



# 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

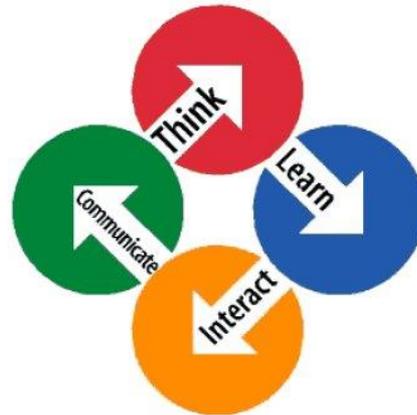


- 1. Be able to apply cost concepts to the decision making process.
- 2. Be able to apply forecasting techniques to obtain information for decision making.
- 3. Be able to participate in the budgetary process of an organisation.
- 4. Be able to recommend cost reduction and management processes for an 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



- When there's a slump in the economy, businesses become highly concerned with cost reduction and seek the fastest way to cut costs. More astute businesses review costs on an ongoing basis regardless of the economy, focusing on key saving opportunities.

# PURPOSE COMPARED WITH COST CONTROL (STANDARD COSTING AND BUDGETARY CONTROL)



- Budgetary Control is the process of establishment of budgets relating to various activities and comparing the budgeted figures with the actual performance for arriving at deviations, if any. Accordingly, there cannot be budgetary control without budgets. Budgetary Control is a system which uses budgets as a means of planning and controlling.
- According to I.C.M.A. England Budgetary control is defined by Terminology as the establishment of budgets relating to the responsibilities of executives to the requirements of a policy and the continuous comparison of actual with the budgeted results, either to secure by individual actions the objectives of that policy or to provide a basis for its revision.
- Brown and Howard defines budgetary control is "a system of controlling costs which includes the preparation of budgets, co-ordinating the department and establishing responsibilities, comparing actual performance with the budgeted and acting upon results to achieve maximum profitability."

# PURPOSE COMPARED WITH COST CONTROL (STANDARD COSTING AND BUDGETARY CONTROL)



- Scope and Techniques of Standard Costing and Budgetary Control
- **Scope:**
  - (1) Budgets are prepared for different functions of business such as production, sales etc. Actual results are compared with the budgets and control is exercised.
  - Standards on the other hand are complied by classifying, recording and allocation of the expenses to cost units. Actual costs are compared with standard costs.
  - (2) Budgets have a wide range of coverage of the entire organization. Each operation or process is divided into number of elements and standards are set for each such element.
  - (3) Budgetary control is concerned with origin of expenditure at functional levels.
  - Standard costing is concerned with the requirements of each element of cost.
  - (4) Budget is a projection of financial accounts whereas standard costing projects the cost accounts.

# PURPOSE COMPARED WITH COST CONTROL (STANDARD COSTING AND BUDGETARY CONTROL)



- *Technique:*
- (1) Budgetary control is exercised by putting budgets and actuals side by side.
- Variances are not normally revealed in the accounts.
- Standard costing variances are revealed through accounts.
- (2) Budgetary control system can be operated in parts. For example, Advertisement Budgets, Research and Development Budgets, etc. Standard costing is not put into operation in parts.
- (3) Budgetary control of expenses is broad in nature whereas standard costing system is a far more technically improved system by means of which the variances are analysed in detail.

# VALUE ANALYSIS AND VALUE ENGINEERING



- CIMA Official Terminology: Value Analysis is “systematic inter-disciplinary examination of factors affecting the cost of a product or service, in order to devise means of achieving the specified purpose most economically at the required standard of quality and reliability”.
- So, the value and quality of a product must be kept the same, or improved, at a reduced cost.
- Value Engineering is the application of value analysis to new products.

# VALUE ANALYSIS AND VALUE ENGINEERING



- CIMA Official Terminology: Value engineering is “Redesign of an activity, product or service so that value to the customer is enhanced while costs are reduced (or at least increased by less than the resulting price increase)”.
- Value engineering relates closely to target costing as it is cost avoidance or cost reduction before production. Value analysis is cost avoidance or cost reduction of a product already in production; both adopt the same approach (details below) i.e. a complete audit of the product.

# VALUE ANALYSIS AND VALUE ENGINEERING



- Undertaking a value analysis exercise
- Such an exercise might involve a series of questions, including:
  - 1. Can a different (cheaper) material be used that is better than the material currently used?
  - 2. Can a different grade of labour complete the manual tasks?
  - 3. Can the use of material components be standardised to facilitate longer production runs if manufactured internally, or gain benefits from bulk buying if purchased
- It is perhaps worth taking a few lines to develop the word “value”. Four aspects of value can be considered:

# VALUE ANALYSIS AND VALUE ENGINEERING



- Cost Value – is the cost of manufacturing and selling an item
- 1. Exchange Value – is the price a customer is prepared to pay for the product, or service
- 2. Use Value – is the purpose the product fulfils
- 3. Esteem Value – is the prestige a customer attaches to the product.
- Example: If a customer simply requires something upon which to sit, s/he would not be willing to pay for a reclining leather chair as s/he simply requires the use value.

