Importance of cost reduction and control

ASSIGN BUSTER

Assignment on financial principles and techniques

Introduction

Strategic investment decision making indicates the process of identifying, evaluating, and selecting among projects which are more likely to have significant effect on the organization's competitive advantage. More clearly, the decision influences what the organization does (i. e., the set of product and service attributes that are offerings of the organization), where it does it (i. e., the structural characteristics that determine the scope and geographical dispersion of organization's operations), and how it does it (i. e., the set of operating processes and work practice). The strategic investment decision making process is arguably one of senior management greatest challenges. It is significantly needed to get these decisions right. If the decision is successful, the firm can enjoy strategic as well as operational advantage. But while the decision proves wrong, either a potential opportunity is lost or it has needlessly spoiled substantial resources (through fruitless investment). Some traditional approaches to strategic investment appraisals – which include payback, accounting rate of return, return on investment, residual income, and discounted cash flow – have been criticized on the basis of a number of grounds. Some main criticisms are their narrow perspective, exclusion of nonfinancial benefits, overemphasis on the short-term, faulty assumptions about the status quo, inconsistent treatment of inflation, and promotion of non-value adding behavior.

Task 1

Cost Reduction Techniques.

Cost reduction means reducing cost associated with production or other cost activities without affecting the quality of product or service as well as

activities. Through cost reduction procedures or techniques managers reduce cost. For this they develop different cost reduction techniques. The success of any organization largely depends on how strategically cost is managed compared with that of competitors. It certainly provides competitive advantage which is essential in this hyper competitive market or business world. As the manager is the higher authority of any organization, they are to develop different types of policies and strategies to run the business successfully.

Processes of Cost Reduction:

- Identify the Saving
- Make your prediction on saving
- Measure the process prior to adjustment
- Make the cost saving change
- Measure the process after
- Confirm saving has been made and it hasn't impacted other areas to make a loss.
- If YES move onto next project.
- If NO go back to the beginning and start again.

Appropriate Costing System:

Cost that is allocated to units of production can be actual cost or standard cost. In an actual or historical cost system, cost is allocated as they occur. Under standard costing system, product operations and process are costed through using standard for both activities and dollar amount. These standards are predetermined in advance of production. The actual cost system and standard cost system can be used with either job order or

process cost accumulation approaches. Job order costing is applied to job order work in factories, workshops and repair shops as well as to work by builders, construction engineers and printers. A variation of the job order cost method is that of costing orders by lots. In the shoe manufacturing companies for example, a contract is typically divided into lots which consists of 100 to 250 pairs of one size and style of shoe. The cost is then accumulated for each lot. On the other hand, the process cost system is applied to industries such as flour mills, breweries, chemical plants and textile factories. However there are many companies that use both job order and process costing according to their needs. The basic difference between job order costing and process costing is the breadth of the denominator. The denominator of job order costing system is small (e. g.: one painting 100 advertising circulars, one special package machine or one highway bridge). But in the case of process costing, the denominator is large (e. g.: thousands of pounds, gallons or board feet.).

Task 2

The importance of developing cost reduction techniques:

- It helps to enhance management performance or efficiency
- It helps to know the nature of cost
- It helps to reduce the cost of operations of the organization
- It helps to set competitive price of product or service
- It helps to increase market share in the industry
- It helps to increase profit or return
- It helps to enjoy competitive advantage over competitors

Proposed costing and pricing systems

Basis of Costing Methods

- Material cost
- Labor cost
- Overhead cost
- Opportunity cost

Structure of Costing

- Costing principles and methodology
- Fixed and variable cost
- Direct cost (material and labor)
- Indirect cost (overhead and activity based costing)
- Product cost and periodic cost
- Product cost and sales cost

Actual Costing

- To set actual cost
- To change to actual cost
- To analyze variance

Evaluation of Project

- Breakeven analysis
- Marginal contribution
- Opportunity cost
- Payback
- NPV, DCF, IRR
- ROI
- ROC

Project Case Pricing

- How to cost project correctly
- How to get project approve
- What cost to exclude
- Essential cost to include
- A business case proposal

Preparing a Master Budget

Master budget is a comprehensive planning document which incorporates several other individual budgets.

The operation budget consists of eight individual budgets which are as follows:

- Sales budget: The sales budget shows the expected sales in units at their expected selling price in a certain period of time. A business firm generally prepares the sales budget for a given period of time on the basis forecasted sales level, production capacity, as well as long and short term goals.
- Production Budget: Production budget is a plan for obtaining the resources needed to carry out the manufacturing operations of the organization to meet up the expected sales and maintain the expected level of ending inventory. The current production level depends on sales level, units of finished goods ending and beginning inventory.
- Direct Material Budget: The directed material budget shows the direct materials business firm needs for its production and the budgeted cost. This budget is very much related to production budget.

