



Zero base budgeting: A revolutionary concept of planning the future activities

Vivek Sharma

PhD, Department of Management, Lalit Narayan Mithila University, Darbhanga, Bihar, India

DOI: <https://doi.org/10.33545/26648792.2020.v2.i2a.33>

Abstract

Zero Base Budgeting is a formalized system of budgeting for the activities of an enterprise as if each activity were being performed for the first time i.e. from zero-base, under this system a number of alternatives for each activity are identified, costed and evaluated in terms of the benefits to be obtained from them. It is based on the premise that every rupee of expenditure requires justification. It reverses the working process of traditional budgeting. No reference is made to previous level of expenditure. Now-a-days, this system of budgeting is being considered as a revolutionary concept of planning the future activities.

Keywords: decision packages, de nova budgeting, incremental budgeting, traditional budgeting, zero-based budgeting

Introduction

The Zero-Base Budgeting (ZBB) is a method of budgeting whereby all activities are reevaluated each time a budget is formulated. It is an approach to budget review and evaluation that requires a manager to justify the resources requested for all activities and projects, including on-going activities and projects, in rank order. Each functional budget starts with assumption that the function does not exist and it is at zero cost. Increments of costs are compared with increments of benefit, culminating in the planned maximum benefit for a given budgeted cost. ZBB is a revolutionary concept of planning the future activities and there is a sharp contradiction from conventional budgeting. ZBB may be better termed as 'De nova budgeting' or budgeting from the beginning without any reference to any base-past budgets and actual happening. ZBB may be defined as a planning and budgeting process which requires each manager to justify his entire budget request in detail from scratch (hence zero base) and shifts the burden of proof to each manager to justify why he should spend any money at all. The approach requires that all activities be analyzed in decision packages which are evaluated by systematic analysis and ranked in order of importance.

The basic requirements for application of ZBB are:

1. There must have a budgeting system within the organisation.
2. It requires managers to develop qualitative measures for use in performance evaluation.

ZBB is based on the premise that every rupee of expenditure requires justification.

The traditional budgeting approach include expenditure of previous year which are automatically incorporated in new budget proposals and only increments are subjected to debate. ZBB assumes that responsibility centre manager has had no previous expenditure. Importance features of ZBB are:

- Concentration of efforts is not simply of 'how much' a unit will spend but 'why' it needs to spend.
- Choices are made on the basis of what each unit can offer for a specific cost.

- Individual unit objects are linked to corporate targets.
- Quick budget adjustments can be made if, during the operating year costs are required to maintain expenditure level.
- Alternative ways are considered.
- Participation of all levels in decision-making.

Requisites for Implementation of ZBB

The steps involved in successful implementation of ZBB are as follows:

- Corporate objectives should be established and laid down in detail.
- Decision units are identified by dividing the organization according to functions or departments.
- The activity of each function or department is described, analyzed and documented.
- The targets and objectives of each activity are clearly determined ignoring existing budget.
- The performance assessment and measurement criteria for each activity is clearly defined.
- Each separate activity of the organisation is described in a decision package.
- In performance of an activity, the alternative methods and costs are evolved.
- Each activity or decision package is evaluated and ranked by cost benefit analysis.
- The benefits achieved at different levels of funding are analyzed.
- The consequences of not funding the activity are to be estimated.
- Resources in the budget are then allocated according to the resources available and the evaluation and ranking of the competing packages.
- Available resources are directed towards alternatives in order of priority to ensure optimum results.

