methods for accomplishing each objective,
justifying spending requests, evaluating options for funding and performance levels, and setting priorities. Their proposals should include an explanation of the spending request, the amount requested, the need and strategic alignment, a cost-benefit analysis, a risk analysis, and anticipated benefits.

8. During the challenge-and-review process, managers present their spending requests and the resource allocation team evaluates each area for redundant and unnecessary requests, accounts for all components of the budget, prioritizes requests best serving strategic goals, examines opportunities to streamline the processes and projects being funded, and rolls out/communicates a comprehensive budget and execution process.

Such an approach is an opportunity for an organization to determine what investments will help it become best-in-class and what cost reductions will help it become more efficient.

**IS ZERO-BASED BUDGETING RIGHT FOR MY ORGANIZATION?**

Cost-reduction initiatives, in general, are hard to sustain. In one survey, less than a quarter of organizations could sustain cost-reduction programs for four years. Although more than half of organizations in one 2017 survey indicated an intention to use zero-based budgeting, very few have yet to do so because of the approach’s complexity.

The allure is obvious. Zero-based budgeting helps organizations approach spending in a more deliberate, purposeful way. It provides a reliable structure for scrutinizing each expenditure and delivers significant cost savings faster than any other budgeting approach. Instead of asking every function or business unit to cut a certain percentage of spending, the organization is asking its managers what needs funding and why. All budgeting participants begin to think like an investor. And every investment is scrutinized.

But zero-based budgeting still requires a formidable amount of work that only the most motivated organizations will take on to instill long-term cost reductions and strategic investments. There are practical demands (including a different talent component than required in traditional budgeting) and considerable requisites that increase the chance of failure.

Some organizations treat zero-based budgeting as a one-time cost-reduction event rather than an ongoing enabler of strategic goals and process/performance improvement. And other organizations find the best-practice requirements for granularity, regular reporting, robust governance, and employee engagement to apply to other budgeting approaches such as rolling forecasts and activity-based budgeting. For those with the process management maturity, advanced analytics savvy, and complementary organizational structures, adoption of zero-based budgeting in its purest form has the potential to transform organizational spending.

APQC recommends that organizations consider their track records in determining their likelihood to make the most common implementation mistakes in zero-based budgeting. Those with mature integrated business planning programs may be the best candidates. An additional consideration is how well the organization can standardize its cost structure and work with a
budget that will likely remain static between budgeting cycles. Organizations should carefully weigh the disadvantages this article outlines against the alluring (but not consistently realized) prospect of significant cost savings for re-investment. Zero-Based budgeting can bring transformational improvements but only for organizations equipped to take on such a demanding approach.

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