Zero Base and Performance Budgets

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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.

What is zero-based budgeting?

As the name says “Zero-based budgeting” is an approach to plan and prepare the budget from the scratch. Zero-based budgeting starts from zero, rather than a traditional budget that is based on previous budgets.

With this budgeting approach, you need to justify each and every expense before adding it to the actual budget. The primary objective of zero-based budgeting is the reduction of unnecessary cost by looking at where costs can be cut.

To create a zero base budget involvement of the employees is required. You can ask your employees what kind of expenses the business will have to bear and figure out where you can control such expenses. If a particular expense fails to benefit the business, the same should be axed from the budget.

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.

Differences between Traditional Budgeting and Zero-Base Budgeting:

In traditional Budgeting, the previous year's budget is taken as a base for the preparation of a budget. Whereas, each time the budget under zero-based budgeting is created, the activities are re-evaluated and thus started from scratch.

The emphasis of the traditional budgeting is on the previous expenditure level. On the contrary, zero-based budgeting focuses on forming a new economic proposal, whenever the budget is set.

Traditional Budgeting works on cost accounting principle, thereby, it is more accounting oriented. Whereas the zero-based budgeting is decision oriented.

In the traditional budgeting, justification of the line items and expenses are not at all required. On the other hand, in zero-based budgeting, proper justification is required, taking into account the cost and benefit.

In traditional budgeting, the top management take decisions regarding any amount that will be spent on a particular product. In contrast, in zero-based budgeting, the decision regarding the spending a specific sum on a particular product is on the managers.

Zero-based budgeting is better than traditional budgeting when it comes to clarity and responsiveness.

Traditional budgeting follows a monotonous approach. On the contrary, zero-based budgeting follows a straightforward approach.

What are the steps to create a Zero-based budget?

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.

Identifying the decision units that need a justification for every line item of expenditure in the proposed budget.

Preparing Decision Packages*. Each decision package is an identifiable and separate activity. These decision packages are connected with the objectives of the company.

The next step in ZBB is to rank the decision packages. This ranking is done on the basis of cost-benefit analysis.

Finally, funds are allocated on the basis of the above findings by following a pyramid ranking system to ensure maximum results.

*Decision packages mean self-contained proposals or module seeking funds. Each decision package comprises the explanation of the activity, the amount involved, the need for the item, the benefit arising from the implementation of the proposal, the expected loss that may be incurred if it is not done and much more.

Zero Based Budgeting Advantages:

Efficiency: Zero-based Budgeting helps a business in the allocation of resources efficiently (department-wise) as it does not look at the previous budget numbers, instead looks at the actual numbers

Accuracy: Against the traditional budgeting method that involves mere some arbitrary changes to the earlier budget, this budgeting approach makes all departments relook every item of the cash flow and compute their operation costs. This methodology helps in cost reduction to a certain extent as it gives a true picture of costs against the desired performance.

Budget inflation: As mentioned above every expense is to be justified. Zero-based budget compensates the weakness of incremental budgeting of budget inflation.

Coordination and Communication: Zero-based budgeting provides better coordination and communication within the department and motivation to employees by involving them in decision-making.

Reduction in redundant activities: This approach leads to identify optimum opportunities and more cost-efficient ways of doing things by eliminating all the redundant or unproductive activities

Although this concept is a lucrative method of budgeting, it is also important to know the disadvantages as listed below:

Zero Based Budgeting Disadvantages:

High Manpower Turnover: The foundation of zero-based budgeting itself is a zero. Budget under this concept is planned and prepared from the scratch and require the involvement of a large number of employees. Many departments may not have adequate human resource and time for the same.

Time-Consuming: This Zero-based budgeting approach is a highly time-intensive for a company to do annually as against incremental budgeting approach, which is a far easier method.

Lack of Expertise: Providing an explanation for every line item and every cost is a problematic task and requires training for the managers.

<u>PERFORMANCE BUDGET</u>

Performance Budget:

Performance budget also referred to as performance-based budgeting is a practice of preparing the budget based on the evaluation of the productivity of the different operations in an organization. Operations which are contributing the most to the profitability, the larger share of the budget is allocated to that division. It leads to optimum utilization of resources such as finance, skills of the staff, use of the productive time etc.

