**Zero-Based Budgeting (ZBB)**

What Does Zero-Based Budgeting Mean?

Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period. The process of zero-based budgeting starts from a "zero base," and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether each budget is higher or lower than the previous

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The Basics of Zero-Based Budgeting (ZBB)

ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped and then measured against previous results and current expectations.

Because of its detail-oriented nature, zero-based budgeting may be a rolling process done over several years, with a few functional areas reviewed at a time by managers or group leaders. Zero-based budgeting can help lower costs by avoiding blanket increases or decreases to a prior period's budget. It is, however, a time-consuming process that takes much longer than traditional, cost-based budgeting. The practice also favors areas that achieve direct revenues or production, as their contributions are more easily justifiable than in departments such as client service and research and development.

**Zero-Based Budgeting vs. Traditional Budgeting**

Traditional budgeting calls for incremental increases over previous budgets, such as a 2% increase in spending, as opposed to a justification of both old and new expenses, as called for with zero-based budgeting. Traditional budgeting analyzes only new expenditures, while ZBB starts from zero and calls for a justification of old, recurring expenses in addition to new expenditures. Zero-based budgeting aims to put the onus on managers to justify expenses, and aims to drive value for an organization by optimizing costs and not just revenue.

**Example of Zero-Based Budgeting**

Suppose a company making construction equipment implements a zero-based budgeting process calling for closer scrutiny of manufacturing department expenses. The company notices that the cost of certain parts used in its final products and outsourced to another manufacturer increases by 5% every year. The company has the capability to make those parts in-house using its own workers. After weighing the positives and negatives of in-house manufacturing, the company finds it can make the parts more cheaply than the outside supplier.

Instead of blindly increasing the budget by a certain percentage and masking the cost increase, the company can identify a situation in which it can decide to make the part itself or buy the part from the external supplier for its end products. Traditional budgeting may not allow cost drivers within departments to be identified. Zero-based budgeting is a more granular process that aims to identify and justify expenditures. However, zero-based budgeting is also more involved, so the costs of the process itself must be weighed against the savings it may identify.