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Zero-based budgeting gets a second look

Digitization is breathing new life into a ground-up budgeting approach that debuted in the 1960s. Here's how CFOs and other business leaders can make it work in their own organizations.

With a new lease on life[1] powered in part by digitization, zero-based budgeting (ZBB) is getting a hard look from companies that see its extremely detailed approach to budgeting as an opportunity to capture operational efficiencies,[2] stimulate growth, and boost performance.[3] Exactly how does ZBB work, and how should a company implement it? How should CFOs assess and apply it? McKinsey partner Wigbert Böhm sat down with the editorial board of *McKinsey on Finance* to discuss just these questions. Here, he outlines the digital and organizational enablers required to implement ZBB.

McKinsey on Finance: *What exactly is zero-based budgeting?*

Wigbert Böhm: It is a budgeting process where, on a very granular level, you go through a company's spending and determine what resources various business units require. That means looking at individual cost categories across all business units. The process puts the burden of proof on the manager who is asking for resources: he or she must demonstrate, on a continual basis, that the resources are in fact still required to achieve business objectives—as much in year three as they were in year one—and that those resources are being managed responsibly. The concept itself was invented in the 1960s, but ZBB was slow to gain traction, in part because, until relatively recently, budgeting processes have been primarily paper based. Just imagine all the extra paperwork ZBB would have generated in large organizations years ago. The emergence of digital budgeting tools has made ZBB a more realistic option these days.

McKinsey on Finance: *How does it work?*

Wigbert Böhm: Teams break down the ZBB process into several discrete stages. The first is creating a sense of transparency. This means using data and digital tools to analyze spending in a business unit, or across business units, according to cost center, cost category, and sometimes vendor. Through this exercise, budget owners for the business units often find that quite a bit of company spending, about 15 percent or 20 percent, is misclassified. This information is taken into account during the second stage—identifying opportunities for process or operational improvements and redefining spending levels to reflect those initiatives. In this critical step, business leaders jointly think through targets and benchmarks and what reasonable budget aspirations should be. The third stage is actually bringing all this information to bear and budgeting from zero, and the final stage is essentially measuring outcomes and ensuring that the ZBB process is institutionalized within the company.

McKinsey on Finance: *What kinds of systems and people do companies need to do zero-based budgeting?*

Wigbert Böhm: As I mentioned, digital is now the biggest enabler of ZBB. Some companies have developed centralized repositories of finance data that allow for transparency in budgeting discussions. Budget owners in the various business units normally keep their own finance cheat sheets with breakdowns of the projects in their portfolios and the resources they are looking for. Now all the budget owners need to do is enter those figures in a template in a digital budgeting tool. The data are fed into this central repository, where they can be sliced and diced, and then inform resource-allocation discussions.

But another big change is that the budget owners themselves should be supported by a cost-category owner [CCO] who vets budget requests associated with particular spending categories for an entire business unit or organization. There might be a CCO for facilities management, for instance—someone who monitors rents, security spending, and so on for all business units—and there would be a separate CCO for, say, HR or logistics expenditures. The CCO holds frequent formal discussions with everyone

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in the company who has this type of spending in their budgets.

McKinsey on Finance: *How many cost-category owners do you need in a typical company?*

Wigbert Böhm: There is no one-size-fits-all approach to assigning CCOs, because it very much depends on the scope of savings being targeted. One global manufacturer had about a dozen CCOs for a ZBB program that was trying to optimize indirect expenditures. Somewhere between 12 and 15 CCOs seems to be the average, but the number must be one that works best for the corporation.

The very existence of this role can change the tenor and content of budgeting discussions. Traditional budgeting discussions are more focused on incremental increases or decreases to existing budgets—“will we cut it by 2 percent this year or increase it by 3 percent?” ZBB forces everyone to engage in a structured consideration of the resources business units and managers actually need to fulfill the task at hand. Rather than assume that funding levels should remain the same, the CCO asks the budget owners from the business units, “Why is this the case, and does it need to be this way?”

McKinsey on Finance: *Is cost-category owner a full-time job permanently?*

Wigbert Böhm: CCOs are typically senior leaders who take on these responsibilities alongside their day jobs. The time commitment is roughly half a day per week. CCOs usually sit with a small team that supports the ZBB process across business units and regions, with maybe a few data analysts and a few IT specialists to maintain the digital budgeting tool. They can be rotated in and out of budget domains, although many find themselves content with building up valuable expertise in the areas they support.

