Use Zero-Based Budgeting to Rightsize Budgets After an Economic Downturn

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Initiatives: IT Cost Optimization, Finance, Risk and Value

Changing business priorities in the wake of a recession means that executive leaders must reassess the services and capabilities they resource. Zero-based budgeting is a tool to rightsize budgets and shift resources toward value-added activities aligned to reprioritized business outcomes.

Overview

Key Challenges

- When challenged to find spend reductions or shift focus to new priorities following a recession, enterprise leaders struggle to articulate the cost benefit of their spend to desired business outcomes.

- In the absence of a structured methodology, executive leaders find it difficult to rightsize, communicate and track changes to their functional budgets needed to align to strategic business outcomes during economic downturns.

- Executive leaders struggle to embed an ongoing strategic cost optimization culture that iteratively assesses spend in terms of business outcomes regardless of whether or not it has been approved in a budget.

Recommendations

Executive leaders responsible for the optimal budgeting of costs in their functional areas should:

- Utilize zero-based budgeting (ZBB) as an approach to drive efficiency and business value by assessing and improving financial transparency and being clear and upfront on the business outcomes to be achieved.

- Establish ZBB as a value maximization approach rather than a cost-cutting tool by aligning, evaluating and optimizing all spend to drive strategic business outcomes.
Sustain ZBB beyond the budgeting cycle by initiating strong monitoring mechanisms to drive an ongoing adoption of value-based spending.

Introduction

A recent Gartner poll of CFOs found that all but two functions, IT and sales, are expected to reduce costs in 2021 versus original budget for 2020. Even within IT and sales, there will inevitably be cost shifting and efficiencies sought as organizations look to refocus priorities in the postpandemic era.

In this cost-pressured environment, executive leaders must find a budgeting process that allows them to assess their spend in terms of the value it drives for the enterprise. They should move away from traditional budgeting processes, which tend to assume a year-on-year continuation of activity and cost, and instead start from zero, where every activity and associated cost is clearly aligned to value, business priorities and outcomes.

Approximately one in four CFOs anticipate using zero-based budgeting (ZBB) in response to COVID-19. Even when this is not the budgeting process being adopted by corporate finance, executive leaders should consider ZBB as a complement to the official budgeting process. Applying ZBB principles gives leaders a strong lever to defend budgeting priorities and allocation in terms of the value being delivered to the enterprise.

Gartner’s five-step process for ZBB includes the prerequisites and follow-on activities required to successfully implement and operationalize the principles of ZBB on an ongoing basis (see Figure 1):

1. Financial transparency — Ensure visibility of spend in terms of cost and activity.

2. Strategic priorities and KPIs — Identify and cascade strategic priorities to evaluate/align costs to. Identify KPIs by which to measure success of investment.

3. Align, evaluate and optimize — Conduct the process of zero-based budgeting as a rightsizing exercise, to be repeated every two to three years.

4. Control and monitor — Perform monthly/quarterly reviews to identify budget variances, budget shifts aligned to business priorities and actions to address variances.

5. Value-based spending — Operationalize the concepts of ZBB through an ongoing process of value-based spending.
Figure 1: Gartner’s Five-Step Zero-Based Budgeting Cycle

Gartner’s Five-Step Zero-Based Budgeting Cycle

1. Financial Transparency
2. Strategic Priorities and KPIs
3. Align, Evaluate and Optimize
4. Control and Monitor
5. Value-Based Spending

Analysis

Utilize ZBB to Drive Efficiency and Business Value With Financial Transparency and Focus on Business Outcomes

Financial transparency and clear strategic priorities and KPIs are two of the prerequisites for a successful implementation of ZBB. Senior executives need to be well-prepared if ZBB is to be successfully implemented and common mistakes avoided to enable a rightsized and value-aligned budget.

Table 1: Prerequisites for Zero-Based Budgeting

<table>
<thead>
<tr>
<th>Prerequisite</th>
<th>Purpose</th>
<th>Consequence if Not in Place</th>
</tr>
</thead>
</table>

Gartner, Inc. | 730116 | Page 3 of 15 |
Financial transparency

- Relationship between activity (cost driver) and cost must be visible
- Enables assessment of levers of cost, which are value adding and which are not
- Visibility into whether costs are variable, fixed, discretionary, nondiscretionary
- Visibility required on cost impacts if spend altered e.g., contract penalties, severance costs

A clear strategic direction at enterprise level

- Strategic intent, business priorities and desired outcomes cannot be deduced by executive leaders in isolation of each other
- Priorities are collaboratively agreed and communicated across functions

- ZBB should not be attempted as spend cannot be effectively prioritized
- Spending decisions will not be supported in terms of business value/outcomes
- See Note 1: Critical Actions for Leaders Following an Economic Disruption

