



# Zero based budgeting

**Enabling finance to drive better decisions on portfolio and cost management**



# About the authors



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Scott is recognized as a thought leader in the semiconductor and high tech industry, and has published many articles and given numerous speeches on advanced technology topics, including zero based budgeting, semiconductor manufacturing, and virtualization in the data center space.



# Why zero based budgeting—and why now?

Zero-based budgeting (ZBB) can be the answer for organizations looking to grow the top line, dramatically reduce waste, free up capital, and sharpen their competitive edge. Regardless of your industry or the type of business you're in, ZBB can be a transformative financial planning technique.

ZBB is not a new innovation; in fact it was first developed in the 1970s. But it soon fell out of favor with most organizations because of the difficulty in applying it. Conceptually, ZBB requires that each year corporate managers start from a "zero base" instead of last year's budget, build their budget from scratch and then justify each line item in order to receive continued funding. There are variations to this approach, as we explain later in the paper, but this is the essence of ZBB. Many executives found that implementing ZBB was unwieldy, labor intensive, highly disruptive and ultimately, did not deliver the anticipated benefits to the bottom line.

However, thanks to a number of factors (see page 5), not the least of which is the innovative technology and power of data and analytics (D&A) capabilities, ZBB has made a big comeback over the past decade. About 300 global companies now use ZBB, and this number is growing.<sup>1</sup>

For example, by employing ZBB (among other business efficiency techniques), U.K supermarket giant Tesco reported shaving more than \$593 million in costs over a 12-month period, and expects total savings to reach nearly \$2 billion by the end of the 2019/2020 fiscal year.<sup>2</sup>

Walgreens also recently implemented a zero-based budgeting initiative where it will spend four months analyzing who is spending how much and on what. It is expecting to derive significant cost-savings from this initiative, including the closing of unprofitable stores and the consolidating of warehouses among other actions.<sup>3</sup>

<sup>1</sup> [Global Companies Extend Use of Zero-Based Budgeting to Slash Costs](#), WSJ, February 27, 2018

<sup>2</sup> [Tesco to review contracts and centralize orders, CFO says](#), WSJ, October 4, 2017.

<sup>3</sup> [Zero-Based Budgeting Stars in Walgreens' Cost-Cutting Push](#), WSJ, January 4, 2019



## How ZBB helped control semiconductor company's R&D spend

A client in the semiconductor space engaged KPMG, LLP the US member firm of KPMG International to enhance control over its R&D spend. By employing the principles of ZBB, KPMG and the client:

- “Baselined” the amounts being spent on various projects and initiatives
- Defined the types of data needed to measure the effectiveness of spending for each project
- Created processes for gathering this data
- Analyzed gaps in information
- Identified strategies for closing these gaps

KPMG conducted a thorough analysis and mapping of the company's R&D programs and activities, including full time employees (FTEs), products and costs. This provided the company with greater transparency into its overall R&D spending, and also broke out spending on individual portfolio programs.

A repeatable process for this analysis and mapping was established, as well as an ongoing governance structure to ensure that the process continues working.

As part of the ZBB framework, the company prioritized its strategically important programs, and then closely analyzed each program's requirements to better determine the type and amount of resources needed to deliver results. This process allowed the company to rapidly reprioritize spending in the event of market or strategy shifts, and identified cost reduction opportunities.

Finally, program tracking was implemented to provide accountability and enable the company to efficiently monitor results. This tracking facilitated the delivery of programs on time and under budget.



### Not just cost savings

ZBB can be applied to capital expenditures, operating expenses, cost of goods sold (COGS), sales and marketing costs, administrative costs, and many other line items. It is critical to understand that while ZBB typically generates costs-savings, it's not just about cutting costs.

Equally, if not more important, it's an effective approach to shifting the mind-set of managers and planners and ensuring that an organization's limited resources are spent in the right places and achieve the most efficient returns. In addition ZBB encourages greater cooperation among different functions, and fosters a “business owner's” perspective within stakeholders. Ideally, this persuades them to evaluate each expense as a strategic investment in the growth and sustainability of the company.

To be sure, ZBB demands a strong commitment in terms of time, expense and budgetary discipline, and needs the backing of senior management. Also, it's not a one-time endeavor; ZBB is designed to be an ongoing process. But when done properly—with a single, coordinated approach that includes D&A, strategy, planning, financial management and change management for stakeholders across the enterprise—ZBB can help organizations address both immediate needs and long-term objectives.

