

ZERO-BASED BUDGETING: AN EFFECTIVE RESPONSE TO ECONOMIC UNCERTAINTY

By Michelle Leon and Chris Troedel

THE RESURGENCE OF ZERO-BASED BUDGETING

Zero-based budgeting (ZBB) is a financial planning technique that resets the cost base of an organization to zero. It is a bottom-up approach that involves justifying each line item based on necessity rather than reverting to the prior period's actuals. ZBB has been used since the 1970s to help companies scrutinize costs, cut unnecessary expenses, and align funding with strategic priorities. ZBB often gains momentum during times of economic instability, as it did during the financial crisis of 2008.

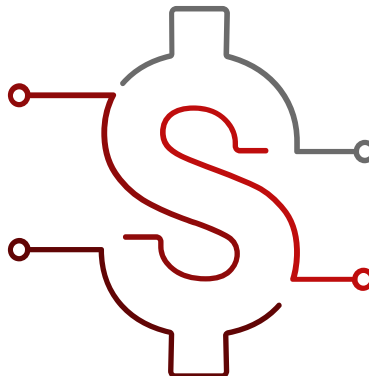
More recently, the economic fallout from COVID-19 is generating dialogue around ZBB for its promise of cost reduction and increased agility. While the economic environment remains uncertain, traditional incremental budgeting will not deliver adequate cost control in a dynamic world of economic volatility, disruptive technologies and fierce competition.

Prior Period's Budget Not Considered

- No automatic 'grandfathering' of costs to the next budget period
- Bases spending levels on necessary activities rather than budget history

Justification of All Costs

- Eliminates manipulation and 'padding' practices in the budgeting process
- Requires more work than traditional budgeting to analyze and prioritize activities



Focus on Required Activities

- Links spending with required activities
- Requires detailed knowledge of the organization's activities to determine whether to reduce or discontinue activities

Alignment with Corporate Strategy

- Aligns expenditures with the overall strategy of the enterprise
- Enables more strategic allocation of expenditures

As many companies watch their revenues fall due to the pandemic's social isolation measures, they are taking a closer look at all costs across the enterprise, eliminating unnecessary spending, and making sure remaining expenditures translate into value for their business.

In a March survey of over 300 global finance executives conducted by Gartner Inc.¹, 20-26 percent said they would zero-base their budgets to respond to the coronavirus. This approach is not surprising as ZBB can result in significant cost savings, as well as improve efficiency and competitiveness. Indeed, ZBB delivers the following benefits that help companies weather this time of uncertainty:

1. <https://emtemp.gcom.cloud/ngw/globalassets/en/finance/documents/trends/covid-industry-perspectives-30-march-2020.pdf>

- **Provide liquidity relief:** Implemented now, ZBB could help companies respond to the crisis and generate liquidity relief through the identification and prioritization of cost-saving measures. Starting from scratch and focusing on value-adding costs will enable companies to make the appropriate decisions and trade-offs
- **Succeed in recovery:** An ongoing, bottom-up analysis that challenges how the organization spends every dollar can deliver a lean, flexible cost base during and after the recovery. This approach can also channel spending to more strategic, growth-oriented uses
- **Drive sustainable cost transformation:** Instituting ZBB principles today can kick-start a sustainable cost transformation that will help firms succeed in the 'new normal' as ZBB fosters a business owner's mindset to spend enterprise resources in the right places

HOW TO APPROACH ZBB

ZBB involves extensive planning, coordination, and support from many levels of the organization. As such, it is of paramount importance to secure c-suite sponsorship and commitment of the ZBB program so that buy-in for the program trickles down to all levels of the organization. Program governance, including roles and responsibilities, is critical to enforce clear accountability across the organization.

It is also essential to determine upfront the ZBB framework and methodology to ensure that the process is applied consistently and uniformly. Defining the ZBB methodology entails delineating specific steps in the process, such as:

- Setting savings targets
- Comparing costs and distinguishing between those that are productive versus unproductive
- Prioritizing spend
- Reallocating funds

Below, we illustrate a recommended ZBB approach.