- Metrics or KPIs have been identified by which to measure and assess the value and alignment of spend activities to the strategic/desired business outcomes
- Provides a framework to assess the alignment of expenses to strategic pillars
- The impact of ZBB decisions cannot be tracked or responded to (see the third recommendation)
Senior level endorsement of the ZBB methodology, either across the enterprise or the function(s) adopting it

- Executive support required for additional time/resources/examination and challenge of activities and costs
- ZBB fails due to cultural push-back on challenge of cost and alignment to value

Clear communication of ZBB purpose, principles and methodologies prior to adoption

- Gain buy-in from the budget holders who will be examining their cost base
- Explain the differences between ZBB and current budgeting process
- Budget holders/teams simply conduct incremental budgeting under a different name (see Common Mistakes section)

Source: Gartner (August 2020)

Establish ZBB as a Value Maximization Approach by Aligning, Evaluating and Optimizing Spend to Drive Strategic Business Outcomes

While ZBB tends to be considered a cost-cutting tool, its role postpandemic should be adapted to rightsize budgets to align functional area spending priorities with business outcomes being sought. This realignment will ensure approved budgets are focused on driving value (as in, enable a business priority/outcome). Of course, overall cost reduction could be an outcome of the exercise (see Figure 2). But this should only be the case if:

- There are no value-adding priorities to which spend could be shifted.
- The enterprise is in a position where cash must be returned to the bottom-line for imminent survival.
ZBB is often seen as a time-consuming, resource-heavy process, which will fail to drive the cost optimization results desired if poorly executed. Gartner research shows that when implemented correctly, ZBB only takes, on average, five additional days relative to non-ZBB approaches. To successfully implement ZBB, avoid the following common mistakes:

Implementing ZBB as an aggressive cost-cutting tool disengages budget holders and teams and can lead to the gaming of budgets to avoid losing funds. ZBB should be framed as an exercise to align spend to value and the enablement of future growth. Focusing on the benefit ZBB could bring to the organization through the realignment of spend on business outcomes, particularly as they fluctuate during/after an economic crisis, will better engage teams in the exercise of assessing and justifying their spend. When cast in a purely cost-cutting light, budget holders are more likely to resist reductions for fear of losing funds, which could lead to budget holders trying to inflate their budgets in anticipation of a cut, thereby rendering ZBB ineffective.

Executive leaders should aim to maximize the value of their spend by ensuring every dollar spent is tightly aligned to the business’ goals. Rather than cutting costs universally, they should pressure test spend for strategic alignment and eliminate only misaligned spend. Approaching ZBB as a value maximization approach, rather than a cost-cutting tool, helps executive leaders identify opportunities to cut wasteful and irrelevant spend and, more importantly, allocate already scarce resources in the most effective manner (see “Value-Based Budgeting, Because Zero Isn’t Valuable”).
Ongoing activities are assumed essential without questioning the need for those activities. Without a framework of organizational business priorities that pressure-tests strategic alignment of costs, ZBB tends to become an exercise in debating dollar value spent on an activity versus a strategic assessment of criticality of spending to achieve business outcomes. As a result, when preparing budgets from scratch, budget holders are liable to view activities that have historically been undertaken as essential. They include them in their zero-based budgets without rethinking their criticality in achieving organizational priorities. It is therefore essential that an organization’s priorities are well-understood, not only by senior leadership, but by budget holders as well. Awareness of corporate priorities equips budget owners to:

- Screen both ongoing and planned activities for alignment with the priorities.
- Identify opportunities to eliminate or reduce investment in less material activities (see Figure 3 and “Zero-Based Budgeting: Overcoming Historical Influences”).

![Figure 3. Tie IT Initiatives and Budget to Business Outcomes](image)

<table>
<thead>
<tr>
<th>Business Outcome</th>
<th>Business Focus</th>
<th>Aggregate</th>
<th>KPI</th>
<th>IT Initiative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Engage and Enhance Customer Experience</strong></td>
<td>Convert Prospects to Customers</td>
<td>Sales Effectiveness</td>
<td>Customer Retention Rate</td>
<td>Data Quality Improvement for Customer Retention</td>
</tr>
</tbody>
</table>

Executive leaders should look to instill standard evaluation criteria that are defined in collaboration with their finance team. This will help ensure that:

- Activities are evaluated fairly.
Common biases in decision making (such as spend decisions being influenced by how well budget holders describe the urgency of their cost, rather than its contribution to business outcomes) are overcome.