ZBB and Traditional Budgeting

ZBB reverses the working process of traditional budgeting. Traditional budgeting starts with previous year expenditure level as a base and then discussion is focused to determine the 'cut' and 'additions' to be made in previous year spending. In ZBB no reference is made to previous level of expenditure. A convincing case is made for each decision unit to justify the budget allotment of resources for that activity during the period under consideration and the available resources are allocated to different activities in order of its importance to optimize results. The points of difference between traditional budgeting and ZBB are as follows:

- Traditional budgeting is accounting-oriented. Main stress happens to be on previous level of expenditure. ZBB makes a decision-oriented approach.
- In Traditional budgeting, first reference is made to past level of spending and then demand is made for inflation and new program. In ZBB a decision unit is broken into understandable decision packages which are ranked according to importance to enable top management to focus attention, only on decision packages which enjoy priority to others.
- In Traditional budgeting, some managers deliberately inflate their budget request so that after the cuts they still get what they want. In ZBB, a rational analysis of budget proposal is attempted.
- Traditional budgeting is not as clear and responsive as ZBB
- In traditional budgeting, it is for top management to decide why particular amount should be spent on a particular decision unit. In ZBB their responsibility is shifted from top management to the manager of decision unit.
- Traditional budgeting makes a routing approach, while ZBB makes a very straightforward approach and immediately spotlights the decision package enjoying priority over others.

ZBB and Incremental Budgeting

The ZBB approach to budgeting is an incremental approach, starting from zero cost, which considers the incremental costs and incremental benefits of each activity. Another incremental approach to budgeting is to consider the incremental effects of changing the level of nature of operations from what they are at the moment. For example, if a company has been producing 1, 00, 000 units of a product each year for several years, it might wish to consider the effect of increasing or lowering the annual production volume in the future. Budgets could be prepared which measure the incremental changes in costs and benefits resulting from an alteration in the level of production. Changes which promise incremental benefits than incremental costs should then be incorporated into the master budget. An incremental budget is presented by a manager to his superior in terms of total money required for the coming period except for any proposed increase. Little explicit information is given about the activities covered by the total funds requested.

In ZBB approach the existing levels of activity will not be taken into account or for granted. ZBB describes in some details the activities represented by both current funding and proposed increases. The focus of attention is, therefore, deviated from the required money input to a functional unit towards the activities and output of the unit in question. Accordingly, ZBB allows a far more critical and thorough analysis of the unit's total activities in

the light of the needs and objectives of the organization and it facilitates the consideration of alternative ways of providing the required service for the coming budget period.

ZBB and Decision Packages

ZBB requires that decision packages are developed and ranked. The first step of preparing the decision package is very critical as the final budget is developed on the basis of these packages which are prioritized. The final budget is produced by taking packages that are approved for funding, sorting them into their appropriate budget units and adding up the costs identified on each package to produce the budget for each unit. As the process of ZBB depends on prioritizing of decision package it is very crucial that decision package are prepared very carefully after a thorough understanding of their contribution to goals and objectives of organisation, resources required (inputs), and expected outputs. The concept of minimum level funding, and the preparation of different decision packages for incremental levels of funding and performance make the preparation of these package a complicated exercise.

Determining the activities around which decision packages should be prepared is the most important step in ZBB. It is necessary to prepare decision packages at the beginning of each organisation to promote detailed identification of activities and alternatives. In order to avoid complications and to give a yardstick or benchmark for control purpose it is necessary to develop norms by identifying the basic requirements (inputs/resources for minimum level) to run the program and the expected outputs at this minimum level funding. Minimum level is that performance or funding level below which it is not feasible to continue a program as it cannot fulfil its objectives. Just as over-allocation and wasteful expenditure should be curtailed, it is necessary to avoid under-allocation and non-availability of funds for proper implementation of programs. Determination of minimum level is a difficult task and it is always much below the current level of expenditure in any government organization. They can either reduce spending and adhere to current level of activity or enhance the level of activity and performance for the same amount of spending. For this purpose also, development of norms is necessary, so that we are able to define how much of the same activity is feasible at the minimum level of funding or what are the extra activities to be included at current higher level of funding. Then performance measures for each level are necessary to develop proper information and control systems.

The decision package are of two types:

1. Mutually Exclusive Packages- Each of these contains an alternative method of getting the same job done. The best option among the packages must be selected by cost-benefit analysis and the other packages are then discarded.
2. Incremental Packages- These divide an aspect of work or activity into different levels of effort. Base package will describe the minimum amount of work that must be done to carry out the activity.

