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Profitable Strategies #2
Zero Base Budgeting

Zero Base Budgeting was first developed by Peter Pyhrr at Texas Instruments in the United States in response to the tendency for organisations to plan and build budgets based primarily on the previous year, after having added for inflation and new initiatives.

The problem with this approach is its tendency for costs to keep increasing year on year, for example with one-off increases for particular purposes becoming forgotten about once no longer essential. The bigger the organisation, the more likely the problem, with more people involved in budgets and central management further from the coal face of the organisation.

A common corporate response is for annual - almost arbitrary - 'chopping back' exercises to reduce overheads and operational costs because of short-term business pressures. There is then a lack of proper engagement with line management resulting in poor decision-making and reduced operational accountability. With so many budgets being developed on an annual year-end calendar basis, these kinds of exercises mostly commonly happen just before Christmas…

The benefits of Zero Base Budgeting

Zero Base Budgeting (ZBB) enables an organisation to avoid losing sight of the resources that it *really* needs to deliver its objectives, through evaluating the options it has against an agreed framework. It is at its most effective when evaluating costs and expenses, such as overheads and cost centres.

Costs can be reduced and profitability improved, efforts and investments can be focused more effectively, and line management accountability increased.

How Zero Base Budgeting works

The core of ZBB supports each cost centre manager in evaluating the needs and effort required for their cost centre, including different ways of delivery and different levels of resource and service delivery. These are summarised through the development of Decision Packages, building on a minimum level of spending, to focus on the key choices that the organisation has.

There are essentially 5 steps in the process.

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Steps in Zero Base Budgeting

1. Set out goals & objectives for the organisation and each cost centre	2.Clarify the 'BAU' levels of cost and effort to run the business for each cost centre	3. Identify options for different ways/ levels of effort to run each cost centre	4.Create Decision Packages – with resources, costs, value, outputs for each	5. Rank Decision Packages and decide which to go with (e.g. cost vs. output)

Illustrative example

Whole Organisation	**Planning Department**	**Options for Planning**	**Planning Decision Packages**	**Decision Package Rank**
Turnover: £53m Profitability: 5% New contracts: 5no. etc.	5 Planners Cost £197k 16 no. contracts 15 no. bids etc.	A) Centralise B) Merge with Estimating C) Regional structure etc.	A) 4 Planners Cost: £157k Service: Moderate B) 1 Planner Cost: £42k Service: Poor C) 7 Planners Cost: £275k Service: High	**Package A**: save £40k and put up with lower service **Package C**: High response service, but cost £78k more **Package B**: save £155k but with big service risk

1. The organisation **sets out its broad goals and objectives** for the whole organisation and for each relevant cost centre. This enables everyone to understand the context of what they are trying to achieve. It could be turnover growth, new customers, margins, cost base etc.

2. For each cost centre, develop a **clear understanding of the business as usual (BAU) levels of cost and effort** required to run the business along the same method of operation and actual costs from the previous year. The figures should be adjusted for inflation, annualising employees only partly in the costs last year, and scaling for growth etc in the business.

3. Tasking and helping cost centre managers to **identify the options** for how to run their function, both in terms of the volume and quality of output, and through different modes of operation. It can be helpful to set some challenges crafted to each one. For example: how to deliver 25-50% cost reductions; run without a function; centralise; or run the function in a completely different way.

4. The next stage is to **develop the options into Decision Packages** that outline these alternative ways to undertake an activity, outlining different levels of effort, cost and output implications. Each Decision Package increment is evaluated as to the value that it brings, and the implications on cost, resources and outputs.

5. The **Decision Packages are ranked** in terms of how essential each of them are, the balance between output and affordability, providing clarity from a zero-base of the build up of costs and resources actually required to deliver the organisations goals for the coming year.

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