

Zero-Based Budgeting

This article **What is Zero-Based Budgeting?** is about high-level **strategic goals** to be implemented into the budgeting process by tying them to specific functional areas of an organization, where costs can be first grouped and then measured against **previous results** and **current expectations**.

Zero-Based Budgeting is used in monitoring of [MBO \(Management by Objective\)](#).

Definition of Zero-Based Budgeting

Zero-Based Budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period, regardless of whether each budget is higher or lower than the previous period.

Or, **ZBB** in [management](#) accounting involves preparing the budget from the scratch with a zero-base and every function within an organization is analysed for its needs and costs.

<https://youtu.be/VU5MtqCMbVo>
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Zero-Based Budgeting is a method of **budgeting**, whereby all the expenses for the new period are calculated based on actual expenses that are to be incurred and not on the differential basis which involves, just changing the expense incurred taking into account change in [operational activity](#).

In this method, every activity needs to be **justified, analyzed** the costs of every function within an organization and **allocating** funds accordingly, regardless of how much money has previously been budgeted to any given line item. **ZBB** can be translated into **cost-saving** that fund future strategic initiatives and drive growth.

Steps of Zero Based Budgeting

There are some steps of Zero-based budgeting :

1. **Identifying the units** that need a justification for every line item of expenditure in the proposed budget.
2. **Preparing Decision Packages** (Decision package comprises the explanation of the activity, money involved, need for the item, the benefit arising from implementing the proposal, etc.) Each decision package is an identifiable and separate activity. These decision packages are connected with the objectives of the company.
3. **Rank the decision packages.** This ranking is done based on a cost-benefit analysis.

4. **Setting the budgeted priorities** on the basis of the above findings to ensure maximum results.

Example of Zero-Based Budgeting (ZBB)

Let us take an example of the **manufacturing department** of a company that spent \$20 million last year. The problem is to budget the expense for the current year. So, in this current year, it can either increase or decrease the requirement to \$22 million or \$18 million, respectively. ZBB involves calculating all the expenses of the department and justifying each one of them. This reflects the actual demand, which may be \$21 million.

Zero-based Budgeting Advantages and Disadvantages

Advantages of Zero Based Budgeting

Efficiency:

ZBB helps in efficient allocation of department-wise resources as it doesn't notice at the historical numbers but notices at the actual numbers.

Accuracy:

Unlike the regular methods of budgeting that involves making some **arbitrary** changes to the previous year's budget, **Zero-based budgeting** makes every department recheck each and every item of the cash flow and compute their operation costs. It helps in cost reduction as it gives a clear picture of costs, unlike the desired performance.

Budget Expansion:

Since every line item is to be confirmed, **Zero-based budget** overcomes the weakness of [incremental budgeting](#) of budget expansion.

Reduce Waste:

It can remove excessive spending by re-examining possible unnecessary amounts.

Promotes Optimization in Business Process Management:

Streamlining spend and focusing on those items that directly make profit for your business through more value, greater efficiency, cost reductions etc. supports continuous improvement over time.

Improvement of Coordination and Communication:

Zero-based budgeting also improves coordination and communication within the department and motivates the employees by involving them in [decision making](#).

Zero-Based Budgeting Disadvantages

Expensive and Complex:

Unlike traditional budgeting system, zero-based budgeting can be very [costly](#), time-consuming, and complicated to execute. It required extra training, new and better software along with the fact that each budget is built from scratch rather than relying on the data from last year can add significant expense when making the change.

Lack of Expertise:

Analyzing every line item and every cost is a difficult task and requires extra training and managers.

It's Disruptive:

Making the change to zero-based budgeting can result emotionally and intellectually taxing for some people. Employees may find it difficult to make the switch to ZBB.

A significant change in the budget can also threaten the entire operation.

Zero-Based Budgeting Vs. Traditional Budgeting

Zero-Based budgeting and traditional budgeting are the two frequently used budgeting techniques. These techniques help the companies to allocate investment to different departments. These methods of budgeting vary from each other in many aspects that are Justification of data, the base of budgeting, flexibility in the modification of budget components, the time required, allocation of resources, ease of preparation and training, etc.

Both methods of budgeting have their own advantages and disadvantages. So you need to choose the preferred method, depending on what they desire to get through the budgeting process.

Zero-Based Budgeting	Traditional Budgeting
In zero-based budgeting, taking the base as zero as if there is no past or historical data. Here all the elements in the cash flow need to be justified.	In traditional budgeting, only the items which are over and above the last year's budget need to be justified. That means only incremental changes require an explanation, not everything items.
Zero-based budgeting is done considering the base as zero. For every financial period, they prepared a fresh budget from the scratch.	Traditional budgeting uses the previous year's budget as a standard to make the current year's budget.
One of the biggest issues with zero-based budgeting is that it is a time-consuming process as they prepared the budget from the start. Any project, before being added to the budget, goes through a lot of comparisons and approvals, which leads to spending enormous time on each project.	In traditional budgeting, since changes are done in the previous year's budget to meet the needs of the current period, half the task is already done before the budget process starts and only some incremental changes are required.
With zero-based budgeting, the management can focus on priority decisions only.	Traditional budgeting is done regarding no priority to vital activities of the business and last year's budget is simply adjusted considering the inflation factor.
Managers need special skills and knowledge to prepare zero-based budgets. Only an experienced and well-trained professional can prepare such budgets. Thus, preparing zero-based budgets is a complex task.	Traditional budgets are quite easier to prepare, as they do not involve complex calculations.

Difference between Zero-based budgeting and Traditional budgeting.