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 7 - Assessment Criteria 2.3:

Level 5: Unit 9

Assessment Criteria 2.3:

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

Suggest improvements to reduce costs, enhance value and quality

Week 7 – Suggest improvements to reduce costs, enhance value and quality

Level 5: Unit 9

Management Accounting: Costing and Budgeting

Lecturer: Matthew Smith-Barrett

Recap: Using performance indicators to identify potential improvements

L.O. 2: A.C. 2.2

10 Key performance Ratios for Management and Cost Accounting:

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

Introduction: Quality

L.O. 2: A.C. 2.3

Such is the importance that their customers place on quality that businesses are forced to make sure that their output is of a high quality. In the competitive environment in which most businesses operate, a failure to deliver quality will lead to customers going to another supplier.

Businesses, therefore, need to establish procedures that promote the quality of their output, either by preventing quality problems in the first place or by dealing with them when they occur.

Quality Costs

L.O. 2: A.C. 2.3

It has been estimated that these **quality costs** can amount to up to 30 per cent of total processing costs. These costs tend to be incurred during the *production phase* of the product life cycle. They have been seen as falling into four main categories:

1. *Prevention costs*. These are involved with procedures to try to prevent items being produced

- that are not up to the required quality. Such procedures might include staff
- training on quality issues. Some types of prevention costs might be incurred during
- the *pre-production phase* of the product life cycle, where the production process could
- be designed in such a way as to avoid potential quality problems with the output.

2. *Appraisal costs*. These are concerned with monitoring raw materials, work in progress

- and finished products to try to avoid substandard products from reaching the customer.

Quality Costs

L.O. 2: A.C. 2.3

3. *Internal failure costs*. These include the costs of rectifying substandard products

- before they pass to the customer and the costs of scrap arising from quality failures.

4. *External failure costs*. These are involved with rectifying quality problems with products

- that have passed to the customer. There is also the cost to the business of its loss
- of reputation from having passed substandard products to the customer.

Quality Costs

L.O. 2:
A.C. 2.3

Figure 5.4 The elements of quality costs

Quality costs fall into four distinct categories. The first two are mainly concerned with avoiding substandard production and the last two with dealing with it should it arise.

Value

L.O. 2: A.C. 2.3

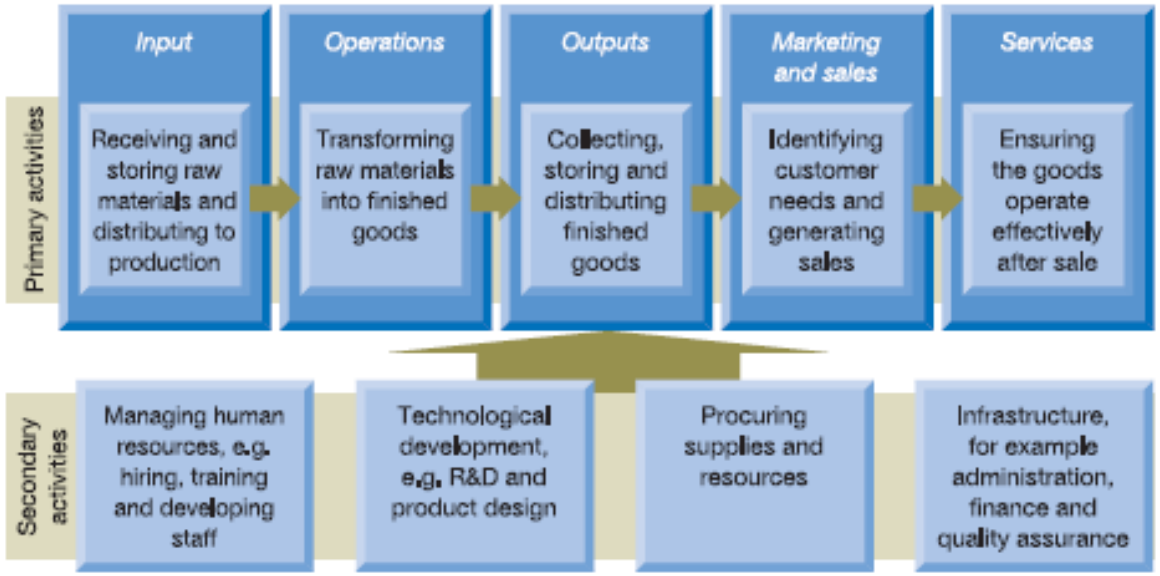
To secure competitive advantage, a business must be able to perform key activities more successfully than its competitors. This means that it must either obtain some cost advantage over its competitors, or differentiate itself in some way from them. To help identify particular ways in which competitive advantage may be achieved, it is useful to analyse a business into a sequence of value-creating activities. This sequence is known as the value chain, and **value chain analysis** examines the potential for each link in the chain to add value.

