From traditional budget planning to zero-based budgeting

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Introduction

A budget is an important financial plan that incorporates a systematic analysis and interpretation of financial forecasts in terms of products, markets and the application of resources. It requires managers to plan. It needs operational and financial resources information for decision making. More importantly, it sets a benchmark that can be used for subsequent performance measurement.

Annual budget planning is conducted every year. When time passes, managers treat it as a regular practice and may fall into the habit of repeating a similar budget allocation and adjusting the figures slightly merely to account for inflation.

Traditional incremental budgeting

Traditional budgeting uses the incremental approach. It begins with previous year's budget and adjusts up or down from that budget to reflect changing assumptions for the new year. For instance, if previous year's budgeted expenditures for a department were $1.8 million, the department may request a 4 percent increase ($72,000) to maintain the same level of service for next year. The justification for increased expenditure is the increased cost of inputs, such as materials and labour. This incremental approach may not incorporate a careful evaluation of the level of services being offered.

Under the incremental approach, government unit managers often strive to spend the year's entire budget, so there is no surplus at the year end. This acts to maintain the current budgetary level and to help the unit manager apply additional funds. For example, at a certain government department office in the New Territories, the officer-in-charge, Wong Kar Ming, was faced with the possibility of having surplus funds of around $150,000 at the fiscal year end. Kar Ming found methods to spend the extra money before the year ended. He posted an internal notice to colleagues saying that those who lived in Kowloon and Hong Kong Island were welcome to apply for a travel allowance. Brand new office furniture was acquired for a new section (before office furniture was centrally dispatched from the government warehouse). The inefficiency and wastage portrayed in this example is often perpetuated and encouraged by incremental budgeting.

Zero-based budgeting

Zero-based budgeting offers a better approach to dealing with these kinds of drawbacks. Unlike in incremental budgeting, zero-based budgeting does not start from the previous year's budget level. Existing operations are studied, and continuance of the operation or activity must be justified on the basis of its usefulness and its need to the company. The manager requesting the budget is responsible for this justification. As a result, each company department begins from zero and prepares a series of budgets – one for each decision package under consideration.

A decision package includes a description of services and related costs. As well as the budget, each package contains a statement of the project goals, plans to achieve these goals, the expected benefits, and the consequent results of not approving this decision package. An option is chosen, and the others are discarded. This planning process requires the managers to take an updated view of their plans and consider the most suitable method to achieve their objectives.

In the past, budgets have emphasized cost control and focused less on effectiveness. There has been an increase in budgetary planning schemes as more companies carry out sophisticated factory planning. Budget planning originated from cost accounting and industrial engineering. Cost accountants use budgeting to set up standard costs and to estimate future expected costs. Industrial engineers use scientific methods to achieve production standards, and then they can plan future operations and performance standards.

Implementation of zero-based budgeting

Zero-based budgeting aims to justify resource allocation in an individual budget scheme, regardless of prior period budgets. It is not based on historical data and begins each budget period afresh. The budget is first allocated as zero unless the manager responsible makes the case for resource allocation. The manager must justify the reasons for the financial resource allocation.

Each budget item is queried as if it were new before any financial resources are allocated to it. Each plan is justified in terms of the total cost involved and the total benefits. Past performance is not referred to as a building block. Zero-based budgets are set to prevent regular budget creeping behaviour that emphasizes inflationary adjustments.

New and old work tasks are treated equally. Every managerial activity is properly identified and then evaluated by analyzing alternative levels of operation for the same activity. These alternatives are ranked and relative priorities are set for achieving effectiveness and efficiency.

A zero-based budgeting system demands that the manager justify the entire budget in detail and explains why the company should spend the money in the manner proposed. This approach differs from traditional budgeting techniques as it emphasizes the analysis of alternatives. The implementation steps are:

1. Managers first establish different decision packages associated with performing each work task, such as forecasting the costs and benefits of conducting a project or outsourcing it, or centralizing versus decentralizing operations.

2. The decision packages should be ranked in order of importance. Tradeoffs between respective packages should be considered. These allow managers to rank priorities and combine decision packages for old and new projects into one,

and allow top management to evaluate and compare the needs of individual units or departments for financial resources allocation.

3. In addition, managers identify different levels for each alternative method of the proposed activity. A minimum level of spending, usually 75 percent of the current operating level, is established and then separate decision packages that consider the costs and benefits of additional levels of expenditure for that particular activity are developed. The setting of different levels enables managers to consider and evaluate the level of expenditure lower than the current operational level. This gives decision-makers the choice of eliminating the activity or allocating resources for the selected level by including changes in expenditure level and tradeoffs among departments.

Referring back to the surplus funds of around $150,000 in the earlier example, there was no justification for spending this amount. Thus this surplus should not be allocated on a continuing basis.

Advantages and disadvantages of zero-based budgeting

Zero-based budgeting provides distinctive advantages over traditional incremental budgeting. These include:

(a) The planning mechanism needs budget setters to examine every budgetary item as if it were new.
(b) It allocates financial resources basing on planning requirements and results.
(c) It prevents incremental budgeting simply based on the previous year's figures with an estimated percentage increase.
(d) It helps the budget setter to develop a questioning attitude; inefficiencies and wastage can then be reduced.
(e) To obtain efficiency, it encourages managers to look for alternative operation plans.

Nevertheless, there are some disadvantages to zero-based budgeting:
(a) This budgeting is sophisticated and can consume a lot of managerial time.
(b) Short-term benefits may take precedence over long-term planning as the latter is less prominent in the planning process.
(c) As a new budget allocation is started every year, there will be annual conflicts over budget allocation.

Improvements to zero-based budgeting

As a way of dealing with the managerial time required, one possibility is to conduct a rolling budget every year and perform a zero-based budget every three to five years, or when a major change occurs in operations. This allows the company to benefit from the advantages of zero-based budgeting without an excessive amount of work being required.

The company should not feel that all budgets must be developed in entirely the same manner. Some departments can use an in-depth study of a zero-based budget while others can use a rolling budget. This is a way of spreading the work required over a number of years instead of concentrating on one certain year. Many companies have implemented the system in some form or another and found that it did not work. If properly implemented, however, the process could show a considerable improvement over traditional rolling budgets. The nature and number of decision packages varies between companies. It is not uncommon for large companies to identify several thousand packages.

After ranking their own packages, top management could rank the packages of all the managers that report to them. Another solution is for each level of management to rank a certain percentage of packages within its own area of responsibility. For example, the first level of management may rank 30 percent of the proposed packages; the next level may rank the next 30 percent of packages, while top management may concentrate on the remaining 40 percent of the budget.

Concluding remarks

Zero-based budgeting requires a programme's existence to be justified in each financial year, as opposed to simply basing budgeting decisions on a previous year's allocation. It provides a systematic method of planning company financial resources. It may require an extensive amount of time and paper work. A combination of zero-based budgets with traditional budgeting spreads the workload involved in justifying new budgets and is one possible method by which zero-based budgeting can be incorporated into current budgeting techniques.

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