



UNIT 13: MANAGING FINANCIAL PRINCIPLES AND TECHNIQUES

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- LO 4 : Be able to recommend cost reduction and management processes for an organisation.

THE BASIC SYLLABUS

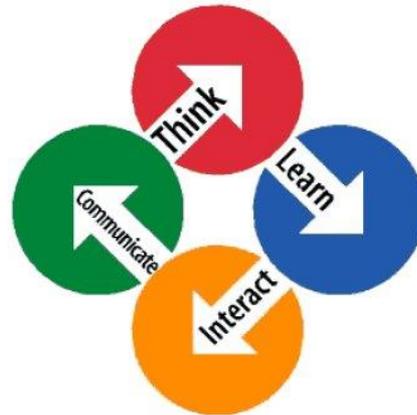


- 1. Be able to apply cost concepts to the decision making process.
- 2. Be able to apply forecasting techniques to obtain information for decision making.
- 3. Be able to participate in the budgetary process of an organisation.
- 4. Be able to recommend cost reduction and management processes for an organisation.
- 5. Be able to use financial appraisal techniques to make strategic investment decisions for an organisation.
- 6. Be able to interpret financial statements for planning and decision making.

LEARNING OBJECTIVES



- Be able to participate in the budgetary process of an organisation



- At the end of the class the students should be able to:-
- Be able to recommend cost reduction and management processes for an organisation.

OVERVIEW



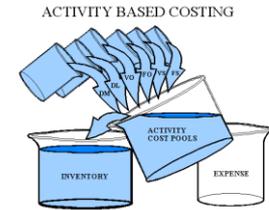
- An approach to the costing and monitoring of activities which involves tracing resource consumption and costing final outputs. Resources are assigned to activities, and activities to cost objects based on consumption estimates. The latter utilise cost drivers to attach activity costs to outputs.'
- CIMA Official Terminology, 2005

Development of activity based costing



- ABC uses cost drivers to assign the costs of resources to activities and unit cost as a way of measuring an output.
- There are four steps to implementing ABC.
- 1. Identify activities
- The organisation needs to undertake an in-depth analysis of the operating processes of each responsibility centre. Each process might consist of one or more activities required to produce an output.
- 2. Assign resource costs to activities
- This involves tracing costs to cost objects to determine why the cost occurred.

Development of activity based costing



- This involves tracing costs to cost objects to determine why the cost occurred. Costs can be categorised in three ways:
 - i. Direct – costs that can be traced directly to one output. For example, the wood and paint that it takes to make a chair.
 - ii. Indirect – costs that cannot be allocated to an individual output, that is, they benefit two or more outputs, but not all outputs. For example, maintenance costs or storage costs.

Development of activity based costing



- iii. General/administration – costs that cannot be associated with any product or service. These costs are likely to remain unchanged, whatever output is produced. For example, salaries of administration staff, security costs or depreciation.
- 3. Identify outputs
 - Identify all of the output for which an activity segment performs activities and consumes resources. Outputs might be products, services or customers.
- 4. Assign activity costs to outputs
 - This is done using activity drivers. Activity drivers assign activity costs to outputs (cost objects) based on the consumption or demand for activities.

Use in calculating cost and pricing policy



- The fundamental advantage of using an ABC system is to more precisely determine how overhead is used. Once you have an ABC system, you can obtain better information about the following issues:
 - ■ Activity costs. ABC is designed to track the cost of activities, so you can use it to see if activity costs are in line with industry standards. If not, ABC is an excellent feedback tool for measuring the ongoing cost of specific services as management focuses on cost reduction.
 - ■ Customer profitability. Though most of the costs incurred for individual customers are simply product costs, there is also an overhead component, such as unusually high customer service levels, product return handling, and cooperative marketing agreements. An ABC system can sort through these additional overhead costs and help you determine which customers are actually earning you a reasonable profit. This analysis may result in some unprofitable customers being turned away, or more emphasis being placed on those customers who are earning the company its largest profits.

Use in calculating cost and pricing policy



- Distribution cost. The typical company uses a variety of distribution channels to sell its products, such as retail, Internet, distributors, and mail order catalogs. Most of the structural cost of maintaining a distribution channel is overhead, so if you can make a reasonable determination of which distribution channels are using overhead, you can make decisions to alter how distribution channels are used, or even to drop unprofitable channels.
- - Make or buy. ABC provides a comprehensive view of every cost associated with the in-house manufacture of a product, so that you can see precisely which costs will be eliminated if an item is outsourced, versus which costs will remain.
 - Margins. With proper overhead allocation from an ABC system, you can determine the margins of various products, product lines, and entire subsidiaries. This can be quite useful for determining where to position company resources to earn the largest margins

Use in calculating cost and pricing policy



- Minimum price. Product pricing is really based on the price that the market will bear, but the marketing manager should know what the cost of the product is, in order to avoid selling a product that will lose a company money on every sale. ABC is very good for determining which overhead costs should be included in this minimum cost, depending upon the circumstances under which products are being sold.
- ■ Production facility cost. It is usually quite easy to segregate overhead costs at the plant-wide level, so you can compare the costs of production between different facilities.