Evaluate whether items should be included in a ZBB by conducting the following tests (see Figure 4):

- Test for strategic alignment — Does the activity, its scope and cost being proposed for the budget, align to and enable a strategic objective?
- Test for efficiency — Is the activity and cost included in the budget sourced in the most cost-efficient way? Have you achieved the best price?

Include only those activities and costs in the budget that are strategically aligned and efficiently sourced. A further round of prioritization to business outcomes may be required if adequate funds are not available for all qualifying activities and costs.
Adopting ZBB as the Default Budgeting Approach Enterprise-wide

Attempting to implement ZBB enterprise-wide and adopting it as the default budgeting approach can generate an insupportable volume of work across the enterprise. This can be unnecessarily cumbersome for functions or areas of the business expected to provide precise and detailed information of their costs, even in areas not deemed critical to budgetary decision making, or where there is no question of the appropriateness of the spend. Executive leaders should collaborate with their peers to:

1. Identify areas of the business that would most benefit from the application of ZBB following changes in business priorities.

2. Focus on these as an initial, partial ZBB implementation — see “An Overview of Zero-Based Budgeting (ZBB).”
Likely candidates for an initial round of ZBB are those functions with high variance from previous budgets, with high discretionary spend or with scope for cost efficiencies, particularly in light of changing business priorities. There are no proven right areas to use ZBB; organizations across different industries report using ZBB for a range of costs – capital expenditures, operating expenses, sales, general and administrative costs and marketing costs.

There is no need to zero-base budgets every year, instead rotate between ZBB years and non-ZBB years, during which traditional budgeting methods should be used. Once adopted, such as in times of economic uncertainty or heavy organizational change, ZBB can be used on a rotation every two to three years, to recalibrate department budgets. This helps to ensure they remain rightsized and focused on business outcomes, without expending additional effort every year to prove every dollar is adding value (see Figure 5).

**Figure 5: Rotating Zero-Based Budgeting Schedule (Illustrative)**

Rotating Zero-Based Budgeting Schedule (Illustrative)

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Areas Using ZBB</strong></td>
<td><strong>Group A</strong></td>
<td><strong>Group B</strong></td>
<td><strong>Group C</strong></td>
<td><strong>Group A</strong></td>
</tr>
<tr>
<td>&lt;ul&gt;</td>
<td>• IT</td>
<td>• HR</td>
<td>• Procurement</td>
<td>• IT</td>
</tr>
<tr>
<td>&lt;ul&gt;</td>
<td>• Sales</td>
<td>• Strategy</td>
<td>• Marketing</td>
<td>• Sales</td>
</tr>
<tr>
<td>&lt;ul&gt;</td>
<td>• BU A</td>
<td>• BU B</td>
<td>• BU C</td>
<td>• BU A</td>
</tr>
</tbody>
</table>

**Process:**
- Departments do not zero-base their budgets every year; instead, they rotate between ZBB years and non-ZBB years.
- During departments’ “off years,” they will perform traditional budgeting.

Source: Gartner 730121

Zero-Based Budgeting Is Seen as a Corporate-Finance-Led Budgeting Initiative

The role of the function undertaking ZBB should not be underestimated, particularly if the adoption of ZBB is recommended by central finance teams. Gartner research shows that, on average, ZBB requires 33% less finance staff at the corporate center, while requiring an additional 33% more business finance FTEs than other budgeting approaches (see Figure 6). Business outcomes are at the core of ZBB and the justification of all costs aligned to those outcomes. Budget holders and business-partnering finance resources should prepare to take on a greater proportion of the budgeting exercise than in other non-ZBB methods.
To ensure that business finance and budget holders adequately understand the purpose, principles and desired outcomes of ZBB, the role of central finance, while reduced in the operational implementation of the budgeting process, should include:

- The communication of strategic objectives
- The provision of ZBB training

Central finance must also collaborate closely with the functions to ensure that regardless of the budgeting method adopted within the function, the enterprise-level budgeting process is adhered to, so all inputs are provided as required and on time.

**Sustain ZBB Beyond the Budgeting Cycle by Adopting Value-Based Spending**

Executive leaders often target procedural changes as part of ZBB implementation, which results in their functions viewing it only as a new method to budget, rather than as a principle for making better spending decisions. Without effectively cascading the rationale for ZBB, budget holders lack conviction about its necessity, and few adopt the approach wholeheartedly as a new working style.
Senior executives should actively demonstrate and reinforce behaviors that are at the core of ZBB, such as:

- Encouraging honest trade-off discussions evaluated in terms of business outcome impacts
- Making tough resource sacrifices

Zero-basing spend aligned to business outcomes shouldn’t end with the budget cycle. It should extend into the daily operational and spend decisions of budget holders. Value-based spending is an active assessment of all spend, regardless of whether or not it has been previously agreed to in the budgeting process. Budget holders should ensure that at the time of commitment, the spend remains aligned to business outcomes and the best use of funds. In this sense, every spend decision becomes a commercial decision.

