A budgetary control systems accounting essay

ASSIGN BUSTER

\n[toc title="Table of Contents"]\n

\n \t

1. CASE STUDY ANALYSIS \n \t
2. APPENDICES 1-9 \n \t
3. BUDGETARY CONTROL SYSTEMS \n \t
4. ADDITIONAL AND ALTERNATIVE APPROACHES \n \t
5. CONCLUSIONS \n \t
6. RECOMMENDATIONS \n

\n[/toc]\n \n

I have re-read my last years HNC paperwork and used my current years HND paperwork to help with the various aspects of the report. I used my HNC costing booklets and lecture notes, HND Investment Appraisal literature, HND Business Tax literature, HND Capital Allowances literature and HNC Standard Costing literature.

I went to the library and used college resources such as ebray for information of more in-depth budgeting control systems. I used Cost and Management Accounting books which covered cost assignment of direct and indirect costs. They covered issues about fixed, variable and semi variable costs. I used Accounting Theory and Practice for in-depth budgetary planning and variance analysis. I used an up to date Taxation book to allow me the most up to date tax percentages to be used, the correct Asset Investment Allowances applicable and the written down values for Capital Allowance calculations.

CASE STUDY ANALYSIS

This formal report has been requested by the Managing Director by Ergo design

He requires a full business report which will appraise the launch of a new quality ergonomic chair. As well as the appraisal, the managing director would like advice on how to set up and implement an efficient budgetary control system. Ergo Design already make a different range of products and are wanting to find out if it would feasible to undertake the making of another new product. The company currently has spare capacity and as they don't want spare capacity are looking into making a new chair. This however involves the purchase or hire of a new asset namely a new machine which will be capable of making the new product. This asset is not inexpensive and cost £125, 000. Ergo Design are guaranteed an order for 1 year amounting to 1800 chairs to be distributed evenly over the month. The factory is only open 48 weeks of the year to allow for maintenance, repairs etc and therefore leaves 12 periods of 4 weeks to evenly distribute 160 chairs per 4 weeks. The company have had a trial period and all seems to be well. The MD awaits reports before committing final sanctions.

APPENDICES 1-9

Attached as appendices is the Activity Based Costing comparison followed by the functional budgets then Capital Investment Appraisal and lastly a Break Even Analysis based on my figures.

Appendix 1. Activity Based Costing comparison. I have used Activity Based Costing (ABC) to work out the costs of producing the new product. Ergo

Design in previous years have recovered costs using a blanket wide rate based on the number of machine hours. The last two years however they have changed to ABC. I have made a comparison using traditional overhead recovery and ABC. ABC was developed in order to more accurately reflect the factors which cause overhead costs to arise. Overhead costs are attributed to products on the basis that it is activities that cause costs to arise. Each activity can be identified with a cost driver and the cost drivers I have used are machine hours, Labour hours, number of orders, production runs, set up hours and inspections. After the cost drivers have been identified then each cost driver's overheads are collected together. These collections of costs are called cost pools. Each pool is then divided by its driver, for example all overheads in the cost pool for the materials ordering process would be divided by the number of orders placed to give a value for the cost of placing an order. The costs of all activities relating to a product would be added together to give the overhead element of the cost of production. Because activity based costing shares out overheads using cost drivers compared with the traditional costing systems which use departments, then a greater number of drivers can be used, reflecting all the different activities taking place in the manufacturing process. This leads to a fairer and more accurate way of charging overheads to the products. The traditional methods ignore the detail of many of the activities that actually take place. In my findings the cost of producing the new product using ABC is £167. 95 per unit whereas the blanket method only £150. 18 is allocated for cost, This would give a higher contribution and a higher profit.

I have assumed that we are going to be charging £195 per unit and at this price we are still making a profit of £63, 975 for the first year. We can look at raising prices at the end of the initial 3 year period if the turnover is still constant.

My creditors are to allow me credit purchases payable for :

Aluminium Sheets………. 1 month Memory Foam……………. 2 months

Fabric…………………………1 month Hardware……………………3 months

My debtors are to be allowed 1 month's credit sales.

A new asset is to be purchased at a cost of £125, 000, which will gather depreciation over 10 years straight line method. The new machine will need to be replaced after this time and will have a residual value of £15, 000. Maintenance will need to be carried out regularly to allow for optimum usage and guarantee residual value. The maintenance cost will be estimated at 5% of the capital cost per annum. The asset is purchased with a long term loan for the full £125, 000. The loan will have a 3% fixed rate interest per annum. The interest is added to the original amount and not compounded yearly. This is to be repaid over 10 years with repayments and interest payments split. The total cost of the loan is £162, 500 with repayments being £62500 every 6 months and Interest being £1, 875.