The following report explores ZBB, its advantages and pitfalls, how to determine if it's appropriate for your organization, and how to implement it.





# A closer look at ZBB

Below are some of the key elements involved in the ZBB process:

## 1 Start with a zero budget baseline

As noted earlier, with ZBB you essentially start with a zero budget baseline each year. This allows a company to gain a fresh perspective on each expense and the mindset to question the status quo.

It prevents managers from simply increasing the budget by a certain percentage over the prior year or “grandfathering” costs to the next budget period. It forces them to validate baseline assumptions with category owners.

ZBB also discourages the “use-it-or-lose-it” budget mentality; that is, the philosophy that if there’s budget money left, they need to spend it before the next budget period or else they’ll lose it the following year. This behavior encourages overspending and misaligns the interests of the budget owner with those of the company as a whole.

## 2 Develop strategic portfolio allocation

ZBB helps allocate resources in a way that aims to optimize strategic investment decisions. Finance is no longer considered a cost center but is viewed as a growth and revenue driver.

The finance function partners with the rest of the business and takes a holistic view of a company’s costs and benefits. Together they allocate resources to maximize returns that benefit the company, not just a department or team.

## 3 Align products and business

In order to align costs to the objectives of products and teams, there must be transparency and a detailed understanding of where costs are coming from with respect to products or services.

Powerful D&A tools can provide the insights and detailed reporting leading to this transparency and deep understanding. The results, in turn, enable the company to focus on profitable products and initiatives, and maximize returns on investments.

## 4 Improve company culture and collaboration

ZBB encourages rigorous discipline around the budget analysis and cost-monitoring processes. With shared accountability, ZBB fosters enhanced collaboration and promotes innovation to improve the cost structure.

It represents a significant shift in how budgeting is done, and may create perceived “winners” and “losers” when it comes to budget allocations, ZBB needs the strong support of senior management to get off the ground. For example, financial or other incentives may need to be aligned to get buy-in from managers and other stakeholders.

## 5 Expect short-and long-term benefits

Although it may take some time to realize the full benefits of ZBB, but many firms experience some gains almost immediately after beginning the program. Simply going through the exercise of preparing for ZBB can pay off in detecting “low hanging fruit” (e.g., obvious but overlooked inefficiencies in operations or ordering, like carrying extra inventory). In addition, the preparation process arms you with the knowledge of where money and other resources are being allocated, which is valuable in and of itself.

While it varies by company and circumstances, expect it to take six to 12 months to get a ZBB program designed and implemented. Further, it’s likely to take at least two budgeting cycles for it to be up and running smoothly and companies to start realizing the full benefits of ZBB.

The first year is typically the most challenging as finance needs to go through the firm’s systems and break out the appropriate data and organize it in the way that is most useful. Once that’s done, it’ll be easier to collect the data in a more automated fashion and categorize it more efficiently. As ZBB becomes a more ingrained part of the company’s mindset, and as technology tools continue to evolve, it will be easier to apply and also more effective.



## Traditional budgeting vs ZBB

With traditional budgeting, an incremental percentage is applied to the current budget. Or, budget line items are carried over to next year's budget with the assumption that it is business as usual. This method doesn't require managers to re-examine what is needed for the following year or finance to identify where to allocate resources most efficiently.

With ZBB, managers build a budget from scratch without using the prior period's budget as a baseline (as seen in the illustration below). So in theory, each budget item is scrutinized, analyzed and justified.

In practice, however, it may not be quite so black and white. There are times when companies may be better off not starting the budget from zero. For example, there may be certain long-standing products a company is absolutely going to market, like Apple's iPhone or an automobile company's best-selling model. A certain amount is going to be allocated to these items; it doesn't have to be debated or analyzed as these costs are a given.

But even within these categories there are legitimate decisions to be made about marginal costs for options on these products, such as the number of colors to offer or how many powertrain or sensor upgrades should be made available. This is where the ZBB process can be effective.