Use in calculating cost and pricing policy



- Clearly, there are many valuable uses for the information provided by an ABC system. However, this information will only be available if you design the system to provide the specific set of data needed for each decision. If you install a generic ABC system and then use it for the above decisions, you may find that it does not provide the information that you need. Ultimately, the design of the system is determined by a cost-benefit analysis of which decisions you want it to assist with, and whether the cost of the system is worth the benefit of the resulting information.

Use in calculating cost and pricing policy



- Lets take a simple example of a purchasing department with 3 expense lines and 3 activities.
- 1. Activities:
 - Process Purchase Orders
 - Review Inventory
 - Evaluate Vendors
- 2. Actual Expenses of \$150,000
 - Wages \$100,000
 - Computer \$ 30,000
 - Travel \$ 20,000
- 3. Assign Expenses to each Activity and 4. Total Expenses for each activity

Total	Wage	Computer	Travel	Total
\$150,000	\$100,000	\$30,000	\$20,000	\$150,000
Process PO	\$80,000	24,000		\$104,000
Review Inventory	\$10,000	6,000		\$ 16,000
Evaluate Vendors	\$10,000		\$20,000	\$30,000

Use in calculating cost and pricing policy



- 5. Survey or estimate how many units
 - Process Purchase Orders: 1,000
 - Review Inventory 50 done weekly
 - Evaluate Vendors 10 vendors
- 6. Calculate Unit Cost
 - Process Purchase Orders: $\$104,000 / 1,000 = \$104/\text{purchase order}$
 - Review Inventory $\$ 16,000 / 50 = \$320/\text{weekly review}$
 - Evaluate Vendors $\$ 30,000 / 10 = \$3,000 \text{ per vendor}$

ACTIVITY BASED BUDGETING



- Activity based budgeting is one approach to budgeting that relies on cost drivers and is closely related to activity based costing. ABB is defined as: 'a method of budgeting based on an activity framework and utilising cost driver data in the budget-setting and variance feedback processes'. Or, put more simply, preparing budgets using overhead costs from activity based costing methodology.

ACTIVITY BASED BUDGETING



- Advantages
- The advantages of ABB are similar to those provided by activity-based costing (ABC).
- •It draws attention to the costs of 'overhead activities' which can be a large proportion of total operating costs.
- •It recognises that it is activities which drive costs. If we can control the causes (drivers) of costs, then costs should be better managed and understood.
- •ABB can provide useful information in a total quality management (TQM) environment, by relating the cost of an activity to the level of service provided.

ACTIVITY BASED BUDGETING



- Disadvantages of ABB
 - A considerable amount of time and effort might be needed to establish the key activities and their cost drivers.
 - It may be difficult to identify clear individual responsibilities for activities.
 - It could be argued that in the short-term many overhead costs are not controllable and do not vary directly with changes in the volume of activity for the cost driver. The only cost variances to report would be fixed overhead expenditure variances for each activity.
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ACTIVITY BASED BUDGETING



- A stores department has two main activities, receiving deliveries of raw materials from suppliers into stores and issuing raw materials to production departments. Two major cost drivers, the number of deliveries of raw materials and the number of production runs, have been identified. Although the majority of the costs of the department can be attributed to the activities, there is a small balance, termed 'department running costs', which includes general administration costs, part of the department manager's salary and so on.
- Based on activity levels expected in the next control period, the following cost driver volumes have been budgeted.
- 250 deliveries of raw materials
- 120 production runs
- On the basis of budgeted departmental costs and the cost analysis, the following budget has been drawn up for the next control period.

ACTIVITY BASED BUDGETING



	<i>Total</i>	<i>Costs attributable to receiving deliveries</i>	<i>Costs attributable to issuing materials</i>	Dept running costs
Cost	\$'000	\$'000	\$'000	\$'000
Salaries – management	25	8	12	5
Salaries – store workers	27	13	12	2
Salaries – administration	15	4	5	6
Consumables	11	3	5	3
Information technology costs	14	5	8	1

ACTIVITY BASED BUDGETING



	<i>Total</i>	<i>Costs attributable to receiving deliveries</i>	<i>Costs attributable to issuing materials</i>	Dept running costs
Cost	\$'000	\$'000	\$'000	\$'000
Other costs	19	10	6	3
TOTAL	<u>111</u>	<u>43</u>	<u>48</u>	<u>20</u>
Activity volumes		250	120	
Cost per unit of cost driver		\$172	\$400	\$20,000

ACTIVITY BASED BUDGETING



- Points to note
- (a) The apportionment of cost will be subjective to a certain extent. The objective of the exercise is that the resource has to be justified as supporting one or more of the activities. Costs cannot be hidden.
- (b) The cost driver rates of \$172 and \$400 can be used to calculate product costs using ABC.
- (c) Identifying activities and their costs helps to focus attention on those activities which add value and
- those that do not.
- (d) The budget has highlighted the cost of the two activities.

REVIEW QUESTIONS



- The Gadget Co produces three products, A, B and C, all made from the same material. Until now, it has used traditional absorption costing to allocate overheads to its products. The company is now considering an activity based costing system in the hope that it will improve profitability.
- The cost per unit under absorption costing is:-

Products	A	B	C
Full cost per unit	\$6.71	\$10.07	\$13.42

The cost per unit under activity Based costing is:-

Products	A	B	C
Full cost per unit	\$7.76	\$10.17	\$12.48

REVIEW QUESTIONS



- Required:
- Explain how activity based costing may help The Gadget Co improve the profitability of each product.

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