Budget holders tend to think of approved budgets as “theirs,” and with the inevitable ups and downs of operating cycles, will find other initiatives to spend budget on if the original initiative alters or disappears. These behaviors will lead to a dilution and circumvention of the ZBB principles. To avoid this, executive leaders should:

- Maintain a comprehensive and regular review of budgets and spend, at least quarterly. Monitoring of spend to budget and latest forecast should be closely aligned to the activities and outcomes that were originally intended in the ZBB exercise.
- Use the metrics and KPIs identified in recommendation No. 1 to measure and assess the value and alignment of spend activities to the strategic/desired business outcomes. Simply spending within budget should not be seen as meeting objectives of budget holders.
- Ensure that senior leadership teams become accustomed to highlighting activity and spend changes on an ongoing basis, so that a collaborative decision can be made regarding where any unused funds can best be allocated to drive business outcomes.
- Make resource allocation decisions required outside of the budgeting process based on alignment to business outcomes and with an evaluation of risk and potential upsides.
- Distribute cost ownership throughout the function/enterprise by introducing dual ownership of costs. Introducing package owners who are responsible for key line items, such as travel or consulting, creates a check and balance to ensure that new spend does not creep into the budget. Package owners must provide authorization of all spend within their category outside of budgetary forecasts. Package owners are incentivized to come in under the line item cost target, while budget holders should be incentivized to achieve business revenue and/or profit targets.
- Emphasize the value of efficiency and innovation. Financial incentives or public acknowledgements should be put in place to reward employees who display behaviors consistent with the ZBB and value-based spending approach. While such individual changes may seem insignificant, organizations with successful implementation claim these changes collectively influence savings that drive growth. Integrating the principles of ZBB into the employees’ day-to-day work helps organizations secure continued savings and benefits from ZBB (see "4 Mistakes to Avoid When Implementing Zero-Based Budgeting").

As value-based spending is adopted into an enterprise's operational, day-to-day spending decisions, the cyclical process of ZBB becomes a process for recalibration and confirmation of alignment to business outcomes, losing its reputation as a tool used only to cut costs.

Evidence

1 Cost reductions are anticipated across most of the enterprise in 2021. See Figure 2 in “Mid-May 2020 CFO Poll: Shallow Cuts Continue, but SG&A to Partially Bounce Back in 2021.”

2 Over one in four CFOs are anticipating using ZBB due to COVID-19. See Figure 3 in “CFO Cost Reduction Actions During COVID-19 as of 30 March 2020.”

3 ZBB cycle time compared to non-ZBB approaches. See Slide 13 in “Zero-Based Budgeting: Separating Fact From Fiction.”

Note 1: Critical Actions for Leaders Following an Economic Disruption
Figure 7: Decisions You Make Today Will Impact Your Organization’s Future

<table>
<thead>
<tr>
<th>Sources of Disruption</th>
<th>Loading Through Uncertainty</th>
<th>Critical Actions for Leaders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pandemic (COVID-19)</td>
<td>Average Efficient</td>
<td>Strategy</td>
</tr>
<tr>
<td></td>
<td>Growth Companies</td>
<td>Adapt quickly to change and pursue objectives confidently.</td>
</tr>
<tr>
<td>Geopolitical</td>
<td>Average Control Costs</td>
<td></td>
</tr>
<tr>
<td>Social</td>
<td></td>
<td>People</td>
</tr>
<tr>
<td>Economic</td>
<td></td>
<td>Put employees first, identify key roles/skills sets and reimagine productivity.</td>
</tr>
<tr>
<td>Financial</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environmental</td>
<td></td>
<td>Costs</td>
</tr>
<tr>
<td>Climate</td>
<td></td>
<td>Don’t risk long-term health with short-term cost cuts.</td>
</tr>
<tr>
<td>Cybersecurity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition</td>
<td></td>
<td></td>
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<tr>
<td>Technology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Digitalization</td>
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</tbody>
</table>

Source: Gartner 730116 C

Recommended by the Authors

Simplify and Depoliticize IT Chargeback Through Collaborative Governance
Outcome-Driven Metrics for the Digital Era
Digital Business KPIs: Defining and Measuring Success
Value-Based Budgeting, Because Zero Isn’t Valuable

Recommended For You

How to Budget for Trade War, Brexit and Economic Uncertainty
How to Respond to Mandatory IT Budget Cuts
Toolkit: Foundational Service Costing
Drive Smarter Savings With More Advanced Cost Definitions
Drive Smarter Savings With Foundational Cost Definitions

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