## What types of companies are adopting ZBB?

Although ZBB is appropriate for almost any company to employ as a way of examining how it's allocating resources and whether it's doing so most efficiently, studies indicate that typical ZBB adopters include:

- Industries associated with narrow margins, such as consumer packaged goods and manufacturing
- Companies with high research and development (R&D) spend, such as information technology (IT) service providers and semiconductor companies
- Acquisition-focused firms looking for economies of scale and greater efficiencies
- Companies wanting to improve revenues by rationalizing portfolios
- Mature companies wanting to accelerate growth by eliminating redundant costs and resources



### Why ZBB now?

ZBB has re-emerged as increasingly popular financial planning tool for the reasons set out below:

#### Technology advances

Incredible advances in technology and D&A capabilities have alleviated the primary roadblock to ZBB adoption. Today's powerful intelligent automation (IA) applications can enhance and streamline the complex work of analyzing data from multiple stakeholders (both internal and external, including vendors and suppliers), identifying spending patterns, highlighting key drivers of expenses, and allocating specific costs—all in a fraction of the time once required by manual processes and spreadsheets.

#### Innovative thinking in finance

With businesses becoming increasingly global, finance must think cross-culturally and cross-functionally to extend beyond its typical boundaries. It needs to partner with the business and understand what's driving it given the changing dynamics of an interconnected world; it can no longer be just a "scorekeeper."

These pressures have made it ever more important for the finance organization to be a revenue driver and not just a cost center. ZBB can be a powerful tool to help it get there.

#### Increasing M&A activity

Increased M&A activity is pushing companies to find ways to realize the savings and other benefits they expect as a result of the transaction. This not only includes top-line growth as a result of optimizing investment decisions, but also bottom-line savings and efficiencies based on economies of scale due to the consolidation. ZBB can help identify areas of potential cost savings and other synergies.

#### New competitors on the block

Competition from start-ups, other smaller companies and even non-traditional business challengers is pressuring companies to be more creative in their approach. Scrutinizing the budget with ZBB and ensuring that scarce resources are allocated to the most logical and profitable areas are ways to gain an advantage. As more companies adopt ZBB and reap the benefits, their competitors may find themselves compelled to follow suit.

#### Tighter profit margins

Some industries, like consumer products may experience razor-thin margins due to competition from firms marketing generics and largely commoditized products. Companies in this situation benefit from gaining more insight and transparency into costs as a way of improving margins.

ZBB leads the company to examining its legacy manufacturing processes, the possibility of adding new technology, or a variety of outsourcing options. ZBB can also help the company review its operational costs and processes, identify inefficiencies, and challenge assumptions about spending practices.

#### Need to maximize top-line growth

In order to drive top-line growth, finance departments need to be able to prioritize where resources should be invested. ZBB can provide a more granular understanding of costs and which of those costs represents the best investment opportunities.

For example, in the mobile gaming industry, the number of user installations is a driver of revenue. This figure is impacted by the amount spent on marketing (as opposed to say, R&D). By adopting a ZBB approach, companies can evaluate what types of marketing spend—TV, radio and/or online advertising, market development, etc. - will likely maximize the potential installs and for which sets of products.

On the other hand, a technology company's most important revenue driver typically is R&D. And for energy, telecom or other types of utility companies, capital deployment is what drives revenue. ZBB can help ensure that these companies allocate their R&D and capital deployment dollars, respectively, most effectively and spend it in the most efficient manner.



# Four criteria for successful ZBB implementation

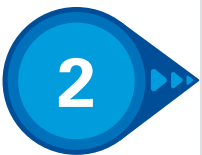
ZBB has the potential to provide many advantages to companies that adopt it. But developing the right ZBB process and then implementing it are not quick or easy tasks despite all of the latest technological innovations. It involves extensive planning, a coordinated, company-wide effort, and support from many levels of the organization, particularly senior management. And it also takes time to bear fruit.

Here are some key elements to keep in mind if you're considering adopting ZBB:



**Create a baseline:** This may take a good deal of time, especially in the first year. But it's a critical component to a successful ZBB implementation and ensures that the company fully understands its expenses, product profitability, and return on investments. You need to break down your spend by program in relation to where your best market opportunities lay. This enables you to identify any potential gaps in where you're putting resourcing today versus where you should be putting them.

The analysis is performed at a strategic level by senior management, together with input from finance, sales, marketing and operations, within the context of the company's long-term goals, market trends and other business factors. To increase the likelihood of accuracy and success, benchmarking metrics and analytical tools should be employed to gather and review the data, and then pinpoint areas where potential savings exist.



