

Strategy & Corporate Finance Practice

# Memo to the CFO: A new approach to 2021 budgeting starts now

The financial-planning process for 2021 presents an opportunity to turn hard-earned lessons from the COVID-19 pandemic into an enduring exercise in linking strategy to value.

*This article is a collaborative effort by the global Strategy & Corporate Finance Practice, including Ankur Agrawal, Michael Birshan, Christian Grube, Matthew Maloney, and Ishaan Seth.*



**For CFOs** as for most executives, 2020, assailed by the COVID-19 pandemic, has unfolded as a blur of employee-safety and economic shocks. Time and the demands of putting together a budget for 2021 allow no rest for the weary, however.

Our conversations with finance leaders over the past six months reveal two contrasting truths about the looming budgeting season. After months of improvising, CFOs recognize that they need real budgets for 2021 to match resources with strategy. But they also know that the business-as-usual budgeting process, with its traditional inputs and standard approaches, is no longer fit for the task. For instance, 43 percent of the 127 CFO respondents we recently surveyed cite the need to streamline their overall budgeting processes to react more quickly and efficiently. Meanwhile, 65 percent anticipate more use of rolling forecasts in 2021 and beyond.<sup>1</sup>

The COVID-19 crisis has affected sectors in different ways. Even within the retail industry, for instance, some subsectors have fared better than others: the grocery subsector is thriving, while the department-store subsector is struggling. Common to all businesses, however, is the need for greater speed and cost control amid ongoing, unprecedented uncertainty.

Under such circumstances, a “perfect” budget for 2021 may not be achievable—but a better budgeting process certainly is. The typical budgeting exercise, whether bottom up or top down, can get stuck in endless negotiations and may not address critical concerns about strategy, value creation, or resource allocation. By contrast, radically redesigned and reimagined strategic budgeting and performance-management processes can generate bolder discussions that are more in line with strategy, deeper insights that can unlock more value, and more agility in resource-allocation decisions.

We see five steps that CFOs can take immediately to remake their budgeting processes for 2021:

- Stress-test scenarios and assumptions to counter uncertainty.
- Reimagine the business from a zero base to determine key business drivers.
- Hold back some spending centrally—as contingent resources—to build flexibility and optionality into budgets.
- Assign finance talent to the highest-priority areas or topics to prevent burnout.
- Rethink decision making to speed up and debias processes.

### **Stress-test scenarios and assumptions**

When kicking off the 2021 budgeting process, CFOs will need to revisit and pressure-test the scenarios, assumptions, and decisions that were made (or not) during the COVID-19 crisis. That review is critical, as different parts of the organization will have similar questions related to crisis response and recovery. Everyone will need to be on the same page. Teams in sales and marketing, for instance, must have a common understanding of when the economic return and the next normal officially start—and therefore how to budget for travel and expenses.

Finance teams will need to determine which of the economic scenarios they projected actually materialized and then systematically examine how various strategic initiatives launched during the crisis have affected corporate performance (in revenue, pricing, sales volume, and competition). Consider the case of a vertically integrated retailer. When its brick-and-mortar stores needed to close in April 2020 as a result of COVID-19, the retailer quickly invested in an e-commerce platform and a logistics partnership to facilitate sales. Now that stores have reopened in some regions, the retailer’s CFO and finance team are revisiting their initial assumptions and considering them against real-time factors, such as sales volumes and how the

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<sup>1</sup> Ankur Agrawal, “A burning platform for digital finance,” LinkedIn, July 30, 2020, linkedin.com.

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omnichannel strategy has performed over the past few months, as well as whether current trends will accelerate, decelerate, or stop altogether in 2021.

It's also a good time for senior-leadership teams to perform independent stress tests of companies' strategic plans. In that way, executives can determine which bold moves might be pursued (if they haven't already done so), both organically and inorganically. Some companies are rethinking their M&A strategies and pursuing acquisitions, partnerships, and divestitures along their supply chains. Those in more stable industries are looking at launching new products and investing in new technologies and business partnerships in the next normal. For example, a pharmaceutical company is investigating digital sales models to complement its traditional go-to-market approaches.

## Reimagine the business from a zero base

Traditionally, business leaders have balked at using zero-based budgeting as a means to understand the critical drivers of a business. The approach—in which expenses must be justified for each budget period—is too arduous, they have argued, involves too much micromanagement, and poses countless other challenges.