1	2	3	4
<p>DESIGN ZBB PROGRAM</p> <ul style="list-style-type: none"> • Ensure c-suite program sponsorship throughout the ZBB process • Determine the ZBB program governance, including set-up of the review panel to make prioritization decisions and address issues • Define the budget framework, cost comparison process, and method of tracking costs • Identify the necessary data attributes and define the data model to support the ZBB program • Devise and implement a communication plan to build understanding and engagement among the staff 	<p>VALIDATE STRATEGY</p> <ul style="list-style-type: none"> • Ensure that the current business strategy and operating model are still valid • Assess which assumptions are still true and what will change in the future • Analyze near-term performance and priorities for the business, including specific growth strategies 	<p>ZERO-BASE ACTIVITIES</p> <ul style="list-style-type: none"> • Zero-base activities • Document activities by function - who is doing what for whom • Classify the activities as follows: <ul style="list-style-type: none"> • <i>Required</i> by law or regulation • <i>Essential</i> to run and sustain business operations • <i>Strategic</i> in terms of customer experience and performance • Identify activities that are: <ul style="list-style-type: none"> • No longer useful and should be stopped • Duplicated across functions • Work with stakeholders to outline the appropriate service level for activities and what is needed to improve service levels • Calculate the cost for service adjustments 	<p>EXECUTE THE ACTION PLAN</p> <ul style="list-style-type: none"> • Define action plan <ul style="list-style-type: none"> • Stop activities deemed no longer useful • Consolidate activities that are duplicated across functions • Standardize and automate required and essential activities as much as possible • Improve strategic activities according to stakeholder / customer feedback (e.g. timeliness) • Redesign the service operating model based on the service level agreed by providers and customers • Ensure that the revised activities are aligned with the vision (step #2) • Perform frequent check-ups to monitor progress and track adherence to targets
<p>EMBED THE CHANGE TO ENSURE SUSTAINABILITY</p> <ul style="list-style-type: none"> • Instill a ZBB mindset through a rigorous cost review process, cost accountability, and aligned incentives • Foster a cost management culture such that the organization continuously looks for ways to reduce costs and ensures that spend is aligned with the right growth opportunities 			

CRITICAL SUCCESS FACTORS OF AN EVOLVED ZBB PROGRAM

Despite its benefits, ZBB has a reputation for aggressive cost-cutting, which negatively impacts employee morale. It is also time-consuming and challenging to execute as the budget is rebuilt from scratch every budgeting period. When done right, however, ZBB redirects spending to more productive uses and instills cost discipline and continuous business monitoring.

Effective implementation of ZBB depends on the following key success factors:

Technology

ZBB requires drill-down and detailed insight into operational cost drivers (e.g., activity volumes, productivity ratios, and input costs). Using digital tools streamlines the process of building the budget and monitoring performance at a granular level of cost. Cloud-based solutions have emerged to support the ZBB process; these technologies can easily model the causal relationship between activity volumes and resource requirements. They present a drastic improvement over manipulating data in spreadsheets, which is complex and error-prone.

Having a single platform in which operational and financial data is unified can also help improve transparency around operational cost drivers. The single platform will enable access to the details of cost (down to the level of the employee or the business trip) and to data around activity volumes, productivity, and resource consumption.

Process

Best practices in executing the ZBB process include the following:

- **Use a consistent and rigorous process** when conducting budget negotiations, with the burden of proof on the requestor. Perform monthly checkups to track savings achieved and ensure that unfavorable variances are quickly addressed

- **Identify quick wins.** Apply ZBB to parts of the organization that warrant it or focus ZBB on where the most significant savings opportunity will be – e.g., areas of overhead (sales, general and administrative expenses) that are not well understood. Not only will such choices help support the adoption of ZBB, but they will also deliver the highest cost savings with minimal disruption to the rest of the organization
- **Reinvest for growth.** Cost reduction can only be successful if the company reinvests the savings to drive growth, innovation, improved productivity, and better customer experience
- **Incentivize and reward high performers** for effectively managing operational expenditures and meeting their cost reduction targets

Governance

Strong governance is required for ZBB to gain traction throughout the organization. In addition to securing c-suite commitment, leadership must set the tone at the top: cost management can only be successful if senior executives lead by example to help change company culture and embed sustainable cost management in the company's DNA. Additionally, budget committees and negotiations should include diverse representation from finance, IT, and business units. A cross-functional team can provide the expertise to effectively challenge and make informed decisions on program direction and resource requirements.

Communication

Buy-in throughout the organization is especially vital in adopting ZBB. Senior management must recognize the concerns of employees while emphasizing that ZBB is not merely a cost-cutting strategy. Instead, ZBB is a way to ensure proper resource allocation so that resources and funds are funneled to strategic growth initiatives. Success lies in driving engagement across the organization such that employees are thinking, "why should I spend this dollar?"

HOW TO APPROACH ZBB

Zero-based budgeting is enjoying a resurgence as companies are looking for ways to unleash hidden value, increase margins, and fuel new growth. ZBB helps organizations recalibrate, reassess, and reallocate resources to improve alignment with business priorities. What was once considered to be a daunting process is now facilitated by technology. Using digital tools, ZBB can accelerate the build and monitoring of the budget at a granular level, replacing manually intensive spreadsheet aggregation with performance analysis and insight. Done right, ZBB can go beyond an ad hoc cost reduction project to a sustainable mindset of cost ownership across the organization.

WWW.CAPCO.COM



© 2020 The Capital Markets Company. All rights reserved.

JN_2233

CAPCO