

Zero-Based Budgeting

Previously in the Members Case Studies I covered the technique of budgets and budgetary control.

Here we explore the benefits of ZBB, Zero Base Budgeting as an alternative to the conventional approach to planning. This reading is an aid to your CPD.

Regards

Dr Philip Dunn
Editor

[To download this article in printable format click here](#)

Zero-Based Budgeting a definition:

Zero Base / Priority Base Budgeting is defined in CIMA terminology as:

"A method of budgeting whereby all activities are re-evaluated each time a budget is set. Discreet levels of each activity are valued and a combination chosen to match funds available."

A further definition is "an operating planning and budgeting process which requires each manager to justify the entire budget request in detail and shifts the burden of proof to each manager to justify why he/she should spend any money. This procedure requires all activities and operations be identified in decision packages which will be evaluated and ranked in order of importance by systematic analysis".

It is acknowledged that ZBB as a system of budgeting was used in the early 60's by the US Department of Agriculture. Research suggests that it was developed as a technique by Peter A Phyhr a senior manager, staff control, at Texas Instruments and is also now widely used in the federal government department in the US and in many large corporate businesses.

ZBB as a planning and decision making technique reverses the process and procedure of the traditional budget setting model.

Traditionally business unit managers simply justify increases over the previous year's budget. It is often on extrapolation of last year's budget by:

- incremental changes for an assumed rate of inflation
- anticipating increases in wages and salaries
- recognising new projects / programmes of activity
- adding incremental business activity as a base for the budget

This model is the one currently used in Coverdrive Ltd.

ZBB however makes no initial assumptions. The manager of each business unit compiles the budget by assessing each potential activity from scratch – the zero base.

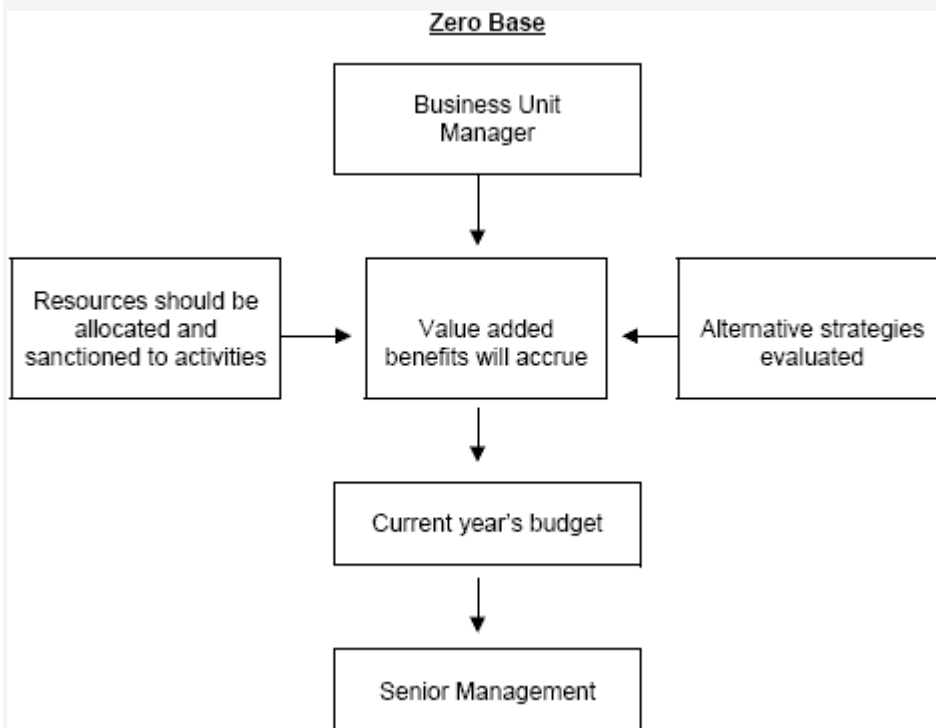
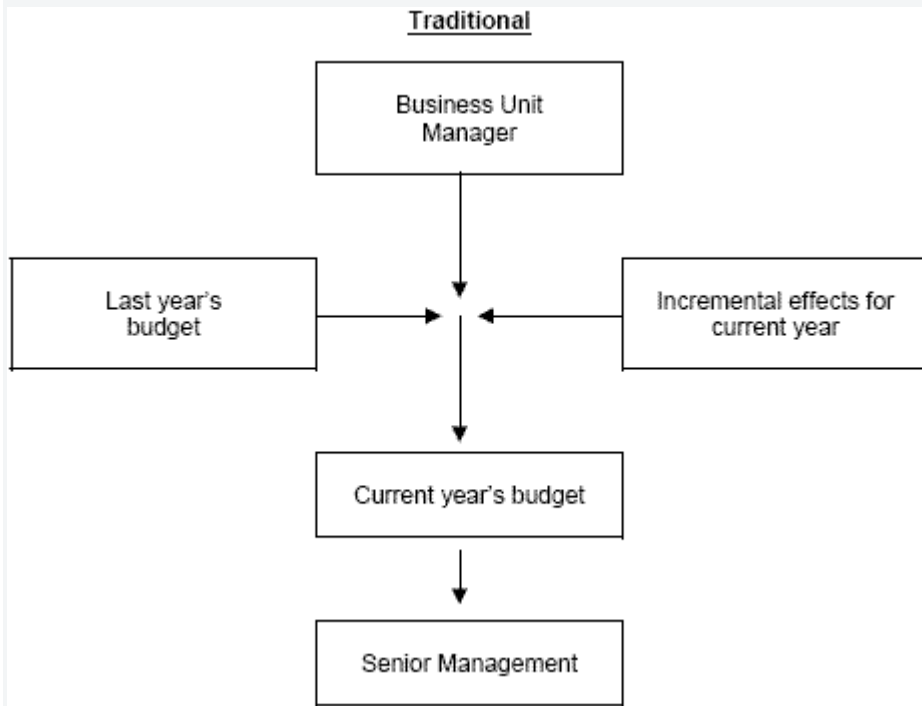
Every department or function is reviewed comprehensively and all expenditures are approved rather than the incremental effects of what has gone before.

