Management Accounting: Costing and Budgeting

Level 5: Unit 9

Lecturer: Matthew Smith-Barrett

Unit Content: (Syllabus)

Level 5: Unit 9

On successful completion of this unit a leaner will:

- Be able to analyse cost information within a business
- Be able to propose methods to reduce costs and enhance value within a business
- Be able to prepare forecasts and budgets for a business
- Be able to monitor performance against budgets within a business

Learning Outcome 2:

Level 5: Unit 9

Upon completion of this Learning Outcome, students should:

- Be able to propose methods to reduce costs and enhance value within a business

To realize the above objective the leaner should be able to:

2.1 prepare and analyse routine cost reports

2.2 use performance indicators to identify potential improvements

2.3 Suggest improvements to reduce costs, enhance value and quality

Week 6 - Assessment Criteria 2.2:

Level 5: Unit 9

Assessment Criteria 2.2:

Upon completion of this lesson, students will be able to:

- Use performance indicators to identify potential improvements

Week 5 – Use performance indicators to identify potential improvements

Level 5: Unit 9

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Recap: Prepare and analyse routine cost reports

L.O. 2:
A.C. 2.1

The most basic and routine cost reports are:

- Direct Materials Costing Report
- Direct Labour Costing Report
- Manufacturing Overhead-Variable Costing Report
- Manufacturing Overhead-Fixed Costing Report

What is Standard Costing?

Why are variances important in analysing routine costing reports?

Introduction: Using performance indicators to identify potential improvements

L.O. 2: A.C. 2.2

Management accountants focus on the ratios that apply to the running of the business. They need to understand how ratios are calculated and the key influences on ratios. This understanding can help managers when controlling the business, and when planning or making decisions about the future.

Accountancy has a lot of ratios, but if you want to use the information you need to go beyond learning how to calculate ratios.

10 Key performance Ratios for Management and Cost Accounting

L.O. 2: A.C. 2.2

Although there as several ways to measure performance, for Management and Cost Accounting, the following 10 Ratios are the most widely used:

1. Gross Profit Margin
2. Direct Material Cost per Unit
3. Direct Labour Cost per Unit
4. Fixed Overhead Cost per Unit
5. Operating Profit Margin
6. Selling and Distribution Cost per Unit
7. Administration Cost per Unit
8. Gearing ratio
9. Return on Net Assets
10. Return on Capital Employed

Gross Profit Margin

L.O. 2: A.C. 2.2

- As a management accountant, it's essential to know more than how to calculate a gross profit margin. Very often you're asked to compare scenarios, so merely identifying one as having a higher gross profit margin than another is likely to be insufficient to any explanation of differences. Explaining *why* one scenario has a higher gross profit margin than another can help managers know where to focus their efforts.

Gross Profit Margin

L.O. 2:
A.C. 2.2

Here are the formulas to find the first four key performance indicators:

1	Gross Profit Margin	=	$\frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100$
2	Direct Material Cost per unit	=	$\frac{\text{Total Material Cost}}{\text{Sales Volume}}$
3	Direct Labour Cost per unit	=	$\frac{\text{Total Labour Cost}}{\text{Sales Volume}}$
4	Fixed Overhead Cost per unit	=	$\frac{\text{Total Fixed Overhead Cost}}{\text{Sales Volume}}$

Gross Profit Margin

L.O. 2: A.C. 2.2

Gross Profit is made up of Sales Revenue less Cost of Sales. Within these are the following key elements:

Sales Revenue	=	Sales Volume	×	Price per unit
Less Cost of Sales (made up of)				
Direct materials	=	Sales Volume	×	Price per unit
Direct labour	=	Sales Volume	×	Direct labour cost per unit
Production fixed overhead				
Equals: Gross Profit				

Gross Profit Margin: the dominant factor

L.O. 2: A.C. 2.2

The *dominant factor* means the element within the gross profit margin that has had the greatest influence over the value of the margin.

In comparing two or more models of operations or proposed product sales for a company, one model may have three or more factors that outweigh the other gross profit elements of another proposal. However, the 1 factor that proposal 2 may have, may be the factor that allows it to yield the higher gross profit. This factor would be the dominant factor and the only factor of true relevance in determining which scenario to chose.

Operating Profit Margin

L.O. 2: A.C. 2.2

As the Management or Cost accountant you need to know the ins and outs that influence the net profit margin of any organization, just as much as you need to understand the gross profit margin.

Gearing (Ratio)

L.O. 2:
A.C. 2.2

This ratio is widely used by accountants. Financial accountants look at historic gearing values; corporate finance accountants look at the structure of companies. Management accountants look at the same fundamental formula, but typically look at business or even activities within a business rather than necessarily the company as a whole.

The Standard Formula is:

8	Gearing	=	$\frac{\text{Debt}}{\text{Debt + Equity}} \times 100$

Gearing (Ratio)

L.O. 2:
A.C. 2.2

Debt and Equity: (Definition)

Word	Definition	Clarification
Debt	Borrowed money used within the business or the specific activity being analysed.	Include all borrowed money. This includes long-term borrowing, short-term loads and overdrafts. (Don't include accounts payable to suppliers of goods and services used as part of the business's trading activity.
Equity	Shareholders' funds made up of all the share capital plus any reserves.	Include all ordinary share capital, all the reserves and, in those companies with non-controlling interests, these are included as well.

Return on Assets and Capital Employed

L.O. 2: A.C. 2.2

This ratio is used to judge pretty much the same thing using both formulas (formulae) although the values used are different. Both calculations use the operating profit, in the return on net assets (RONA) this is divided by the net assets of the business. The return on capital employed (ROCE) is found by dividing the operating profit by the total capital employed, the same value we used to find the gearing ratio.

Formulas:

9	Return on Net Assets	=	$\frac{\text{Operating Profit}}{\text{Net Assets}} \times 100$
10	Return on Capital Employed	=	$\frac{\text{Operating Profit}}{\text{Total Assets} - \text{Accounts Payable and other creditors}} \times 100$

Conclusion: Performance Indicators

L.O. 2: A.C. 2.1

The ten performance indicators highlighted here are all relevant specifically to management accountants. They might not all meet the strict dictionary definition a of ratio, and none are expressed as x:1, but they're incredibly important in managing a business effectively. Managers who learn about these ratios from their management accountants have the opportunity to use them to ensure the business runs profitably and is able to continue. Without them, managers are directing their business almost blindfolded.

Reference List

L.O. 2: A.C. 2.1

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