The Zero-Based Approach to Smarter Spending for Industrial Companies

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Aggressive cost cuts may be tempting, but they often leave companies less equipped to compete. Instead, companies should apply an old idea made new: zero-based budgeting.

Today’s shock-upon-shock global economy can cause companies to act in haste, making aggressive cuts in staff and operations before conditions get even worse. It’s a particularly tempting approach for the industrial segment, with its long lead times, significant fixed
costs, high energy usage, and reliance on supply chains stretched thin around the world. Better to cut quickly and thoroughly than prolong the process, the thinking goes.

The problem is that such an uncalibrated response can cause unforeseen consequences that hobble a company’s recovery. Too blunt an instrument can sink morale, curtail growth, and motivate top talent to march out the door. Companies that move fast but fail to respond with more agile cost management methods and reallocation of resources will become less competitive. They’ll also miss an opportunity to become more resilient.

A better answer? An old idea made new: zero-based budgeting (ZBB). Developed in the 1970s, zero basing requires companies to reexamine and justify each of their activities as if they were brand-new. Notably, the final question to be answered in a zero-basing exercise is not “Is this expenditure necessary?” Instead, it’s “Does this expenditure support the company’s strategic goals for success in the market?”

The “budgeting” in zero-based budgeting is something of a misnomer. The methodology goes way beyond a budgeting exercise, allowing industrial organizations to become more mindful and flexible about spending allocations. Full visibility into expenditures and activities—either those wasted with low value-add or those with high value-add—helps guide what to do next in uncertain times. And it does so without losing focus on the future, ensuring that growth is still paramount even while resources are being reevaluated.

A New World for Industrial Resourcing

Disruption has become the norm. Ukraine. Pandemic. Rising interest rates. Rising temperatures. Rising energy prices. All are dislocating supply chains and contributing to price inflation on a global scale. Overhead costs such as energy, IT, and logistics, as well as personnel expenses, are escalating too, pressuring corporate EBIT margins.

This reality is no short-term blip. Uncertainty—social, political, economic—is becoming a permanent feature of the business environment, requiring organizations to rethink and restructure how they plan and execute operations.
The counter to these powerful negative forces is surprisingly straightforward. Organizations must find cost savings, then reallocate those financial assets and capacity to growth-inducing areas. Doing so requires organizational agility, relentless focus on cost management, and commitment to investing in growth.

This is where zero-based budgeting comes in. Applied in a holistic, companywide, cross-silos manner, ZBB provides tools and techniques for organizations to tackle upcoming disruptions and become more resilient. It allows them to rediscover their ability to produce significant and sustainable cost reductions without slowing performance or reducing competitiveness. We have seen ZBB deliver unprecedented transparency and gross savings of between 10% and 30% of costs. Savings are applied to the most strategic areas, such as reinvesting for growth in core and adjacent businesses, underwriting M&A, or accelerating business transformation.

Although major industrial companies have adopted ZBB methods, many more could benefit. This is especially true as we head into 2023, with energy prices remaining uncertain. Industrial companies are typically advanced in the cost optimization of their direct materials and services spending. Often, advanced R&D and industrialization teams apply a broad portfolio of cost optimization methods, such as target costing. But these companies' strength in managing direct materials and services costs is very often a weakness in indirect spending. Very low transparency into indirect costs and their sources provides excuses for less than ideal behaviors. In these situations, ZBB methods can lead to significant improvement in managers’ attitudes toward costs while also enhancing overall cost competitiveness.
A Deeper Dive into Zero Basing

The zero-based budgeting approach reimagines the indirect cost base from scratch and allocates funds based on necessity and value—rather than building on past budgets. Companies can redirect spending toward growth opportunities by identifying unnecessary spending trapped in legacy areas. They do this by asking such questions as: If I would start from the beginning, how would I design my budget? What planning processes could lead to energy efficiencies in production? How can I avoid our bad habit of paying excessive airfreight charges for last-minute shipping to customers?

Although short- and long-term cost reduction is a primary goal of ZBB, it also optimizes resources by identifying demand reduction levers and fine-tunes processes to weed out inefficiencies. In other words, the goal is not just to cut spending but to recognize the causes of that spending. For example, if an auto parts manufacturer needs to decrease costs to reflect falling revenue projections, it could use ZBB methods to identify and change variable IT spending by looking at discrete cost areas such as cloud capacity, CAD license fees, and IT development projects. This surgical approach to cutting costs avoids indiscriminate hacks.

