Zero Based Budgeting: Advantages And Disadvantages

Introduction

Zero-based budgeting originated in the 1970s. Many businesses will budget the plan out things with the focus to grow the financial strength. In the past, businesses would only look at only major cost and would assume that everything is already in place and does not need to be double-checked. In ZBB everything that is to be budgeted needs to be assessed. This means that budgets are started from a zero-base, with a fresh decision on everything being made every year(Presidency.ucsb.edu).

ZBB is a method of budgeting in which all expenses must be justified for each new period. It starts from a zero base and every function within an organization is analyzed for its needs and cost.

Advantages

There are few companies that have benefited a lot by using ZBB and they are 3G Capital Partner which were the force behind the merger of Krafts food and H.J.Heninz, Jimmy Carter president of USA referred in case study 1, Cadbury, Oreo referred in case study 2.

1. Accuracy: it helps the company to look over every department to make sure they are getting the optimum utilization of funds (Perspective on considering a Zero-Based Budgeting (ZBB) planning approach, Deloitte Analysis).
2. Efficiency: this technique helps to judge the actual need of the company by focusing on the current number instead of past budgets. Which removes the probability of making any errors as the whole budget is drafted based on the current needs of the company.
3. Reduction in wasteful spending: it can remove redundant spending by reexamining potentially unrequired expenditures. As each and every department of the company are examined for the wastage of resources and their needs to complete the given task (Money Matters).
4. Coordination and Communication: it helps the communication within departments by involving employees in decision making and budget prioritization (Deloitte Analysis).

Disadvantages

There are failures which were noticed while using the ZBB model for example: Infosys in 2000 used ZBB and failed, IBM used ZBB when they were in hardware business which went in loss and later sold their business and started a new venture.

1. Creating ZBB within a company can take enormous amount of time, effort and analysis that would require extra staff.
2. In many cases the managers can attempt to skew numbers to make expenditure into vital activities, thus creating a “need” for them. This would cause companies to continue to waste money(Perspective on considering a Zero-Based Budgeting (ZBB) planning

approach, Deloitte Analysis.).

3. Intangible Justification: this type of budget requires intangible justification of their budgets, which can be difficult on many levels. Departments like marketing and advertisement requires justifying their expenses or they may not use in the next year due to fluctuation of the market. This can reduce the profit in the future due to not being able to justify their expenses.
4. Managerial time: As ZBB comes at the cost of time and extra training for managers. This means extra time every year to do the budget and training. It is very essential for the staff to understand ZBB(E finance).
5. Slower response: Due to the amount of time required to do ZBB, managers and employees are less likely to revise the budget of the previous year so they fail to cope up with the changing market. This means that it will take longer time to move money from one department from another. ZBB can potentially leave gaps between departments as they don't react to sudden change or needs of the department (Deloitte Analysis).

Situations where ZBB can be used.

Example: Suppose a company making construction equipment implements a ZBB process calling for closer scrutiny of the expenses in its manufacturing departments. The company then notices that the cost of certain parts used in its final product and out sourced to another manufacturer in increasing 5% every year. The company has the capability to make those parts in house and with its own worker. After seeing all the approaches the company finds that it can make the parts cheaper outside suppliers (case study 1)

Instead of blindly increasing the budget by a certain percentage and masking the cost the company should identify various other alternatives to outsource or to reduce their costing. As ZBB is more involved so the costs of the process itself must be justified and more refined (case study 2)

Conclusions

Despite the increasing popularity and interest in ZBB, they are not a cost-effective option for most of the organization. On the contrary ZBB components and theories maybe of some use in few sectors under specific circumstances (Kavanagh, Shayne 2015). The economic environment plays a very important role in this as it influences ZBB to renewed it trends, become more practical and be more cost sensitive for the organization(appendices 2 case studies). For example, organizations can examine alternative activities, methods and technologies that maybe less costly, focuses more on the underlying cost drivers and are more effective at enabling strategy. The organization needs rarely merit a full ZBB exercise (Deloitte POV/Article, April 2012).