McKinsey on Finance: *What does it look like when companies implement zero-based budgeting?*

Wigbert Böhm: A large European utility used ZBB to find savings of $150 million from its baseline spending of about $900 million, which included all direct and indirect costs. The company went through a rigorous process of building up its data sets, using existing systems to collect and assess financial and process information from across the company. It massaged these data using new digital tools. Through this exercise, executives found duplicate spending in some areas—primarily in misaligned talent. It found opportunities to redeploy some of its HR experts, for instance, and some of its experts in digital to parts of the company where they could better serve as business partners. The discussions between budget owners and CCOs and the broader assessment process, from start to finish, took about eight months. The utility reinvested some of the $150 million savings in the company and shared some of it with stakeholders. Now that the groundwork has been done, the European utility should be able to follow the same ZBB process in subsequent years within the normal budgeting time frame.

You could imagine that a smaller company, like a business in a private-equity portfolio, might follow a similar approach, albeit at a more limited scale—eight weeks, maybe, instead of eight months.

McKinsey on Finance: *Do all companies perform zero-based budgeting every year? For every division?*

Wigbert Böhm: Many of the companies we've seen are doing it every year and across multiple divisions. Again, digitization is the key here—an annual ZBB process becomes much more tenable when you use digital budgeting tools and build organizational capabilities, such as training all budget owners in the new approach or enabling automated reporting for the CCOs. The digital budgeting tool is primarily used to physically construct budgets and inform annual funding discussions, but CCOs can also use it as a tracking tool to follow up on and address any deviations from plan.

McKinsey on Finance: *Even using digital tools, ZBB seems like increased work for budget owners and cost-category owners. When does it make sense to follow the ZBB process every year, and when not? And under which scenarios does it make sense to deploy ZBB company-wide versus in individual business units or regions?*

Wigbert Böhm: If a company is targeting one-time savings, it could get by without using ZBB, perhaps—or at least it wouldn't require a digital tool to go through the exercise. But if you want to do ZBB annually and you want to succeed in this effort, you need to invest in a digital budgeting tool for the sake of efficiency and to gain deeper insights.

The decision about whether to roll ZBB out company-wide versus in individual business units or regions is mostly driven by specific business needs. One global food producer did a country-by-country rollout because it had four or five different business units, with a lot of synergies, that had never really been integrated or captured. This was part of the company's objective in using ZBB—making sure that the different business units in each country cooperate more, reduce duplicate spending, and exploit basic cost-savings opportunities, such as merging their logistics networks or rationalizing their supplier base. Another firm might find that deploying ZBB in only one region or one business unit suits its needs. What usually ends up happening, however, is that companies that start with a limited scope see great impact from ZBB and often decide to use it more broadly.

McKinsey on Finance: *How does zero-based budgeting work with traditional budgeting processes?*

Wigbert Böhm: In many companies, ZBB becomes the new way of budgeting and ends up replacing existing budgeting processes. When supported by the right tools and the right team, this process can be faster and less resource intensive over the long term. Obviously, a lot depends on the company's starting point.

McKinsey on Finance: *What is the CFO's role in the zero-based-budgeting process?*

Wigbert Böhm: Depending on executives' appetites, some CFOs may choose to take on cost-category ownership themselves. It doesn't happen a lot, but it does happen. More important, you need a strong mandate from the top to run this kind of program and support all the discussions that must happen. Budget conversations are fraught, most of the time. A budget owner may call the CFO and complain about the CCO's proposal. If the CFO doesn't support the process, the whole thing is over. The CFO must be the evangelist for ZBB. And it's not just a matter of getting the CFO's support—the CEO and other C-suite leaders also need to get on board. One way to win them over is to share tangible examples of success—showing how people have been able to work more efficiently because of smarter resource utilization, for instance. This whole process, after all, is about improving resource allocation and ensuring that money is being spent in a meaningful way, not in a wasteful way. ■

[1] Matt Fitzpatrick and Kyle Hawke, "The return of zero-base budgeting," August 2015, McKinsey.com.

[2] Kyle Hawke, Matt Jochim, Carey Mignerey, and Allison Watson, "Five new truths about zero-based budgeting," August 2017, McKinsey.com.

[3] Ronald Falcon, Kyle Hawke, Matthew Maloney, and Mita Sen, "How absolute zero (-based budgeting) can heat up growth," January 2018, McKinsey.com.

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