Many of those objections evaporated, however, in the wake of the COVID-19 crisis—probably because business leaders no longer faced the base decision about *whether* to shift spending but rather the more urgent choice of *how much and where*. For example, a mining company now force-ranks large capital-expenditure projects along a spectrum of potential

returns and risks, while a major hospital chain has reallocated conference and travel budgets toward telemedicine and work-from-home capabilities.

Business leaders' mindsets changed when they were forced to move resources from areas that were once considered untouchable and saw that those moves resulted in a better prioritization of projects, an improved understanding of fixed versus variable costs, and a clearer overview of risks and opportunities. Whether CFOs realize it or not, they have been using zero-based-budgeting principles and approaches to determine what levels of spending are truly required to keep the lights on or to support recovery efforts.

As CFOs are preparing their 2021 budgets, many of them recognize that they are already starting from zero in some areas. In most companies, for instance, spending on things such as travel and entertainment (T&E), internal events, and procurement was greatly reduced in 2020. Rather than revert to precrisis ways of working, CFOs should use this opportunity to reset the base in other areas of the organization, as well.

In collaboration with business-unit leaders, CFOs and finance teams will need to conduct a rigorous review of spending in key areas. What would that look like? Some companies convene red and blue teams regularly to review proposed spending. Others use ownership matrices (with designated P&L and cost owners) to track and review expenditures during budget-creation and monthly performance discussions. For example, the president of one business unit, who has P&L responsibility for it, also oversees the T&E cost

category for the whole company. The leader is then responsible for challenging P&L owners from other business units about their T&E spending: What key drivers, decisions, and assumptions were built into their budgets? Together with the CFO and finance team, all owners can examine and determine the T&E cost-management principles that should be deployed globally.

### **Hold back some spending centrally**

In most companies, budgets are typically fixed for the year, but in response to the COVID-19 crisis, many businesses have had to be more flexible, confidently shifting resources as needed to survive. To monitor the situation in real time, for instance, they have deployed spending control towers, cash war rooms, and dashboards. And they are using different kinds of key performance indicators (KPIs), such as the cash-burn rates of suppliers and distributors and the growth rate of COVID-19 cases.

CFOs will need to maintain that flexible approach in 2021. Indeed, they should take a modular approach to budgeting, building various options and contingencies into budgets. Budgets should also include centrally controlled pools of funds (around 10 to 15 percent of a company's total spending) to be used when certain triggers so indicate—for instance, when demand increases in certain countries, there is a drop in customer-retention rates, and specific product, service, or geographic scenarios materialize. The centrally managed pools of funds should be focused on supporting variable-cost categories but may also be released in stages throughout the year to support capital expenditures, R&D projects, and hiring initiatives.

Under that approach, projects are broken down into phases, and each phase is subject to a go or no-go decision. The overarching goal, of course, is to allocate resources with more agility so that funding can more closely mirror rapidly changing industry and business demands. For example, a healthcare

company quickly resized its sales and marketing investments, given the decline in elective procedures as a result of the pandemic. The finance team set up a stage gate whereby sales resources could be added back as demand for elective procedures grew, as it did in the third quarter of 2020.

Some companies encourage venture-capital-like pitches from division and business leaders for additional funding within the year to fuel growth. In those instances, a small team (comprising only the CEO and the heads of finance and operations) meets frequently—every month at least—to assess trigger points, debate proposals, and decide how to reallocate funds from the centrally managed pool. The team has the leverage to determine what's best for the company's overall strategy and value-creation efforts, but business-unit leaders also have an opportunity to speak their piece and secure maximum resources for their units.

### **Assign finance talent to the highest-priority areas or topics**

The COVID-19 pandemic has upended how finance teams work. Most have had to radically change it: at a faster pace, with shorter reporting cycles, and remotely, all while supporting high-stakes budgeting and planning decisions. Much of the work was instinctively tackled by small squads that came together to solve immediate, high-priority problems. Everyone was tapped to help, regardless of their area of specialization or day job. Often, the solutions involved bootstrap, one-time, ad hoc analyses and insights—all of which took a toll on the teams.

Looking to 2021 (and beyond), digital tools may take some of the pressure off finance teams dealing with the lingering effects of the COVID-19 crisis and future crises. Finance-team members may still need to embrace agile work groups, but if they are handling modular budgets and operating under a contingent resourcing approach, the very nature of their work will change—from reactive to proactive.