Basically, performance budget requires an evaluation of the performance and productivity from one budget period to another budget period. Hence, it is the process of identifying the results achieved by each division of the organization. Furthermore, performance budget does not focus on the individual activities which are necessary for developing strategies. Instead, the core focus is the achievement of the overall goal of the division. This helps the managers to frame the strategy of the division. Hence, performance budgeting is based on the concept of zero-based budgeting.

Generally, not for profit organization and the government departments use performance budget. It is used to justify the application of money. Not for profit and government earns through taxes levied on the citizens and lack of correct information may result in an ineffective performance budget which affects the entire project.

PROCESS OF PERFORMANCE-BASED BUDGETING:

Set Goals

The organization shall make the list of the goals. The goal here indicates the end result. The goals should be clear to each employee of the organization. Clear goal and communication of the same results into successful implementation of performance-based budgeting.

Thus, this step is planning and budgeting.

Periodic Evaluations

The next step is the periodic evaluation of the performance to achieve the desired goals of the organization. The organization shall develop a systematic step by step approach for evaluation. Performance measurement is subjective which differs from person to person. Hence, the organization shall try to quantify the result based on the outcomes.

Thus, this step is a measurement of results. Performance Indicators. Performance indicators help in evaluating the effectiveness and efficiency of the program. A performance indicator is a standard for measurement. The selection is based on the extent of the following:

It’s relevance

Cost-effectiveness

Comparability

Representative

Accountability:

The organization is going to be accountable for the result or outcomes. The primary focus of the performance budget is the outcome and not the inputs. Likewise, the staff is accountable for organizational goals. Besides, performance-based budgeting expects to achieve a level of results based on the given level of resources. Thus, this step is called evaluation and communication of results.

Performance-Based Vs Traditional Budget:

The amount of money to be spent for the particular purpose for example on staff salary, office supplies, equipment etc. are included in the traditional budget. However, what is to be accomplished by each dollar spent is indicated by the performance budget. Previously, the organizations were not following the performance-based approach. However, currently, the organizations follow the performance-based approach.

Example of Performance Budgeting:

30% reduction in death ratio of HIV-Positive patients by the end of 2020.

20% increase in production in 2018 by staff training on a monthly basis.

50% reduction in infant mortality rate by implementing robust vaccination centers in all different parts of the country by 2022.

Advantages of Performance Budget:

In the advanced world, the management of money becomes one of the important factors for any organization. The performance budget plays an important role to achieve efficiency.

Set Accountability:

In the public sector organization and not for profit organization, performance budget helps to increase the accountability. The employees have to quantify a particular goal based on the priority and the tax payer’s money. Unquestionably, taxpayer and the donors have interest in knowing where the money is spent. It evaluates the benefit accruing to the citizens and society.

Clear Purpose:

Performance budgeting indicates clearly the objective on which the money is going to be spent. By making the purpose clear, it becomes easier to assess the performance and correct the deviations.

Improvement in Performance:

The performance budget improves the performance of the programs on a continuous basis. In addition to, it leads to the overall operational efficiency of the organization. Also, it overcomes the limitations of traditional budgeting.

Transparency:

Performance-based budgeting helps in bringing the transparency in the budget preparation. The performance budget helps in taking better financial decisions for the allocation of resources. It reviews the operational efficiency of the projects. Hence, one can say, it links the entire process of planning, implanting and evaluation of the results.

Disadvantages of Performance Budget:

Subjective:

Since the performance budget is subjective in nature, it creates disagreement amongst the management. Also, social projects are with a long-term vision. It is difficult to quantify in money terms. The costs may differ from one government body to another government body. Therefore, the more use of result based approach helps in improvement of the budgetary process, accountability, and administration of the organization.

The performance budget requires a strong system of accounting. Therefore, the reporting system has to be strong for its successful implementation.

Manipulation of Data:

Staff may manipulate the data. Further, the calculation of the financial information is not reliable because of the errors in preparation. Therefore, Proper internal control system helps in maintaining the accuracy of the data.

Difficult for Long-Term:

The time period between the allocation of resources in the project and the achievement of the result might be more than a year. Undoubtedly, it makes difficult to measure the results of the projects in long-term.

"If any Doubt & Question Contact During Class Time"
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