There is currently spare capacity within Ergo Design's production facilities and can therefore produce 2 batches of 20 chairs per week for the full 48 weeks that the factory is open. This allows for surplus stock of (1920-1800)= 120 chairs surplus at the end of the year. We will supply 150 chairs per

month to the customer and make 160 chairs to allow for full capacity, this will leave us a surplus of 10 chairs which will be opening stock for the month of Feb and the units will 10 more units every month compounded.

The following budgets are prepared for the first six months of the new multi-level chair and include:

Appendix 2. Opening Balance at beginning of the month of Jan. This is the beginning of the month and lists the purchases made to enable the company to begin production and sell them at the end of the month.

Appendix 3. Key Variables input. As the figures were given for batches I had to break them down into single units costs so that a uniform approach was taken across the board. The direct material costs have accounted for the biggest costs followed by the labour then the variable overheads.

Appendix 4. Sales budgets- This is also the main budget which has to be prepared first. It shows that we are to sell 150 units per month at a cost of £195 creating a sales value of £29, 250.

Production budget- This budget is prepared after the sales budget and states the amount of units to be produced within the period. I have carried over excess units in case of any unforeseen circumstances which will reduce production in later months e. g. machinery breaking down and staff absences etc. The machinery is also working at full capacity if I make the amount required as well as the excess.

Direct Material usage budget is prepared next and the figures are for 1 single unit which is obtained from the key variables sheet shown in Appendix 2.

Direct material purchases budget is next with figures for the required production for each month and the cost of goods to be purchased. The cost figure is taken from the key variable appendix 2.

Direct labour budget figures come from the production budget for the amount to be produced multiplied by the cost of the direct labour unit from key variables appendix 2.

Overhead budget gives us monthly fixed overheads and depreciation figures taken from key variables in appendix 2.

Variable cost budget……. This budget takes the amount of units to be produced multiplied by the variable cost per unit. Both these figures are from the key variables sheet.

Production cost budget……This budget gives us a breakdown of how much each unit will cost to produce. It takes into consideration the material and variable costs and add the figure to the raw material costs.

Debtors budget….. We have been giving our debtors 1 month to pay after receiving their finished goods.

Creditors budget……We have 4 of these for each of the different raw materials we need. Each shows opening balances, purchases, payments and closing balances.

Appendix 5. The Cash budget shows the inflows and outflows and gives a final figure for the bank balance to go into the Balance sheet.

Appendix 6. The Operating statement lists the cost of sales when taken from sales will give us a profit. Expenses are then deducted leaving us with healthy net profit of £25, 744. 25

Appendix 7. The Balance sheet is the 6 month balance sheet ending on 30th June 2013. Our current assets are a higher amount than our current liabilities and therefore give us net current assets to be added to the fixed assets. Once the long term liabilities come off then this leaves us with a balance of £25, 844. 25

Appendix 8. Capital Investment appraisal. I have started this by working out the inflows for the first 3 years as we know the selling price and we know the change in production. After year 3, I have assumed that turnover will remain stable and have therefore carried out my Capital Allowance calculations over 10 years. I have deducted the Asset Investment allowance of £25, 000 and written down value for each year at 18%. I have assumed a residual value of the machine to be £15, 000 and added the balancing allowance figure to the capital allowances. Using the inflow figures and deducting capital allowances for each year, I was able to work out the taxable amount and tax it at this year's appropriate amount. I carried out 2 Discounted Cash Flow (DCF) methods , 1 being Net Present Value (NPV) and the other is the Internal Rate of Return (IRR). The DCF includes all cash flows and the time value of money telling you what you £1 will be worth in X years ahead. The IRR also includes the time value of money and includes all cash flows but the IRR if far more easily understood. If the net present value is zero or positive, the project is accepted, I have used 15% and 45% discount factors and they are both returning a positive number so the project should be accepted. You can think

of IRR as the rate of growth a project is expected to generate and a higher IRR value would provide a much better chance of strong growth. The rate for this project is 59. 93 so again promoting the acceptance of this project..

Appendix 9. I have put in an extra break even analysis chart for your perusal as break even charts work well with a single product. The break-even analysis is a calculation of the approximate sales volume required to just cover costs, above which production would be profitable or unprofitable break-even analysis focuses on the relationship between fixed costs, variable cost, and profit. The summary shows that the BEP in units 1058 and the margin of safety in units is 742. Costs taken into account are distinguished by variable costs which change in according to the production level.