**Identify and prioritize candidates:** Companies need to identify which costs are good candidates for budget allocation re-evaluation. Ideally, when you launch ZBB, it's a company-wide effort covering all business units—operations, production, sales, marketing and so on. This is the most efficient way to do ZBB. This can be a vast, time-consuming, almost overwhelming effort for some organizations.

As a result, many companies roll out ZBB in stages, starting with areas that represent the biggest opportunities for savings or return on investments. So, for example, technology companies might focus on R&D spend, consumer companies on marketing and advertising spend, and utilities on capital spend.

However, companies should continue working to expand ZBB to other areas on a yearly basis. Otherwise, if one part of a company is doing ZBB and another one is using incremental budgeting, there's going to be a misalignment of priorities and spending.





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**Provide change management education and training.** ZBB can have a profound impact on personnel, including workforce reductions, reassignments and disruption. Thus, companies considering converting to ZBB will benefit from taking a holistic and structured approach that addresses personnel risks. This includes analyzing the company's risk and readiness for large-scale personnel and organizational change, designing and executing a communications strategy, conducting job impact analyses, and implementing workforce transition programs.

Workshops for senior management, all the way down to personnel involved in the ZBB planning process can be beneficial. The workshops should be designed to educate them about why the company is doing ZBB, help them understand the processes and costs involved, explain the benefits and any anticipated obstacles, and get their input.

A key message that needs to be stressed is that ZBB is not just a cost-cutting strategy (although some areas will likely see budget reductions and personnel dislocation). It's primarily a way to ensure the proper allocation of resources, and improve the profitability and viability of the organization.



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**Drive with CFO leadership and senior management support:** The ZBB effort typically is led by the company's chief financial officer (CFO). But it's essential that the CFO works closely with the various business units and operations so that ZBB essentially becomes a bottoms-up process.

ZBB is most effective when the CFO partners with the business and doesn't treat them as underlings who must carry out his or her orders. For example, it's not productive when the CFO simply tells business units to cut their budgets by 10 percent or that they'll be getting a three percent budget increase. ZBB works best when the CFO asks the business to provide data showing what they need to be successful, and the CFO provides the tools and the dollars to make it happen within the framework of the budget.

When making a major, company-wide change like ZBB, support from senior management is essential, especially in the early stages of the process. In-person meetings and communications from the CEO and other senior officials explaining why ZBB is critical, how the company and its people will benefit, and clearly laying out expectations will go a long way to ensuring the initiative's success.



## Final thoughts

ZBB represents the next phase of a company's budgeting and finance strategy. It offers finance organizations an opportunity to improve margins, realize benefits from acquisitions, maximize top-line growth, allocate resources strategically, have better insight into costs, and become closer partners with the business.

While ZBB typically generates costs-savings, its goal is much more than simply cutting costs. It's about allocating an organization's limited resources to the areas where they'll do the most good and deliver the most efficient returns. If executed properly, ZBB drives business units to adopt a "business owner's" mentality and judge each expense as a strategic investment in the company growth and success.





## How KPMG can help you

KPMG, LLP is dedicated to supporting the growing needs and responsibilities of the CFO. It is a fully integrated, cross-functional team of experienced professionals who serve clients around the globe. Our professionals help clients identify and address the challenges of working in a rapidly changing digital age, enabling them to meet current needs while positioning them for future success.

We help clients align their finance organizations with the strategies of the businesses to realize and sustain value over both the short and the long term. Clients benefit from a multi-disciplinary team of accounting, tax, forensic, internal controls, strategy, business process and IT professionals who work seamlessly and collaboratively in assisting in organizational strategy, design and implementation.

What differentiates KPMG is the hands-on approach our professionals take in delivering services. We bring passion and fresh insights to the issues that challenge CFOs and their finance functions, and are committed to your continued success.

We supplement our hands-on approach with innovative technology capabilities and industry-leading IA and D&A tools. They enable us to provide, data-supported recommendations that underpin strategies such as ZBB. But don't just take our word for it. The Forrester Wave Report stated that KPMG International is a leader among consulting service providers and awarded us the highest score of any vendor it evaluated. It added that we provide "high value consultants with operational experience who have deeper insights on the day-to-day battles clients fight."

And thanks to our extensive geographic footprint—established through our global network of member firms located in all of the world's commercial hubs—we have access to first-hand, real-time information on matters that impact organizations, no matter where you are based or operate—now or in the future.



"Organizations should look to KPMG International when they need help with technical, advisory, or compliance engagements."

— Forrester Wave report, 2017



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