# VALUE ANALYSIS AND VALUE ENGINEERING



- On the other hand a second customer would be prepared to pay a premium price for a luxury item, they are prepared to pay for the esteem value.
- Cost reduction does not happen by accident, it results from a systematic approach when introducing a
- value analysis study. Usually a company establishes a value analysis team who may adopt the following
- processes:
- Step 1
- Selecting a product or service for study.

# VALUE ANALYSIS AND VALUE ENGINEERING



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- Step 2 Obtaining and recording information.
- Step 3 Analysing the information and evaluating the product.
- Step 4 Considering alternatives.
- Step 5 Selecting of the least cost alternative.
- Step 6 Recommendation.
- Step 7 Implementation and follow-up.

Source: BPP Study Text, P2

# VALUE ANALYSIS AND VALUE ENGINEERING



- In conclusion, value analysis is not an exact science, and there is no one approach that fits all situations.
- Companies operate in a dynamic environment and need to be able to accommodate the emergence of new products, new competitors, and changing economic circumstances. Value analysis is simply one of the many tools available to companies when balancing costs, price and profit.

# DIFFICULTIES WITH INTRODUCING COST REDUCTION PROGRAMMES



- Cost reduction can be generally defined as the act of cutting costs to improve profitability. A cost reduction, which is a "hard" cost saving, usually takes the form of a tangible year-over-year bottom-line cost reduction such as:
  - the direct reduction of a capital or operating expense, such as a decrease in the annual lease payments, a reduction in the telecommunications cost, or a reduced annual IT maintenance fee
  - a process improvement that results in real and measurable cost reductions, such as a process improvement that allows more units to be produced on the line in the same time-frame (productivity improvement) and/or with the same amount of raw material inputs (waste reduction)
  - a net reduction in prices paid for the raw materials procured when compared to prices paid in the previous year

# DIFFICULTIES WITH INTRODUCING COST REDUCTION PROGRAMMES



- Once you've identify those areas that are hemorrhaging cash, you reduce the costs by identifying cost reduction strategies and change management plans to implement those strategies. The following strategies are often good starting points:
  - Labor (talent management and contingent workforce management)
  - Parts (strategic sourcing, design for supply, and enterprise cost management)
  - Operations (manufacturing intelligence, best practice implementation, supplier management)
  - Transportation (distribution network re-design, shipment consolidation, multi-mode utilization)
  - Buying (spend analysis, strategic sourcing, decision optimization)
  - Selling (market intelligence, partnerships, green and sustainable, brand building)

# QUALITY AND VALUE



- Prudent and efficient value analysis produces cost reduction as one of the main benefits to any institution. However, the institution has to make cost reduction activities one of their primary goals usually embedded in value analysis. Activities normally involves the generation of ideas and follow through processes from initiation to implementation employing the right cost reduction strategies. To achieve your goals, practical effective project management processes must be used as well. Use the right resources, individual or company with the right practical background and experience. Benefits of cost reduction without sacrificing function and quality.

# TOTAL QUALITY MANAGEMENT



- Total quality management was a very powerful process in its day for dealing with inefficiency - particularly the cost of errors and waste. In the mid-1980s a veritable army of consultants swept through organisations to rid them of error-prone processes. A central idea was that of 'zero defect', as exemplified in this story told at the time:
- Some Western buyers visited a Japanese shoe factory. Much impressed, they asked for a million pairs of shoes - with no more than five defective pairs.
- The first box duly arrived; there were five pairs of defective shoes. The buyers rang to complain. They were told: 'Well, you ordered a million pairs and no more than five defects. So we shipped you the defects. We don't actually do defects.'

# TOTAL QUALITY MANAGEMENT



- TQM was originally a Japanese philosophy brought to the West by W Edwards Deming. When the flood of consultants retreated (everyone had been TQMed), another influx came in through TQM reborn - or Six Sigma. This again focused on zero defect but was more institutionalised; people were almost regarded as 'initiates' and graded up to 'black belt'.
- One needs to be very discerning about these corporate theories and belief systems. The significance of TQM to accountants is that it suggests that one of the key drivers of cost is the cost of quality defects; this can be up to 10 percent of the total cost structure, and some have estimated more.

# MEASURING THE COST OF QUALITY



- Many companies promote quality as the central customer value and consider it to be a critical success factor for achieving competitiveness. Any serious attempt to improve quality must take into account the costs associated with achieving quality since the objective of continuous improvement programs is not only to meet customer requirements, but also to do it at the lowest cost. This can only happen by reducing the costs needed to achieve quality, and the reduction of these costs is only possible if they are identified and measured. Therefore, measuring and reporting the cost of quality (CoQ) should be considered an important issue for managers.

# MEASURING THE COST OF QUALITY



- There is no general agreement on a single broad definition of quality costs (Machowski and Dale, 1998). However, CoQ is usually understood as the sum of conformance plus nonconformance costs, where cost of conformance is the price paid for prevention of poor quality (for example, inspection and quality appraisal) and cost of non-conformance is the cost of poor quality caused by product and service failure (for example, rework and returns). According to
- Dale and Plunkett (1995), it is now widely accepted that quality costs are: the costs incurred in the design, implementation, operation and maintenance of a quality management system, the cost of resources committed to continuous improvement, the costs of system, product and service failures, and all other necessary costs and non-value added activities required to achieve a quality product or service.

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