Should You Consider Zero-Based Budgeting in 2016?

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Many companies today are under considerable pressure to sustain growth by increasing revenue, controlling costs and improving profits. In the process, they are reviewing their cost management programs with the goal of improving results, especially during this time of the year when most companies are submitting budgets for 2016 and beyond.

The application of specific budgeting techniques varies depending on the company and industry dynamics. The process of building a simple budgeting plan can start by using historical or last year's values as a base to which you can apply new anticipated revenues and related expenses. A more robust and cost management budgeting process, however, instead starts from a blank slate. This is referred to as zero-based budgeting, or ZBB.

Reducing SG&A Costs with ZBB

Zero-based budgeting is defined as a method of budgeting in which all expenses must be justified for each new period. It starts from a "zero base" and then every function within the organization is analyzed based on its true need and costs. An article published by McKinsey & Company noted that when ZBB is properly implemented it can reduce costs associated with sales, general and administrative (SG&A) expenses by between 10 percent and 25 percent within six months of implementation. [1]

ZBB is a repeatable process that enables you to scrutinize all expenditures in your annual budget, manage your financial performance on a monthly basis, and create a cost-management culture throughout your organization. By using ZBB effectively, you can obtain visibility into your cost drivers that enables you to set budget targets that are both aggressive and realistic.

Proponents of ZBB can often be found in companies that have been through a recent acquisition and are looking to eliminate redundant overhead costs and realize cost savings in future post-merger budgeting years. Other organizations see value in reassessing their budgets with ZBB methodology after finding that previous functional budgets were growing but the results were less than satisfactory. You will also find more companies using ZBB in cost-competitive environments where prices cannot be easily raised and among companies that are experiencing profit erosion.

What ZBB Is … and Isn't

According to the McKinsey & Company article, many companies avoid using ZBB because, for one thing, they are afraid that it's too inflexible. It points out some of the misperceptions about ZBB that keep companies from using this helpful tool to cut costs and boost productivity.

For example, business owners and CFOs often think that ZBB means nothing more than building a budget from scratch. But it's much more than this: ZBB implements a structured approach that leads to cost accountability, visibility and governance. The result is a culture of cost management in your organization.

Another misperception about ZBB is that is forces companies to slash costs drastically. In reality, cost reduction using ZBB is based on top-down savings targets, not bottom-up cost baselines. So a company might set a goal of reducing costs by 20 percent and then give managers autonomy in deciding how to reach this target — instead of forcing managers to save nickels and dimes by eliminating coffee service or turning the thermostat down.

Many companies also mistakenly believe that ZBB only focuses on reducing SG&A costs. This is also untrue: ZBB can be applied to any and all business costs, including operating and marketing expenses, capital expenditures, and variable costs like cost of goods sold and variable distribution. However, zero-based budgets do need to be volume adjusted in monthly performance reports when ZBB is used with variable costs. And when ZBB is used with capital expenditures, the expenditures must be categorized according to investment choices instead of by types of expenses.

Perhaps the worst misperception about ZBB is that it cannot be used by growth companies. Nothing could be further from the truth: in fact, ZBB helps growing businesses redirect wasteful costs to other areas of the business where they can help drive further growth. For example, costs allocated to back-office operations can be redirected to areas that have a more direct impact on customer satisfaction and thus can help attract new customers and retain the ones you currently have.

Finally, it's important to note that using zero-based budgeting does not replace the need to perform financial forecasts. Budgeting is essentially a plan for where a business wants to go, while a forecast indicates where the business is actually headed. Financial forecasting determines how companies should allocate their budgets for future periods. Budgeting creates a baseline and is traditionally used to compare actual revenue and expenses to the results that were expected — a process commonly referred to as variance analysis. Zero-based budgets and forecasts can be updated or re-evaluated at any interval that management determines to be most useful, especially if due to changing market conditions. Both are an integral part of strategic planning.

Concluding Thoughts

Many Los Angeles and Southern California executives are currently reviewing their cost management programs with the goal of improving results in 2016. The application of specific budgeting techniques varies depending on the company and industry dynamics, but a more robust and cost management budgeting process starts from a blank slate, or zero-based budget. ZBB is a repeatable process that enables you to scrutinize all expenditures in your annual budget and create a cost-management culture throughout your organization. Using ZBB effectively will enable you to obtain visibility into your cost drivers that enables you to set budget targets that are both aggressive and realistic.

1 Five Myths (and Realities) about Zero-Based Budgeting
http://www.mckinsey.com/insights/corporate_finance/five_myths_and_realities_about_zero_based_budgeting

About CFO Edge

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