- Direct Labor Budget: To prepare direct labor budget and the direct materials budget, production budget is needed. It helps personnel department of the organization to plan for new hires and repositioning of employees. A good labor budget is very helpful for a business firm to avoid urgent hiring and help to prevent the shortage of labor.
- Factory Overhead Budget: This budget includes all the production costs except for direct materials and direct labor budgets. Manufacturing cost is the cost that varies in direct proportion with the manufactured units and how the business firm carries out its operation.
- Selling and administrative expenses budget: This type of budget indicates a plan for all non-manufacturing expenses. This budget provides you with a guideline for selling and administrative activities for the period of your budget.
- Budgeted income Statement: Budgeted income statement is the last part of operational of a master budget. It actually estimates the expected operating income from budgeted operations in a certain period of time.

The second part of master budget includes financial budget and financial budget is the combination of following two individual budgets:

Cash Budget: A cash budget shows the effect/impact of all the budgeted activities on cash. Through preparing a cash budget, the management of a business firm is supposed to be able to make sure that they have sufficient cash on hand needed to carry out activities. It also helps them to have enough time to plan for any additional financing and plan for investment of surplus cash.

Budgeted Balance Sheet: Budgeted balance sheet is the last part in preparing master budget. This budgeted balance sheet shows the expected financial position at the end of the fiscal year (at a point of time) or budget period.

It is very important to understand how to prepare a master budget since it helps a business to maximize its profit/return and to have a good handle on their budget period.

Potential for the Use of Activity Based Costing

- ABC system provides highly accurate product or customer cost that a company can use for strategic decision.
- This system helps to understand the cause effects relationship between day to day activities and product or customer cost and theory aids the operational control purpose of cost management system.

Task 3

Calculation of ratio

Ratio analysis of Amber Lights ltd for two years is as follows:

Last Year

a) Return on capital employed = Net Profit/Total capital

= 8000/109000

= 7. 34%

b) Return on ordinary shareholder’s fund = Net profit/ ordinary shareholder’s fund

= 8000/16000

= 50%

c) Gross profit margin = Gross profit/Net sales

= 92000/350000

= 26. 29%

d) Net profit margin = Net profit/Net sales

= 8000/350000

= 2. 29%

e) Current ratio = Current asset/current liabilities

= 110000/50000

= 2. 2: 1

f) Acid test ratio = C. A-Closing stock/ current liabilities

= 110-44/50

= 1. 32: 1

g) Average stock turnover period = Cost of sales/Average Inventory

= 258000/44000

= 5. 86 times

Period = 360/5. 86

= 61. 43 days

This Year

a) Return on capital employed = Net Profit/Total capital

= 12000/117000

= 10. 26%

b) Return on ordinary shareholder’s fund = Net profit/ ordinary shareholder’s fund

= 12000/16000

= 75%

c) Gross profit margin = Gross profit/Net sales

= 110000/420000

= 26. 19%

d) Net profit margin = Net profit/Net sales

= 12000/420000

= 2. 86%

e) Current ratio = Current asset/current liabilities

= 136000/92000

= 1. 48: 1

f) Acid test ratio = C. A-Closing stock/ current liabilities

= 136000-63000/92000

=. 79: 1

g) Average stock turnover period = Cost of sales/Average Inventory

= 310000/63000

= 4. 92 times

Period = 360/4. 92

Analysis of Operating Efficiency and Profitability

The given ratio of Amber Lights ltd. indicates two types of ratio including operating efficiency and profitability. The operating profitability ratio indicates that return on capital employed ratio of last year is 10. 26% and this year is 7. 34%, return on ordinary shareholder's fund ratio of last year is 50% and this year is 75%, gross profit margin of last year is 26. 29% and this year is 26. 19%, on the other hand, net profit margin ratio is 2. 29% and this year is 2. 86%. So we can say from the above discussion that operating profitability of two year is very close except ordinary shareholder fund. So this year performance is better than last year. We also see from the operating efficiency ratio that current ratio of last year is 2. 20: 1 and current year is 1. 48: 1, acid test ratio of last year is 1. 32: 1 and current year is . 79: 1, and average stock turn over period of last year is 61. 43 days and this year is 73. 17 days. From the given data of last year and the current year of

Amber Lights ltd we find that last year performance is better than this year. So from the given data analysis we can say that last year operating efficiency was better than that of current year.

