

REVISION : ZBB

What is zero-based budgeting?

zero-based budgeting was Developed by Peter Pyhrr in the 1970s. As an accounting manager for Texas Instruments, Peter Pyrrh created zero-based budgeting to facilitate the incorporation of top-level strategic objectives into the budgeting process by tying them to specific functional areas within the organization.

As the name says “Zero-based budgeting” is an approach to plan and prepare the budget from the scratch. Zero-based budgeting starts from zero, rather than a traditional budget that is based on previous budgets.

With this budgeting approach, you need to justify each and every expense before adding it to the actual budget. The primary objective of zero-based budgeting is the reduction of unnecessary cost by looking at where costs can be cut.

To create a zero base budget involvement of the employees is required. You can ask your employees what kind of expenses the business will have to bear and figure out where you can control such expenses. If a particular expense fails to benefit the business, the same should be axed from the budget.

Differences between Traditional Budgeting and Zero Base Budgeting

- 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.
- 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.
- Traditional Budgeting works on cost accounting principle, thereby, it is more accounting oriented. Whereas the zero-based budgeting is decision oriented.
- 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.
- In traditional budgeting, the top management take 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 is better than traditional budgeting when it comes to clarity and responsiveness.
- Traditional budgeting follows a monotonous approach. On the contrary, zero-based budgeting follows a straightforward approach.

What are the steps to create a Zero based budget?

- Identifying the decision units that need a justification for every line item of expenditure in the proposed budget.

- Preparing Decision Packages*. Each decision package is an identifiable and separate activity. These decision packages are connected with the objectives of the company.
- The next step in ZBB is to rank the decision packages. This ranking is done on the basis of cost-benefit analysis.
- Finally, funds are allocated on the basis of the above findings by following a pyramid ranking system to ensure maximum results.

*Decision packages mean self-contained proposals or module seeking funds. Each decision package comprises the explanation of the activity, the amount involved, the need for the item, the benefit arising from the implementation of the proposal, the expected loss that may be incurred if it is not done and much more..

Zero Based Budgeting Advantages

- **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.

- **Coordination and Communication:** Zero-based budgeting provides better coordination and communication within the department and motivation to employees by involving them in decision-making.
- **Reduction in redundant activities:** This approach leads to identify optimum opportunities and more cost-efficient ways of doing things by eliminating all the redundant or unproductive activities

Although this concept is a lucrative method of budgeting, it is also important to know the disadvantages as listed below:

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.

Source: <https://cleartax.in/s/zero-based-budgeting>