Budgeting and Cost Control – Traditional versus Modern Approaches

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16 March 2016

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Contents

Traditional versus Modern

Modern approaches to costing, budgeting and control:

- Less focus on number-crunching and ‘the pack’
- Less focus on ‘blind’ cost reduction
- Less focus on the past
- Less focus on internal results and outcomes
- Less of an operational activity

- More focus on ‘competitive advantage’
- More focus on long-term sustainability and business STRATEGY
- More focus on non-financial KPIs
- More focus on ‘relevance’ instead of ‘rules’
- More of a strategic activity

Traditional Costing

Mark-up	£
STEP 1: Cost	100
STEP 2: Profit	20
STEP 3: Selling price	120

Calculating a product cost

Absorption Costing Cost Card	
Direct materials (2kg @ £7.50 per kg)	£15
Direct labour (3 hrs @ £10 per hr)	£30
Direct expenses (£30 for machine hire)	£30
PRIME COST	£75
Production overhead cost (3 hrs @ £5 per hr)	£15
Non-production overhead cost (% of advertising spend per unit)	£10
FULL COST	£100
Mark up	20%
PRICE	£120

Traditional Costing

Problems with Traditional costing

- Focus on the past - costs become out of date quickly
- “Random” basis for apportioning costs
- Singular basis for apportioning costs
- Volume (hours, units) may not be the driver of costs at all
- Ignores external factors – how will “the cost” be received by the market

Relevant costing

Relevant costs

- Future
- Incremental
- Cash flows

Example

Materials Ltd is currently considering a job that requires 1,000 kg of raw material. What is the relevant cost in each of the following alternative situations?

(a) The material is used regularly within the firm for various products. The present inventory is 10,000 kg purchased at $1.80 per kg. The current purchase price is $2.00 per kg.

(b) The company has 500 kg in inventory, bought two years ago for $1.50 per kg, but no longer used for any of the firms' products. The current market price for the material is $2.00, but the company could sell it for 80c per kg.

(c) The company has 1,500 kg in stock. This material is not currently available to buy and if not used on this job it would be used in the manufacture of Zed's. Each Zed generates $8 contribution for the company and uses 2 kg of this material.

Example

Labour Ltd is currently considering a job that requires 100 hours of labour. What is the relevant cost in each of the following alternative situations?

(a) There is 300 hours' worth of spare labour capacity. There is a union agreement that staff cannot be laid-off. The workers are paid $6.50 per hour.

(b) The company has no surplus capacity at the moment, but additional temporary staff could be hired at $4.50 per hour.

(c) Staff are working at full capacity and will have to be taken off production of a different product in order to undertake this job. The details of the other product are shown below:

	$/unit
Selling price	60
Direct material	10
Direct labour – 1 hour	12

Traditional Control – Ratios

Profitability

- Gross margin %
- Operating profit margin %
- Net profit margin %
- Asset turnover
- Return on capital employed %

Traditional Control – Ratios

Return on capital employed % (ROCE)

$$\frac{\text{Profit before interest and tax}}{\text{Equity and long term debt}} = \%$$

Traditional Control - Ratios

Disadvantages

- Easily manipulated
- Discourages investment
- Ignores required return
- Short-termism

Modern Control - Ratios

EVA ©

- Devised by Stern Stewart
- Adjust for items which add economic value but accounting standards disallow

Economic Value Added (EVA) ©

Conflict between reported figures and true performance

- Training
- Marketing
- R&D
- Salaries
- Depreciation

Questions

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