Managers should evaluate the value added benefit from activities by asking questions as:

- Is the activity or function necessary?
- Does the activity add value?
- If the activity was not carried out, what would be the consequences?

- What level of activity is required?
- Is the activity performed efficiently?
- Is it cost effective?

The following diagrams compare and contrast the Traditional v Zero-Base approach:



ZBB technique requires that both decision units be identified and decision packages developed.

Decision units are responsibility centres as expense centres, profit centres or investment centres. The manager of the decision unit justifies the budget proposal.

Decision packages are developed by managers for their responsibility centre and includes issues as:

- The function of the business unit.
- Performance measure or measures for the unit.
- Costs and benefits from the unit at various levels of activity and resource allocation.
- Effects or not operating at those levels.

The packages are evaluated and ranked using costs / benefit analysis technique.

The Zero-Based budgeting process thus comprises three distinct stages:

- Identify and define decision packages
- Evaluate and rank packages
- Allocate resources

A decision package is an activity within the organisation that results in costs and or revenues.

A decision has to be made whether or not an activity should be carried out. The question to be addressed is whether or not the activity is worthwhile. Decision packages are compared and ranked in order of preference. Business unit managers prepare packages for the activities within their responsibility centre.

Two types of decision packages have been identified:

- Mutual exclusive packages are those which contain alternative methods of performing an activity. A comparison of costs and benefits of the options available in the package are evaluated.

For example Coverdrive may consider contracting out its delivery of finished goods as a package, whereas, a second package would involve handling deliveries 'in house' with its own fleet of vehicles.

- Incremental packages sub-divides aspects of an activity into differing levels of effort.

The base package specifies the minimum amount of resources required to carry out an activity and the other packages specify additional activity and the relevant costs and benefits.

- Evaluate and rank packages.

Each package is ranked in terms of priority on the basis of its value added benefit to the business unit.

This process provides managers with a technique which aids the allocation of scarce resources to activities within responsibility centres.

The ranking process is participative and may involve managers from expense centres, profit centres and investment centres within the organisation.

The overall ranking of the packages is reviewed by the senior management team who consider the views of the entire management structure.

- Allocation of Resources.

Resources in the budget are then allocated on the basis of the evaluation and ranking of the various options in the form of competing packages.

The results of the evaluation guide senior management in prioritising resource allocation.

Benefits of ZBB

Although the technique is difficult to implement it is acknowledged has having a number of value added benefits which include:

- It can aid organisational change.
- It focuses management attention to organisational objectives.
- Managers are concerned with the future rather than the past.
- Established priorities in relation to resource allocation and optimum use of funding.
- Increases staff motivation through participative management and responsibility for decision making.
- Organisational communication and co-ordination is improved.
- Assists in identifying inefficient and obsolete activities within the organisation.
- Compels planning and examines cost effective ways of improving activities.

There are also some disadvantages related to the technique. These include:

- Time-consuming in terms of management input compared to traditional method.
- Often difficult to define decision units and decision packages.
- Requires additional management training (at a cost).
- There is often the temptation to focus on the short-term rather than the longer-term.
- It takes time to show real value added benefit of implementing such a system.

Conclusion

It can be said that Zero-Base Budgeting is a systematic logical approach to allocating limited resources where they will do the most good.