BUDGETARY CONTROL SYSTEMS

A budget is a financial plan for an organisation prepared in advance for a given period.

Budgets can be prepared as a whole or broken down into component departments e. g. sales and production or purchases or cash or capital etc.

There can be many different types of budgets and for a variety of departments such as sales or production or financial items such as capital, expenditure, manpower, purchase etc.

The budgeting process is a vital part of a business's planning and control.

The overall objective of the company is prepared in advance and agreed with cooperation and detailed into a feasible plan of action.

It is about planning, monitoring, reviewing and amending budgets to suit management objectives.

When the long term strategies are written down everyone is starting from the same place and it will not matter if new people come and go, the long term plans will still be there.

Long term objectives after being decided need to be broken down into manageable chunks of short term objectives. A limiting factor needs to be distinguished and a budget is prepared solely for this. The most common limiting factor is sales and this needs to be as accurate as possible as all other budgets will be based on the limiting factor's budget.

Once all the budgets are prepared a master budget is drafted and given to all of the budget holders for agreement. Once any tweaks or changes are made and an agreement reached then the master budget is presented to senior management.

When the budgets need to be prepared again for the next period then actual figures are measured against budgeted figures and there are favourable and adverse variances produced showing management what areas need attention and where money is being lost, it may be efficiency problems that are highlighted for attention etc.

There is actually an 8 step plan involved in advanced preparation budgeting.

Step 1 is agreeing long term goals

Step 2 Changing long term goals to short term goals

Step 3 Identify limiting factor

Step 4 Prepare limiting factor budget

Step 5 Prepare all other budgets

Step 6 Bring all budgets together to prepare the master budget

Step 7 Agree with all budget holders

Step 8 Present to the management

There are many benefits to having financial planning and good budgetary control to name a few, by doing extensive planning there is a much clearer picture on where the business is going. It will reduce stress in the work place with all staff knowing where, when and how things are to done. Management can keep on top of things and have peace of mind. With budgeting control there is a more detailed structure of how the business is organised. With all the planning, organising and controlling it is easier for management to keep on top of changes and variances and make it easier to quickly adapt to the said changes. There is co-ordination with everyone working in the same direction. Budgets can be used to make communication and motivation more effective using them to exchange information concerning ideas, goals, achievements etc. thus giving staff a sense of togetherness and teamwork with everyone working towards the same goal.

There is however barriers with a lack of knowledge, resources or motivation making the planning extremely difficult to start. Maybe not knowing where to start or even how to start. Maybe needing to sacrifice some things for others.

Budgets are a time consuming job and to draw up each individual budget is a laborious task but it is still worthwhile as the benefits usually outweigh the efforts. If there is no co-ordination then the planning will fall apart. Preparing budgets is extremely subjective and they are based on predicted assumptions.

ADDITIONAL AND ALTERNATIVE APPROACHES

The company has taken out a loan for the CNC machine perhaps they could have hired it for a year or so, see how the product is doing then maybe buy it later on. Leasing equipment means there is not maintenance or repair costs to consider.

Instead of keeping the CNC machine for 10 years with a value of £15, 000, Ergo designs can sell it sooner when it is worth more money.

The company have adequate production facilities at this time and are therefore not considering contracting out however with proper budgetary controls in place it will be easier to spot any variance changes with efficiency or cost and it may be that in the future it may well be cheaper to contract certain parts of the process out to someone else. They do not run at full capacity in the other products they make and look at contracting out some of that work instead.

The company should put in place an advertising campaign for when they believe sales will stabilize to generate renewed interest in the product which can be researched by potential buyers now as it has been on the market for 3 years.

As Direct material has accounted for the biggest cost maybe Ergo Design can look around for cheaper suppliers or substitute certain ingredients for others.

A price increase could be implemented in later years.

CONCLUSIONS

The launch of this new product is feasible. It is returning a good profit and there is lots of potential for increasing profitability in the coming next few years and there is room for selling price increases. The new asset can be used for its economical life, sold off earlier or can be hired out to other companies so more room for increased profitability.

RECOMMENDATIONS

A proper budgetary control system should most definitely be put in place.

Future advertising is also a must. They need to do this sooner rather than later as they have only projected increases in turnover for the next 2 years.

As the cost of materials are so high, I would recommend that the buyers look around for alternative materials or try to negotiate more with the current suppliers for larger discounts.

Let’s be aware of the future, this can be done easier with the budgetary control in place. We need to be aware of what our competitors are up to and trends in markets. We need to be aware of what the government is changing and how it will affect the business e. g. Higher corporation taxes, inflation rates etc.