



Zero-Based Budgeting

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ABSTRACT

Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period. Zero-based budgeting starts from a "zero base" and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one.

KEYWORDS

zero based budgeting, communication, Waste and abuse, control system

Introduction

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ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped, then measured against previous results and current expectations.

Meaning and Definition: Zero-based budgeting in *management accounting* involves preparing the budget from the scratch with a zero-base. It involves re-evaluating every line item of cash flow statement and justifying all the expenditure that is to be incurred by the department.

Thus, zero-based budgeting definition goes as a method of budgeting whereby all the expenses for the new period are calculated on the basis of actual expenses that are to be incurred and not on the incremental basis which involves just increasing the expenses incurred in the previous year at some fixed rate. Under this method, every activity needs to be justified, explaining the revenue that every cost will generate for the company.

Contrary to the traditional method of budgeting in which past trends or past sales/expenditure are expected to continue, zero-based budgeting assumes that there are no balances to be carried forward or there are no expenses that are pre-committed. In the literal sense, it is a method for building the budget with zero prior bases. Zero-based budgeting lays emphasis on identifying a task and then funding these expenses irrespective of the current expenditure structure.

Zero Based Budgeting Steps

1. Identification of a task
2. Finding ways and means of accomplishing the task
3. Evaluating these solutions and also evaluating alternatives of *sources of funds*
4. Setting the budgeted numbers and priorities

An example of zero-based budgeting is given below to understand how it works.

Zero Based Budgeting Example

Let us take an example of a manufacturing department of a company ABC that spent \$ 10 million last year. The problem is to budget the expenditure for the current year. There are multiple ways of doing so:

- The board of directors of the company decides to increase/decrease the expenditure of the department by 10 percent. So the manufacturing department of ABC Ltd will get **11millionor**
- 9 million depending on the management's decision.
- The senior management of the company may decide to give the department the same amount as it got in the previous year without hiring more people in the department, or increasing the production etc. This way, the department ends up getting \$ 10 million.
- Another way is, as, against the traditional method, management may use zero-based budgeting in which the previous year.

How Zero base budgeting works

someone is dealing with finances, a plan has to be put in place to manage expenditures. There are pros and cons to all types of budgeting challenges, and this form of budgeting bears consideration before getting started.

Here is a sampling of some of the positive and negative aspects of using budgeting that begins with a zero balance on a regular basis.

Communication: Most companies have an internal means of communication with managers, employees and others who may be involved in projects. Dealing with the communications aspects of this form of budgeting may require some additional training, but in the long run, it can be very beneficial for a company.

- **Pros:** On the plus side, the process enforces the need for everyone to be part of the same team. Regular communication between management and team members becomes the "accepted" norm.
- **Cons:** Launching a new budgeting method is likely to cause some problems initially and will require a great deal of training. Companies who do not already do a good job of communicating expectations may find this change very challenging.

Cost controls: Generally, it is very simple to take the previous year's budget numbers, add or subtract from them and determine what will be required to make this year a success. The downside is that this does not always force department, project or division heads to evaluate their spending in relation to their outcomes.

- **Pros:** This type of budgeting forces everyone to pay more attention to how they intend to invest money, time and resources. Overall, this can result in better control over costs. Resources would have to be evaluated for

each portion of a project (or department) and more cost effective methods of accomplishing goals should be reviewed.

- **Cons:** Unfortunately, the downside could be the number of man hours that it would take to transition from a standard operating budget to the new model. In addition, the amount of paperwork that is often required can result in great projects or programs being brought to a screeching halt because of the amount of time and resources it takes to deal with this budgeting model.

Waste and abuse: Companies of all sizes, not for profit agencies, and government agencies all have room for improvement. Almost without fail, there are areas where dollars are wasted and budget numbers get abused. Production managers may “play” with numbers to make them fit their budgets, hours may be limited on a project to keep the numbers in line with the budget, or research may be put off until a later time to make sure that budget calculations stay in line. Starting at zero every year can help rein in this type of abuse and waste.

- **Pros:** Creating a budget for a large organization or project is challenging. This type of budgeting forces someone to carefully consider each dollar they want to invest into a project or program. This type of evaluation can help eliminate fraud and abuse as it forces a department (or project) manager to examine each aspect of a program carefully and eliminate overlapping functions or outcomes.
- **Cons:** One of the most frustrating aspects of this type of budgeting may be that there is no baseline that is established. Unfortunately, this may result in being unable to change course if something is not working well as the process to get the change budgeted may prove unwieldy. When there is a “measurable” outcome, this may be far easier to deal with but when there is no specific “output,” this can create problems.

Having understood zero-based budgeting calculation; some of the advantages of zero-based budgeting are stated below:

Zero Based Budgeting Advantages:

1. **Accuracy:** Against the regular methods of budgeting that involve just making some arbitrary changes to the previous year's budget, zero-based budgeting makes every department relook each and every item of the cash flow and compute their operation costs. This to some extent helps in cost reduction as it gives a clear picture of costs against the desired performance.
2. **Efficiency:** This helps in efficient allocation of resources (department-wise) as it does not look at the historical numbers but looks at the actual numbers
3. **Reduction in redundant activities:** It leads to the identification of opportunities and more cost-effective ways of doing things by removing all the unproductive or redundant activities.
4. **Budget inflation:** Since every line item is to be justified, zero-based budget overcomes the weakness of incremental budgeting of budget inflation.
5. **Coordination and Communication:** It also improves co-ordination and communication within the department and motivates employees by involving them in decision-making.

Although zero-based budgeting merits make it look like a lucrative method, it is important to know the disadvantages listed as under:

Zero Based Budgeting Disadvantages:

1. **Time-Consuming:** Zero-based budgeting is a very time-intensive exercise for a company or a government funded entries to do every year as against incremental budgeting, which is a far easier method.
2. **High Manpower Requirement:** Making an entire budget from the scratch may require the involvement of a large number of employees. Many departments may not have an adequate time and human resource for the

same.

3. **Lack of Expertise:** Explaining every line item and every cost is a difficult task and requires training the managers.

Conclusion:

Zero-based budgeting aims at reflecting true expenses to be incurred by a department or a state [in the case of budget making by the government]. Although time-consuming, this is a more appropriate way of budgeting. At the end of the day, it is a company's call as whether it wants to invest time and manpower in the budgeting exercise to provide more accurate numbers or go for an easier method of incremental budgeting.

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