Zero-Based Budgeting in Three Steps

ZBB goes beyond simple cost cutting. The objective is to rigorously reset the nonpersonnel cost basis of an organization and ensure that it is kept lean on a long-term basis. Industrial enterprises can approach zero basing in three steps:

- **Create transparency.** Through cost mapping and advanced data analytics, industrial companies quantify spending on each business unit at a highly granular level. This generates views into not only where costs are allocated but what operational cost drivers are at play. Value can be extracted only by being intentional and transparent about what generates demand. For example, look at how much business units spend on services or procurement compared with other units. Such an analysis can reveal significant differences in spending in similar areas and support challenges to budget managers.
A key element in ZBB is building up dual cost accountability. As a supplement to existing P&L owners, a new business role, the “cost category owner,” is given responsibility for challenging spending behaviors and eliminating any bias in favor of sacred cows. Cost category owners develop a cross-business-unit perspective along each cost category and typically request rigorous tracking of the value realized from each initiative as part of their ZBB responsibility.

With these three steps accomplished, the industrial enterprise has a solid foundation for the upcoming cost setting and budgeting cycle, starting at “year zero.” Better still, the effort enables sustainable and long-term cost savings potential, with each activity justified by its contribution to the business’s overall value.

Becoming a Zero-Based Organization

- **Identify value.** A critical initial task for organizations transitioning to a resource management mindset is identifying value creation levers and challenging third-party indirect costs and personnel spending. This generates creative thinking about potential savings and drives alignment around new spending patterns. For example, to identify value creators in logistics, steps could include making the main cost buckets and transportation requirements (mode of transport, customs duties, warehousing, packaging) transparent and then developing cost reduction initiatives such as switching a planned airfreight operation to sea or rail. Companion initiatives could introduce new business case approval mechanisms for choosing the most cost-efficient transport, reducing external warehouse space, or reducing packaging spending through improved packaging solutions.

- **Enable execution.** Execution enablement is the iterative process of providing the organization with the framework and resources required to achieve strategic outcomes ranging from simple policy changes to operating model revisions. Outsourcing or insourcing shared service centers would be an example of an operating model change. Companies can also establish roadmaps and milestone charters, implement best-in-class digital tools to accompany the transformation, and empower organizational change through a ZBB journey for their management teams.
Using ZBB tools and techniques to improve cost management in uncertain times would be a worthy effort in itself. But zero basing’s structured process can (and should) also lead to a culture of cost management. Driven from the very top of the organization, ZBB establishes a collective financial discipline by advocating a shift in mindset from "What is mine?” to “What is best for the company?”

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When a company transforms into a zero-based organization (ZBO), legacy management hierarchies yield to a fast, streamlined, and flexible organizational structure. For example, the initiatives undertaken could reduce hierarchical layers across the organization’s functions and increase managers’ spans of control. Companies should also attempt to break down information and process silos within functions and identify redundant capabilities across business units. Moreover, the ZBO aims to connect organizational design to the strategic agenda by planning for future talent and capability needs while articulating current goals. A typical question could be “What accomplishments do we expect from people in the organization?”

Never Waste a Crisis

Now that market disruptions seem likely to persist for the foreseeable future, industrial companies need to take both defensive and proactive action around cost management. Zero-based budgeting provides companies with immediate interventions to ensure viability in uncertain times. They can prepare for future market turbulence by taking the following measures:

- **Allocate sufficient funds to growth areas and value-added activities.** Take out waste, reduce legacy business costs, and reallocate savings to promising growth
Companies often use ZBB in uncertain times to strengthen the business model and prepare for the next growth chapter. One automotive supplier applied the methodology to create financial flexibility for planned investments in core and adjacent businesses and to inject a value mindset among its management team. In parallel, it designed a zero-based organization to improve agility and accelerate time to market. “With ZBB, we reached a step change in our competitiveness,” according to the CEO.

Zero-based budgeting delivers benefits in virtually all market conditions. In the current economic climate, it provides a foundation for long-term resilience. But instituting a ZBB framework and driving the related cultural and organizational change can be hard work. Expect entrenched functions to resist, at least initially. Expect managers to chafe at challenges to their budgeting priorities. Expect the budgeting processes to take two steps back for every one step forward until the new regimen settles in. Given these challenges, companies need to think proactively about the transformation steps, mindset, and resource allocation practices required to achieve long-term success.

- **Create new ways of working.** Establish a culture of cost consciousness and simplicity with an owner-operator mindset.
- **Introduce cultural change.** Create and embed a cost management ethos through new roles, responsibilities, and processes.
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