To guard against burnout, CFOs and finance leaders must set priorities appropriately. They should rely on top-down and 80/20 approaches—with clear directions to staffers, for instance, on expected analyses, outputs, and timelines. CFOs can set such priorities using a driver-based model that breaks down the P&L (from revenue to cash) and links it to operational KPIs. Such a model can give finance leaders some perspective on what really matters and the topics, projects, and initiatives that will require finance teams' immediate time and attention. The model can also illuminate the opportunities CFOs have to accelerate positive trends and offset negative trends.

In all cases, it is important for CFOs to lead with empathy. It is critical to establish clear communications plans—for instance, scheduling weekly meetings and “pulse checks” to gauge how teams and projects are faring.

### **Rethink decision making**

For 2021, especially, it will be critical to get buy-in from entire leadership teams on high-level strategic objectives, projected economic scenarios, cost-saving targets, resource-reallocation targets, and financial plans. CFOs will need to explain why the standard budgeting process is, in many respects, moot and how, for 2021 and beyond, finance teams will be focused on options, agile reinvestment, and so on.

To make changes to daily business operations, finance leaders will also need to link their operational KPIs with strategic plans and provide real-time data about the effect of the COVID-19 crisis on their companies. If those things are done well, CFOs can strengthen their positions within C-suites and emerge as core thought partners to business leaders.

Most important, CFOs and finance teams must be transparent about the new and different kinds of KPIs that will be most relevant in their 2021 budgets and financial plans. Budgets are typically the bases for setting corporate and individual performance targets, with employees' incentives linked to companies' ability to meet certain financial targets. Under the current economic uncertainties, that traditional approach may be counterproductive. In fact, many CFOs we have spoken with say they are considering linking at least some part of their incentive payments to individual outcomes (that is, to employees' ability to execute specific strategic initiatives) rather than basing incentives fully on corporate outcomes.

Again, there are ways that companies can speed up and debias their decision-making processes and discussions. During the crisis, for instance, some companies have replaced large all-hands-on-deck videoconferences with “wartime councils” in which smaller groups of senior stakeholders gather once and act rapidly. For example, the monthly business-

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cycle review at a company had turned into an onerous task. Analysts would spend days preparing hundreds of bespoke analyses and slides for marathon meetings with the senior-leadership team. But the backward-looking materials often raised more questions than they answered, and discussions were often rambling and unfocused. Everyone's time was being wasted. In the wake of the COVID-19 crisis, when rapid responses were at a premium, the team knew that it needed to redesign the process radically. It did so by defining a clear meeting objective at the outset and dividing the monthly report into two sets of standardized pages: one set on trends (sent as a pre-read) and one set on the highest-priority variances of risks and opportunities. After the process redesign, the monthly discussions became much more effective, focusing on relevant business units, budget exceptions, outstanding questions, data required to answer questions, relevant KPIs, and comparisons against actuals.

## Getting started

By reimagining budgeting models, CFOs can help develop strategic plans that look and feel much different than in previous years. The redesigned plans will include multiple scenarios that inform strategic direction, zero-based approaches to important business areas and select cost categories, centrally controlled pools of funds to be deployed flexibly, and monthly performance discussions that are focused on creating value and impact.

To get started, CFOs should assemble a cross-functional team to help accomplish two key tasks.

The first task is to review previous scenarios and stress-test the strategic plan (including any big moves) for 2021, and the second is to begin the top-down process of translating the strategic plan into a budget. Those tasks can be managed in parallel, but having a cross-functional perspective will be critical for ensuring that the budgeting process is comprehensive and that everyone buys into the approach—especially important when significant shifts in strategy and resources are involved.

In fact, in those areas in which radical changes are anticipated—closing a facility, for instance, or building an e-commerce platform—CFOs may also convene smaller teams to perform cleansheet analyses. In addition, they could schedule several cross-functional budgeting workshops between now and the end of the year to foster healthy debate and, ultimately, gain agreement on inevitable resourcing trade-offs.

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The past year has been challenging; 2021 will probably present its own thorny issues. It's a unique moment for the CFO, and a crucial transformation project awaits. So what's the plan? How will you do things differently? How will you translate lessons learned during the first months of the crisis to improve the finance function in the longer term? The goals should be to focus on big moves linked to strategy and to maintain a through-cycle mindset. After all, the companies that invest now in resilience and sustainability are the ones we will all still be talking about in the long term.

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