

9.8: Zero-Based vs. Incremental Budgeting

Learning Objectives

- Differentiate between zero-based and incremental budgeting

Given the pressure to budget effectively, firms scrutinize the process. Ultimately, there are two common approaches for establishing an annual budget: zero-based and incremental.

Zero-based budgeting assumes that the budget is built from “zero.” That is, nothing is carried-over or assumed from previous periods. Often, there is a temptation within organizations to justify activity with “that’s what we’ve always done” or “last year, we did this.” Those justifications imply that past activity, and the associated spend, will be repeated. However, within a zero-based budget approach, past activity and spend should NOT be assumed. The budget is not based on previous budgets or past performance. Instead, each expense needs to be justified before it will be added to the official budget.

The benefit of a zero-based budget is that it forces decision-makers to scrutinize their assumptions about what has and will make their plan effective, prioritizing specific activities. For instance, consider a retailer that runs an annual back-to-school promotion, including granola bars, toaster pastries, and fruit snacks. Let’s assume that they invest \$45,000 to advertise the sale, not including product discounts:

- Granola Bars
 - Sales revenue: \$258,691.23
 - Gross margin: \$ 63,638.04
 - Gross margin percent: 6%
- Toaster Pastries
 - Sales revenue: \$103,724.51
 - Gross margin: \$ 20,774.90
 - Gross margin percent: 0%
- Fruit Snacks
 - Sales revenue: \$ 97,319.61
 - Gross margin: \$ 32,115.47
 - Gross margin percent: 0%

Let’s assume this was a successful promotion—it did generate \$116,528.41 in gross margin (\$63,638.04 + \$20,774.90 + \$32,115.47), not including other items that shoppers may have added to their carts during the trip.

But, how might the investment change the next year, using a zero-based budget assumption? Think about the \$45,000 advertising expense. Shouldn’t that be applied across each segment (granola bars, toaster pastries, and fruit snacks)? Do you start to feel differently about any of the product segments, knowing that \$15,000 in advertising costs will need to be subtracted from their gross margin?

Said another way, would you still argue to invest \$15,000 to advertise toaster pastries if you’ll only generate \$20,774.90? As it stands, you have \$5,774.90 (\$20,774.90 – \$15,000.00) to pay against other operating expenses, after allocating \$15,000 in advertising costs. Would you be eager to defend that to your boss? With a zero-based budgeting approach, you’d need to defend the activity and spend, if you wanted to include it in the budget. That might be a tough task, indeed.

Incremental budgeting uses previous budgets and actual performance as a baseline from which to build forward-looking budgets. Each line item, meaning each planned expense, is adjusted to reflect expected competitive activity, economic factors, consumer trends, and other applicable issues that potentially affect performance. Thus, incremental budgeting takes into consideration the changing competitive landscape and the organization’s needs.

In this approach, decision-makers make adjustments to year over year (YOY) budgets, meaning compared to the last year, to reflect anticipated changes to the business environment. In the example used above, the manager might reflect the cost of advertising as \$50,000, believing that media rates will increase in the coming year. Or, they may increase the expected sales revenue for each of the product segments, having seen positive trends for each throughout the year. These small changes are built into an overall budget that provides a comprehensive view of all activity and associated costs.

The benefit of incremental budgeting is that it challenges decision-makers to go in-depth to analyze planned activity and associated expenses. Further, it encourages those same managers to consider what trade-offs they'd make within their budget to prioritize certain activities over others. If leaders have determined that the total budget will not increase by more than 4% YOY, then a manager with an estimated budget of +7% will be expected to update their plan, prioritizing the plans that best assures they meet their annual goals, while reducing exposure on others to meet the +4% target. This is particularly effective when multiple decision-makers are competing for a limited supply of dollars to invest. Simply, leadership will challenge the managers to identify the best opportunities for growth, ultimately allocating funding for them while managing the budget to its target.

? Practice Questions

<https://assessments.lumenlearning.co...sessments/9243>

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