Limitation of Ratio Analysis:

Although ratio analysis provides important implications, there are some limitations of ratio analysis. The main limitations of ratio analysis are given below:

- Accounting treatment varies between firms
- Firms with different divisions operating in different industries make it difficult to find industry ratio analysis
- Some Results may be in consistent
- Ratios which are outside an industry range might be cause of much concern.

Task 4

Financial Appraisal Methods

There are several different appraisal methods and each of those methods has its particular applications, advantages and drawbacks.

Simple Payback

This is one of the simplest and widely recognized methods of cost/benefit analysis. Payback period is defined as the length of time required to recover the original investment on the project, through cash flows. The cash flows include operating profit, less income tax payable, plus depreciation.

Internal Rate of Return

It can be said that it is the mostly used method for the financial evaluation of a company's investment. The internal rate of return (IRR) can be defined as the rate of return required to make the present value of future cash flows plus the final market value of the investment, equal to the current market price for the investment. Actually it is a discount rate making the net present value equal to zero.

Average Rate of Return

The average rate of return is calculated profit after tax divided by book value of investment. Under this method, the entire life of any project is considered.

Net Present Value

Net present value is one of the discounted cash flow techniques. This method considers time value of money. It is calculated as present value of future cash inflows over the life of the project less present value of cash outflows.

Benefit Cost Ratio

Benefit cost ratio is another version of net present approach. Under this approach, the benefits from the project are reduced to their present value at a specified rate of discount and this figure is divided by the present value of the cost of the project.

Discounted Cash Flow

This approach actually represents what a company is willing to pay at the present (today) to receive anticipated cash flow in future years. So it is a process of converting future earnings into today's money. Future cash flows

are discounted to demonstrate their present values and determine the value of the project.

These are well established and understood appraisal tools to financially evaluate projects. All appraisal methods are not supposed to provide the same result. Increasingly, with the creation of stakeholder value being determined by an organization's environmental and social policies and values, new criteria and perspectives will have to be factored into organizations' decision-making process.

Strategic Issues in Making Investment Decisions

The prime objective of every business organization is to make money for the owners now and in the future. Investment decision plays a significant role in making investment decisions.

Both quantitative as well as qualitative issues must be considered in decision making.

Short-term decisions are relatively easy on the quantitative side:

- Would you rather spend $10, 000 or $15, 000 given the same revenue?
- Would you rather sell something for $5. 00 per unit or $7. 00 per unit given the same costs?
- Would you rather have net income of $60, 000 or $50, 000?

Long-term (investment) decision involves two additional dimensions as follows:

- Timing
- Magnitude

Discounted Cash Flow Analysis addresses the timing issue.

Discounted Cash Flows (DCF Analysis)

A dollar today is worth more than a dollar in the future.

A dollar in the future is worth less than a dollar today.

Steps to DCF

To determine future cash flows

To determine the appropriate discount rate

Higher discount rate = lower present value

Lower discount rate = higher present value

High risk generally requires greater return

Higher risk = higher discount rate

Discount the future cash flows by using the selected hurdle rate

Compare the present value of the future cash flows to the investment

If PV of inflows > PV of outflows, project is acceptable

If PV of inflows < PV of outflows, project is rejected

NPV = PV of all Inflows – PV of all outflows

Tools of DCF:

PV = to compute the present value of single future amount or a set annuity using a given particular discount rate

FV = to compute the future value of a single present amount or a set annuity given a particular discount rate

Rate = to computes the particular discount rate needed to convert a present value to a future value or a future value to a present value

NPV = to computes the net present value of a series of dissimilar future cash flows given a particular discount (hurdle) rate

- If NPV > 0, the investment is acceptable
- If NPV < 0, the investment is rejected

IRR = computes the discount (hurdle) rate which makes net present value equal to zero.

- If IRR > the hurdle rate, the investment is acceptable
- If IRR < the hurdle rate, the investment is rejected

Example: Suppose, company XYZ wants to make investment decision of $ 200000 for a project. The company must justify the PV of cash inflows and compare it with the cash outflows. If the value of PV is greater than cash outflow then the company should accept the project.

Conclusion:

Cost concept is very essential for decision making process. As the manager is the higher authority of any organization, they are to develop different types of policies and strategy to run the business successfully. So development of cost reduction procedures is one of the most important strategies. It is very important to develop cost reduction procedures because it increases the profit of the firm through reducing cost of production. If the

manager cannot control cost their operating expense will be higher and higher and therefore reducing the profit of the firm. A firm which can not control cost cannot sustain in the competitive business world. So to make proper investment decisions financial managers should have clear knowledge about financial principles and techniques for better performance.