Value Chain

L.O. 2: A.C. 2.3

- Figure below sets out the main 'links' in the value chain for a manufacturing business.

Figure 9.5 The main links in the value chain of a manufacturing business



The five primary activities which form the links in the value chain, are underpinned by four support activities.

Source: Adapted from Porter, M., *Competitive Advantage*, The Free Press, 1985, pp. 11–15.

Value Chain

L.O. 2: A.C. 2.3

Value chain analysis applies as much to service-providing businesses as it does to manufacturers. Service providers similarly have a sequence of activities leading to provision of the service to their customers. Analysing these activities in an attempt to identify and eliminate non-value-added activities is very important.

Each link in the value chain represents an activity that will incur costs and affect profits. Ideally, each will add value – that is, the customer will be prepared to pay more for the activity than it costs to carry out. If, however, a business is to outperform its rivals, it must ensure that the value chain is configured in such a way that it leads either to a cost advantage or to differentiation.

Total Quality Management (TQM)

L.O. 2: A.C. 2.3

Definition:

Total quality management is a managerial accounting concept where an organization strives to produce higher quality products with few defects being shipped to customers. Total quality management is a lean business practice often associated with continuous improvement and just-in-time inventory and just-in-time manufacturing.

Total Quality Management (TQM)

L.O. 2: A.C. 2.3

The TQM concept goes beyond even producing products since it implies improving the complete organization. Waste in any area of the business is identified even in general and administrative costs. Since customer service is a large part of every modern business, customer service quality standards are also looked at for improvement.

Developing Quality-based performance measures

L.O. 2: A.C. 2.3

- Four such measures are:
  - quality control,
  - delivery performance,
  - materials waste, and
  - machine downtime.

- Managers can use benchmarking to focus attention on measuring how well one is doing against levels of performance that may be found either inside or outside of the organization.

Conclusion: Quality and Value

L.O. 2: A.C. 2.3

Although not the sole function of the management accountant, the management accountant plays an integral role in the realization of quality of output and the increasing of a businesses value.

This is so achieved through identifying the areas of profitability for the company and also the areas with which improvements can be made to reduce wastage and costs.

Reference List

L.O. 2: A.C. 2.1

- Methods, C. (2015). *Cost Estimation and Cost Measurement Methods or Techniques*. [online] Transtutors.com. Available at: http://www.transtutors.com/homework-help/accounting/decision-making-cost-measurement-methods/ [Accessed 8 Sep. 2015].
- Available at: http://kfknowledgebank.kaplan.co.uk/KFKB/Wiki Pages/Marginal and absorption costing.aspx#Marginal_x0020_costing [Accessed 8 Sep. 2015].
- Joyce, John. MANAGEMENT ACCOUNTING – PERFORMANCE EVALUATION. 1st ed. CIMA, 2015. Print.
- Value Adder, Business Value – Definition; http://www.valuadder.com/glossary/business-value-definition.html
- Porter, M., *Competitive Advantage*, The Free Press, 1985, pp. 11–15.