ZBB is Beneficial

The arguments in favour of implementation of ZBB are:

- In course of ZBB process, inefficient and obsolete operations are identified and removed.
- It adds psychological impetus to employees to avoid wasteful expenditure.

- It help in close monitoring of cost behaviour patterns in order to decide the effect of alternative course of action.
- It is a planning tool for management which helps in identification of wasteful and obsolescent items of expenditure.
- The documentation required enables a coordinated in-depth knowledge of an organization's operations to be available to all management.
- The scarce resources will be allocated more efficiently to activities and departments of the organization according to priority of programs. This system weeds out inefficiency and reduces the cost of production because every budget proposal is evaluated on the basis of cost-benefit analysis.
- ZBB is not based on incremental approach, so it promote operational efficiency because it requires manager to review and justify their activities or funds requested.
- Since this system requires participation of all managers in preparation of budgets, responsibility of all level of management is successful execution of budgetary system can be ensured.

Criticism Levelled Too

The criticism levelled against ZBB for the following reasons:

- ZBB will lead to an enormous increase in paper work created by the decision packages. The assumptions about costs and benefits in each package must be continually updated, and new packages developed as soon as new activities emerge.
- ZBB is criticized for emphasis of short-term benefits to the detriment of long-term benefits.
- ZBB may encourage the false idea that all decisions have to be made in the budget. Management must be able to meet unforeseen opportunities and threats in all times and must not be restricted from carrying out new ideas simply because they were not approved by a decision package cost benefit and ranking analysis.
- Where objectives are very difficult to quantify as in research and development or general administration, ZBB does not offer any significant control advantage.
- Defining the decision units and decision package is the difficulty encountered by companies introducing ZBB.
- ZBB requires a lot of training for managers. If managers do not understand correctly the idea at the back of ZBB, it cannot be introduced successfully.
- ZBB might call for management skills in decision analysis to construct decision packages which the organisation does not possess.
- Another problem with ZBB is the difficulty of the ranking process. Managers face the following three common problems.
 1. The large number of packages they have to rank.
 2. There is often a conceptual difficulty in having to rank packages which they regard as being equally vital, for legal or operational reasons.
 3. It is difficult to rank completely different types of activity, especially where activities have qualitative rather than quantitative benefits, such as spending on staff welfare and working conditions, where ranking must equally be entirely subjective.

Conclusion

We may conclude that Zero-Base Budgeting is a formalized system of budgeting for the activities of an enterprise as if each activity were being performed for the first time i.e. form zero-base. The budgeting of a function, the start is from scratch or zero and not on the basis of trends or historical figures adjusted for inflation and other conditions. It starts from the basic premise that the budget for the next year is zero and every process or expenditure has then to be justified in its entirety in order to be included in the next year's budget. The burden of proof thus shifts to each manager to justify why the money should be spent at all and to indicate what would happen if the proposed activity is not carried out and no money is spent. Under this system a number of alternatives for each activity are identified, costed and evaluated in terms of the benefit to be obtained from them. The established activities will have to be compared with alternative applications of the resources that they would use during the budgetary planning period.

References

1. Handa KL. Expenditure Control and Zero Base Budgeting, Indian Institute of Finance, New Delhi, 1991.
2. Ibrahim Mustapha. Zero-based Budgeting is a Panacea to Fiscal Distress, Saudi Journal of Business and Management Studies, 2017, 2(10).
3. Pyhrr PA. Zero Base Budgeting, John Wiley and Sons Inc. New York, USA, 1973.
4. Stonich PJ. Zero-Based Budgeting: A Practical Management Tool for Evaluating Exprenses, John Wiley and Sons Inc., New York, USA, 1977.
5. Willioms John J. Zeor-base Budgeting: Prospects for Developing a Semi-Confusing Budgeting Information System, Accounting, Organisations and Society, 1981, 6(2).
6. Winer Stanley, Premchand A. Government Budgeting and Expenditure Controls: Theory and Practice International Monetary Fund, Washington DC, 1985.