

Zero-Based Budgeting

Meaning

Zero-based budgeting (ZBB) is an approach to making a budget from scratch. The budget is not based on previous budgets. Instead, the budget starts at zero. It involves re-evaluating every line item of cash flow statement and justifying all the expenditure that is to be incurred by the department.

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

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 differential basis which involves just changing the expenses incurred taking into account change in operational activity. Under this method, every activity needs to be justified, explaining the revenue that every cost will generate for the company.

Zero Based Budgeting Steps

1. Identifying the decision units that need a justification for every line item of expenditure in the proposed budget.
2. Preparing Decision Packages*. Each decision package is an identifiable and separate activity. These decision packages are connected with the objectives of the company.
3. The next step in ZBB is to rank the decision packages. This ranking is done on the basis of cost-benefit analysis.
4. Finally, funds are allocated on the basis of the above findings by following a pyramid ranking system to ensure maximum results.

Differences between Traditional Budgeting and Zero Base Budgeting

1. In traditional Budgeting, the previous year's budget is taken as a base for the preparation of a budget. Whereas, each time the budget under zero-based budgeting is created, the activities are re-evaluated and thus started from scratch.

2. The emphasis of the traditional budgeting is on the previous expenditure level. On the contrary, zero-based budgeting focuses on forming a new economic proposal, whenever the budget is set.

3. Traditional Budgeting works on cost accounting principle, thereby, it is more accounting oriented. Whereas the zero-based budgeting is decision oriented.

4. In the traditional budgeting, justification of the line items and expenses are not at all required. On the other hand, in zero-based budgeting, proper justification is required, taking into account the cost and benefit.

5. In traditional budgeting, the top management takes decisions regarding any amount that will be spent on a particular product. In contrast, in zero-based budgeting, the decision regarding the spending a specific sum on a particular product is on the managers.

Zero Based Budgeting Advantages

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- **Efficiency:** Zero-based Budgeting helps a business in the allocation of resources efficiently (department-wise) as it does not look at the previous budget numbers, instead looks at the actual numbers
 - **Accuracy:** Against the traditional budgeting method that involves mere some arbitrary changes to the earlier budget, this budgeting approach makes all departments relook every item of the cash flow and compute their operation costs. This methodology helps in cost reduction to a certain extent as it gives a true picture of costs against the desired performance.
 - **Budget inflation:** As mentioned above every expense is to be justified. Zero-based budget compensates the weakness of incremental budgeting of budget inflation.

Zero Based Budgeting Disadvantages

- **High Manpower Turnover:** The foundation of zero-based budgeting itself is a zero. Budget under this concept is planned and prepared from the scratch and require the involvement of a large number of employees. Many departments may not have adequate human resource and time for the same.
- **Time-Consuming:** This Zero-based budgeting approach is a highly time-intensive for a company to do annually as against incremental budgeting approach, which is a far easier method.
- **Lack of Expertise:** Providing an explanation for every line item and every cost is a problematic task and requires training for the managers

Conclusion

Zero-based budgeting targets at presenting true expenses to be incurred by a department. Although this budgeting method is time-consuming, this is a more appropriate way of budgeting. This includes all-inclusive analysis of the budget proposal and if the managers make irrelevant variations so as to achieve what they want, they are probably exposed.