

Zero Based Budgeting 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 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.

Contrary to the [traditional 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

Extensive Course on: [‘Budgeting and Forecasting’](#) **

- 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

To understand the [Steps in Zero Based Budgeting](#), an example 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 \$ 11 million or \$ 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's number of \$ 10 million is not used for calculation. Zero-based budgeting application involves calculating all the expenses of the department and justifying each of these. This reflects the actual requirement of the manufacturing department of company ABC which may be \$ 10.6 million.

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

How Zero Based Budgeting is different from Other Methods

To have a clear understanding, it is necessary to understand the key differences between the other methods of budgeting like [Activity Based](#)

[Budgeting](#) etc.

[Zero Based Vs. Activity Based Budgeting](#)

[Zero Based Vs. Traditional Budgeting](#)

[Zero Based Vs. Incremental Budgeting](#)

Zero Based Budgeting Advantages

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.

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

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.

Budget inflation: Since every line item is to be justified, zero-based budget overcomes the weakness of [incremental budgeting](#) of budget inflation.

Coordination and Communication: It also improves coordination 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

Time-Consuming: Zero-based budgeting is a very time-intensive exercise for a company or a government-funded entities to do every year as against incremental budgeting, which is a far easier method.

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.

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.

References:

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